

**Economics**  
**Standard level**  
**Paper 2**

Thursday 3 November 2016 (afternoon)

1 hour 30 minutes

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**Instructions to candidates**

- Do not open this examination paper until instructed to do so.
- You are not permitted access to any calculator for this paper.
- Section A: answer one question.
- Section B: answer one question.
- Use fully labelled diagrams and references to the text/data where appropriate.
- The maximum mark for this examination paper is **[40 marks]**.

## Section A

Answer **one** question from this section.

1. Study the extract below and answer the questions that follow.

### New Zealand dollar overvalued

- ❶ The New Zealand finance minister said the exchange rate of the New Zealand dollar (NZD), is “unsustainably high; it is somewhere between 10 % to 15 % overvalued”.
- ❷ The NZD had been near its record high against the US dollar before weakening last week on slower inflation figures and a fall in dairy prices. The NZD has gained about 6 % so far this year.
- ❸ However, the finance minister said that New Zealand exporters had developed strength because of the high currency. “New Zealand is actually in reasonably good shape,” he said. “We have had an export sector operating with a strong exchange rate now for five or six years and that has had an impact on efficiency.”
- ❹ An economist said recently that the central bank might consider intervening in the currency market to achieve a **depreciation** in the value of the NZD.
- ❺ The Reserve Bank (central bank) governor raised the official interest rate for the fourth time this year to 3.5 % at a time when other major economies have their rates at record low levels.
- ❻ He said that, “Encouragingly, the economy appears to be adjusting to the **monetary policy** tightening that has taken place since the start of the year. It is important that inflation expectations remain contained. This interest rate increase will help keep future average inflation near the 2 % target and ensure that the economic expansion can be sustained”.
- ❼ New Zealand’s economy is expected to grow at an annual pace of 3.7 % over 2014. New Zealand government figures showed a monthly trade (in goods) surplus of \$247 million in June 2014 compared to \$371 million in June 2013. The annual trade (in goods) balance turned to a surplus of \$1.2 billion from a deficit of \$819 million a year earlier.
- ❽ Global demand for New Zealand dairy products has been a key support for the country’s exports over the past 18 months, though prices have dropped this year with increased supply.

[Source: adapted from “NZ dollar unsustainably high”, *The New Zealand Herald*, 23 July 2014;  
“Dollar dives after reserve bank lifts rate to 3.5pc”, *The New Zealand Herald*, 24 July 2014;  
and “NZ dollar slides to six-week low after rate hike”, *The New Zealand Herald*, 24 July 2014]

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**(Question 1 continued)**

- (a) (i) Define the term *depreciation* indicated in bold in the text (paragraph 4). [2]
- (ii) Define the term *monetary policy* indicated in bold in the text (paragraph 6). [2]
- (b) Using an exchange rate diagram, explain how the increase in the official interest rate to 3.5% is likely to affect the value of the New Zealand dollar (paragraph 5). [4]
- (c) Using an AD/AS diagram, explain how “monetary policy tightening” may affect a country’s inflation rate (paragraph 6). [4]
- (d) Using information from the text/data and your knowledge of economics, discuss the possible economic consequences of an overvalued New Zealand dollar on the New Zealand economy. [8]

2. Study the extract below and answer the questions that follow.

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**(Question 2 continued)**

- (a) (i) Define the term *interest rates* indicated in bold in the text (paragraph ❶). [2]
- (ii) Define the term *inflation* indicated in bold in the text (paragraph ❸). [2]
- (b) Using an exchange rate diagram, explain how speculation is contributing to the rising value of the British pound (paragraph ❶). [4]
- (c) Using an appropriate diagram, explain why it is possible that “British firms producing exported goods that have few substitutes have reported no reduction in export revenue despite the appreciation” (paragraph ❸). [4]
- (d) Using information from the text/data and your knowledge of economics, discuss possible consequences of the appreciation of the British pound. [8]

## Section B

Answer **one** question from this section.

3. Study the extract and data below and answer the questions that follow.

### Ecuador sees 2014 trade deficit falling with new import rules, but at what cost?

- ❶ In the period from January to May 2014, Ecuador posted a trade surplus of US\$483 million, moving from a deficit of US\$626 million one year before.
- ❷ The government has been implementing an import-substitution policy to reduce the trade deficit. On 4 December 2013, Ecuador's Foreign Trade Committee established new quality control measures for the importation of 293 items, including cosmetics, toys, toothpaste, meat and cereals. In order for goods on the list to be imported a certificate needs to be obtained, ensuring that the products meet quality control standards. There are up to 13 steps to be taken before a product may enter as a result of the excessive regulations holding up the certificates.
- ❸ The import-substitution policy also involves a move to provide support to domestic industries. The president firmly believes in the benefits of sheltering **infant industries**. He has complained about imports such as coconut water, banana puree or cornflakes, which he believes could be produced by domestic industries, supported by appropriate policies. In addition, he points out that Ecuador is a top exporter of fine aroma cocoa, but imports approximately US\$25 million worth of chocolate per year. Other measures to protect domestic industries include anti-dumping measures and higher tariffs on raw materials and capital equipment that are available in Ecuador.
- ❹ In the month since this intervention started, different businesses have begun to feel both the advantages and disadvantages. Pica, one of the largest companies in the plastic industry, has taken advantage of the policy. The reduction in the importation of certain products has allowed them to increase their own production.
- ❺ In contrast, Toni Industries, one of the most important dairy businesses in the country has suffered. It has complained that cornflakes, which the company uses as a **complementary good** to one of its key products, could not get through customs because it did not have the quality control certificate.
- ❻ Many industry analysts and economists argue that closing off imports will isolate the country and create a false sense of competitiveness. They are also concerned that the government seems to be assuming that other countries will not react. Some argue that the government should seek to create incentives for investment, like tax benefits, or legal security, which would allow the entry of new competitors into the Ecuadorean markets.

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(Question 3 continued)

**Table 1: Selected exports and imports for Ecuador, January to May 2014**

<b>Exports</b>	<b>Export revenue (US\$ billion)</b>	<b>Imports</b>	<b>Import spending (US\$ billion)</b>
Crude oil	5.74	Raw materials	3.20
Bananas	1.12	Capital goods	2.68
Shrimp	1.09	Consumer goods	2.01
Flowers	0.34		

[Source: adapted from www.reuters.com, 21 January 2014; www.panampost.com, 20 January 2014; www.latinvex.com, 19 March 2014 and www.blogs.wsj.com, 14 July 2014]

- (a) (i) Define the term *infant industries* indicated in bold in the text (paragraph 5). [2]
- (ii) Define the term *complementary goods* indicated in bold in the text (paragraph 5). [2]
- (b) Using an AD/AS diagram, explain how moving from a trade deficit to a trade surplus would affect real GDP in Ecuador, *ceteris paribus*. [4]
- (c) Using a definition of the term *ceteris paribus*, explain why it is necessary to include this assumption in part (b). [4]
- (d) Using information from the text/data and your knowledge of economics, evaluate Ecuador’s import-substitution policy as a means of achieving economic growth and development. [8]

4. Study the extract below and answer the questions that follow.

### Ghana to seek help from International Monetary Fund

- ① Ghana has said it will seek financial aid in the form of a loan from the International Monetary Fund (IMF) to help stop the rapid decline in the value of the cedi, Ghana's currency, and close a large **budget deficit**. Ghana's transformation from one of Africa's fastest growing economies to the home of the world's worst-performing currency has become a concern. The exchange rate depreciated by 40% against the US dollar in 2014. The fall in the currency has led to increases in the price of consumer goods such as sugar and fuel; inflation is at an unacceptable 15%.
- ② Despite being a major exporter of gold, oil and cocoa, Ghana's current account deficit has risen sharply to 12% of its gross domestic product (GDP). This is partly due to a rapid increase in demand for imports and falling gold prices. Additionally, oil revenues have not been as strong as expected.
- ③ The government is also struggling with a wide budget deficit, which stood at 10% of GDP last year. Ghana's good reputation for fiscal responsibility has worsened considerably as the government tripled salaries for police officers and soldiers.
- ④ It is expected that the news of talks with the IMF will be positively received in international financial markets. The finance minister has said the step would help to stabilize the currency, to bring domestic prices under control, and also to restore investors' confidence in Ghana's economy.
- ⑤ A Ghanaian spokesperson noted that the IMF would insist on the government introducing measures to tackle inflation and reduce its budget deficit. The IMF says that Ghana needs to tighten its budget immediately, by reducing public sector wages, lowering subsidies and increasing taxes. The IMF is likely to demand a limit on borrowing and perhaps some privatization of power and water companies.
- ⑥ Earlier this year, problems in the economy had led to nationwide protests, with thousands of workers across the country protesting in the streets about the rise in the cost of living. The country's largest trade union says the government has been mismanaging the economy. In response to the protests, a government minister said that the government would work very hard to achieve **economic development** to make life easier for the working people of Ghana but that all Ghanaians would have to make "some sacrifices for the economy to recover".

[Source: adapted from <http://news.yahoo.com>, 3 and 4 August 2014; <http://online.wsj.com>, 3 August 2014 and [www.bbc.com/news](http://www.bbc.com/news), 24 July 2014 and 4 August 2014]

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**(Question 4 continued)**

- (a) (i) Define the term *budget deficit* indicated in bold in the text (paragraph ❶). [2]
  - (ii) Define the term *economic development* indicated in bold in the text (paragraph ❷). [2]
  - (b) Using an exchange rate diagram, explain how the large current account deficit may have affected the value of the Ghanaian cedi. [4]
  - (c) Using an AD/AS diagram, explain how the falling value of the Ghanaian cedi may have contributed to inflation. [4]
  - (d) Using information from the text/data and your knowledge of economics, discuss possible consequences of International Monetary Fund (IMF) financial aid on Ghana's economic growth and development. [8]
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