ECONOMICS
HIGHER LEVEL
PAPER 3

Wednesday 8 November 2006 (morning)

2 hours

INSTRUCTIONS TO CANDIDATES

- Do not open this examination paper until instructed to do so.
- Answer three questions.
- Use fully labelled diagrams and references to the text / data where appropriate.

1. *Study the extract below and answer the questions that follow.*

The True Cost of Flying

❶ Flights by subsidized airlines in Europe are endangering the global climate and the ozone layer. They fly free of environmental regulations. The European boom in "low-cost" airlines, encouraged by tax incentives, is increasing the level of poisonous gases in the atmosphere, causing **negative externalities**. It is also lowering the demand for train travel, which is less polluting and a more efficient substitute.

❷ The number of these airlines has grown significantly in recent years in the United States and Europe. In Germany alone there are more than 10 commercial airlines that offer flights at very low prices between the country's major cities and tourist destinations in France and Spain.

❸ European airlines can charge low airfares because national governments do not tax jet fuel, the only tax-free fuel in the world. In addition, commercial aviation does not have to pay the value-added tax (indirect tax) that is applied to all other commercial transactions.

❹ As well, the local governments in Europe excuse the "low-cost" airlines from other taxes in order to attract them to their smaller airports. This policy has led to the modernization of tiny airports in a number of cities.

❺ Furthermore, train travel, a good alternative for trips within Europe, is suffering as a result of this form of "unfair competition", because the airlines are often selling services below cost.

❻ The burning of jet fuel releases greenhouse gases that contribute to global warming and the process of climate change. The Britain-based environmental group Tourism Concern predicts that by 2015, half of the annual destruction of the ozone layer will be caused by commercial air traffic.

❼ The only international instrument for reducing greenhouse gas emissions, the Kyoto Protocol, which issues **tradeable permits**, does not include emissions from international aviation. It is very difficult to introduce the problem of commercial aviation emissions into international treaties, since the governments are influenced by the (aeronautics) industry.

❽ The advertising suggests that we can all fly around the world almost free and without problems. But it is time that we face the consequences and take action: we must reduce aviation.

[Source: adapted from *Tierramérica News Service (IPS)*, December 2004]

(This question continues on the following page)

(Question 1 continued)

(a) Define the following terms indicated in bold in the text:

(i) negative externalities (*paragraph* ❶) *[2 marks]*

(ii) tradeable permits (*paragraph* ❼). *[2 marks]*

(b) Using an appropriate diagram, explain how travelling by commercial airlines may be a source of market failure. *[4 marks]*

(c) Using an appropriate diagram, explain how the tax-free fuel allows commercial airlines to earn more profits. *[4 marks]*

(d) Using information from the text and your knowledge of economics, evaluate **two** possible solutions to the environment problems caused by commercial airline travel in the article. *[8 marks]*

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

The Czech Republic

The Czech Republic's economy grew at a healthy pace last year. The OECD*, in its latest report on the country, forecasts **GDP** growth of 3.9 % in 2004 and 4.2 % in 2005, both above the country's long-run trend rate. The **current account deficit**, however, remains one of the world's highest at 6.2 % of GDP last year. The economy faces other challenges. Government spending is rising, creating a big budget deficit and the need for higher taxes. The country must also make its labour market more flexible in order to ease some of the problems relating to rising unemployment.

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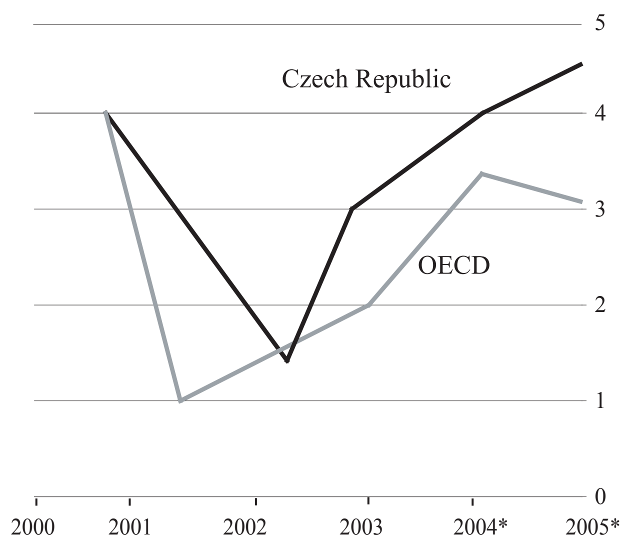
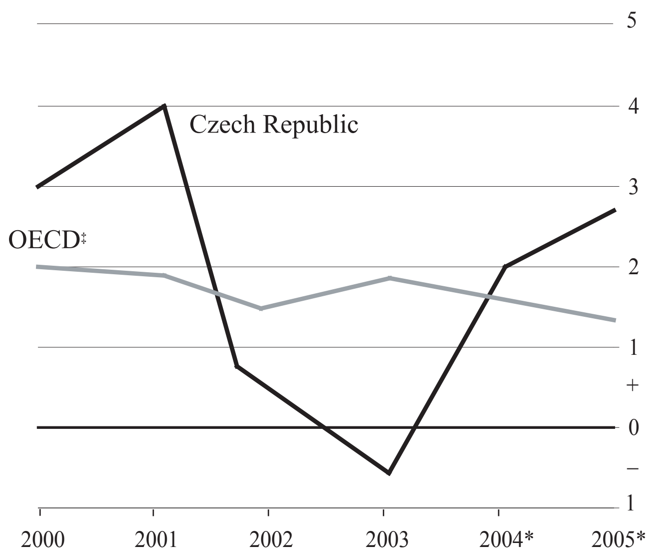
* OECD is the Organization for Economic Cooperation and Development (formed 1960). The members are the EU countries, USA, Canada, Japan, New Zealand, Australia, Mexico, South Korea, Norway, Switzerland and Turkey.

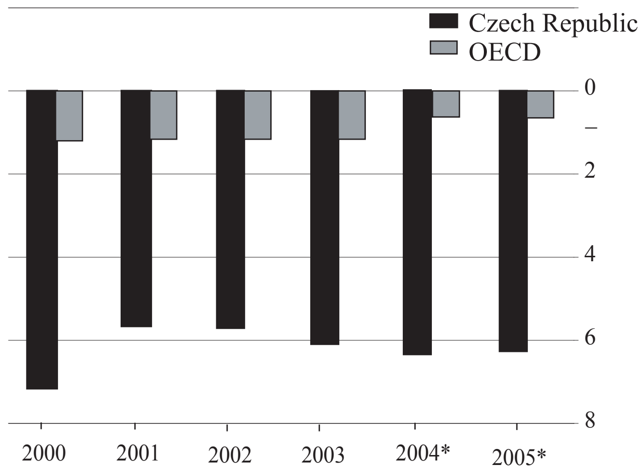
GDP
% increase on a year earlier



Consumer prices†
% change on a year earlier



Current account balance
% of GDP



* Forecast † Private-consumption deflator ‡ Excluding Hungary, Mexico, Poland and Turkey

[Source: adapted from *The Economist*, November 2004

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(Question 2 continued)

(a) Define the following terms indicated in bold in the text:

(i) GDP *[2 marks]*

(ii) current account deficit. *[2 marks]*

(b) Using an appropriate diagram, explain how making the labour market more flexible may "ease some of the problems relating to rising unemployment" *(text)*. *[4 marks]*

(c) Using an AD/AS diagram, explain **one** possible reason why Czech consumer prices might have risen since 2003. *[4 marks]*

(d) Using information from the text and your knowledge of economics, evaluate **two** possible measures that could be adopted by the Czech government to reduce the current account deficit. *[8 marks]*

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

US is urged to stabilize the dollar

❶ Top officials from Germany and France tried to put pressure on the United States, Asia and even Europe, to act to restore balance to global currency markets and support the US dollar, which has been falling in value.

❷ While the finance ministers of Germany and France stated Europe's view that the United States must make a determined effort to reduce its huge budget and trade deficits, the ministers also acknowledged that other regions had a role to play.

❸ "Europe has to do more for growth and Asia must do more for the flexibility of its currencies," they said at a meeting of French and German finance officials in Paris.

❹ A stronger economic expansion in Europe would attract more American exports, helping to reduce the American trade gap. Eliminating **managed exchange rates** in Asia, and notably China, would redistribute the economic impact of the weak dollar, which so far has mainly affected the euro. European firms are concerned about the falling international competitiveness of their products.

❺ At the same time, the finance ministers played down suggestions that the "Group of 7*" finance ministers and central bankers might be preparing extreme measures to support the dollar, like massive intervention in currency markets.

❻ Instead, the officials are likely to stick to previous statements that economic restructuring, like deficit reduction and structural reforms, are the most effective long-term approach to currency fluctuations.

❼ The comments came following a new report that central banks were reducing their reserves of dollars worldwide, putting the American currency under strong, downward pressure. The report stated that two-thirds of 56 central banks surveyed have reduced their dollar reserves and bought euros over the past two years, leading to an **appreciation** of the euro.

❽ The survey, conducted for Royal Bank of Scotland, found that central banks would continue to play a major role in currency markets through their accumulation of reserves, though the pace of buying and selling could diminish in coming years.

[Source: from an article in the *International Herald Tribune,* 25 January 2005, adapted to allow access for students to topics in the curriculum, and so that the language meets the needs of second-language learners]

* The "Group of 7" consists of France, the USA, Britain, Germany, Japan, Italy and Canada

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(Question 3 continued)

(a) Define the following terms indicated in bold in the text:

(i) managed exchange rates (*paragraph* ❹) *[2 marks]*

(ii) appreciation (*paragraph* ❼). *[2 marks]*

(b) Using an appropriate diagram, explain how the American economy could be affected by economic expansion in Europe. *[4 marks]*

(c) Using an appropriate diagram, explain how the actions of central banks have led to downward pressure on the US dollar. *[4 marks]*

(d) Using information from the text and your knowledge of economics, evaluate the possible consequences of the strengthening euro on the countries which use the euro. *[8 marks]*

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

How Europe's sugar regime is destroying livelihoods in the developing world

❶ European consumers and taxpayers are paying to destroy livelihoods in some of the world's poorest countries. Through the sugar regime of the Common Agricultural Policy (CAP), they are paying for a system that rewards a few sugar producers in Europe, while reducing markets and opportunities for farmers and agricultural labourers in the developing world.

❷ Quotas and high tariffs set Europe's sugar prices at almost three times world market levels. Each year, consumers and taxpayers pay €1.6 billion. And each year developing countries suffer the consequences of the resulting unfair trade practices. High guaranteed prices result in huge surpluses and Europe is **dumping** those surpluses overseas. This is only made possible by export subsidies.

❸ Europe should be importing sugar, but because of subsidies, the EU, one of the world's highest cost producers of sugar, is the world's biggest exporter of white sugar, accounting for 40 per cent of world exports last year.

❹ Developing countries are affected by Europe's sugar policies in four ways:

- high tariffs and import quotas prevent some of the world's poorest countries from gaining access to EU markets.
- because Europe dumps its excess production overseas, it prevents LDC exporters from entering foreign markets.
- a few developing countries receive valuable quota access to export their cane sugar to the EU. But even they can only export raw sugar, to be processed in the EU – so inhibiting the development of their own refining industries.
- the effect of European subsidies is that world prices are forced down – often to levels below the costs of production of even the lowest cost producers such as Malawi, Mozambique and Zambia. Such low prices have resulted in **deteriorating terms of trade** for LDC sugar exporters.

❺ As representatives of one of the world's richest and most powerful trading blocs, policy makers in Europe have responsibilities to developing countries. That includes a responsibility to make globalization work for the poor – to make trade fair. Maintaining the current sugar regime is a situation that, in the long run, is bad for both Europe and the developing world.

[Source: adapted from *Oxfam Briefing Paper 27*, August 2002]

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(Question 4 continued)

(a) Define the following terms indicated in bold in the text:

(i) dumping (*paragraph* ❷) *[2 marks]*

(ii) deteriorating terms of trade (*paragraph* ❹). *[2 marks]*

(b) Using an appropriate diagram, explain how the granting of subsidies to EU sugar producers will give them an advantage over other producers. *[4 marks]*

(c) Using a comparative advantage diagram, explain why, "Europe should be importing sugar" *(paragraph* ❸*)*. *[4 marks]*

(d) Using information from the text and your knowledge of economics, evaluate the statement that, "maintaining the current sugar regime is a situation that, in the long run, is bad for both Europe and the developing world" *(paragraph* ❺*)*. *[8 marks]*

5. *Study the extract below and answer the questions that follow.*

The Tiger in Front

❶ If it were not for two things, India's economic performance would seem remarkable. In 1991, India began to dismantle its import substitution policy, adopting an outward oriented strategy. Since then, the country has achieved average annual economic growth of 6 %. The proportion of people living below the poverty line, 50 % in 1978, fell to 25 % by 2000. Since 1991, average GDP per head (at purchasing power parity) has doubled. However, a significant proportion of the people are still poor and that is one of the things that make India's success less impressive. The number of poor people in India is more than 260 million and nearly half of its children under five are underweight. The World Bank estimates that 35 % of Indians live on less than $1 a day, compared to 17 % of Chinese.

❷ The second thing is China. Comparisons are unavoidable. The two countries are unique in each being home to more than one billion people, many of them poor. Other Asian successful countries, such as Singapore and Hong Kong, are relatively small places. China, however, proves that size is no obstacle to high growth. China has done better than India on almost every measure of economic growth and poverty reduction. India's growth rate of 6 % seems impressive, but then looks ordinary compared to China's growth rate of almost 10 %.

❸ China has received $500 billion in **foreign direct investment** since 1980: India has received less than a tenth of that. Indeed, India lacks **investment** of all kinds. India invests only about one quarter of GDP, whereas China's investment is about 40 %. The gap shows especially in infrastructure such as roads, sea ports and airports, and electricity supply. However, India and China still face similar challenges. Their primary economic problems are unemployment, regional inequality, and the poverty of farmers, who face very low prices, which tend to fluctuate a great deal.

❹ In the Human Development Index, China is 94th out of 177 countries, with a score of 0.745, whereas India, with 0.595, comes 127th. However, there has been a 36 % rise in the Indian index since 1980. In international trade, China leads the way. In 2004, China overtook Japan to become the world's third largest trader behind America and Germany. Although India's trade has been growing at up to 16 % per year, the increase in China's trade in 2004 was bigger than India's total foreign trade.

[Source: adapted from *The Economist,* March 2005

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(Question 5 continued)

(a) Define the following terms indicated in bold in the text:

(i) foreign direct investment (*paragraph* ❸) *[2 marks]*

(ii) investment (*paragraph* ❸). *[2 marks]*

(b) Explain how allowing for differences in purchasing power may give a more realistic value of the average GDP per head in India. *[4 marks]*

(c) Using an appropriate diagram, explain how the government could help to protect farmers against fluctuating prices. *[4 marks]*

(d) Using information from the text and your knowledge of economics, evaluate the effectiveness of adopting an outward oriented strategy to achieve economic development. *[8 marks]*