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Economics
Standard level
Paper 2

Friday 13 November 2020 (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]**.

Section A

Answer **one** question from this section.

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

Argentina's currency keeps falling

- 1 The year 2018 started badly for Argentina when the worst drought in 50 years negatively affected its export revenues from maize and soybeans, both important exports. The economy suffered several additional problems: a stronger United States dollar (US\$), international investors selling Argentinian assets due to a lack of confidence in the economy, rising inflation from 25% to nearly 50% (**Figure 1**) and a significant depreciation of the peso, Argentina's currency (**Figure 2**).
- 2 When Argentina's president was elected in 2015, inflation was at 25%. He gave the central bank freedom to raise interest rates, which encouraged foreign investors to buy government bonds. The government had borrowed a lot of money from overseas to finance the persistent **budget deficit**, but by 2018, foreign investors were interested in other markets.
- 3 As the peso was overvalued in 2015, it kept demand for imports high and made it hard for exports to compete. The current account deficit rose to more than 5% of **gross domestic product (GDP)** but slowly narrowed in 2018, because the president allowed the peso to float freely.
- 4 In May 2018, in an attempt to control the inflation rate and stop the fall in the peso's value, the Argentinian central bank raised interest rates to 40%. In addition, it started selling foreign currency reserves. However, there were concerns that if the selling of foreign currency reserves continued, they would be depleted quickly. To address this concern, the president negotiated a US\$50 billion loan from the International Monetary Fund (IMF). Yet the peso continued to fall. The IMF loan means that most of Argentina's debt-servicing requirements are covered until 2020. However, under IMF loan conditions, the budget deficit must be cut by postponing infrastructure projects, subsidies must be cut, and government jobs must be cut.
- 5 A spokesperson from the IMF said "Argentina has a floating, market-determined exchange rate, and the IMF fully supports that. The exchange rate should continue to be determined by market forces."
- 6 The peso's weakness causes imported oil prices to go up, further raising inflation. The falling real incomes of households combined with higher interest rates will affect the economy negatively, possibly leading to a recession. Interest rates will remain high for some time, discouraging investment. Economists expect Argentina to fall into recession, for the fifth time in a decade.

(This question continues on the following page)

(Question 1 continued)

Figure 1: Argentina's inflation rate

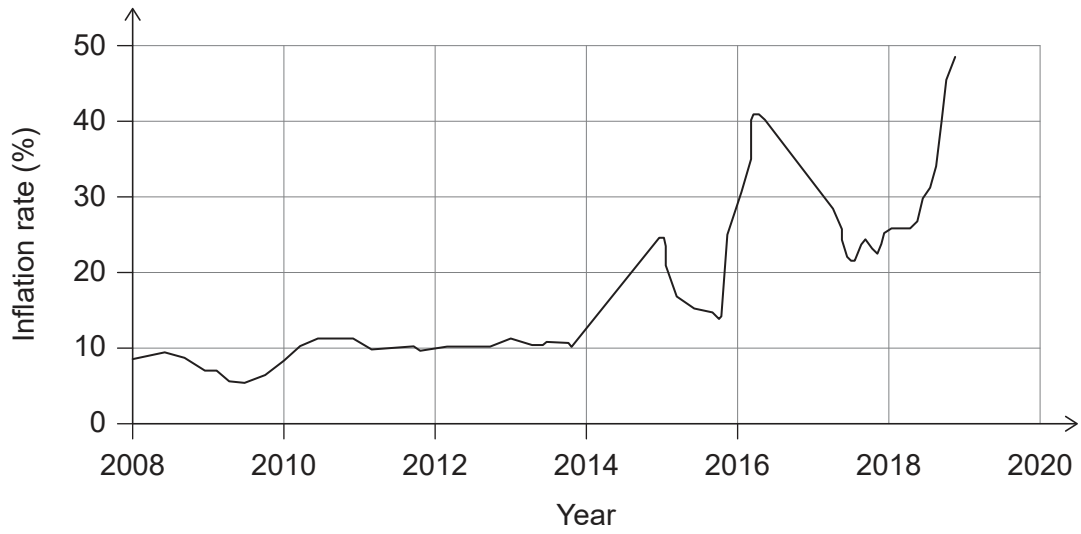


Figure 2: The weakening of the Argentine peso

Gallas, G., 2018. Why confidence in Argentina's economy is dwindling. BBC, available at: <https://www.bbc.co.uk/news/world-latin-america-44107630>

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(This question continues on page 5)

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(Question 1 continued)

- (a) (i) Define the term *budget deficit* indicated in bold in the text (paragraph **2**). [2]
- (ii) Define the term *gross domestic product (GDP)* indicated in bold in the text (paragraph **3**). [2]
- (b) Using an exchange rate diagram, explain how raising interest rates would “stop the fall in the peso’s value” (paragraph **4**). [4]
- (c) Using an AD/AS diagram, explain how the peso’s weakness is “raising inflation” (paragraph **6**). [4]
- (d) Using information from the text/data and your knowledge of economics, discuss the view that Argentina should keep its floating exchange rate system. [8]

Turn over

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

Unwanted consequences of United States–China trade war

- 1** In order to reduce its trade deficit, the United States (US) announced tariffs of 25 % on imports of steel and 10 % on imports of aluminium from various countries in March 2018. The US government also accused China of unfair trade practices and wants China to import more American-made products.
- 2** In July 2018, the first **tariff** on Chinese imports took effect and the Chinese government retaliated with a ban on US soybeans. In response, the US threatened to impose additional tariffs on imports worth almost US\$300 billion, including a 25 % tariff on cars and car parts. This would be very damaging to the Chinese economy, which is slowing down, and workers in some provinces have become unemployed.
- 3** The **trade war** has also caused anxiety in the European Union and Australia, which are likely to see their trade with China affected. Global trade in goods has been slowing, with exports from trade-dependent nations (such as Japan and South Korea) to China declining. Economists have estimated that other countries could see exports to China drop by as much as 20 %. As of early 2019, Germany’s economy is almost in recession, partly because of the slowing Chinese economy. If the US imposes its threatened car tariffs, a recession in Germany is inevitable.
- 4** In the US, concerns were raised that the trade war has reduced business confidence. The decrease in demand from China, which results partly from trade tensions, has hurt the profits of US companies such as Apple Inc. and Caterpillar Inc. On the other hand, consumers and producers in the US are switching to domestically-produced goods due to the higher prices of some imported products from China.
- 5** In an attempt to reduce the risk of a sharp economic slowdown, China’s central bank eased monetary policy. Economic data showed that small- and medium-sized manufacturing companies saw the largest negative impact from the slowdown of its economy. Therefore, the government changed the definition of a “small business”, allowing more firms to have access to subsidized lending by state-owned commercial banks.
- 6** As the impacts of tax cuts enacted in the US in 2017 are disappearing, the US government is becoming more aware that the US economy is hurt by the trade war and is heading towards slower growth.

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(Question 2 continued)

- (a) (i) Define the term *tariff* indicated in bold in the text (paragraph **2**). [2]
- (a) (ii) Define the term *trade war* indicated in bold in the text (paragraph **3**). [2]
- (b) Using an international trade diagram, explain the outcome on US producers of the introduction of a tariff on imports from China (paragraph **2**). [4]
- (c) Using an AD/AS diagram, explain the desired impact of China’s “eased monetary policy” on its economic growth (paragraph **5**). [4]
- (d) Using information from the text/data and your knowledge of economics, discuss the arguments for and against the trade protection measures imposed by the US on China. [8]

Turn over

Section B

Answer **one** question from this section.

3. Study the following extract and answer the questions that follow.

Pakistan and the International Monetary Fund

- 1 Pakistan is a low-income country with a rapidly growing population and widespread poverty. As of 2019, it has a large budget deficit due to high levels of military spending and high costs of debt servicing (35% of the deficit is interest payments). It is also experiencing a widening current account deficit and is heavily dependent on foreign aid.
- 2 Pakistan's government is negotiating a loan from the International Monetary Fund (IMF). Amongst its conditions, the IMF has said that the government must decrease private-sector regulation such as regulations on financial institutions. The government must also sell state-owned enterprises and government revenue must be raised by increasing indirect taxes and improving tax collection systems. Furthermore, the IMF insists that the government cuts its spending further.
- 3 The government has stated that the IMF loan is essential to restore confidence in Pakistan's economy. This would help to attract foreign direct investment (FDI) to encourage economic growth and help break out of the poverty cycle. High debt levels and slowing economic growth in 2018 discouraged FDI. The IMF loan is also needed to help persuade other multilateral lenders such as the World Bank and the Asian Development Bank to provide and extend loans.
- 4 In the past, Pakistan has had 21 agreements with the IMF with limited success—any balance of payments or external debt improvement has been temporary. The IMF states that this is because Pakistan has not always met the conditions of the loans, while other stakeholders argue it was the lack of support given to Pakistan to implement the conditions and to allocate the loan funds appropriately.
- 5 Economists say that there needs to be a focus on improving **human capital** to provide the large number of young people entering the labour force with the skills to grow businesses. The quality of education needs to improve and to be combined with an effort to provide girls with greater access to education—female participation in the labour force is the lowest in the region.
- 6 The World Bank has financed education and infrastructure, such as renewable energy projects, in poor regions of Pakistan. However, critics of the World Bank argue that the projects are not making a significant difference and the construction of hydroelectric dams leads to environmental damage.
- 7 The government believes that the macroeconomic concerns of the IMF should be addressed first, and poverty issues in Pakistan can be dealt with later.

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(Question 3 continued)

- (a) (i) State **two** functions of the International Monetary Fund (IMF) (paragraph **2**). [2]
- (ii) Define the term *human capital* indicated in bold in the text (paragraph **5**). [2]
- (b) Using a poverty cycle diagram, explain how the government of Pakistan could intervene to “break out of the poverty cycle” (paragraph **3**). [4]
- (c) Using an externalities diagram, explain how “greater access to education” for girls in Pakistan could reduce market failure (paragraph **5**). [4]
- (d) Using information from the text/data and your knowledge of economics, evaluate the potential impact of the IMF and the World Bank on economic development in Pakistan. [8]

Turn over

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

Trade strategies in the Philippines

- 1** For more than 20 years the Philippines has been limiting the volume of rice it imports. However, the agreement with the World Trade Organization (WTO) that permitted these restrictions expired in 2017. In early 2019, the government replaced the quantity restrictions with tariff protection. A 35 % tariff on imported rice from the Association of Southeast Asian Nations (ASEAN)* was imposed to protect the domestic rice industry in the Philippines. Following the replacement of the quota with a tariff, rice prices are expected to fall significantly. However, urban households want the president to allow rice to be imported without any tariffs to reduce food bills even further.
- 2** The poorest quintile of households in the Philippines consumes nearly twice as much ordinary rice and 20 times more National Food Authority (NFA) rice compared to the richest quintile. Rising food prices are pushing up inflation as a result of increasing salaries in urban areas. The daily minimum wage in Manila, the Philippine capital, will increase by 4.9%, the highest hike in six years, to the equivalent of US\$10.11. Farming and fishing provide the livelihoods for around one-third of the labour force in the Philippines. Land reform programmes are slowly being implemented to change the current situation of unfair ownership of land and resources by a few individuals. However, uncertainty continues to discourage investment in adequate irrigation systems in the countryside. As an agricultural country, irrigation in the Philippines is very important. Improvements in the quality of infrastructure services will help cut the cost of doing business, attract more investment, and enhance productivity around the country. Food manufacturing, including food and beverage processing, remains the most dominant primary industry in the Philippines. This has become a focus in the hope of increasing farm incomes, because this part of the economy is currently dominated by big international companies. Major exports of processed fruits and nuts include mangos, pineapples, bananas and peanuts.
- 3** The Philippine Export Development Plan (PEDP) 2018–2022 calls for boosting the export of services, increasing export competitiveness, and exploring new markets. Efforts have already been made to harmonize the country's standards, testing, certification and quality accreditation of products to improve trade and comply with standards in the European Union. The PEDP aims to increase the volume and value of exports by encouraging investment in production processes and supply chains. Another strategy to achieve the plan's objective is to exploit existing and new opportunities from trade agreements.
- 4** The Philippines lacks the infrastructure needed to attract export-oriented manufacturing. To support the PEDP, the government needs to increase its spending on new airports, roads and bridges. These public works are critical to boosting the incomes of people in poorer areas by connecting them better to Manila. To allow for this extra spending, a series of tax reforms was started: the income tax for the highest income earners has been raised from 30 % to 35 %, and indirect taxes have been increased.

* ASEAN consists of Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar (Burma), Philippines, Singapore, Thailand and Vietnam.

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(Question 4 continued)

- (a) (i) State **two** functions of the World Trade Organization (WTO) (paragraph **1**). [2]
 - (ii) Define the term ***inflation*** indicated in bold in the text (paragraph **2**). [2]
 - (b) Using a Lorenz curve diagram, explain the possible impact on the distribution of income in the Philippines when “the income tax for the highest income earners has been raised from 30 % to 35 %” (paragraph **4**). [4]
 - (c) Using an AD/AS diagram, explain the impact on the potential output of the Philippines of the government increasing its “spending on new airports, roads and bridges” (paragraph **4**). [4]
 - (d) Using information from the text/data and your knowledge of economics, evaluate the use of export promotion as a means of achieving economic development in the Philippines. [8]
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References:

- Figure 1** Adapted from Anon, n.d. Argentina Current Account, *Trading Economics*, <https://tradingeconomics.com/argentina/current-account>.
2. Adapted from Tang, F. and Wang, O., 2019. China prepares for testing 2019 by freeing up US\$210 billion in latest move to boost ailing economy. *South China Morning Post*, <https://www.scmp.com/economy/china-economy/article/2180758/china-prepares-testing-2019-freeing-us210-billion-latest-move>; and Donnan, S., 2019. U.S.-China Negotiations Risk Shutting Out the Rest of the World. *Bloomberg Businessweek*, <https://www.bloomberg.com/news/articles/2019-02-28/u-s-china-negotiations-risk-shutting-the-rest-of-the-world-out>. Used with permission of Bloomberg LLP Copyright © 2021. All rights reserved.
 3. © International Baccalaureate Organization 2020.
 4. Adapted from *Philippines News Agency*, “Proposed Ph Export Plan Backs PDP 2017-2022 Targets”, June 21, 2018, <https://www.pna.gov.ph/articles/1039017>.