Diploma Programme
Programme du diplôme
Programa del Diploma

Economics
Higher level
Paper 2

Wednesday 3 May 2017 (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.

Relief as Kenya raises tariff for steel and iron imports

❶ Steel manufacturers in Kenya are set to benefit as the government moves to protect the local manufacturing industry from cheap steel and iron imports.

❷ In 2014 a government official announced an increased **tariff** on steel and iron imports. “Our steel mills are closing down due to unfair competition from cheaper imported iron and steel products,” he explained. “To protect and create more jobs in the iron and steel industries, tariffs on a wide range of imported iron and steel products will be increased from 0 % and 10 % to 25 %,” he said. The government official further stated that as well as protecting the local industries from cheaper imports, the protectionist measures would raise an additional 2.6 billion Kenyan shillings (Kenya’s currency) annually in government revenue and support **economic growth**.

❸ The potential of local industries to expand and create jobs through trade has been held back by a number of administrative barriers. The government remains focused on improving the business environment. Over the past six months, the government has made it easier to register a company and trade across borders. The time taken to move goods out of the main harbour has fallen sharply; non-tariff barriers such as roadblocks have also been reduced. Importers of refined industrial sugar and wheat are also pleased after the government scrapped requirements to pay unnecessary administrative charges.

❹ However, there is a belief among manufacturers that there is a need for more deregulation to lower their costs of production and in effect reduce the cost of doing business.

Kenya sees gross domestic product (GDP) growth picking up but current account a concern

❺ Good economic growth rates in neighbouring countries like Uganda help to boost Kenyan exports, particularly for agriculture that makes up nearly a quarter of the Kenyan economy. The government suggests that the main risks to growth are the slow performance of developed economies that are key export markets for Kenyan goods and services, and Kenya’s large and persistent current account deficit of over 10 % of gross domestic product (GDP) in the last three years. This is a major concern for sustained economic growth and the value of the Kenyan shilling.

[Sources: adapted from www.standardmedia.co.ke, 13 June 2014; www.af.reuters.com, 25 July 2014 and www.cnbcafrica.com, 25 November 2013]

(This question continues on the following page)

(Question 1 continued)

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

(ii) Define the term *economic growth* indicated in bold in the text (paragraph ❷). [2]

(b) Using an international trade diagram, explain the impact on the Kenyan government of implementing a tariff on steel imports. [4]

(c) Using an AD/AS diagram, explain how “good economic growth rates in neighbouring countries like Uganda” benefit Kenya’s economy (paragraph ❺). [4]

(d) Using information from the text/data and your knowledge of economics, evaluate the claim that trade protection measures will support economic growth in Kenya. [8]

Turn over

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

Australia's terms of trade

❶ Australia's terms of trade fell sharply in the three months through to June 2015, the largest fall since the global financial crisis of 2008. Official trade price data released by the Australian Bureau of Statistics (ABS) imply the terms of trade slumped by about 5.8 % from the March quarter. This may worsen the **current account deficit**.

❷ The terms of trade index is now significantly below its September 2011 peak because of ongoing falls in the prices of iron ore, coal and energy. This is of critical importance given Australia's growing reliance on income from exports of liquefied natural gas.

❸ "The golden age of commodity-driven income growth is long gone," said an economist at Commonwealth Bank. "The continued fall in the terms of trade reflects a pronounced fall in the purchasing power of Australian households and businesses. This has been a familiar theme over the past few years," he said. "Basically, falling commodity prices, namely iron ore and coal, have weighed heavily on export revenues and therefore, real **gross national income** growth."

❹ Falling prices for exports are likely to damage the Australian government's revenue expectations and to damage hopes for any rebound in economic strength in the near future.

❺ While the quantity of export shipments – chiefly iron ore – continues to break records, the revenues received by the nation's biggest exporters continue to fall and several key economists fear that this may lead to a recession. This would break a 24-year run of unbroken economic growth.

❻ The Australian dollar's 0.4 % fall in the exchange rate has done little to offset this effect, and the Reserve Bank of Australia continues to signal that it may take further measures to lower its current price of around AU$1 = US$0.73.

❼ The ongoing terms of trade collapse highlights the urgency for governments and companies to accelerate efforts at encouraging productivity. The manager of the Reserve Bank of Australia said, "Australia's dreadful productivity effort over the last decade was masked by the rapidly increasing terms of trade up until 2013. This kept our income growing but the weakness now is harshly exposed as commodity prices slide".

Figure 1 – Export and import indices for Australia

Year	Index of export prices	Index of import prices
2011	100	100
2015	77	108

[Sources: Extract: Adapted from Fairfax Syndication, www.afr.com/news, 30 July 2015
Table: ABS data used with permission from the Australian Bureau of Statistics, July 2015, www.abs.gov.au]

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(Question 2 continued)

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

(ii) Define the term *gross national income* indicated in bold in the text (paragraph ❸). [2]

(b) Using a definition of price elasticity of demand, explain why “the revenues received by the nation’s biggest exporters continue to fall” (paragraph ❺). [4]

(c) Using a definition of the terms of trade, explain the terms of trade change in Australia from 2011 to 2015 (Figure 1). [4]

(d) Using information from the text/data and your knowledge of economics, discuss the possible effects of the fall in Australia’s terms of trade on the Australian economy. [8]

Section B

Answer **one** question from this section.

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

Indonesia's economy

❶ Indonesians hope that their new president will be able to speed up reforms to stimulate economic growth and economic development. These reforms include upgrading **infrastructure**, reducing red tape (excessive regulations) and reducing corruption. It is also hoped that he will increase Indonesia's global competitiveness, create new jobs and educate one of the world's youngest workforces.

❷ Some government policies are already being implemented. These include a large power plant construction programme, tax incentives to infant industries and tax cuts for industries like transport, telecommunications, metal production and agricultural processing. In addition, there has been a decision to reduce fuel subsidies in order to contribute funds towards the government's record US$22 billion investment in infrastructure projects. The subsidies had kept fuel prices low in a country where millions of people live in poverty.

❸ Despite the policies, Indonesia is struggling. Economic growth is slow and consumer confidence has deteriorated. Indonesia's main export commodities are coal, gold and palm oil, for which prices have fallen. The inflation rate is 7.26 %, which is above the central bank's target range of 3 to 5 %. Slower growth in the world economy makes the situation even worse for Indonesia's struggling economy.

❹ Economists have said that the president must put his efforts into improving export competitiveness by making investments in education and training.

❺ The costs of doing business in Indonesia are high due to paperwork and confusing regulations. The government has adopted policies to improve this. These policies aim to create certainty and transparency for foreign investors and to empower small businesses, which play a critical part in Indonesia's economy. Other policies, such as obtaining loans and encouraging **micro-credit** institutions, make it easier to gain access to credit.

❻ Trade protection and intervention are increasing as policymakers look to reduce imports, manage markets and promote domestic industries.

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(Question 3 continued)

Figure 1 – Indonesian development statistics

	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Relative poverty (% of population)	16.6	15.4	14.2	13.3	12.5	11.7	11.5	11.0
Absolute poverty (in millions)	37	35	33	31	30	29	29	28
Gini coefficient	0.35	0.35	0.37	0.38	0.41	0.41	0.41	–*
Human Development Index (HDI) value	–*	0.654	–*	0.671	0.678	0.681	0.684	–*

[Sources: adapted from World Bank and Statistics Indonesia; www.legalbusinessonline.com, accessed 18 September 2015; www.indonesia-investments.com, accessed 23 August 2015; www.hdr.undp.org, accessed 23 August 2015; www.bloombergview.com, accessed 9 August 2015; www.reuters.com, accessed 9 August 2015; www.lowyinterpreter.org, accessed 23 August 2015 and www.data.worldbank.org, accessed 23 August 2015]

* signifies no data available

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

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

(b) Using a demand and supply diagram, explain the impact on the market for fuel of the government's decision to reduce fuel subsidies (paragraph ❷). [4]

(c) Using a production possibilities curve (PPC) diagram, explain how "the government's record US$22 billion investment in infrastructure projects" will affect Indonesia's production possibilities (paragraph ❷). [4]

(d) Using information from the text/data and your knowledge of economics, discuss the possible impacts of market-oriented **and** interventionist policies on Indonesia's economic development. [8]

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

Zambia's reliance on copper exports

❶ Due to its economic success, Zambia has recently been classified as a middle-income country by the World Bank. According to the United Nations (UN) classification, Zambia is in the medium human development category. However, outside mining and export areas, the standard of living remains extremely low for Zambians.

❷ Zambia is one of the world's top producers of copper. The country's economy is reliant on copper exports, which make up 80% of export earnings. Mining employs approximately 90 000 people and contributes approximately 25–30% of government revenue in Zambia.

❸ From 1997 to 2013, mining attracted US$12.6 billion in **foreign direct investment**, helping Zambia become one of Africa's top economic performers, with average annual gross domestic product (GDP) growth of 6.4% over the last decade.

❹ But now foreign and local businesses, including giant multinational mining corporations and small Zambian companies, have been hit hard by a rapid fall in the price of copper. In January 2015, the price reached a five-and-a-half year low of approximately US$5353 per tonne, below the estimated **marginal cost** of production of US$5500. Sadly for many domestic Zambian mines, their marginal costs are even higher because their mines are old, deep and expensive to operate.

❺ The fall in commodity prices is linked to the slowdown in Chinese economic growth. China accounts for 45% of global copper consumption. The situation highlights the vulnerability of Africa's resource-dependent nations to changes in China's economy. This is an indicator of the need for Zambia to diversify its economy away from primary commodities. This will require the government to implement structural reforms to improve the supply side of the economy.

❻ Zambia is facing other economic problems as well as the falling price of copper. Most of Zambia's electricity is produced from hydropower, but a severe drought has led to widespread power cuts, further threatening copper mining. The power problems and fall in copper prices have driven the Zambian kwacha (Zambia's currency) to record lows due to a widespread selling of currencies which are linked to commodities. It lost 17% of its value against the US dollar from December 2014 through to the end of March 2015. The weakness of the Zambian kwacha is raising import costs and feeding into inflation.

❼ The governing Patriotic Front party, which has been in power since 2011, attracted voters by promising to share the country's mineral wealth more equitably, raise wages and improve infrastructure. But now the government is struggling to maintain fiscal discipline, as the budget deficit has risen to an unacceptable level of approximately 10% of GDP.

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(Question 4 continued)

❽ There has also been much attention to the unsustainable mining practices of foreign and domestic mines in Zambia. These have added to Zambia's challenges of poverty alleviation, economic growth and economic development.

[Sources: adapted from www.reuters.com, 8 September 2015; Financial Times, "*Zambia's copper belt reels as price falls*", 26 January 2015; Financial Times, "*Zambia bears the brunt of China's economic slowdown*", 9 September 2015; Wall Street Journal, "*Copper Mine Shutdown Threatens Zambia's Economy*", 3 August 2015 and World Bank, "*Making Mining Work for Zambia*", 17 June 2015]

Figure 1 – Selected economic indicators for Zambia, Malawi, Sub-Saharan Africa and middle income countries

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(a) (i) Define the term *foreign direct investment* indicated in bold in the text (paragraph ❸). [2]

(ii) Define the term *marginal cost* indicated in bold in the text (paragraph ❹). [2]

(b) Using an AD/AS diagram, explain how the falling value of the Zambian kwacha (Zambia's currency) is "feeding into inflation" (paragraph ❻). [4]

(c) Using a Lorenz curve diagram, explain the meaning of the different Gini coefficient values for Zambia and Malawi shown in **Figure 1**. [4]

(d) Using information from the text/data and your knowledge of economics, discuss the possible impacts of Zambia's reliance on copper production on its economic development. [8]