THIS IS A LEGACY SPECIFICATION

OCR
RECOGNISING ACHIEVEMENT

ADVANCED GCE

ECONOMICS

Economics in a European Context

2888

Candidates answer on the Answer Booklet

OCR Supplied Materials:
- 16 page Answer Booklet

Other Materials Required:
None

Friday 29 January 2010
Afternoon

Duration: 1 hour 45 minutes

INSTRUCTIONS TO CANDIDATES

- Write your name clearly in capital letters, your Centre Number and Candidate Number in the spaces provided on the Answer Booklet.
- Use black ink. Pencil may be used for graphs and diagrams only.
- Read each question carefully and make sure that you know what you have to do before starting your answer.
- Answer **all** the questions.
- A copy of the pre-issued stimulus material is included in the question paper. You must **not** bring your original copy into the examination.
- Do **not** write in the bar codes.

INFORMATION FOR CANDIDATES

- The number of marks is given in brackets **[ ]** at the end of each question or part question.
- You will be assessed on the quality of your written communication. All answers should be in continuous prose.
- This is the synoptic paper. You will, therefore, gain credit for demonstrating in your answers how individual aspects of the subject can be used to explain and evaluate economic issues and problems raised by the stimulus material.
- The total number of marks for this paper is **60**.
- This document consists of **12** pages. Any blank pages are indicated.

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Answer **all** questions.

1 **(a)** Using the data in Extract 1, compare:

- Slovakia's economic growth rate with that of the euro area over the period 2004 – 2008;
- the change in Slovakia's employment with that of Ireland over the period 2004 – 2008. **[6]**

(b) Analyse the circumstances in which rapid economic growth, such as that experienced in Slovakia in 2007, might **not** create inflationary pressures. **[9]**

2 Comment on the market failures which might arise from greater reliance on the private sector to finance and provide healthcare in Slovakia. **[10]**

3 Comment on the reasons why Slovakia has attracted increased foreign direct investment since it joined the EU in 2004. **[15]**

4 Discuss the likely benefits for the Slovakian economy of membership of the euro area. **[20]**

Slovakia: 'shining star' of Central and Eastern Europe

Introduction

Slovakia was one of eight former command economies in Central and Eastern Europe which joined the European Union (EU) on 1 May 2004. In the four years since it joined the EU, its economic performance has earned it the reputation of the 'shining star' of Central and Eastern Europe. In 2007, its nominal GDP was US$75 billion, and its GDP per capita was US$13 766 (41% of the average of the EU) – both were much higher than when it joined the EU. Adjusting for differences in purchasing power, Slovakia's GDP per capita at purchasing power parity increased by 50% from 2004 to 2007 or from barely 50% of the EU average to 62%.

Slovakia's rapid and sustained economic growth has led some commentators to make comparisons to Ireland's experience of EU membership. The comparison, however, does not do justice to Slovakia's spectacular economic performance. High rates of economic growth in Slovakia had been achieved without increases in the rate of inflation until recently. Its track record on reducing inflation was impressive up to the third quarter of 2007 when external inflationary pressures caused its inflation rate to rise above 4%, in common with many other economies in the EU.

There are many explanations for Slovakia's impressive growth performance. Slovakia has benefited from reforms of its economy which have increased work and investment incentives. These reforms have involved deregulation and privatisation, most of which have improved economic efficiency. Not all reforms have been popular. For example, there are concerns that the movement away from state finance and provision of healthcare has resulted in a number of market failures. Nevertheless, there can be no doubt that the reformed economy is an attractive one to foreign investors for a number of reasons. This resulting increase in foreign direct investment is considered by many as an important underpinning of Slovakia's strong macroeconomic performance.

So strong has been this performance and Slovakia's convergence with the economies of the euro area that the EU has deemed it fit for Slovakia to adopt the EU's single currency on 1 January 2009. Time will tell whether this will provide further benefits to the economy of Slovakia and allow the star of Central and Eastern Europe to continue to shine forth.

Pre-issued stimulus material

Extract 1 **Selected macroeconomic indicators for Slovakia, Ireland and the euro area**
Eurostat, European Commission.

Extract 2 **Slovakia's growth performance in 2007**
adapted from Shining star, the Economist, 18 February 2008.

Extract 3 **Healthcare reforms in Slovakia**

Extract 4 **Foreign investment in Slovakia**
adapted from Slovakia's economy enjoys EU boom,
Tamsin Smith, BBC News, 2 May 2005.

Extract 5 **Slovakia gets the go ahead for membership of the EU's single currency**

Extract 1

Selected macroeconomic indicators for Slovakia, Ireland and the euro area

Fig 1.1 Annualised GDP growth in Slovakia, Ireland and the euro area

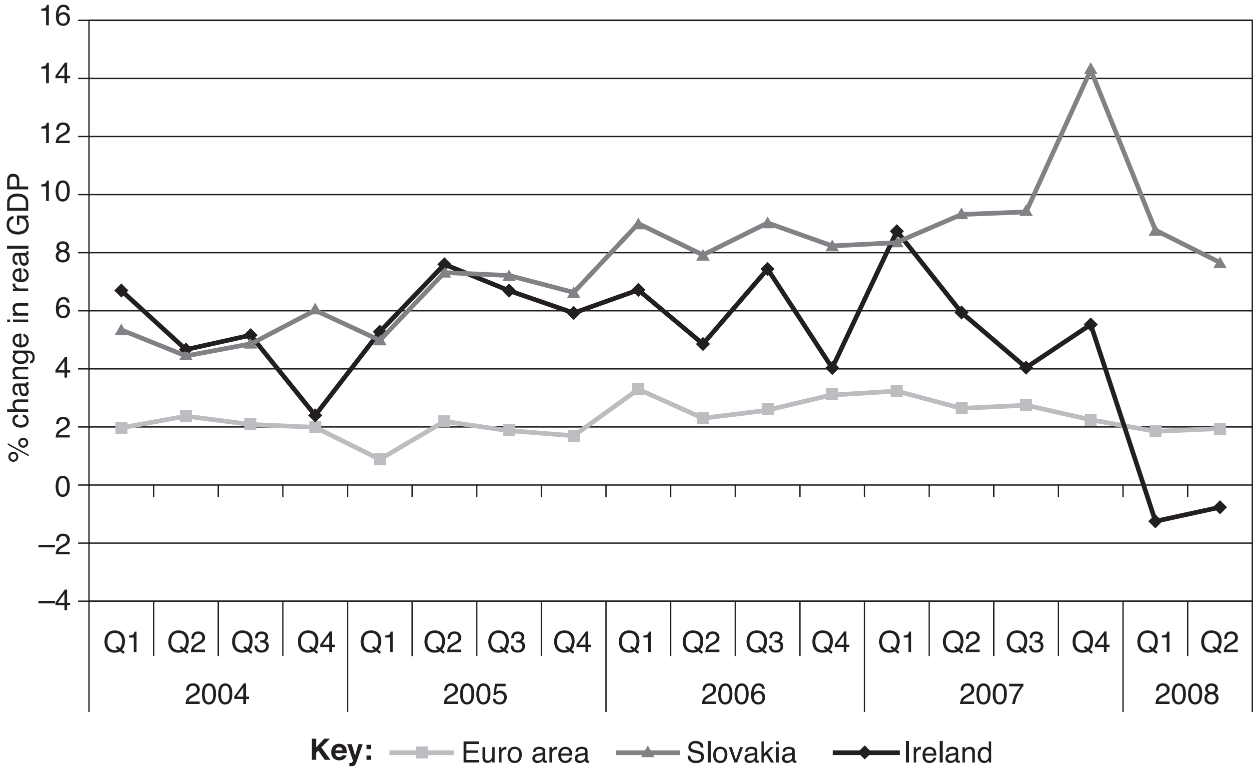


Fig 1.2 Annualised growth in investment in real terms in Slovakia, Ireland and the euro area

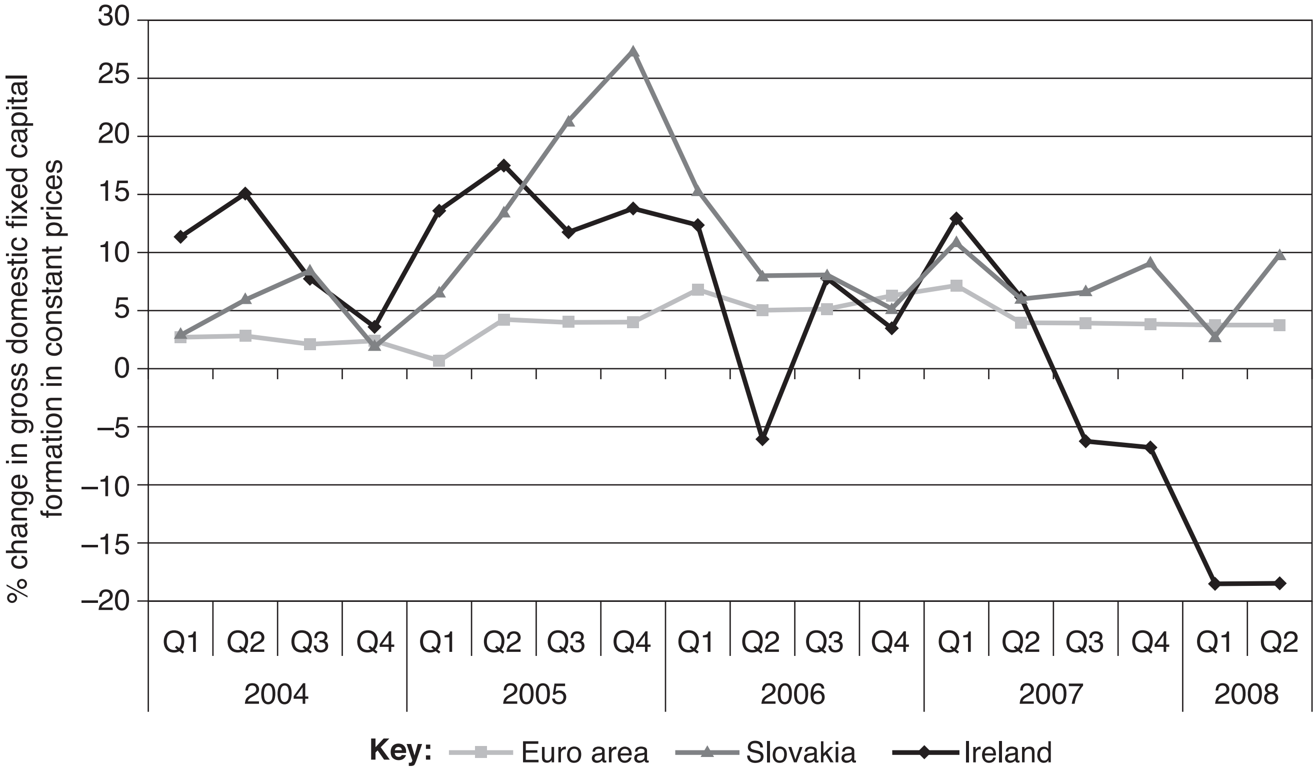
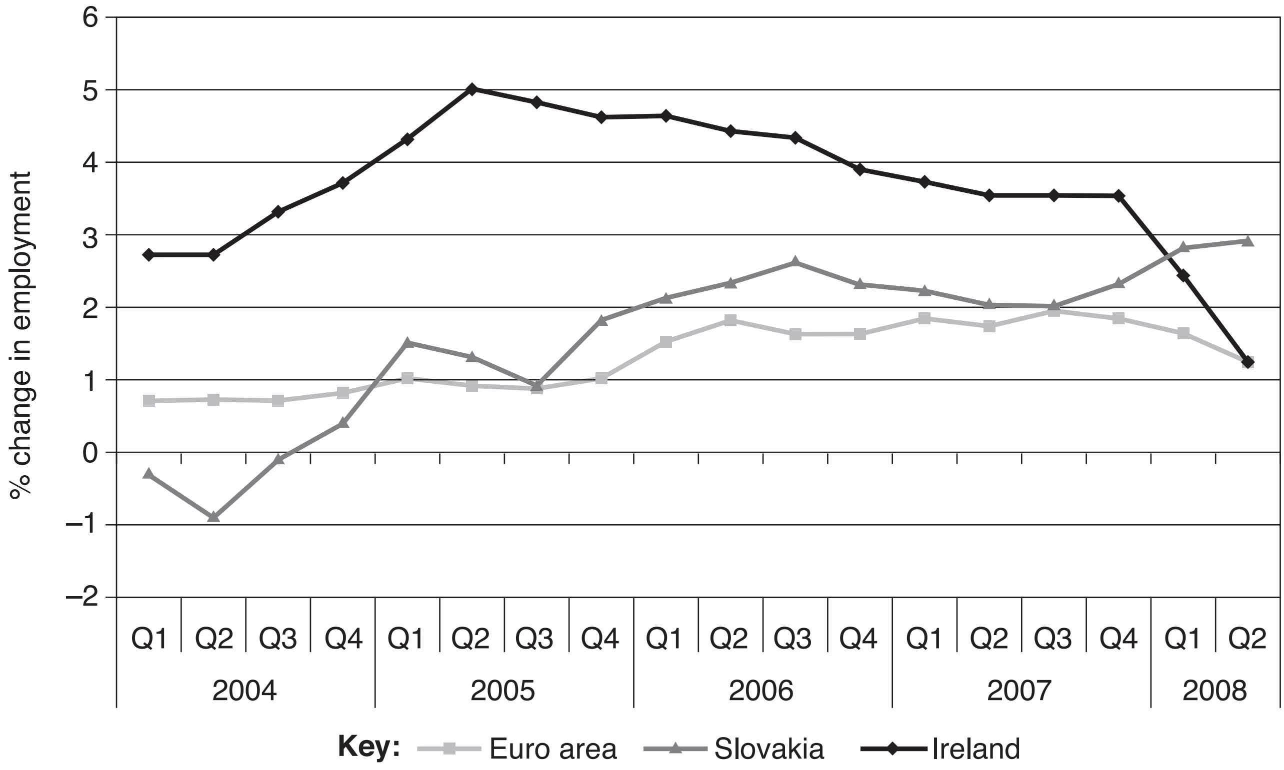


Fig 1.3 Annualised growth in employment in Slovakia, Ireland and euro area



Extract 2

Slovakia's growth performance in 2007

The Slovak economy grew by an astonishing 14.1% in the fourth quarter of 2007, pushing annual growth into double digits. The fourth-quarter result, announced in an estimate by the Slovak Statistical Office on February 14th 2008, was surprising in several respects. First, it was far in excess of the 9.4% year-on-year growth rates seen in each of the two previous quarters. As a result, GDP growth for the full-year is projected at 10.5%. Second, most economies in the EU experienced a growth slowdown in the fourth quarter; Slovakia, by contrast, has experienced a robust expansion—and its growth rate was already far above that of Western Europe and just about all of the new Central and Eastern European members.

Slovakia's rapid economic growth is mostly due to growth in value-added in industrial output, principally from the export-oriented automotive sector. Kia Motors, PSA Peugeot Citroen and Volkswagen all registered strong performances, as did their component suppliers and electronics manufacturers Sony and Samsung.

The final positive aspect of the latest performance is that there is no sign of overheating in the economy, although it will only be possible to state this with full confidence once an exact breakdown of the data becomes available. Consumer demand is growing strongly, at 6–7%, but this is not worrying in the Slovak context; crucially, it is lower than the headline GDP growth rate. For as long as Slovakia continues to have its economic growth driven by investment and industrial expansion (mainly with an eye on foreign markets), there is little ground for concern. Inflation is rising but, at an annual rate of 3.8% in January, it remains in line with the rates seen in much of Western Europe.

Looking ahead, however, there are signs of a slowdown, with GDP forecast to grow by 7% this year. With a lower contribution from net exports, GDP growth will weaken in 2008; real wage growth will cool a little too, while government spending will rise only moderately as the government strives to meet the Maastricht fiscal criterion. Investment will continue to grow at around the same pace as in 2006–07, but the overall impact will be to dampen GDP growth. However, at a forecast level of 7% this will keep Slovakia as one of the EU and Central and Eastern Europe's star performers.

Extract 3

Healthcare reforms in Slovakia

Since 2003, Slovakia has introduced major reforms in order to improve economic efficiency in all sectors of its economy by increasing the incentives to work and invest. These reforms include the privatisation of most of its state-owned enterprises, the creation of a more flexible labour market and reforms to its system of social benefits and pensions. The result has been a significant reduction in the government's budget deficit and national debt.

These reforms have not always proved popular amongst the people of Slovakia. The reforms have included:

- a reduction in social benefits;
- increases in the retirement age;
- a reduction in state provision of healthcare;
- a greater reliance on the private sector to finance and provide healthcare.

Prior to 2003, healthcare in Slovakia was largely financed and provided by the state. This created a burden on public expenditure as the debts of state hospitals and clinics were increasing every year by around 0.7% of GDP. Since 2003, the system has gradually been transformed. Healthcare is now provided by private companies and financed by private healthcare insurance. This has introduced the profit motive into healthcare and incentives to produce better services at lower cost. However, it is not clear that the overall economic efficiency of the Slovakian healthcare system has been improved because of the impact of a range of market failures associated with private finance and provision in this sector of the economy.

Extract 4

Foreign investment in Slovakia

Slovakia has been attracting investment from big business and spending from foreign day-trippers and stag night revellers since joining the EU. The cobbled streets and fountain-lined squares of Bratislava's old town have always charmed the tourists. But now Slovakia's capital is gleaming with foreign investment. It has become the eastern European darling of the multinationals – foreign investment totalled €2.2bn in 2005, twice the amount attracted in 2003 (the year before it joined the EU).

According to the World Bank, Slovakia had one of the fastest changing business environments in the world last year. Comparisons have been made with Ireland's economic transformation in the 1990s. Low labour costs, low taxes and economic stability make Slovakia one of the most attractive economies in Europe. Last year, the government replaced its income, corporate and sales taxes with a 19% flat tax rate which is now eyed enviously by some Western countries including Austria and Germany. The biggest investments in Slovakia have been in the automotive sector. Fifty kilometres outside Bratislava, a vast car manufacturing plant for Peugeot-Citroen has sprung up in less than a year. Huge flat-roofed white buildings now cover an area that used to be grassy countryside. The diggers are still hard at work, but soon Peugeot-Citroen, Kia Motors, Ford and Hyundai will be manufacturing cars alongside Volkswagen. By 2008, Slovakia is expected to produce more cars per head than any other country in the world – and it's not just car manufacturers who are coming to the country. Other foreign direct investment (FDI) is concentrated in the banking sector and companies such as Tesco have invested in the retail sector.

There is, however, little of this kind of investment outside the capital. The east of Slovakia still has poor infrastructure and unemployment reaching 20%. Even in Bratislava, there is limited enthusiasm for the nation's new economic stardom.

"Not much has changed for me," says Petra. "I guess it's easier to travel and get credit cards, but that's about it. Oh yes... we have some nice EU flags on our buildings now!"

"I think the real changes and economic benefits will come about when we join the euro," says Nadia, a banker.

Western European visitors to Bratislava seem more impressed. There are Austrians getting hair cuts in salons here, making a quick day's shopping trip over the border. And it seems that Bratislava is now on the map for the British stag night. "This is much better than Prague," says Tony Jeffreys, from Suffolk. "We hadn't really thought of it before, but it's now easy to get here, and it's part of the EU, isn't it?"

Extract 5

Slovakia gets the go ahead for membership of the EU's single currency

A report by the European Commission in May 2008 concluded that Slovakia was ready to adopt the euro. The country had met all the criteria in full and its recent economic performance had shown that:

- since August 2007, it had a rate of inflation which was below the average of the three EU member states with the lowest rate of inflation, and that this was set to continue into the future;
- the country's currency, the koruna, had successfully participated in the EU's Exchange Rate Mechanism since 2005 and had kept within the permitted band of fluctuation without devaluation;
- Slovakia's long-term interest rates had fallen and had converged with that of the euro area;
- Slovakia's excessive budget deficit of 2004 had been successfully reduced to under 3% of GDP and national debt stood at under 30% of GDP.

As a result of Slovakia meeting the Maastricht Convergence Criteria and its recent strong and stable economic performance, EU Finance Ministers gave the go-ahead for Slovakia to join the euro on 1 January 2009. The conversion rate to the euro was set at 30.126 koruna, which some have said might make it difficult for Slovakia to maintain downward pressure on inflation. The Slovakian government had called for a higher conversion rate in order to keep inflation low. Slovakia's Prime Minister, Robert Fico, had broadly welcomed the prospects for membership of the euro in 2007 in a speech to the European parliament. He warned, however, of the risk of a jump in consumer prices as had been experienced when Slovenia joined the euro in 2007.