



**ECONOMICS
HIGHER LEVEL
PAPER 3**

Thursday 20 May 2010 (morning)

2 hours

INSTRUCTIONS TO CANDIDATES

- Do not open this examination paper until instructed to do so.
- Answer three questions.
- Use fully labelled diagrams and references to the text / data where appropriate.

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

Rising prices blamed on the “big” supermarkets

- ① Since 1990, supermarket prices in Australia have risen twice as fast as anywhere else in the developed world. An inquiry into supermarket prices has established that consumers are paying much more for basic items such as bread, milk, meat and eggs compared to other developed countries as shown in Table 1.

Table 1

	Australia	USA	France	Germany	Japan
Food inflation rate (1990–2006)	68%	46%	28%	17%	4%

- ② The inquiry conducted by the Australian Competition and Consumer Commission into supermarket prices, concluded that the three largest supermarket chains, Coles, Woolworths and Franklins, are charging higher prices for their goods and services. They are acting as a **collusive oligopoly**. They are earning **abnormal profits** (sometimes called supernormal profits or economic profits) and are allocating resources inefficiently.
- ③ In opening remarks at the commission, it was said that competition had collapsed at the expense of consumers, creating an oligopolistic market structure, where the three largest supermarkets control over 80% of Australia’s food sales, as Table 2 indicates. They are also diversifying into other areas such as banking, takeaway food, cut flowers and gasoline (petrol).

Table 2

	Australia	USA	France	Germany	Japan
% share of food sales of three largest supermarket chains	80.4%	21%	38%	47%	17.5%

- ④ Small independent food stores want the government to intervene and not allow the total market share of these three supermarket chains to be larger than 75%, with no supermarket chain controlling more than 25% of the market. Over the last 20 years, many small independent food stores have closed due to the extended trading hours of the large supermarkets, favourable rental agreements for these large stores, the economies of scale generated by their size, and because independent food stores have been bought by the three larger companies.
- ⑤ The three large supermarket chains claim the existing situation should be maintained because of the number of people they employ (173 000 people in Australia), the long-term careers in the retail sector they provide and the service businesses they attract to rural parts of Australia.

[Source: adapted from *The Age*, 9 April 2008 and http://www.regional.org.au/articles/agriculture/beef/bin_retail1.htm]

(This question continues on the following page)

(Question 1 continued)

- (a) Define the following terms indicated in bold in the text:
 - (i) collusive oligopoly (*paragraph 2*) *[2 marks]*
 - (ii) abnormal profits (*paragraph 2*). *[2 marks]*
- (b) Using an appropriate diagram, explain how collusive oligopolies can earn abnormal profits. *[4 marks]*
- (c) Using an appropriate diagram, explain how the increased size of the supermarkets has led to economies of scale (*paragraph 4*). *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate a decision by the Australian government to reduce the total market share of the three largest supermarket chains to 75% (*paragraph 4*). *[8 marks]*

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

Moving towards a recession

- ① Economic performance in the United States (USA), Western Europe and Japan according to economic indicators such as the growth of output, investment, employment and wages, has been getting worse in each downward phase of the business cycle since 1973. The current cycle in the USA, which began in early 2001, has been the worst of all. Gross Domestic Product (GDP) growth has been the slowest in any comparable cycle since the 1940s; growth in investment is down 30% and the creation of jobs is down 65%. In addition, hourly wages have not increased in real terms since 1979. This forms the background for the current economic problems that began in 2007.
- ② Many economists believe that the USA economy is now in recession. Falling house prices have reduced the ability of homeowners to borrow against their property, which in turn reduces their ability to spend freely on consumer goods and services. This fall in consumer spending has led to businesses hiring less labour in some industries, which has further slowed consumer spending. The construction of new homes has fallen, with sales of new homes falling even faster, resulting in a large oversupply of homes, which will continue to force down prices even more.
- ③ The USA Federal Government is considering tax cuts and additional government spending to stimulate the economy, even if this increases the budget deficit. The hope is to encourage consumer spending and business investment although this may add to inflationary pressures. The chairman of the Federal Reserve (the central bank) in the USA has indicated that he is happy to support the use of fiscal policy by lowering interest rates.
- ④ Cuts in **indirect taxes** and direct taxes affect production costs, disposable income and the spending power of consumers, and have an impact on the allocation of **resources (factors of production)**. They may also have a psychological effect on investors.

[Source: adapted from *The New York Times*, 13 and 17 January 2008]

(This question continues on the following page)

(Question 2 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) indirect taxes (*paragraph 4*) *[2 marks]*
 - (ii) resources (factors of production) (*paragraph 4*). *[2 marks]*
- (b) Using an appropriate diagram, explain how a fall in consumer spending could lead to a recession. *[4 marks]*
- (c) Using a demand and supply diagram, explain why the price of labour (wages) will fall if businesses hire less labour. *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate the role of fiscal policy in stimulating the USA economy. *[8 marks]*

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

Pakistan’s economy

- ❶ There was a positive transformation in the Pakistani economy in the early 2000s. The **exchange rate** was allowed to float, exports of primary commodities increased along with **foreign direct investment** and foreign reserves, while government debt fell.
- ❷ By 2007, however, Pakistan faced a number of political and economic problems. In addition to political instability, there were hailstorms and diseases destroying crops, which led to large increases in food imports. The price of imported raw materials continued to increase with 27% of the higher import expenditure due to the increase in oil prices. Industrial production began to fall. Foreign investment in shares fell from US\$1.5 billion in 2006 to US\$97 million.
- ❸ These events have led to Pakistan’s highest current account deficit ever, amounting to 8.6% of Gross Domestic Product (GDP) (June 2008).

Table 1

	2007	2008	2009 (estimated)
Real GDP growth (%)	6.0	5.8	4.4
Current account balance (% of GDP)	–5.7	–8.6	–8.3
Exchange rate (Pakistani rupees to US\$)	61	66	64
Consumer price inflation (%)	7.6	19	11

- ❹ What is the government doing? The new budget (2008–2009) aims to reduce the budget deficit from 7% of GDP to 4.7% (by raising tax revenue and reducing government expenditure). It will also introduce tariffs and quotas. While the introduction of tariffs could help reduce the twin deficits (budget deficit and current account deficit), it could reduce consumer welfare and lead to an inefficient allocation of resources.
- ❺ The government is preparing a plan aimed at increasing foreign exchange earnings through export-led growth. The intention is to diversify production and exports in industries in which Pakistan has a comparative advantage, making better use of the country’s abundant labour supply and natural resources.

[Source: © The Economist Newspaper Limited, London (12 June 2008)]

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(Question 3 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) exchange rate (*paragraph ①*) [2 marks]
 - (ii) foreign direct investment (*paragraph ①*). [2 marks]
- (b) Using an appropriate diagram, explain how increased spending on food imports (*paragraph ②*) could affect Pakistan’s exchange rate. [4 marks]
- (c) Using an appropriate diagram, explain how the continuing increase in prices for imported raw materials (*paragraph ②*) could have contributed to the impact on the general price level and output in 2008 (*Table 1*). [4 marks]
- (d) Using information from the text/data and your knowledge of economics, evaluate the impact on the Pakistani economy of the decision to introduce tariffs (*paragraph ④*). [8 marks]

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

Vietnam's changing economy

- ❶ Vietnam has achieved an impressive turnaround in its agricultural sector. Whereas in the mid-1980s the country was on the verge of famine, today it is the second-largest rice exporter in the world. In addition, it produces and exports a variety of farm, fishery and forest products, though these activities are not always consistent with **sustainable development**.
- ❷ Important factors behind the success of Vietnam's agriculture were privatization of farms and equitable distribution of land ownership, stabilization of the economy in the mid-1980s, liberalization (freeing) of farm prices and its policies based on **free trade**.
- ❸ Vietnam's economic transformation is often measured in terms of the declining share of the agricultural sector in Gross Domestic Product (GDP) and the corresponding increase in the shares of the industrial sector and the service sector. Where the primary sector (agriculture, forestry and fisheries) used to provide over two-thirds of all jobs 10 years ago, now it provides only about half of all jobs.
- ❹ Until recently, the government and international agencies were advising Vietnamese farmers to diversify their production, partly by moving towards non-farm industries, and partly by diversifying crops within agriculture. An example of the diversification suggested is the development of "craft industries" producing simple homespun products and tourism that would bring rich tourists who would buy these products. However, in recent months there have been rapid increases in rice prices due to increases in world demand for rice. This would provide large benefits for rice farmers. The government is now concerned that diversification has gone too far, as some rice farmers have already switched out of rice production.
- ❺ In the long term, Vietnam may face a far more serious danger. Scientists predict a rise in the sea levels along its coast that by the year 2100 could submerge one-eighth of its land area, as well as give rise to extreme weather conditions. As most of Vietnam's agricultural land and population are near the sea, such developments would be highly destructive to the country and its economy.

[Source: © The Economist Newspaper Limited, London (24 April 2008)]

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(Question 4 continued)

- (a) Define the following terms indicated in bold in the text:
 - (i) sustainable development (*paragraph 1*) *[2 marks]*
 - (ii) free trade (*paragraph 2*). *[2 marks]*
- (b) Using the concept of income elasticity of demand, explain the change in relative importance of the agricultural sector in comparison to the industrial and the service sectors in Vietnam (*paragraph 3*). *[4 marks]*
- (c) Using an appropriate diagram, explain the likely long-term impact of a rise in sea levels on the productive capacity of the Vietnamese economy (*paragraph 5*). *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate diversification as a policy option for improving export performance in Vietnam. *[8 marks]*

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

Fair trade in Malawi

- ❶ Malawi is one of the world's least developed countries, with about 85 % of the population living in rural areas. Agriculture accounts for more than 30 % of Gross Domestic Product (GDP) and 90 % of exports. The economy depends on economic assistance from the International Monetary Fund (IMF), **World Bank** and individual donor nations.
- ❷ The district hospital at Mchinji in Malawi was built nearly 20 years ago to provide basic healthcare services to the population. Healthcare services also have major external benefits for the economy (positive externalities), such as more productive workers, lower absenteeism from work and higher economic growth. The hospital was originally built to serve 275 000 people, but now serves 600 000. Malawi has the lowest number of doctors *per capita* in the world.
- ❸ Work started recently on a hospital extension. The extension has been paid for by fair trade groundnuts, grown in Malawi and sold to British shoppers. This story is being repeated throughout Malawi with fair trade revenues being used to improve infrastructure and better educational opportunities. Disadvantaged producers and families are benefiting from fair trade funds.
- ❹ Fair trade is seen as a form of aid. The **free market** was not providing enough income to farmers, but now groundnut farmers receive a guaranteed payment above the world equilibrium price for their goods, and use the extra payments to make improvements in their communities. Fair trade advocates payment of fair prices and social and environmental standards in the production of a wide range of goods. The focus is on exports from developing to developed countries, working with very poor producers to help them achieve a position of greater economic security and self-sufficiency.
- ❺ Fair trade has become one of the fastest growing retail sectors in Great Britain. Consumers are spending more than UK£450 million (US\$900 million) annually on fair trade products.
- ❻ Fair trade, however, has its critics. Free market economists argue that by encouraging oversupply, fair trade agreements result in the inefficient allocation of resources and may drive prices down in the long term. Other critics have pointed out that the major beneficiaries of free trade agreements are the large supermarkets rather than the poor producers in developing countries.

[Source: adapted from *The Guardian Weekly*, 15 February 2008]

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(Question 5 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) World Bank (*paragraph 1*) *[2 marks]*
 - (ii) free market (*paragraph 4*). *[2 marks]*
- (b) Using an appropriate diagram, explain how a guaranteed price above the equilibrium price will benefit groundnut farmers (*paragraph 4*). *[4 marks]*
- (c) Using an appropriate diagram, explain how the provision of hospital services has positive externalities (*paragraph 2*). *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate fair trade as a means of improving the welfare of people in Malawi. *[8 marks]*
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