Diploma Programme
Programme du diplôme
Programa del Diploma

Economics
Standard level
Paper 2

Tuesday 5 May 2015 (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]**.

9 pages

2215 – 5113

Section A

Answer **one** question from this section.

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

Latvia to join the eurozone monetary union

❶ Latvia will become the 18th country to adopt the euro after being approved for membership by the European Commission. The country has met the criteria for eurozone membership, including low inflation, low long-term interest rates, a stable exchange rate, low public debt and low budget deficits.

❷ Latvia joined the European Union (EU) **customs union** in 2004. This resulted in a large increase in the availability of credit and strong economic growth in Latvia. However, the 2008 global financial crisis resulted in the collapse of one of its leading banks and massive economic instability. Economic output fell by about 20 % and Latvia had to accept a bailout (loans) from the International Monetary Fund (IMF) and the EU.

❸ Latvia kept the lat (the Latvian currency) pegged to the euro throughout the crisis. At the time, some economists argued that devaluation would have been a better way to improve the economy. However, Latvia followed the path of other countries such as Greece and Ireland, and chose to improve competitiveness through austerity measures. This involved increasing **direct taxes** and cutting government spending and public sector wages.

❹ By late 2010, the economy was growing again and Latvia had repaid the loans to the IMF and the EU. In 2012, the economy expanded by 5.6 %, the fastest of any country in the EU, although output was still 12 % below its pre-crisis peak. In addition unemployment was falling, but it remained high at 12.4 %.

❺ For Latvia, which shares a border with Russia, the attraction of the euro is about economics and security. Entering the eurozone in January 2014 is part of a process of shifting away from the influence of Russia, and following its northern neighbour Estonia which joined the eurozone in 2011. Lithuania hopes to join the eurozone in 2015.

❻ Public support for joining the eurozone has been low. Evidence from one survey suggests that a small majority of Latvia's population opposes membership, fearing that prices will rise and Latvians will be drawn into the problems facing Europe's struggling economies.

❼ Nonetheless, there are signs that support is growing. The Latvian prime minister said that "switching to the euro will help economic growth and bring increased foreign investment. Unlike countries that can afford to ignore the euro and additional integration, Latvia cannot easily stand on its own. This is good news, not only for Latvia, but also for the eurozone. It shows that there is still confidence in the single currency".

[Source: adapted from www.reuters.com, 5 June 2013; http://online.wsj.com, 9 July 2013 and www.theguardian.com, 16 July 2013]

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(Question 1 continued)

(a) (i) Define the term *customs union* indicated in bold in the text (paragraph ❷). [2]

(ii) Define the term *direct taxes* indicated in bold in the text (paragraph ❸). [2]

(b) Using an AD/AS diagram, explain how devaluation of the lat (the Latvian currency) might have been used to improve the Latvian economy during the financial crisis (paragraph ❸). [4]

(c) Using a production possibilities curve (PPC) diagram, explain the change in Latvia's economy from 2008 to 2012 (paragraphs ❷ and ❹). [4]

(d) Using information from the text/data and your knowledge of economics, evaluate the possible impact of Latvia joining the eurozone. [8]

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

Brazil's currency slides to new low

❶ In August 2013, the **exchange rate** of Brazil's currency, the real, fell to its lowest level against the United States dollar (US$) since February 2009 because of the poor performance of its economy. This fall is expected to continue, at least in the short term.

❷ Much of the weakness of the real is due to the possibility that the US central bank may soon start to reverse its easy monetary policy as a result of increased growth in the US. There is speculation that the US interest rate might rise at some point in the future. The consequence of this is that money is leaving developing economies such as Brazil.

❸ Brazil's central bank tried to fight the outflows by raising interest rates three times in 2013 to a high of 9% and injecting US$7.6 billion into the foreign exchange market in one week. Even with such interventions, the value of the real was down by more than 10%. The central bank defends its actions, saying that its interventions prevented even larger falls in the value of the currency.

❹ A weaker currency poses additional problems for the central bank in the form of imported inflation. The speed of the real's decline creates problems for companies, which struggle to make plans when they do not know where the currency will be in the future.

❺ In contrast, the finance minister sees a possible advantage to a weaker currency. "The new exchange rate makes Brazil more competitive," the minister told reporters after meeting with leading business people. He acknowledged, however, that the sudden swings in the currency "are not positive for the economy".

❻ Analysts say that the value of the real is unlikely to increase until the economic outlook improves. Forecasters expect economic growth to remain low at 2.2% in 2013. This is slightly up from the previous year, but much lower than the 7.5% growth in 2010. Brazil is also concerned about inflation, which is at an annual rate of 6.3%. This is near the top of the government's target range and is another reason why the central bank has raised interest rates.

❼ Brazil also moved from a US$9.9 billion trade surplus in 2012 to a US$5 billion trade deficit in 2013, contributing to the economy's problems. Brazil's **current account deficit** has increased significantly. The combination of these economic events presents difficult problems for policy makers.

[Source: adapted from http://online.wsj.com, 16 and 19 August 2013 and http://en.mercopress.com, 20 August 2013]

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(Question 2 continued)

(a) (i) Define the term *exchange rate* indicated in bold in the text (paragraph ❶). [2]

(ii) Define the term *current account deficit* indicated in bold in the text (paragraph ❼). [2]

(b) Using an exchange rate diagram, explain how the speculation that the US central bank may change its monetary policy has affected the value of the Brazilian real (paragraph ❷). [4]

(c) Using an AD/AS diagram, explain how the move from a trade surplus to a trade deficit could harm the Brazilian economy (paragraph ❼). [4]

(d) Using information from the text/data and your knowledge of economics, evaluate the possible consequences for the Brazilian economy of the fall in the value of the Brazilian real. [8]

Section B

Answer **one** question from this section.

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

Extract 1

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(Question 3 continued)

Extract 2

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Figure 1 – Selected economic data for Ivory Coast

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(a) (i) Define the term *entrepreneurship* indicated in bold in the text (paragraph ❹). [2]

(ii) Define the term *gross domestic product (GDP)* indicated in bold in the text (paragraph ❺). [2]

(b) Using a demand and supply diagram, explain the impact of a price floor on the market for cocoa in Ivory Coast (paragraph ❶). [4]

(c) Using information from **Extract 2**, explain how the servicing of debt has an opportunity cost that may affect development in Ivory Coast. [4]

(d) Using information from the text/data and your knowledge of economics, evaluate government intervention in promoting economic development in Ivory Coast. [8]

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

Equatorial Guinea

❶ Equatorial Guinea has the third largest reserve of oil in Africa, discovered in 2006. However, the country does not have a single oil refinery that can convert the oil into gasoline (petrol). The government has made agreements with multinational corporations (MNCs) from China and the United States (US) for unrefined oil to be exported in exchange for cash payments and loans. Other natural resources that have not yet been exploited include gold, zinc and diamonds. Beyond the oil sector, subsistence farming still dominates. The oil boom has led to inflationary pressures, with an average annual inflation rate of 6.1 % in the period 2003–2013.

❷ Equatorial Guinea is now the richest country in Africa in terms of per capita income. The World Bank estimate for **gross national income (GNI)** per capita at purchasing power parity (PPP) for 2012 was US$21 715; while a current estimate puts income per capita as high as US$33 600. When last profiled in 1995, income per capita was just US$330.

❸ Very little of the income goes towards economic development. It is true that roads now run deep into the interior of the country, and that there has been a recent surge in infrastructure investment, following the first phase of Horizon 2020, the government's National Development Plan. Nonetheless, the majority of Guineans still live without clean drinking water and sanitation, with continual power cuts, while average life expectancy stands at just 51 years – the eighth lowest in the world. Inequality is growing day by day.

❹ As the country moves into the second phase of the National Development Plan, the government is planning to redirect public investment from infrastructure towards the development of new economic sectors, such as fisheries, agriculture, tourism and finance.

❺ There is a lack of accurate economic data that makes it difficult to track progress on socioeconomic indicators. A World Bank public expenditure review carried out in 2010 recommended a reallocation of resources towards human development, especially education and health.

Figure 1 – Selected economic data for Equatorial Guinea – 2009 to 2012

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[Source: Text: "Equatorial Guinea, Country Profile", *New Internationalist*, July/August 2013 and *The World Bank Country Report*, http://www.worldbank.org/en/country/equatorialguinea/overview]

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(Question 4 continued)

(a) (i) Define the term *gross national income (GNI)* indicated in bold in the text (paragraph ❷). [2]

(ii) List **two** of the measures that make up the Human Development Index (Figure 1). [2]

(b) Using an AD/AS diagram, explain why “the oil boom has led to inflationary pressures” (paragraph ❶). [4]

(c) With reference to the text/data, explain **two** possible barriers to economic development in Equatorial Guinea. [4]

(d) Using information from the text/data and your knowledge of economics, evaluate the likely contribution of the oil export revenues as a means toward achieving economic growth and development in Equatorial Guinea. [8]