N15/3/ECONO/HP2/ENG/TZ0/XX

Diploma Programme
Programme du diplôme
Programa del Diploma

Economics
Higher level
Paper 2

Wednesday 4 November 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]**.

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Section A

Answer **one** question from this section.

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

Swiss current account surplus grows

❶ Switzerland recorded a current account surplus of 11 % of gross domestic product (GDP) in 2012. This was an increase from 9 % of GDP the year before.

❷ According to Switzerland's central bank, the Swiss National Bank (SNB), which released its balance of payments figures recently, this increase in the current account surplus was caused mainly by an increase in investment income, which nearly doubled to CHF40 billion.

❸ In terms of trade in goods and services, a surplus of CHF57 billion was recorded, compared with CHF59 billion in 2011. The decline was due to the fact that there was a 3 % increase in expenditure on imports of goods and services, but only a 2 % increase in the revenues from exports of goods and services.

❹ The Swiss financial account saw a net capital outflow of CHF97 billion – nearly three times the 2011 figure. This occurred after the SNB purchased large amounts of foreign exchange in an attempt to keep the Swiss franc from appreciating to damaging levels. The high level of the Swiss franc was a result of financial investors seeking safety in the Swiss franc, when severe problems in the eurozone created fears about the value and safety of the euro.

❺ The Swiss economy outperformed the eurozone in early 2013 as GDP in the eurozone shrank for a sixth straight quarter. This was largely caused by contracting economies in France, Italy, the Netherlands and Spain. The eurozone is now stuck in its longest recession on record.

❻ The Swiss economy performed better than expected in the first quarter of 2013, with GDP growth rising to 0.6 % as a result of strong levels of **consumption**, particularly in health and housing.

[Source: adapted from http://centralbanking.com, 15 August 2013; http://genevalunch.com, 15 August 2013 and http://futurecurrencyforecast.com, 31 July 2013]

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(Question 1 continued)

(a) (i) List **two** components of the financial account (paragraph ❹). [2]

(ii) Define the term *consumption* indicated in bold in the text (paragraph ❻). [2]

(b) Explain the difference between direct/portfolio investment and income from investment in the balance of payments. [4]

(c) Using an exchange rate diagram, explain how the problems in the eurozone impacted the Swiss franc (paragraph ❹). [4]

(d) Using information from the text/data and your knowledge of economics, discuss the consequences of a rising current account surplus. [8]

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

Gulf banks debating currency peg to US dollars

❶ Qatar's central bank suggests some Gulf States* should consider moving from a **fixed exchange rate**, with their currencies pegged to the US dollar, to a floating exchange rate system. Bankers and economists throughout the region are debating this issue.

❷ Qatar's central bank governor said the country planned no change to its peg to the dollar, with the exchange rate now fixed at QAR3.64/US$1. However, "with increasing integration in international trade, services, and asset markets, a higher degree of exchange rate flexibility may become more desirable" he said. Qatar is battling against higher rates of inflation in 2013. Inflation is at the highest level since 2009.

❸ Saudi Arabia and the United Arab Emirates (UAE) have pegged their currencies to the dollar for decades. They have been able to do this because their inflation rates have been low and stable, and they have had substantial oil export revenues giving them large reserves of foreign currency.

❹ As a result there has been no need to change official exchange rates, said the chief economist at National Bank of Abu Dhabi: "Fixing the currency gives stability and visibility for business contracts". There are good arguments for pegging the currency to the US dollar. However, it can result in imported inflation from other economies. In 2007, the US was cutting interest rates. This meant that, in order to maintain the fixed exchange rate, the UAE also had to cut its interest rates. This was at a time when the UAE was booming and experiencing high inflation.

❺ Currently there is no pressure on the pegged rate and if necessary a central bank can revalue or devalue its currency when required. It is commonly agreed that the best time to change a fixed currency regime is when there is no pressure.

❻ A senior economist at a commercial bank agrees that the UAE should consider dropping its currency peg to the US dollar and moving to a floating exchange rate for the dirham (the UAE currency). He says that the US dollar's weakness relative to other currencies was a positive stimulus for **economic growth**. However, growth in the UAE is already quite strong and so having its currency pegged to a weak currency could harm the economy by leading to higher inflation.

* Gulf States: include Bahrain, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates

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(Question 2 continued)

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

(ii) Define the term *economic growth* indicated in bold in the text (paragraph ❻). [2]

(b) Using an exchange rate diagram, explain how the United Arab Emirates (UAE) could maintain a fixed value of its dirham to the US dollar if there were upward pressure on the dirham. [4]

(c) Distinguish between a devaluation and a depreciation of a currency. [4]

(d) Using information from the text/data and your knowledge of economics, discuss the view that some Gulf States "should consider moving from a fixed exchange rate" to "a floating exchange rate system" (paragraph ❶). [8]

Section B

Answer **one** question from this section.

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

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(Question 3 continued)

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Figure 1 – Economic data for Botswana – 2011

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(a) (i) List **two** Millennium Development Goals **other than** universal primary education (paragraph ❹). [2]

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

(b) Using a production possibilities curve (PPC) diagram, explain the likely effect of the high HIV/AIDS rate on production possibilities in Botswana. [4]

(c) Using an AD/AS diagram, explain why inflation may fall as a result of "lower demand-side pressures" (paragraph ❻). [4]

(d) Using information from the text/data and your knowledge of economics, discuss the possible outcomes of a move away from government intervention and towards more market-oriented strategies in Botswana (paragraph ❽). [8]

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

Brazil government gives coffee farmers a lifeline

❶ Coffee prices in 2011 encouraged **investment** by Brazilian coffee farmers who increased the land devoted to coffee and spent heavily on new farming techniques and fertilizer. High prices also convinced farmers in Columbia to replant many coffee plantations with more productive coffee bushes. In 2012, good weather resulted in an unexpectedly large crop. As a result of these combined factors, the price of coffee beans has dropped sharply from more than US$1.50 per pound (lb) to less than US$0.30 per lb.

❷ To make matters worse for Brazilian growers, falling prices have been accompanied by rising costs; coffee is still largely picked by hand, and wages are rising fast in Brazil. Farmers who grow coffee beans tend to specialize in the production of coffee, and do not plant other crops. Diversification is the usual way for farmers to protect themselves from volatile prices. Sugar cane, which could be a potential alternative crop, also has low prices.

❸ The International Coffee Organization (ICO) has called for governments in coffee producing countries to offer support to their farmers. The ICO observes that farmers in many countries are facing coffee bean prices that are below their total costs of production. "The socio-economic importance of coffee as a key source of income, particularly in rural areas, means that every effort should be made by governments to support their farmers", the organization said.

❹ Comments from the ICO came just ahead of a Brazilian government announcement that it was going to provide support for Brazil's coffee growers by offering to buy up to 3 million bags of coffee at a price of BRL343 per bag. This is equivalent to around US$1.12 per lb. The offer, which sets a **price floor**, should provide temporary relief to farmers. The extra 3 million bags of coffee would bring government coffee stocks to their highest levels in more than a decade.

❺ The Brazilian president announced the support programme on a trip to Minas Gerais, Brazil's top coffee-producing state, in the following terms, "I was here in the region when I was a candidate for president in 2010 and I know how important the coffee producers are for the economy".

[Source: adapted from http://reuters.com, 7 August 2013; http://economist.com, 13 July 2013 and http://agrimoney.com, 7 August 2013]

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(Question 4 continued)

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

(ii) Define the term *price floor* indicated in bold in the text (paragraph ❹). [2]

(b) Using a demand and supply diagram explain, referring to the concept of price elasticity of demand, why there has been such a sharp drop in the price of coffee beans (paragraph ❶). [4]

(c) Using a diagram that shows a firm's short-run costs of production, explain why some farmers may still be able to produce even though they are in a situation where coffee bean prices are below their total costs of production (paragraph ❸). [4]

(d) Using information from the text/data and your knowledge of economics, discuss the likely impact of the Brazilian government's intervention in the coffee market on economic development in Brazil. [8]