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Economics

Higher level

Paper 2

16 May 2023

Zone A afternoon | **Zone B** morning | **Zone C** afternoon

1 hour 45 minutes

Instructions to candidates

- Do not open this paper until instructed to do so.
- You are permitted access to a calculator for this paper.
- Unless otherwise stated in the question, all numerical answers must be given exactly or correct to two decimal places.
- You must show all your working.
- 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]**.

Answer **one** question.

1. Read the extracts and answer the questions that follow.

Text A — Overview of Mexico

- 1 Mexico, with its abundant natural resources, is the second largest economy in Latin America. However, compared to other Latin American countries, Mexico has underperformed. Its annual economic growth rate averaged 2.5% between 1994 and 2019. Per capita income rose more slowly, at an average rate of less than 1% annually.
- 2 Government expenditure has been rising, while taxation revenue has been stable or falling. Therefore, there is concern about the increasing government debt. If there is a recession, automatic stabilizers will increase the budget deficit, further raising the level of government debt. However, the International Monetary Fund (IMF) forecasts that government debt will stabilize in the mid-2020s, at around 65% of gross domestic product (GDP).
- 3 The oil sector makes an important contribution to Mexico's economy. Earnings from this sector were about 30% of total government revenue in 2019. However, as countries increase their use of alternative energy sources, the long-term trend of falling oil prices will probably continue.
- 4

Paragraph removed for copyright reasons
- 5 Since 1994, the exchange rate for the peso (Mexico's currency) has been floating. In March 2020, the rate changed from 18 pesos per United States (US) dollar to 25 pesos per US dollar. During 2020, the deficit on the balance of trade in goods continued to widen. However, by April 2021 the trade balance had changed to a surplus as exports of manufactured goods rose strongly. The deficit on the current account has also been narrowed by rising net **remittances**.

Text B — Free trade agreements

- 1 The North American Free Trade Agreement (NAFTA) was a three-country accord negotiated by the governments of Canada, Mexico, and the United States that entered into force in January 1994. NAFTA eliminated most tariffs on products traded between the three countries, with a major focus on liberalizing trade in agriculture, textiles, and automobile manufacturing. The deal also sought to protect intellectual property, establish dispute resolution mechanisms, and through side agreements, implement labor and environmental safeguards. Trade among the NAFTA members tripled over the following 25 years, partly due to trade disputes between the US and China.
- 2 Following the establishment of NAFTA, productivity increased in Mexico. US and Canadian firms viewed Mexico as a low-cost location for factories, which could improve their competitiveness. Therefore, foreign direct investment (FDI) into Mexico grew significantly throughout the 1990s and early 2000s. In the industrial north of Mexico, high-tech manufacturing factories were established and wages increased. However, the agricultural south did not benefit from the FDI. Agricultural exports from Mexico did increase, but Mexican farmers, especially corn producers, faced competition from subsidized US agriculture.

(This question continues on the following page)

(Question 1 continued)

- 3** The wage differential between the US and Mexico was predicted to decrease significantly, but a large wage gap remains. NAFTA’s effect on employment has been mixed. Some workers became unemployed when their firms lost market share due to increased competition, while others gained from the creation of new market opportunities.
- 4** In 2020, NAFTA was renegotiated as the US–Mexico–Canada Agreement, which kept elements of NAFTA, while adding provisions regarding digital trade and financial services. The requirement that a high proportion of the inputs used in exported goods must come from member countries may mean that the cheapest inputs cannot be used. There are also additional rules to protect the environment and support labour rights. For example, 40 % of the value of the components in each vehicle exported from Mexico must come from factories paying a wage of at least US\$16 per hour. As a result, the incomes of Mexicans who find industrial employment are raised.

Text C — Access to banking and finance in rural areas

- 1** The persistence of income inequality in Mexico is partly due to domestic factors, such as underdeveloped financial institutions and low productivity in the large informal sector. Improving access to banking and finance could significantly benefit low-income households and small firms.
- 2** The Expanding Rural Finance Project aims to provide finance for women, young people, and small firms in rural areas where there are no commercial banks. Over 170 000 loans (averaging US\$1850 per loan) were provided from 2016 to 2020. Among the recipients, 76 % lived in rural areas and 81 % were women.

Table 1: Economic data for Mexico

	2010	2019
GDP (real growth rate, %)	5.12	–0.06
GDP per capita (US\$ PPP)	9271	10267
Balance of trade in goods (US\$ million)	–2943	5214
Current account balance (% of GDP)	–0.46	–0.33
FDI, net inflows (US\$ million)	30477	29375

Table 2: Development data for Mexico

	2010	2019
Population (million)	114	128
Gini coefficient	0.472	0.454*
Human Development Index (HDI)	0.748	0.779

* estimate

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(Question 1 continued)

- (a) (i) List **two** functions of the International Monetary Fund (IMF) (**Text A**, paragraph **2**). [2]
- (ii) Define the term *remittances* indicated in bold in the text (**Text A**, paragraph **5**). [2]
- (b) (i) Using information from **Table 1** and **Table 2**, calculate the value of Mexico's gross domestic product (GDP) in US\$ in 2019. [2]
- (ii) Sketch a minimum wage diagram to show the possible effect of a minimum wage on unemployment in Mexico (**Text A**, paragraph **4**). [3]
- (c) Using a business cycle diagram, explain how automatic stabilizers will affect the decrease in real GDP that occurs during a recession (**Text A**, paragraph **2**). [4]
- (d) Using a demand and supply diagram, explain why the price of oil will probably continue to fall (**Text A**, paragraph **3**). [4]
- (e) Using a J-curve diagram, explain the likely reason why the change in the exchange rate for the peso initially caused the deficit on the balance of trade to widen and then eventually led to a surplus (**Text A**, paragraph **5**). [4]
- (f) Using a poverty cycle diagram, explain how the Expanding Rural Finance Project raises incomes in rural areas (**Text C**). [4]
- (g) Using information from the texts/data and your knowledge of economics, discuss the costs **and** benefits for Mexico of participation in the free trade agreement with the US and Canada. [15]

Turn over

2. Read the extracts and answer the questions that follow.

Text D — Overview of Indonesia and palm oil production

- 1 Indonesia is the largest economy in Southeast Asia and its gross domestic product (GDP) has grown strongly. The proportion of those living in absolute poverty in Indonesia decreased from 37.4 % in 1999 to 2.7 % in 2019.
- 2 The palm oil industry is a major contributor to the Indonesian economy, accounting for 4.5 % of GDP and providing employment for over three million Indonesians. Palm oil production is technologically simple and **profit** margins are large. As a low-cost producer, Indonesia produces over 50 % of the world's output. Palm oil is the most widely used vegetable oil in the global market. It is an ingredient in many products (including foods, cosmetics, cleaning products and biofuel) and demand continues to increase.
- 3 In 2015, despite a widening budget deficit, the Indonesian government began subsidizing biodiesel (a type of renewable fuel) made from palm oil to make it more price competitive with conventional diesel. The subsidies were aimed at reducing Indonesia's dependence on fossil fuel imports and at increasing exports of high-value refined palm oil products.
- 4 In Indonesia, 80 % of the palm oil produced is exported, contributing substantially to export revenue and to government tax revenue. However, palm oil prices are volatile, due to changes in supply, making planning difficult and causing fluctuations in the exchange rate. For example, studies show that, due to the low price elasticity of demand (PED) for primary commodities, an increase in the price of palm oil results in greater export revenue. Consequently, the rupiah (Indonesia's currency) may appreciate.
- 5 In 2019, the European Union (EU) decided to impose an 18 % tariff on imports of palm oil based biodiesel from Indonesia, partly due to concerns that palm oil production damages the environment. The EU also claimed the tariff was necessary to offset the effects of the biodiesel subsidy.

Text E — Sustainable Development Goal (SDG) 12 and concerns about palm oil production in Indonesia

- 1 In the past, the Indonesian government supported the rapid growth of palm oil production in order to increase GDP and employment. This policy often resulted in an inefficient use of land and high carbon emissions, as a result of deforestation.
- 2 Sustainable Development Goal (SDG) 12 (responsible consumption and production) requires resources to be used more efficiently and sustainably through changes in production methods. Unsustainable use of Indonesia's natural resources will probably reduce long-term economic growth. Forests are necessary for food security, fuel, shelter and jobs. They also reduce the carbon in the atmosphere and protect against floods.
- 3 Rates of deforestation in Indonesia have decreased recently. The World Bank's Forest Carbon Partnership Facility is providing US\$110 million in aid to help reduce deforestation. Protecting forests from agricultural expansion will significantly reduce emissions. Profits will be lower, but the reputation of the palm oil industry will be improved and its long-term future made more secure.
- 4 More than 50 multinational companies (MNCs) which use palm oil in their products have pledged to ensure that their suppliers do not contribute to deforestation. Pressure from the MNCs is encouraging Indonesian producers to use natural resources more sustainably.

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(Question 2 continued)

Text F — Small-scale farmers and the Indonesian Sustainable Palm Oil (ISPO) certificate

- 1** Small-scale farmers manage approximately 40 % of Indonesian plantations, but produce only 30 % of Indonesia’s palm oil, because of poor farming techniques, low quality seeds, and a weak banking system, which limits their access to finance. In addition, land disputes occur due to a lack of **property rights**. To make up for their low productivity, farmers sometimes illegally clear more land for planting.
- 2** The Indonesian Sustainable Palm Oil (ISPO) certification system requires that palm oil producers only occupy land legally, that they do not plant in areas designated as forest, and that they use sustainable agricultural practices. Initially, only large plantations had to get certification. However, the system was extended in 2020 and now small-scale farmers also have to obtain certification. Participating in the system should improve the productivity of small-scale farmers and reduce deforestation.

Table 3: Economic data for Indonesia

	2010	2019
GDP (real growth rate, %)	6.22	5.02
GDP per capita (US\$ PPP)	8506	12 312
Budget deficit (rupiah, billion)	98 010	296 000
Balance of trade in goods (US\$, million)	31 003	3508
Current account balance (US\$, million)	5144	-30 279
Palm-oil production (million tonnes)	21.80	47.12

Table 4: Development data for Indonesia

	2010	2019
Population (million)	242	271
Percentage of population with income below US\$1.90 a day (2011 PPP)	13.3	2.7
Gini coefficient	0.364	0.382

Table 5: National income statistics for Indonesia

	2019
GDP (US\$, billion)	1119
Gross national income (US\$, billion)	1085

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(Question 2 continued)

- (a) (i) Define the term *profit* indicated in bold in the text (**Text D**, paragraph **2**). [2]
 - (ii) Define the term *property rights* indicated in bold in the text (**Text F**, paragraph **1**). [2]
 - (b) (i) Using information from **Table 5**, calculate net factor income from abroad (in US\$) for Indonesia in 2019. [2]
 - (ii) Sketch an AD/AS diagram, showing how the change in the balance of trade in goods from 2010 to 2019 is likely to have affected real GDP (**Table 3**). [3]
 - (c) Using a demand and supply diagram, explain the effect of a subsidy on the market for palm oil based biodiesel (**Text D**, paragraph **3**). [4]
 - (d) Using an exchange rate diagram, explain how a rise in palm oil prices may cause an appreciation of the Indonesian rupiah (**Text D**, paragraph **4**). [4]
 - (e) Using an international trade diagram, explain the effect of the EU tariff on the imports of palm oil based biodiesel from Indonesia (**Text D**, paragraph **5**). [4]
 - (f) Using a Lorenz curve diagram, explain how the distribution of income changed in Indonesia between 2010 and 2019 (**Table 4**). [4]
 - (g) Using information from the texts/data and your knowledge of economics, discuss whether there is a conflict between meeting Sustainable Development Goal 12 (responsible consumption and production) and the objective of economic growth in Indonesia. [15]
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References:

- Text B** Chatzky, A., McBride, J., Sergie, M.A., 2020. *NAFTA and the USMCA: Weighing the Impact of North American Trade* [online] Available at: <https://www.cfr.org/backgrounder/naftas-economic-impact> [Accessed 14 March 2022] Reprinted with permission. For more analysis and backgrounders on NAFTA and foreign policy, visit CFR.org.
- Text C** Melloh, C., The Borgen Project, 2021. *Expanding financial access in Mexico* [online] Available at: <https://borgenproject.org/expanding-financial-access-in-mexico/> [Accessed 14 March 2022] Source adapted.
- Table 1** World Bank Data Bank, World Development Indicators, n.d. [online] Available at: <https://databank.worldbank.org/source/world-development-indicators> [Accessed 14 March 2022] Source adapted.
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- Text D** The World Bank, 2021. *Indonesia Economic Prospects : Boosting the Recovery* [online] Available at: [https:// documents.worldbank.org/en/publication/documents-reports/documentdetail/379141623773793892/ indonesia- economic-prospects-june-2021](https://documents.worldbank.org/en/publication/documents-reports/documentdetail/379141623773793892/indonesia-economic-prospects-june-2021) [Accessed 14 March 2022] License: CC BY 3.0 IGO.
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- Table 3** World Bank Data Bank, World Development Indicators, n.d. [online] Available at: [https://databank.worldbank.org/ source/world-development-indicators](https://databank.worldbank.org/source/world-development-indicators) [Accessed 14 March 2022] Source adapted.
- Table 4** World Bank Data Bank, World Development Indicators, n.d. [online] Available at: [https://databank.worldbank.org/ source/world-development-indicators](https://databank.worldbank.org/source/world-development-indicators) [Accessed 14 March 2022] Source adapted.
- Table 5** World Bank Data Bank, World Development Indicators, n.d. [online] Available at: [https://databank.worldbank.org/ source/world-development-indicators](https://databank.worldbank.org/source/world-development-indicators) [Accessed 14 March 2022] Source adapted.

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