Diploma Programme
Programme du diplôme
Programa del Diploma

Economics
Higher level
Paper 2

Tuesday 5 May 2015 (morning)

1 hour 30 minutes

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]**.

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Section A

Answer **one** question from this section.

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

Latvia to join the eurozone monetary union

❶ Latvia will become the 18th country to adopt the euro after being approved for membership by the European Commission. The country has met the criteria for eurozone membership, including low inflation, low long-term interest rates, a stable exchange rate, low public debt and low budget deficits.

❷ Latvia joined the European Union (EU) **customs union** in 2004. This resulted in a large increase in the availability of credit and strong economic growth in Latvia. However, the 2008 global financial crisis resulted in the collapse of one of its leading banks and massive economic instability. Economic output fell by about 20 % and Latvia had to accept a bailout (loans) from the International Monetary Fund (IMF) and the EU.

❸ Latvia kept the lat (the Latvian currency) pegged to the euro throughout the crisis. At the time, some economists argued that devaluation would have been a better way to improve the economy. However, Latvia followed the path of other countries such as Greece and Ireland, and chose to improve competitiveness through austerity measures. This involved increasing **direct taxes** and cutting government spending and public sector wages.

❹ By late 2010, the economy was growing again and Latvia had repaid the loans to the IMF and the EU. In 2012, the economy expanded by 5.6 %, the fastest of any country in the EU, although output was still 12 % below its pre-crisis peak. In addition unemployment was falling, but it remained high at 12.4 %.

❺ For Latvia, which shares a border with Russia, the attraction of the euro is about economics and security. Entering the eurozone in January 2014 is part of a process of shifting away from the influence of Russia, and following its northern neighbour Estonia which joined the eurozone in 2011. Lithuania hopes to join the eurozone in 2015.

❻ Public support for joining the eurozone has been low. Evidence from one survey suggests that a small majority of Latvia's population opposes membership, fearing that prices will rise and Latvians will be drawn into the problems facing Europe's struggling economies.

❼ Nonetheless, there are signs that support is growing. The Latvian prime minister said that "switching to the euro will help economic growth and bring increased foreign investment. Unlike countries that can afford to ignore the euro and additional integration, Latvia cannot easily stand on its own. This is good news, not only for Latvia, but also for the eurozone. It shows that there is still confidence in the single currency".

[Source: adapted from www.reuters.com, 5 June 2013; http://online.wsj.com, 9 July 2013 and www.theguardian.com, 16 July 2013]

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(Question 1 continued)

(a) (i) Define the term *customs union* indicated in bold in the text (paragraph ❷). [2]

(ii) Define the term *direct taxes* indicated in bold in the text (paragraph ❸). [2]

(b) Using an AD/AS diagram, explain how devaluation of the lat (the Latvian currency) might have been used to improve the Latvian economy during the financial crisis (paragraph ❸). [4]

(c) Using a production possibilities curve (PPC) diagram, explain the change in Latvia's economy from 2008 to 2012 (paragraphs ❷ and ❹). [4]

(d) Using information from the text/data and your knowledge of economics, evaluate the possible impact of Latvia joining the eurozone. [8]

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

Is India in danger of another crisis?

❶ The Indian prime minister has tried to reduce concerns that the country is headed for a balance of payments crisis, similar to the one that the country experienced in 1991. At that time, India was on the verge of defaulting on its foreign debt and had to be rescued by the International Monetary Fund (IMF).

❷ There are a few key similarities between the situation in 2013 and the situation in 1991. India still has a persistent current account deficit and its weak currency, the rupee, makes it more difficult to finance the deficit. Officials are worried because the current account deficit is larger, and the rupee is weaker than it was in 1991.

❸ The rupee has declined by more than 15 % between May and August this year (2013), and has hit a record low against the US dollar. This is largely to do with the expectation that the Federal Reserve (US central bank) may not continue to use monetary policy to stimulate the US economy. As a result, there is speculation that the US **interest rate** might rise at some point in the future. The consequence of this is that money is leaving developing economies such as India.

❹ The countries that are most at risk are those with large current account deficits, and India has one of the largest. The current account deficit hit a record high of 6.7 % of gross domestic product (GDP) in 2012. Domestic issues make the situation even worse: India has a large budget deficit as well as a high rate of inflation. Both are reasons why portfolio investors would like to take their money out of India. Furthermore, economic growth has also dropped to 5 %, the slowest growth since 2003.

❺ In a recent speech, the prime minister noted that the current account deficit was high, and blamed increased imports of gold as a key factor. In recent months, the government has sharply raised **tariffs** on gold. Surprisingly, the Indian government and the central bank have also proposed measures to support the rupee.

❻ After the crisis in 1991, there were many reforms and the country became more globally integrated. This led to a period of strong growth. However, reforms have slowed down and analysts say that this has prevented India from reaching its tremendous potential.
The threat of a crisis may be just what is needed for the government to speed up the supply-side reforms necessary to increase growth and reduce the current account deficit. These reforms would include policies to promote industry, reduce the regulatory burdens and importantly increase investment in education.

[Source: adapted from www.bbc.co.uk, 8 August 2013; www.businessweek.com, 19 August 2013 and http://online.wsj.com, 17 August 2013]

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(Question 2 continued)

(a) (i) Define the term *interest rate* indicated in bold in the text (paragraph ❸). [2]

(ii) Define the term *tariffs* indicated in bold in the text (paragraph ❺). [2]

(b) Distinguish between a current account deficit and a budget deficit (paragraph ❹). [4]

(c) Using an exchange rate diagram for the rupee (India's currency), explain how the value of the rupee has been affected by the expectation that the US central bank may change its monetary policy (paragraph ❸). [4]

(d) Using information from the text/data and your knowledge of economics, evaluate the policies that India might use to reduce the current account deficit. [8]

Section B

Answer **one** question from this section.

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

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Figure 1 – Export commodities of China and three African countries

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(Question 3 continued)

Figure 2 – Aid provided by China to various African countries

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(a) (i) Define the term *bilateral trade agreements* indicated in bold in the text (paragraph ❶). [2]

(ii) Define the term *infrastructure* indicated in bold in the text (paragraph ❻). [2]

(b) Using a comparative advantage diagram, explain why "China's exports tend to be concentrated in manufactured goods and the African countries mostly export primary goods" (paragraph ❷). [4]

(c) Using a production possibilities curve (PPC) diagram, explain how the provision of "free training to 53 700 people from Africa" will increase potential economic output (paragraph ❻). [4]

(d) Using information from the text/data and your knowledge of economics, discuss the extent to which trade between China and African countries is a more effective way of achieving economic development than Chinese aid to African countries. [8]

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

Economic growth in Peru

❶ The Peruvian economy has been growing by an average of 6.4 % per year since 2002 with a slightly appreciating exchange rate and low **inflation**. Growth was in the 6–9 % range for 2010–2013, due partly to a leap in private investment. This was especially in the raw materials extraction sector, which accounts for more than 60 % of Peru's total exports. Rising Asian demand for copper and gold has been a large contributor to Peru's growth.

❷ Despite Peru's strong macroeconomic performance, dependence on mineral and metal exports and imported food makes the economy vulnerable to fluctuations in world prices. This is reflected in its volatile terms of trade (Figure 1).

❸ The Peruvian president has pursued moderate, pro-market policies while adding new government programmes in order to provide additional social support for the poor. Peru's rapid expansion coupled with transfer payments and other benefits have helped to reduce the poverty rate. The percentage of people living on less than US$2 a day has halved to about 28 % since 2003, but inequality persists (Figure 2) and continues to present a threat to the new government. The president has pledged to further cut the poverty rate to 15 % through increased transfer payments, an increase in the minimum wage, and pensions.

❹ There has also been deregulation in business practices, making it much easier to start and run a private firm. Changes in employment regulations have created more flexibility in the labour market.

❺ Peru's free trade policy has continued under the president's administration. The United States-Peru Trade Promotion Agreement was signed on 12 April 2006, opening the way to greater trade and investment between the two economies. Peru signed trade agreements with South Korea, Japan and Mexico in 2011.

❻ Peru has continued to attract foreign investment. However, political disputes and protests may harm some projects, particularly in mining. Poor infrastructure hinders the spread of growth to Peru's inland areas. Much of the economy remains informal and untaxed. The strengthening of the sol (Peru's currency) could hurt the economy. In 2013, the central bank purchased a record US$13 billion in the foreign exchange market in an attempt to keep the national currency from rapid **appreciation**.

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(Question 4 continued)

Figure 1 – Peru terms of trade

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Please go to http://www.tradingeconomics.com/peru/terms-of-trade and click on the '2002' option to display the graph.

Figure 2 – Peru income distribution

	2005	**2010**
Gini coefficient	0.51	0.46

[Source: adapted from "A middle class emerges from Peru growth", *Financial Times*, 9 January 2013; www.heritage.org and www.indexmundi.com, accessed 17 August 2013]

(a) (i) Define the term *inflation* indicated in bold in the text (paragraph ❶). [2]

(ii) Define the term *appreciation* indicated in bold in the text (paragraph ❻). [2]

(b) Using an accurate definition of the terms of trade, explain **one** reason for the change in Peru's terms of trade index from January 2008 to January 2009 (Figure 1). [4]

(c) Using a Lorenz curve diagram, explain the change in Peru's income distribution from 2005 to 2010 (Figure 2). [4]

(d) Using information from the text/data and your knowledge of economics, discuss the view that economic development may best be achieved through a balance of market-oriented policies and government intervention. [8]