Diploma Programme
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Economics
Higher level
Paper 2

Monday 10 May 2021 (morning)

45 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.
- Answer one question either from Section A or from Section B.
- Use fully labelled diagrams and references to the text/data where appropriate.
- The maximum mark for this examination paper is **[20 marks]**.

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Answer **one** question **either** from Section A **or** from Section B.

Section A

1. Study the following extract and data and answer the questions that follow.

Filipino rice farmers prepare for trade liberalization

❶ To meet its obligations under World Trade Organization (WTO) rules, the president of the Philippines has asked the government to eliminate the current quota system for rice imports. As an important part of food security measures, the government wants to achieve self-sufficiency in the production of rice. To support this goal, the WTO allowed the Philippines to extend its rice quota until June 2017 to allow more time for local farmers to prepare for **free trade**.

❷ The current quota system for rice imports makes domestic prices rise dramatically during periods of low domestic supply.

❸ Eliminating the quota on rice aims to make the rice market more competitive, which could reduce the price of rice by as much as 7 Philippine pesos (PH₱) per kilogram (kg). The National Economic and Development Authority has estimated that lower rice prices could save Filipino households as much as PH₱2362 per year. However, if the rice quota is eliminated, economists have warned that the government must prepare local rice producers so that they can either compete with rice imports or move to producing other crops. "Currently Filipino farmers cannot compete with Vietnamese farmers who may enjoy economies of scale" declared one economist. "The solution is to bring down the cost of production of rice."

❹ To help Filipino farmers to adjust to competition from lower-priced rice imports, the government has allocated funds to the Rice Competitiveness Enhancement Fund. This fund will provide support to farmers in order to increase productivity by supplying high-yield seeds and fertilizer. It will also provide subsidies to encourage the use of agricultural machinery and will offer support services and training to farmers.

❺ Apart from being an essential food for many Filipinos, rice is also an important input for the food industry. The plan to remove the import quota will reduce the inflation rate in the Philippines by up to 0.4 %. In July 2018, the central bank governor reported that inflation had reached 5.7 %, well above the government's target range of 2 % to 4 %. He stated that "supply-side factors are the main drivers of the present inflation. These factors include rising international oil prices, higher indirect taxes and poor weather conditions that have affected food supply". The president stated that the removal of the rice quota was one solution to ease the rising inflation.

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(Question 1 continued)

Table 1: Average economic costs and prices of rice in the Philippines and Vietnam

	Philippines	**Vietnam**
Average total cost per kg of rice	PH₱12.41	PH₱6.53
Price per kg of rice	PH₱12.19	PH₱9.64

(a) (i) State **two** functions of the World Trade Organization (WTO) (paragraph ❶). [2]

(ii) Define the term *free trade* indicated in bold in the text (paragraph ❶). [2]

(b) Using an AD/AS diagram, explain how removing “the import quota will reduce the inflation rate in the Philippines” (paragraph ❺). [4]

(c) Using a perfect competition diagram, explain whether farmers in the Philippines are making an economic profit or loss (Table 1). [4]

(d) Using information from the text/data and your knowledge of economics, evaluate the impact on the economy in the Philippines of removing the rice quota. [8]

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

Trade war with the United States puts pressure on China's currency

❶ As a trade war between the United States (US) and China worsens, a central bank official has said that China will not use its currency to deal with trade conflicts and will continue with the market-based reforms of its exchange rate system. In the past, the US has accused China of being a currency manipulator that has maintained a **fixed exchange rate** to keep the renminbi (RMB, China's currency) undervalued. According to a US trade official, "a depreciating currency is good for the Chinese economy".

❷ The value of the renminbi has fallen 9 % against the US dollar (US$) in the past six months. Expansionary domestic **monetary policy**, concerns about economic growth and an escalating trade war continue to put downward pressure on the renminbi. Allowing the value of the renminbi to fall suggests that the central bank is currently maintaining a managed exchange rate rather than a fixed peg to the US dollar.

❸ The cause of the lower value of the renminbi—aside from a slowdown in Chinese economic growth—is a shrinking current account surplus. The US has imposed tariffs on US$250 billion worth of Chinese imports. The US president has also threatened to impose tariffs on the remaining imports from China. This, along with a widening trade deficit in services, caused mainly by the rise in Chinese tourists travelling abroad, would further reduce China's current account surplus. In 2017, China's current account surplus was 1.6 % of gross domestic product (GDP). By the first quarter of 2018, the surplus became a small deficit.

❹ There is international concern about the potential damage that a prolonged trade war with the US could cause to the Chinese economy. Central bank officials in China are concerned about the depreciating currency but are trying to avoid central bank intervention. To support the export sector, the Chinese government is considering measures such as subsidies and exemptions from some indirect taxes. These measures, along with a falling renminbi will allow Chinese exporters to avoid passing on some of the tariff costs to US consumers.

❺ To complicate matters for China, economic growth in the US is causing US interest rates to rise and the US dollar to strengthen. This, along with China's first current account deficit in 20 years, is negatively affecting China's financial account. Responding to the rising US interest rates with increases of its own is not a good option for China's central bank, because Chinese companies have a heavy debt burden that is slowing economic growth. Recently, a government official advised against increasing China's interest rate because of its impact on borrowing costs in China.

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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 *monetary policy* indicated in bold in the text (paragraph ❷). [2]

(b) Using an exchange rate diagram, explain why the "widening trade deficit in services" could lead to a depreciation of the renminbi (paragraph ❸). [4]

(c) Using an AD/AS diagram, explain how "increasing China's interest rate" could affect its economic growth (paragraph ❺). [4]

(d) Using information from the text/data and your knowledge of economics, discuss the view that a depreciating currency is good for the Chinese economy. [8]

Section B

3. Study the following extract and answer the questions that follow.

Can the Democratic Republic of the Congo achieve its economic potential?

❶ The Democratic Republic of the Congo (DRC) is a nation of great potential. It has large mineral resources and an abundance of fertile land. The mining and export of cobalt, copper and gold are the main source of government revenue. However, the abundance of natural resources causes devastating conflicts as rebel groups fight for control of the DRC's resources. With a population of 80 million and **gross domestic product (GDP) per capita** of only US$457, the DRC is one of the world's poorest nations. It is ranked 176 in the world in terms of the Human Development Index (HDI).

❷ The government has been accused of relying too much on tariffs, but to improve living standards, the government needs revenue to spend on agriculture, electricity and roads. Furthermore, business owners in the DRC complain of corruption and increasing "red tape" (excessive regulations).

❸ The government believes that a strong agricultural sector could boost economic growth but only 10 % of the land is used for farming. Rice, maize and other crops grow well in the tropical climate and yet the government spends US$1 billion per year importing basic foods. According to a government spokesperson, the lack of infrastructure is a major barrier to the processing and transporting of agricultural products. The DRC's road network is so bad that farmers and traders often make a two-week trip in small boats down the Congo River to sell their produce. The DRC has just 27 877 kilometres (km) of roads. It is estimated that 90 000 km of national roads and 150 000 km of rural roads must be built.

❹ In addition, the World Bank reports that only 17 % of the DRC's population has access to electricity, despite the capacity of the Congo River to generate enough electricity to satisfy the needs of the region.

❺ To make matters worse, the regional conflicts have affected the availability of healthcare services. It is estimated that half of the health centres have been looted*, burnt or destroyed. Government expenditure on healthcare per capita remains one of the lowest in the world. Non-governmental organizations (NGOs) are relied on to protect the health and wellbeing of citizens. NGOs help to achieve this by distributing medicine and teaching families about hygiene and proper sanitation.

* looted: goods stolen from a place, typically during a war or riot

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(Question 3 continued)

(a) (i) Define the term *gross domestic product (GDP) per capita* indicated in bold in the text (paragraph ❶). [2]

(ii) List **two** components of the Human Development Index (HDI) (paragraph ❶). [2]

(b) Using an externalities diagram, explain the benefits of hygiene and sanitation education programmes (paragraph ❺). [4]

(c) Using a production possibilities curve (PPC) diagram, explain how the production possibilities (potential output) of the DRC might be affected if there were greater access to electricity (paragraph ❹). [4]

(d) Using information from the text/data and your knowledge of economics, evaluate the effectiveness of interventionist policies as a means of achieving economic development in the DRC. [8]

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

Economic development in Honduras and Guatemala

Honduras

❶ Honduras is a developing country in Central America. While historically dependent on the export of primary products, Honduras has more recently diversified its exports to include clothing and automobile components. Honduras' economy depends heavily on exports to the United States (US) and, to a lesser extent, on remittances (money sent by a foreign worker to their home country).

❷ In rural areas, approximately one out of five Hondurans lives in **absolute poverty**. The country is also vulnerable to external shocks and has experienced worsening terms of trade. Revenue earned by the agricultural sector has decreased by one-third over the past two decades. This is partially due to the declining prices of the country's export crops, especially bananas and coffee beans.

❸ The Dominican Republic-Central America Free Trade Agreement (CAFTA-DR) has helped attract foreign direct investment (FDI). However, a threat to future FDI inflows is Honduras' high level of crime and violence. It has one of the highest murder rates in the world.

Guatemala

❹ Guatemala shares a border with Honduras. Guatemala has the largest population and the biggest economy in Central America. Guatemala is the top remittance recipient in Central America as a result of large numbers of Guatemalans living and working in the US. These inflows on the current account are equivalent to two-thirds of the country's export revenue and about 10 % of its gross domestic product (GDP).

❺ The agricultural sector employs 31 % of Guatemala's labour force. Key agricultural exports include sugar, coffee, bananas and vegetables. The CAFTA-DR has reduced the barriers to FDI, resulting in increased **investment** and diversification of exports, particularly in iron, steel and non-traditional agricultural exports (such as high-priced fruits and vegetables). While the free trade agreement has improved the conditions for investment, FDI continues to be limited by concerns over security, the lack of skilled workers and poor infrastructure.

❻ With some of the worst poverty, malnutrition and infant mortality rates in the region, Guatemala's economic development is slowing. Those worst affected live in rural areas. Faster economic growth is crucial to achieving the country's medium- and long-term poverty reduction objectives.

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(Question 4 continued)

Table 2: Selected economic data for Honduras and Guatemala

	Honduras	**Guatemala**
Human Development Index (HDI) rank	133	127
Gross national income (GNI) per capita in purchasing power parity (PPP) terms (US$)	4215	7278
GDP per capita in PPP terms (US$)	5600	8100
Real GDP growth rate (%)	4.80	2.80
Tax collection (% of GDP)	19.30	10.40
Gini coefficient	0.47	0.53
Sanitation access (% of total population)	83	64
Health expenditure (% of GDP)	7.69	6.20
Education expenditure (% of GDP)	5.87	2.83
Time required to start a business (days)	13	27

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

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

(b) Using a perfectly competitive firm diagram, explain the effect of declining prices of coffee beans on the profits of Honduras' coffee farmers in the short run (paragraph ❷). [4]

(c) With reference to the data in **Table 2**, explain why the GNI per capita for Guatemala is lower than its GDP per capita. [4]

(d) Using information from the text/data and your knowledge of economics, contrast the potential for economic development in Guatemala and Honduras. [8]

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