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Economics
Higher level
Paper 2

Thursday 28 October 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]**.

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.

The strong Thai baht

- 1 Thailand's currency, the Thai baht, ended 2019 at its highest value in more than six years. With a 7.8% gain against the United States dollar (US\$), it was the currency that appreciated the most among major Asian currencies.
- 2 The Thai baht's appreciation was caused by several factors. Many foreign investors are attracted by Thailand's economic stability, high levels of foreign reserves, low inflation rate and low unemployment (**Table 1**). However, the inflation rate is below the central bank's target.
- 3 Initially, the central bank of Thailand (BoT) was not too concerned, as the strong Thai baht was helping Thai importers and those who had foreign debts. Additionally, Thai producers could afford to import new technology and capital equipment. An appreciating currency could also help improve the country's terms of trade.
- 4 However, a strong currency can have severe consequences on an export-oriented country like Thailand. Exports account for 65% of **gross domestic product** (GDP), and in 2019 exports declined by 7%. Additionally, the tourism industry, which makes up approximately 20% of GDP and accounts for 16% of employment, started to express concern. Economic growth in 2019 was 3%, down from 4.1% in 2018.
- 5 Therefore, towards the end of 2019, the BoT implemented measures to prevent further appreciation of the Thai baht. The BoT reduced controls on capital outflows to make it easier for Thai citizens to move money abroad. Additionally, restrictions were placed on the amount of money foreigners could hold in Thai bank accounts.
- 6 The BoT is considering further measures including the use of foreign reserves, a decrease in the interest rate, and imposing controls on capital inflows, to prevent speculative inflows. However, these controls may impact the country's credibility and financial markets. Expansionary monetary policy may also increase household debt which, at 78.6% of GDP, is among the highest in Asia.
- 7 The BoT is concerned about using foreign reserves, as this may result in Thailand being labelled a currency manipulator* by the US. Currently, Thailand's overall large **current account surplus** is the only requirement it meets to be labelled a currency manipulator. However, Thailand's bilateral trade surplus with the US is currently US\$19 billion, which means it is close to meeting a second requirement. Thailand wants to avoid being labelled a currency manipulator as the US may use trade protection in retaliation.

* currency manipulator: the US will label a country as a currency manipulator if the following three requirements are met (a country will be placed on a watchlist if they meet two of the requirements):

1. The country is using its foreign reserves to change the value of its currency to gain an advantage
2. The country has a bilateral trade surplus with the US of over US\$20 billion
3. The country has a current account surplus of more than 2% of its GDP.

(This question continues on the following page)

(Question 1 continued)

Table 1: Thailand macroeconomic indicators 2019

Current account surplus	US\$3.4 billion
Unemployment rate	1 %
Inflation rate	0.3 %
Economic growth	3 %

- (a) (i) Define the term *gross domestic product* indicated in bold in the text (paragraph **4**). [2]
- (ii) Define the term *current account surplus* indicated in bold in the text (paragraph **7**). [2]
- (b) Using an exchange rate diagram, explain how a decrease in the interest rate might influence the value of the Thai baht (paragraph **6**). [4]
- (c) Using a production possibilities curve (PPC) diagram, explain how the importing of “new technology and capital equipment” might affect Thailand’s production possibilities (paragraph **3**). [4]
- (d) Using information from the text/data and your knowledge of economics, evaluate the implications of the strong Thai baht on Thailand’s economy. [8]

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

Free Trade Agreement between the European Union and Indonesia

- 1 The European Union (EU) and Indonesia are currently negotiating a free trade agreement (FTA). The agreement will aim to increase trade, avoid trade protection and expand foreign direct investment (FDI). Indonesia has the largest economy and population in Southeast Asia. The EU is Indonesia's third-largest trading partner.
- 2 The FTA could see the clothing and footwear industry in Indonesia increase by over 10%. However, the labour-intensive manufacturing industry has historically been known for poor working conditions and low wages. On the other hand, increased output could decrease the high unemployment in Indonesia (currently at 12%). The EU expects its car industry to benefit from the FTA. The agreement would encourage the EU to specialize in cars, and Indonesia to specialize in clothing, therefore both countries could benefit from comparative advantage.
- 3 Since Indonesia's main competitors already have trade agreements with the EU, establishing an FTA is a priority for the Indonesian government. The EU has a potential market of 510 million consumers, and may offer areas for growth during a time of lower global trade and uncertainty due to the trade war between the United States and China.
- 4 However, recent trade issues between the EU and Indonesia have slowed down negotiations. The EU announced that palm oil biodiesel is unsustainable and will phase these fuels out by 2030. Experts say that palm oil causes excessive deforestation and contributes to climate change. Indonesia is the world's largest exporter of palm oil.
- 5 The EU has imposed **tariffs** on biodiesel exports from Indonesia, which may result in Indonesia losing a market worth over US\$450 million. Palm oil represents 12% of Indonesia's total exports, contributes approximately 2.6% to gross domestic product (GDP), and the industry employs more than 15 million people. The EU is Indonesia's largest palm oil customer. Additionally, some EU manufacturing businesses are unhappy with the tariffs as they rely on palm oil to produce their products, such as processed foods.
- 6 In response, Indonesia filed a lawsuit with the World Trade Organization (WTO), stating that the EU's policy on biodiesel is unfair and is damaging the international image of palm oil. Indonesia claims it is committed to sustainable production practices and to protecting its forests.
- 7 To make up for losing the EU's market, Indonesia is actively exploring other markets to boost its exports of palm oil. Other countries like China, India and Russia have a more relaxed policy on palm oil and have growing demand for it. Indonesia has also retaliated to the tariff through an investigation into whether EU dairy products exported to Indonesia benefited from subsidies, and has recommended a 20%–25% tariff on EU dairy products.
- 8 However, the EU has tried to lower tensions by offering a US\$17 million grant to improve trade conditions and capacity in preparation for the FTA. Experts have said that the FTA could support the development of legal and sustainable palm oil production through supporting good governance and capacity building. Indonesia has stated it would welcome help to decrease any market failure caused by palm oil.

(This question continues on the following page)

(Question 2 continued)

- (a) (i) Define the term *tariffs* indicated in bold in the text (paragraph **5**). [2]
- (a) (ii) State **two** functions of the World Trade Organization (WTO) (paragraph **6**). [2]
- (b) Using a demand and supply diagram for processed food, explain how the EU's tariff on palm oil might impact the market for processed food in the EU (paragraph **5**). [4]
- (c) Using a production possibilities curve (PPC) diagram to illustrate comparative advantage, explain why the EU would export cars to Indonesia and Indonesia would export clothing to the EU (paragraph **2**). [4]
- (d) Using information from the text/data and your knowledge of economics, discuss the economic effects on Indonesia of establishing a free trade agreement with the EU. [8]

Section B

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

Changing times for Vanuatu

- 1 Vanuatu is an island nation in the west of the Pacific Ocean. The islands are isolated with 80% of the population living in rural villages as subsistence farmers. In recent years, Vanuatu has experienced strong economic growth driven by tourism, construction and foreign aid. However, Vanuatu has a United Nations (UN) status as the world's most vulnerable country to natural disasters, and this vulnerability is intensified through climate change. Furthermore, economic development in Vanuatu is constrained by lack of education, limited public sector capacity, poor infrastructure and low labour market participation rates of women and youth.
- 2 Vanuatu currently faces growing income disparities between rural and urban areas. The poverty rate is currently at 3.8% in the rural areas and 10.4% in Port Vila, the capital city. Urbanization has led to large numbers of unskilled low-income workers concentrated in informal sectors in Port Vila. As a result, there is a shortage of housing, water and electricity services.
- 3 The UN categorizes Vanuatu as a Least Developed Country, but it will be moving to the higher category of Developing Country by the end of 2020. This will mean that some special assistance such as access to development finance, trade and market access, and technology transfer will be slowly withdrawn. However, there will be benefits for Vanuatu as it will gain greater access to commercial lenders, **foreign direct investment** (FDI) and climate finance funds.
- 4 To help with the transition to the new UN category, Australia and New Zealand are continuing aid projects to improve public sector capacity, increase economic participation of women and youth and improve access to electricity in Vanuatu. Moreover, Japan and China have significantly increased aid through grants and concessional loans. China is now the leading donor to Vanuatu.
- 5 The Vanuatu government has targeted the development of **human capital** through education, healthcare and infrastructure. Most of the aid from China has been used to develop new airports and shipping ports. This infrastructure will further help producers to access export markets and gain economies of scale. However, government institutions need to be improved so that the benefits of export revenues are redistributed to those in need. Historically, the lack of good governance has led to misuse of funds.
- 6 Economists believe the foreign aid spending could help attract FDI, which is important to help Vanuatu develop export markets in organic beef, sandalwood oil, tamanu oil and canarium nuts to provide areas for growth. Historically, growth was driven through import substitution by subsidizing manufacturing industries.
- 7 Vanuatu is currently reforming the tax system to lower the reliance on indirect taxes and implementing a progressive tax system to increase government revenue. The increased tax revenue will also decrease Vanuatu's dependence on foreign aid.

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(Question 3 continued)

- (a) (i) Define the term *foreign direct investment* indicated in bold in the text (paragraph **3**). [2]
- (ii) Define the term *human capital* indicated in bold in the text (paragraph **5**). [2]
- (b) Using a demand and supply diagram, explain how a subsidy changes the consumer surplus for a good (paragraph **6**). [4]
- (c) Using a Lorenz curve, explain how a progressive tax system could change Vanuatu's income distribution (paragraph **7**). [4]
- (d) Using information from the text/data and your knowledge of economics, discuss the effectiveness of foreign aid in achieving economic development in Vanuatu. [8]

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

New policies for Brazil

- 1** From 2010 to 2014, Brazil experienced an economic boom with annual gross domestic product (GDP) growth of 8 %. During this time, the government spent heavily on social programmes (including cash transfers and pensions) that helped millions to get out of the poverty cycle. The poverty rate decreased from 22 % to 9 % and the Gini coefficient dropped from 0.581 to 0.515. However, the spending on social programmes resulted in fiscal deficits and a large public debt, which is currently 80 % of GDP.
- 2** In 2015, Brazil entered a recession that lasted until 2017. During the recession GDP declined by an average of 3 % per year. By 2017, the number of Brazilians living in **absolute poverty** climbed by 13 %, inequality worsened, and unemployment was 12 %. From late 2017 to 2019, Brazil struggled to recover, with only approximately 1 % annual economic growth.
- 3** Some economists blamed the slow recovery on the lack of investment in education and technology during the economic boom. According to those economists, investment in human and physical capital was necessary to improve productivity and decrease the reliance on the production of primary commodities. Historically, spending on education has not been effective in reaching the very poor.
- 4** In 2018, a newly elected government, aiming to stimulate economic growth, introduced market-oriented policies. Since Brazil has a large economy, the new government believed that Brazil should take advantage of world trade and foreign investment to boost economic growth and achieve economic development.
- 5** The new government aimed to increase the number of **multinational corporations** (MNCs) investing in Brazil through deregulation and trade liberalization. Furthermore, in 2020 several state-owned enterprises were privatized.
- 6** Additionally, new labour market and tax reforms were introduced to create jobs, increase labour force participation and make it easier for firms to hire and fire workers. The reforms included increasing the retirement age and reducing transfer payments. However, trade unions claim that the reforms are unfair and will lead to the exploitation of workers.
- 7** There is concern that deregulation, privatization and market liberalization will put pressure on Brazil's environment, threaten sustainable development, and benefit only urban areas. In 2017, the government introduced "**green GDP**" as an official measure and committed to environmental protection goals. This is necessary because, for example, over 40 % of the population live in areas without access to a sewage system and manufacturing companies are dumping untreated wastewater in rivers, contributing to water pollution.

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(Question 4 continued)

- (a) (i) Define the term *multinational corporations* indicated in bold in the text (paragraph **5**). [2]
 - (ii) Define the term “*green GDP*” indicated in bold in the text (paragraph **7**). [2]
 - (b) Using a business cycle diagram from 2010 to 2019, explain how cyclical unemployment may have changed during the economic boom (paragraph **1**) and the recession (paragraph **2**) in Brazil. [4]
 - (c) Using an externalities diagram, explain how manufacturing companies in Brazil are contributing to market failure (paragraph **7**). [4]
 - (d) Using information from the text/data and your knowledge of economics, evaluate the impact of market-oriented policies on economic development in Brazil. [8]
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