

Economics
Higher level
Paper 2

Tuesday 3 May 2016 (afternoon)

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]**.

Section A

Answer **one** question from this section.

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

South Korea quietly intervenes on the won to support economy

- ❶ South Korea's foreign exchange authorities have been engaged in a quiet war in the foreign exchange market in recent months. This has been in order to hold down the value of the country's currency, the won, against the US dollar to support exports and help keep the economy on its fragile recovery track.
- ❷ The government has been keen to stimulate domestic **consumption** and reduce the country's reliance on trade. However, domestic demand has been damaged by a ferry accident that killed more than 200 passengers earlier this year. The accident damaged consumer confidence and harmed economic activity in a number of sectors, including retail and travel. Exports have also suffered from slow growth in China, South Korea's biggest export market.
- ❸ South Korea's central bank reduced its growth forecast for the coming year noting that economic growth is below the economy's potential rate. The finance minister has said that the country needs to implement fresh policies to stimulate the economy. He promised to look into "all possible steps" across fiscal and monetary policies. Low inflation gives the central bank room to support the economy. Consumer prices rose 1.7% in June from a year earlier, below the central bank's target range of 2.5% to 3.5%.
- ❹ The rapid increase in the value of the won is a concern to producers in the country. Both Hyundai Motor Company and Samsung Electronics Limited blame the stronger currency for threatening their profits in the last year. They also complain that many countries, including China and Japan, have engineered weaker currencies to help make their goods more competitive. A spokesperson from Hyundai Motor Company said that Japanese rivals had benefited from a 30% depreciation of the Japanese yen over the past two years.
- ❺ Many analysts have downplayed manufacturers' concerns about the strengthening won arguing that Hyundai Motor Company and Samsung Electronics Limited both manufacture most of their products outside South Korea. They also note the positive impact on South Korea's steel and chemical manufacturers of cheaper raw material imports in a country that has almost no oil and iron ore.
- ❻ Despite a commitment to free markets, South Korean authorities have often intervened in currency markets, which has caused tension with the United States (US) and the International Monetary Fund (IMF). The IMF has warned against excessive intervention. It said that the won is still undervalued after falling sharply following the global financial crisis. The IMF argues that movements in the won should be determined by the market and that South Korea holds enough reserves of US dollars.

[Source: adapted from www.uk.reuters.com, 14 July 2014; www.scmp.com, 11 July 2014; www.ft.com, 24 July 2014 and www.bloomberg.com, 10 July 2014]

(This question continues on the following page)

(Question 1 continued)

- (a) (i) List **two** responsibilities of a country's central bank (paragraph ③). [2]
- (ii) Define the term *consumption* indicated in bold in the text (paragraph ②). [2]
- (b) Using an AD/AS diagram, explain why the strength of the won (South Korea's currency) may be harming economic growth. [4]
- (c) Using an exchange rate diagram, explain how the authorities have been able to "hold down" the value of the won against the US dollar (paragraph ①). [4]
- (d) Using information from the text/data and your knowledge of economics, discuss the view that the South Korean authorities should intervene in the foreign exchange market. [8]

Turn over

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

Indonesia's current account deficit

- ❶ Bank Indonesia, the central bank of Indonesia, kept its main interest rate steady, because a large current account deficit limited its ability to lower borrowing costs to support a slowing economy. The current account deficit is expected to reach US\$27 billion by the end of the year. The deficit widened due to seasonal factors, such as foreign debt payments and the transfers of funds overseas by **multinational corporations (MNCs)** repatriating earnings.
- ❷ Indonesia's current account has been in deficit for 11 consecutive quarters as the slump in commodity prices in recent years has reduced export revenues, while import expenditure has remained high as a consequence of the country's strong economic expansion.
- ❸ In mid-2013, the current account deficit was even bigger, inflation neared 10%, and the exchange rate of the rupiah (Indonesia's currency) rapidly decreased by 21%. In response, Bank Indonesia tightened **monetary policy**. This slowed down inflation, but also slowed economic growth. The value of the Indonesian rupiah has increased by more than 4% this year, although it is still undervalued.
- ❹ This year, the economy has been growing at 5.1%, the slowest pace since 2009. A weaker rupiah is hurting some businesses, and so a continued appreciation in the currency could help strengthen the economy by reducing import prices.
- ❺ The governor of the central bank said that the current interest rate level, in place since November 2013, was consistent with its 3.5% to 5.5% inflation target. He also predicted that the current account deficit for the second half of 2014 would be smaller due to the increase in exports of mineral ores.
- ❻ Economists have suggested that the best way to lower the deficit would be to cut oil imports by raising domestic oil prices. It has been suggested that the central bank has done its job by tightening monetary policy and now it is the government's job to raise fuel prices, by reducing fuel subsidies. This would help to reduce both the current account deficit and the budget deficit.
- ❼ There are also future threats as the United States is expected to raise its interest rates in the coming year. This could intensify capital flows from fast growing developing economies to developed economies, and further fuel price increases are likely in world markets.

[Source: adapted from "Indonesia Holds Key Rate as Current Account Deficit Persists", *Bloomberg News*, 14 August 2014; "Indonesia's Current Account Deficit Widens in Q2 to 4.27% of GDP", *Jakarta Globe*, 14 August 2014 and "RI back in 'fragile' condition", *The Jakarta Post*, 15 August 2014]

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(Question 2 continued)

- (a) (i) Define the term *multinational corporations (MNCs)* indicated in bold in the text (paragraph ❶). [2]
- (ii) Define the term *monetary policy* indicated in bold in the text (paragraph ❷). [2]
- (b) Using an appropriate diagram, explain why “the slump in commodity prices in recent years has reduced export revenues” (paragraph ❷). [4]
- (c) Using an AD/AS diagram, explain why “tightened monetary policy” may have “slowed down inflation” and “slowed economic growth” (paragraph ❸). [4]
- (d) Using information from the text/data and your knowledge of economics, discuss the implications for Indonesia of a persistent current account deficit. [8]

Turn over

Section B

Answer **one** question from this section.

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

Singapore

- 1 Singapore is a high-income economy in South-East Asia. The country provides the world's most business-friendly regulatory environment for local entrepreneurs and is ranked among the world's most competitive economies. Presently, the strong manufacturing and services sectors have become the main drivers of the Singapore economy. There is a wide range of businesses, with a particular focus on high value added goods and services.

Timor-Leste (East Timor)

- 2 Timor-Leste (formerly known as East Timor) is a developing economy in South-East Asia. Timor-Leste gained independence from Indonesia in 2002. The country and families were torn apart by violence in the years before independence. Nearly 70% of all buildings, homes and schools were destroyed. An estimated 75% of the population were forced to move due to the violence.
- 3 After serious challenges, Timor-Leste has progressed, particularly due to its endowment of natural resources, especially oil. With the petroleum revenue boom, **fiscal policy** has been expansionary and the economy has grown rapidly as a result of government spending, focusing on major **infrastructure**, development of skills, and other institutional changes. A main goal was to generate increased and sustainable private sector investment as a means to increased job opportunities and to reduce poverty. These developments are starting to contribute to poverty reduction and improved social outcomes.

[Source: adapted from *The World Bank – country reports*, 2013]

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(Question 3 continued)

Figure 1 – Selected economic data for Singapore and Timor-Leste – 2013

	Singapore	Timor-Leste
Human Development Index (HDI) data		
HDI rank	9	128
HDI value	0.901	0.62
Life expectancy at birth	82.32	67.54
Mean years of schooling	10.20	4.42
Expected years of schooling	15.40	11.70
Gross national income (GNI) per capita (2011 purchasing power parity (PPP) US\$)	72 371.23	9 673.61
Other selected data		
Population (millions)	5.41	1.13
Gross domestic product (GDP) per capita (2011 PPP US\$)	71 474.89	11 814.79
Urban percentage of population	100.00	29.11
Foreign direct investment (FDI), net inflows (% of GDP)	20.62	4.31

[Source: adapted from *UNDP Human Development Reports*, www.hdr.undp.org, accessed August 2014]

- (a) (i) Define the term *fiscal policy* indicated in bold in the text (paragraph ③). [2]
- (ii) Define the term *infrastructure* indicated in bold in the text (paragraph ③). [2]
- (b) Using a production possibilities curve (PPC) diagram, explain the effects of the violence in Timor-Leste on production possibilities (potential output) (paragraph ②). [4]
- (c) Explain why the gross national income (GNI) per capita for Timor-Leste is lower than the gross domestic product (GDP) per capita (Figure 1). [4]
- (d) Using information from the text/data and your knowledge of economics, compare and contrast the Human Development Index (HDI) data for Singapore and Timor-Leste in terms of their relevance for economic development. [8]

Turn over

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

Rwanda

- ❶ 20 years after the 1994 genocide* that claimed the lives of 800 000 people, international views about Rwanda are mixed. On one hand, there is admiration for the country's dramatic development progress and economic success, while on the other, there is criticism of political repression. Human rights activists maintain that Rwanda too often suppresses political opposition and free speech.
- ❷ Development indicators show significant changes in education, public health and the economy. Rwanda spends huge proportions of its national budget on health and education. In 2011, almost 24 % of total government expenditure went to health and 17 % to education. Child and infant mortality rates have fallen dramatically. Life expectancy has risen from 48 years in 2000 to more than 64 years in 2012. Significant progress has been made in terms of the Millennium Development Goals.
- ❸ The economy has grown at an average of nearly 8 % per year from 2010 to 2014 because of increased agricultural productivity, tourism and government spending on infrastructure and housing.
- ❹ However, extreme poverty remains a reality for more than 60 % of the population. Poverty has fallen, but an estimated 63 % of Rwandans continue to live on less than the equivalent of US\$1.25 a day and 82 % on less than US\$2 a day. In 1985, the Gini coefficient was 0.28. It climbed to a peak of 0.53 in 2005 and in 2010 stood at 0.51. In spite of major achievements, the prime minister noted that "Poverty and inequality remain serious challenges. The growing youth population means that we need to create 200 000 jobs every year".
- ❺ Rwanda is heavily dependent on **official development assistance (ODA)**. This was cut in 2012 after a United Nations report accused the Rwandan government of supporting a rebellion in the neighbouring Democratic Republic of Congo. Although aid resumed in 2013, the cutback severely limited the government's budget. The World Bank reported that the temporary cut in aid could still "threaten the economic outlook for Rwanda".
- ❻ The government is starting a programme of privatization and liberalization with the goal of attaining rapid and sustainable economic growth and reducing poverty. The aim is to transform the economy from its 90 % dependence on subsistence agriculture into a modern, broadly based economic engine, welcoming investors and creating employment and new opportunities. Rwanda's recent entry into the East African Community (a **customs union** comprising Burundi, Kenya, Tanzania and Uganda) should further improve its economic potential.

[Source: adapted from www.rw.undp.org, accessed 29 September 2014; www.theguardian.com, 8 October 2013; www.nytimes.com, 23 March 2014 and www.afdb.org, accessed 29 September 2014]

* genocide: the deliberate killing of a very large group of people from a particular ethnic group or nation.

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(Question 4 continued)

Figure 1 – Selected economic data for Rwanda and Nigeria

	Rwanda	Nigeria
Life expectancy at birth	64.1	52.5
Expected years of schooling	13.2	9.0
Gross national income (GNI) per capita (2011 purchasing power parity (PPP) US\$)	1403	5353
Human Development Index (HDI) value (2013)	0.506	0.504
HDI rank (2013)	151	152

[Source: adapted from www.hdr.undp.org, accessed 29 September 2014]

- (a) (i) Define the term *official development assistance (ODA)* indicated in bold in the text (paragraph 5). [2]
- (ii) Define the term *customs union* indicated in bold in the text (paragraph 6). [2]
- (b) Using a Lorenz curve diagram, explain what happened to income inequality between 1985, 2005 and 2010 (paragraph 4). [4]
- (c) Using data from Figure 1 with reference to Rwanda and Nigeria, explain why higher gross national income (GNI) per capita might not lead to higher economic development. [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]