

372/01

ECONOMICS – EC2

P.M. FRIDAY, 9 June 2006

(1 hour)

ADDITIONAL MATERIALS

In addition to this examination paper, you will need an 8 page answer book.

INSTRUCTIONS TO CANDIDATES

This paper contains **one** compulsory question.

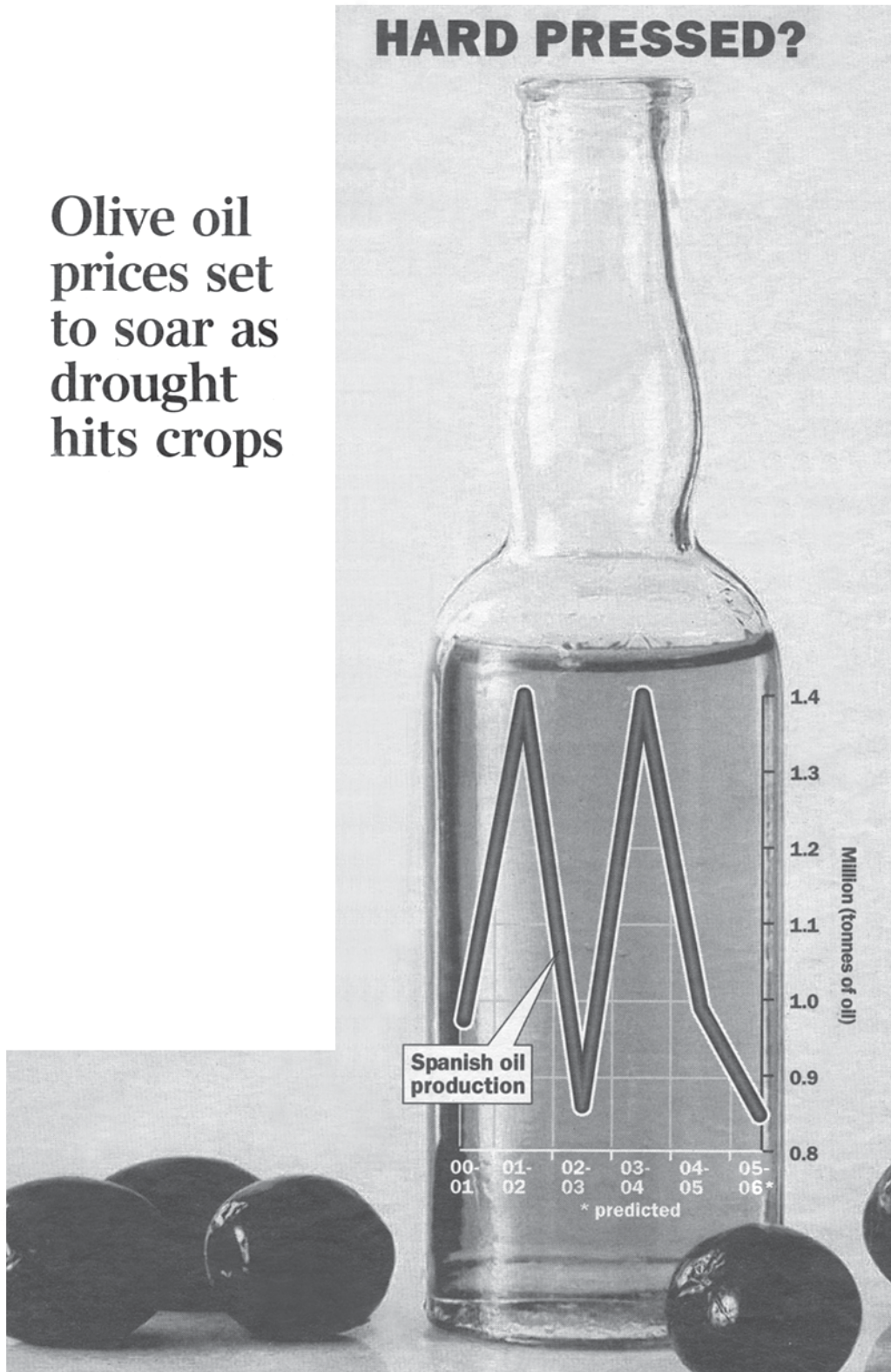
INFORMATION FOR CANDIDATES

The number of marks is given in brackets at the end of each question.

You are reminded of the necessity for good written communication and orderly presentation in your answers.

Study the information on pages 2 and 3 and then answer the questions that follow.

Olive oil prices set to soar as drought hits crops



A scorching drought in Spain has sent olive oil prices climbing as farmers in the world's top producing country estimate that this year's harvest could fall by almost 30%. Olive oil has been quoted at 3,000 euros a ton (\$3,643), some 20% above the price of a year ago as the combined effects of frost and now drought ravage the crop.

- 5 “Consumers won't pay those prices... Everything has a limit,” said Oscar Lopez, a market administrator of an olive oil exchange. Traders reckon that when prices reach three to five times sunflower oil prices, consumers start switching to the cheaper substitute.

To date this has not happened with demand very strong, partly because olive oil bottlers want to keep large stocks as there is so much uncertainty in the market. In addition, consumers appreciate the health
10 benefits of the product in their diet. The olive oil industry estimates that people consume more olive oil each year. The market is very strong, according to industry analysts, with ever increasing demand.

Olives are grown on unirrigated land and so rely on the elements for water. This year rainfall in Spain reached its lowest level since records began in 1947. Last winter frosts destroyed about 4% of the crop, and although some of the trees have been replanted they will not bear fruit for at least five years.
15 Spain consumes about 600 000 tons of olive oil and exports the rest, mainly to Italy. Italy is the world's number two producer, followed by Greece.

The European Union (EU) provides financial support to olive oil producers but new reforms were introduced in 2004. The EU's Common Agricultural Policy (CAP) is introducing a payment to farmers that breaks the link between the amounts paid to olive oil producers and their level of production.
20 Other policies that could have been considered include a buffer stock scheme operated by the three major EU producers or the CAP. However, the EU is under pressure from the World Trade Organisation (WTO) to reduce guaranteed prices and export subsidies in order to bring EU agricultural prices closer to those prevailing in world markets.

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- (a) Define price elasticity of supply and using the data comment on the price elasticity of supply of olive oil production. [6]
- (b) With the aid of a diagram, explain how changing demand and supply conditions caused olive oil prices to rise in 2004. [8]
- (c) How might a fall in the production of olive oil affect the Spanish economy? [8]
- (d) Comment on the cross elasticity of demand relationship between olive oil and sunflower oil. [6]
- (e) Using the data, discuss the view that the European Union should leave the price and production of olive oil to the free market rather than setting guaranteed minimum prices. [12]