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**ECONOMICS
STANDARD LEVEL
PAPER 2**

Thursday 11 November 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.

World food prices

- ❶ Food prices have risen by 45% since the end of 2006. Prices have risen due to a mix of long-term and temporary factors. Strong food demand from emerging economies, reflecting stronger *per capita* income growth, accounts for much of the increase. Rising biofuel production adds to the demand for corn, in particular, because corn is used in the production of biofuels. In addition, increased production of corn leads to falling production of other foods, raising their prices as well. At the same time, elasticity of supply of food remains low and inventory levels (stocks) in many food markets have declined to the lowest levels in years. Drought conditions in major wheat-producing countries (e.g. Australia and Ukraine), and higher input costs (animal feed, energy, and fertilizer) have also contributed to higher food prices.
- ❷ Table 1 outlines the policy responses to increasing food prices in some countries, some of which have made the problem worse.

Table 1

	Policy response to increasing food prices
Argentina	Corn export taxes increased to 25 %, wheat export taxes increased to 28 %
Azerbaijan	Eliminated indirect tax on grains
Bangladesh	Reduced tariffs on rice and wheat imports by 5 %
Ecuador	Maximum prices for bread
Egypt	Raised food subsidies
Honduras	Export ban on maize
Mexico	Removed quotas on maize, milk and sugar

- ❸ Higher food prices affect socioeconomic groups and households within countries differently. Higher food prices hurt the urban poor because food accounts for a very large share of their expenditures. In many countries, food can account for 70 to 80% of expenditures by the poorest quarter of the population. In such circumstances, food price increases can have a large negative impact on their purchasing power.
- ❹ Farmers in food exporting countries may benefit from higher prices assuming that food price increases “trickle down” to farmers. Since farming is the major source of income for a large part of the rural population in most developing countries, higher prices could help to reduce rural poverty. The size of the benefit will depend on whether farmers are able to respond to the higher prices through increased **investment**, which would allow them to increase supply.

[Source: adapted from <http://www.imf.org/external/np/exr/faq/ffpfaqs.htm> and <http://www.fao.org/es/esc/common/ecg/538/en/RisingPricesIFAD.pdf>, 14 February 2008]

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(Question 1 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) indirect tax (*Table 1*) *[2 marks]*
 - (ii) investment (*paragraph 4*). *[2 marks]*
- (b) Using an appropriate diagram, explain how rising biofuel production may affect the market for corn (*paragraph 1*). *[4 marks]*
- (c) Using an appropriate diagram, explain why the elasticity of supply for many commodities is low. *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate Ecuador’s policy response to increasing food prices (*Table 1*). *[8 marks]*

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

Pollution of Indonesia’s Cisadane River continues

- ❶ “I still remember when the water in the Cisadane River was very clean – I could clearly see fish swimming around,” said a 65-year-old resident, as he remembered his childhood. “Look at the river now – no one can see the bottom of it, despite being only about two metres deep. The water is dirty, smelly and heavily polluted,” he complained.
- ❷ Indonesia’s **economic growth** over the past three decades has meant that many industrial firms have been established along the riverbanks. It is said that these firms are the most serious polluters of the river and are suspected of continuously dumping their liquid waste directly into the water.
- ❸ Unfortunately, the polluted river is the main source of water for local water suppliers, who take and process the polluted water to serve the needs of their 500 000 customer. This doesn’t include thousands of locals living along the riverbanks who also use the river water for their daily needs – for washing, bathing and even cooking.
- ❹ A representative of one of the water suppliers told The Jakarta Post recently that the pollution in the river water had given rise to huge water processing costs to make the water safe for domestic use by customers. Although the water suppliers are able to pass on most of the increased costs to their consumers, this worsens the living standards of local households. According to the suppliers, the latest water sample indicated that the water contained chemical substances which greatly exceeded the limits set out in government regulations.
- ❺ The water suppliers blamed officials at the local environmental agencies for their failure to control the illegal dumping of liquid waste into the river. Along with the possible danger for people using the water, the pollution had also damaged the environment. This clearly represents a grave threat to **sustainable development**. One village leader complained, “the polluted river water has also killed fish in ponds, the area of which extends to around 200 hectares. The government is doing nothing. These companies should be fined”.
- ❻ However, environmental agency heads claim “we have regulations but it’s impossible for us to monitor hundreds of industrial firms that allegedly dump their liquid waste into the river at night. We do not have the necessary inspectors and equipment”.

[Source: <http://www.thejakartapost.com/news/2008/02/05/cisadane-river-still-filthy-despite-recent-highprofile-visits.html>, 2 May 2008.]

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(Question 2 continued)

- (a) Define the following terms indicated in bold in the text:
 - (i) economic growth (*paragraph 2*) *[2 marks]*
 - (ii) sustainable development (*paragraph 5*). *[2 marks]*
- (b) Using an appropriate diagram and the concept of elasticity, explain why “the water suppliers are able to pass on most of the increased costs to their consumers” (*paragraph 4*). *[4 marks]*
- (c) Using an appropriate diagram, explain why the problem discussed in the text illustrates an example of a market failure. *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate the use of regulation as a solution to the market failure caused by the pollution of the Cisadane River. *[8 marks]*

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

Iceland

- ❶ Iceland's *per capita* income has been growing at double the OECD* rate since the mid-1990s. It is now the fifth-highest among member countries and more than a quarter above the OECD average. This impressive performance is due to extensive structural reforms that deregulated and opened up the economy, thereby encouraging greater **entrepreneurship**. Strong economic growth has been accompanied, however, by mounting imbalances in the economy. Aggregate demand has increased beyond potential output. As a result, inflation and the current account deficit have become problems. Cuts in personal income taxes, intended as a supply-side policy to enhance efficiency, contributed to inflationary pressures.
- ❷ Inflation has exceeded the official target of 2.5% since mid-2004. The Central Bank has been hesitant in raising interest rates in the past, and has only recently begun to tighten **monetary policy** by increasing interest rates. Monetary policy will need to remain tight until inflation expectations are consistent with the inflation target set by the Central Bank. This is crucial because of the effect that wage increases have in creating cost push inflation. It would also be helpful if members of the government respected the independence of the Central Bank, as this would reinforce the credibility and effectiveness of policy.

* OECD is the Organization for Economic Cooperation and Development (formed in 1961). The members in 2006 were: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea (South), Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom and the United States.

[Source: http://www.oecd.org/document/15/0,3343,en_2649_34569_40158159_1_1_1_1,00.htm, 28 February 2008]

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(Question 3 continued)

Figure 1: GDP, % increase on a year earlier

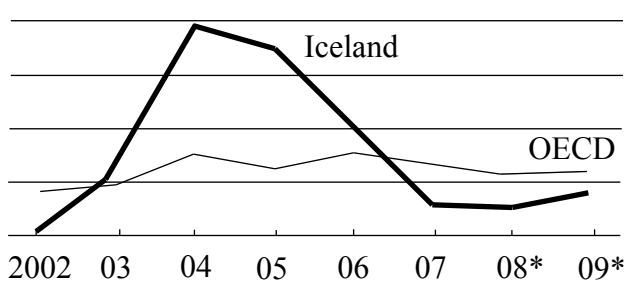


Figure 2: Consumer prices, % increase on a year earlier

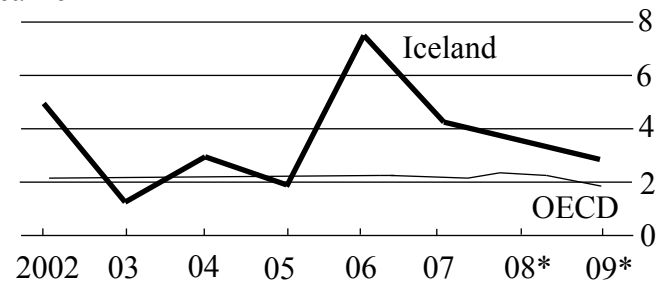


Figure 3: Current account, as % of GDP: Iceland

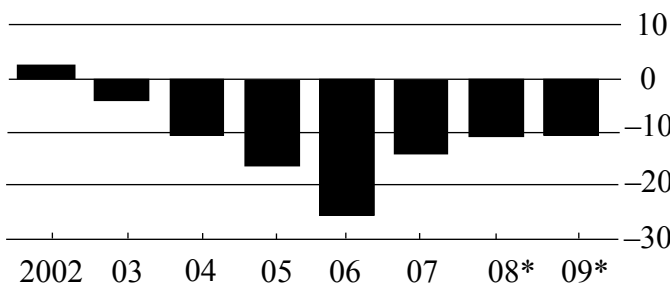
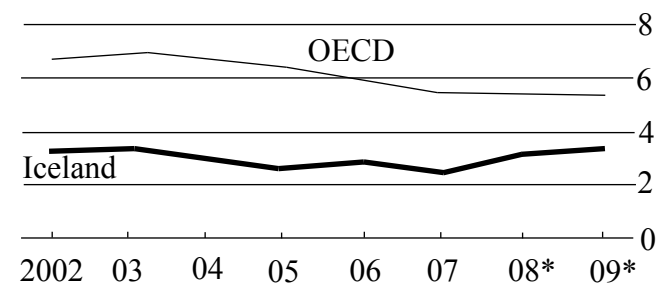


Figure 4: Unemployment, as % of labour force



* Forecast

[© The Economist Newspaper Limited, London, 13 March 2008.]

- (a) Define the following terms indicated in bold in the text:
 - (i) **entrepreneurship** (paragraph 1) [2 marks]
 - (ii) **monetary policy** (paragraph 2). [2 marks]
- (b) Using an appropriate diagram, explain the likely effect of aggregate demand increasing “beyond potential output” (paragraph 1). [4 marks]
- (c) Using an AD/AS diagram, explain how wage increases create cost push inflation (paragraph 2). [4 marks]
- (d) Using information from the text/data and your knowledge of economics, evaluate the consequences for Iceland’s economy if it maintains tight monetary policies. [8 marks]

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

It is time to embrace more trade with China

- ❶ There is much debate about the future of global trade. In the current economic slowdown it is likely that there will be a widespread increase in protectionist policies, such as tariffs and **quotas**. However, these restrictions can be destructive and further slow down an economy.
- ❷ There is also debate about the role of China in global trade. China's rise as an economic power has made people worry that businesses and jobs are leaving their countries and moving to China. However, this is misleading since in reality trade with China is actually generating significant employment opportunities for Europe and the United States (US).
- ❸ There is a growing trend that is often not recognized; China's role in the global market is changing from being the top manufacturing centre and exporter to becoming a powerful global buyer as well. This new trend is just beginning and needs the support of world leaders, as the global economy can only grow through greater economic openness.
- ❹ Over the past two decades, trade with China has gone through big changes. Economic reforms, as well as the country's entry into the World Trade Organization, have allowed China to supply cheaper goods to Europe and the US, and helped western companies to cut costs by moving their production lines to China.
- ❺ Now we are in a new phase, where China is buying significantly more from the global market than it did in the past. China's most recent trade figures indicated a rise in exports of 18% in the last year while imports increased by 31%, shrinking the nation's **current account surplus**. China is expected to be the world's biggest import market in 10 years.
- ❻ China's role as the world's biggest supplier will not fade away. There is a lot of competition from cheaper alternative markets, such as Bangladesh, India and Vietnam, but nothing can beat China's vast choice of products and suppliers. Over the years, Chinese suppliers have improved their advantage in terms of pricing, good infrastructure, speed to market and compliance with international standards. Consumers worldwide will, therefore, continue to benefit from China's ability to offer a wide choice of goods at low prices.
- ❼ At the same time, producers in Europe and the US are already benefiting from China's growing appetite for food and beverages, home supplies, industrial machinery and construction materials.

[Used with the permission of Jack Ma, Alibaba Group.]

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(Question 4 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) quotas (*paragraph 1*) *[2 marks]*
 - (ii) current account surplus (*paragraph 5*). *[2 marks]*
- (b) Using an appropriate diagram, explain how a western company can benefit by moving its production lines to China (*paragraph 4*). *[4 marks]*
- (c) Using a tariff diagram, explain why policy makers might choose to increase tariffs during an economic slowdown (*paragraph 1*). *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate the possible effects of China’s increased role in global trade. *[8 marks]*

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

Promised food yet to appear amid crisis

- ❶ Food riots across Haiti have left at least six Haitians and a UN peacekeeper dead. They also resulted in a large increase in international promises of food and agricultural aid, but only a small fraction of the food has been delivered – less than 2% as of early July 2008.
- ❷ According to aid workers, the poorest families need immediate help, and little of the promised emergency food has reached them. Most of what has reached Haiti is stuck in ports or in warehouses. It has not been possible to distribute the food aid due to high fuel prices, poor **infrastructure** and a weak and corrupt national government.
- ❸ A World Food Programme spokesman said that it is difficult to get food into Haiti, and that his agency is focusing on urban areas that are easiest to reach. “We’re trying to help as much as we can, but that doesn’t mean we’ll solve everything,” he said.
- ❹ Emergency food aid programmes are only temporary measures. Programmes to create jobs and help Haitian farmers increase production are more critical to ending the country’s chronic hunger and helping both urban and rural Haitian households to break out of the poverty cycle.
- ❺ As a means of addressing Haiti’s development problems, Spain is proposing a different aid model. Spain has promised US\$100 million to help revitalize agriculture in Haiti and rebuild roads and schools. The **bilateral aid** will be provided from 2009 to 2012. However, the Deputy Prime Minister of Spain urged Haiti to improve its security so Spain could continue investing in the Caribbean nation.

[Adapted from: ‘Slow aid delivery, failing farms deepen hunger crisis in Haiti’, available at http://www.nydailynews.com/latino/2008/07/21/2008-07-21_slow_aid_delivery_failing_farms_deepen_h-1.html.]

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(Question 5 continued)

Figure 1

IMAGE REMOVED FOR COPYRIGHT REASONS

- (a) Define the following terms indicated in bold in the text:
- (i) infrastructure (*paragraph 2*) *[2 marks]*
 - (ii) bilateral aid (*paragraph 5*). *[2 marks]*
- (b) Using an appropriate diagram, explain why it remains difficult for “Haitian households to break out of the poverty cycle” (*paragraph 4*). *[4 marks]*
- (c) **QUESTION REMOVED FOR COPYRIGHT REASONS** *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate aid as a means of achieving economic development in Haiti. *[8 marks]*
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