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Economics
Standard 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 answer the questions that follow.

China and global trade

- 1** On 15 January 2020, the United States (US) and China signed a deal that reduced some tariffs and required China to buy more from US producers. This was a first step towards resolving a **trade war**, which had reduced bilateral trade flows by 9% and investment flows by 60%. However, critics argued that the deal left most tariffs unchanged and did not deal with deeper disagreements.
- 2** The US, the European Union (EU) and Japan are calling for tougher World Trade Organization (WTO) rules on government support for firms that manufacture items such as steel or solar panels. The support, which is often in the form of subsidies, has allegedly undermined competing firms overseas, either by promoting exports or by decreasing imports, and therefore distorted global trade. Other governments also give subsidies, but there are claims that China uses them more extensively.
- 3** The proposed WTO rule change would require governments to prove that subsidies do not give domestic firms an unfair advantage over foreign firms and that they do not lead to excess supply in the global market. If the rules are implemented, the WTO may regain some of the authority that it has lost in recent years.
- 4** One of the US government's goals when imposing huge tariffs on Chinese-made goods was to bring back manufacturing jobs to the US. Therefore, despite the new deal, the 25% tariff on Chinese-made furniture will stay. As a result, many US furniture firms that had used overseas factories to make their US company-branded products have reduced their imports of Chinese-made furniture.
- 5** Meanwhile, Vietnam, Cambodia and Bangladesh are benefitting because US manufacturers of wood furniture are setting up factories there. Therefore, some other US producers are asking for the tariff on Chinese-made wooden furniture to apply to all wooden furniture imported into the US, regardless of where it is manufactured.
- 6** China is becoming less dominant as an exporter and more integrated into the global trading system. Its current account surplus was over 10% of gross domestic product (GDP) in 2007, but it declined to just 0.4% in 2018. Chinese producers are increasingly buying raw materials and other inputs from overseas producers. Although most electronic devices sold in the US are assembled in China, Chinese firms are often dependent on foreign suppliers. If the US and China tried to be less interdependent, it would take more than 10 years for China to become self-sufficient in the production of computer semiconductors and for the US to shift to other suppliers of electronic devices.

(This question continues on the following page)

(Question 1 continued)

- (a) (i) Define the term *trade war* indicated in bold in the text (paragraph **1**). [2]
- (ii) List **two** functions of the World Trade Organization (WTO) (paragraph **2**). [2]
- (b) Using a tariff diagram, explain the likely effect on consumer surplus of a 25% tariff on all wooden furniture imported into the US (paragraph **5**). [4]
- (c) Using a foreign exchange diagram, explain the possible effect of China's large current account surplus in 2007 on the exchange rate of China's currency (the renminbi) (paragraph **6**). [4]
- (d) Using information from the text/data and your knowledge of economics, evaluate China's use of subsidies as a form of trade protection. [8]

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

South Korea's exchange rate and central bank intervention

- 1 From mid-2017 until mid-2019, there was a downward trend in the exchange rate of the South Korean won (South Korea's currency), and some commentators suggested that it was being deliberately undervalued. Despite the lower exchange rate, however, the value of South Korean exports declined by 10.3% during 2019.
- 2 The main reason for the decline in the value of exports was the weak market for semiconductors. Lower global prices of semiconductors, the largest single export item for South Korea, led to a drop of 25.9% in the value of exports, despite an increase in their volume. Evidently, price competitiveness of exports from South Korea is not as significant as before, because its exports are now mainly luxury or high-technology items.
- 3 In November 2019, South Korea's current account surplus reached US\$5.97 billion, more than 4% of gross domestic product (GDP). The financial account in the balance of payments had a net outflow of US\$5.34 billion, which was mainly due to a net outflow of US\$4.01 billion in **foreign direct investment** (FDI). There was also a net outflow of US\$1.07 billion in portfolio investment, because domestic residents increased their financial assets overseas while inward flows declined.
- 4 The Bank of Korea (South Korea's central bank, BoK) had reduced interest rates to record lows in October 2019, which partly accounted for the large portfolio investment outflows. Monetary policy is likely to continue to be expansionary through 2020, with the possibility of another interest rate reduction, because economic growth is forecast to be low, at less than 2.5%. The forecast for inflation is that it will be below 1.5%, while the unemployment rate is expected to continue to rise to over 4%.
- 5 While the BoK is not targeting a specific level for the exchange rate, it seems determined to intervene when the market is unstable. Its actions, however, have contributed to South Korea being accused by the United States (US) of changing the value of its currency to gain an export advantage. If the US concludes that South Korea has been manipulating its exchange rate unfairly, it could impose trade barriers on imports from South Korea.
- 6 However, through the last six months of 2019, the South Korean won started to rise against the US dollar (US\$). The appreciation was partly due to speculation and expectations of a rise in demand for semiconductors. Moreover, in August 2019, the BoK sold US dollars in order to prevent the South Korean won from depreciating again. Overall, the central bank's foreign exchange intervention has been aimed at restraining the South Korean won's depreciation or stabilizing the market rather than at trying to promote exports.

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(Question 2 continued)

Figure 1: South Korea’s exchange rate with the US\$

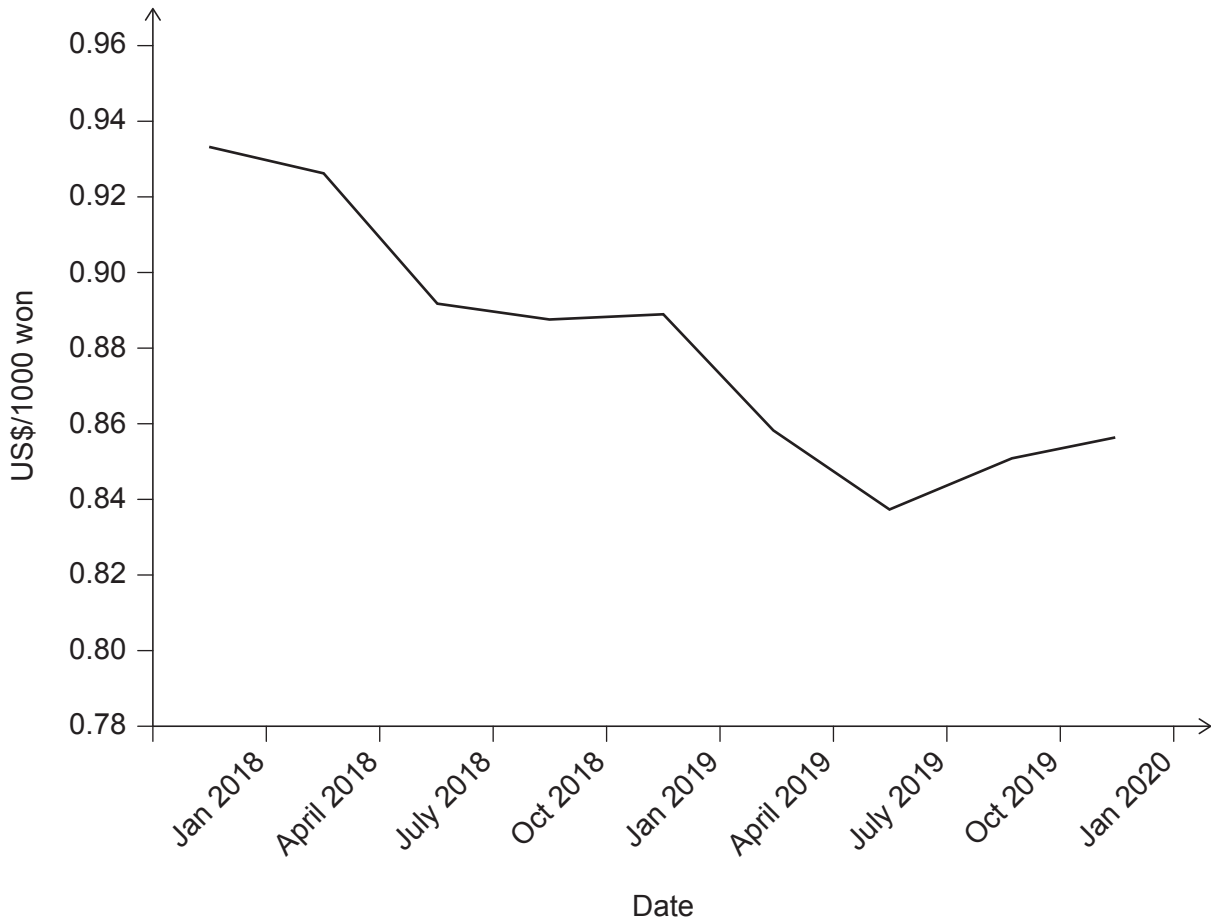


Table 1: South Korea’s balance of trade in goods and services, seasonally adjusted

	2018	2019
Balance of trade in goods and services (US\$ billion)	79.15	55.84

- (a) (i) Define the term *foreign direct investment* indicated in bold in the text (paragraph **3**). [2]
- (ii) List **two** responsibilities of a central bank (paragraph **4**). [2]
- (b) Using an AD/AS diagram, explain how the change in the balance of trade in goods and services from 2018 to 2019 could have affected South Korea’s economy (**Table 1** and paragraph **1**). [4]
- (c) Using an exchange rate diagram, explain the effect on the South Korean won’s exchange rate of South Korea’s central bank selling US dollars (paragraph **6**). [4]
- (d) Using information from the text/data and your knowledge of economics, evaluate the South Korean central bank’s decision to intervene in order to prevent the South Korean won from depreciating again. [8]

Turn over

Section B

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

Coffee production in Honduras

- 1 Coffee farmers in Honduras, Central America, are struggling to earn enough revenue to cover production costs. Some have left their farms and migrated to the United States (US). Many remaining families depend on remittances (money sent by a foreign worker to their home country) from relatives in the US.
- 2 The agricultural sector, which employs about 28 % of the labour force in Honduras and accounts for 45 % of gross domestic product (GDP), has always faced difficulties and has had very little government support. Fluctuations in international commodity prices are also a problem. The average global price of a 60 kg bag of coffee beans dropped from US\$140 in 2017 to US\$62 in 2019, because countries such as Vietnam, Indonesia and Ethiopia increased their exports.
- 3 Scientists say that the greatest threat to crops comes from global warming. The World Bank has estimated that over the next 30 years climate change could force around 1.4 million people to leave Central America for the US. Meanwhile, global warming is partly blamed on the US continuing to operate coal-fired power plants, which account for about 30 % of its electricity generation.
- 4 Rising temperatures and uncertain weather have affected plant growth, ruined harvests and led to pests and diseases. The amount of land suitable for growing coffee, which is Honduras's most important agricultural export, will probably fall by over 40 % before 2050. Already, the number of coffee producers has declined by 25 % in some areas. Furthermore, reduced yields of subsistence crops like corn and beans could significantly increase malnutrition.
- 5 Foreign aid from the US includes humanitarian aid and grants to non-governmental organizations (NGOs) that have projects helping farmers adapt to climate change. However, the US administration has threatened to stop all foreign aid to Central America, claiming that its governments are failing to reduce the flow of migrants to the US. Between 2016 and 2019, the total annual aid budget for Central America had already dropped from US\$750 million to US\$530 million. The biggest reductions were in projects assisting rural economies and agriculture, while there was a small increase in funds for drug control and border enforcement, in order to reduce the number of migrants to the US.
- 6 There is concern among local coffee growers that if aid is stopped there will be more **unemployment**, leading to more migration and abandoned farms.
- 7 NGOs are helping coffee farmers to cope better with droughts and to diversify into other crops, such as avocados or timber. Global coffee sellers, including Starbucks, are supporting some projects in the hope that they can ensure the future supply of coffee. However, coffee farming in Honduras may never be profitable again.

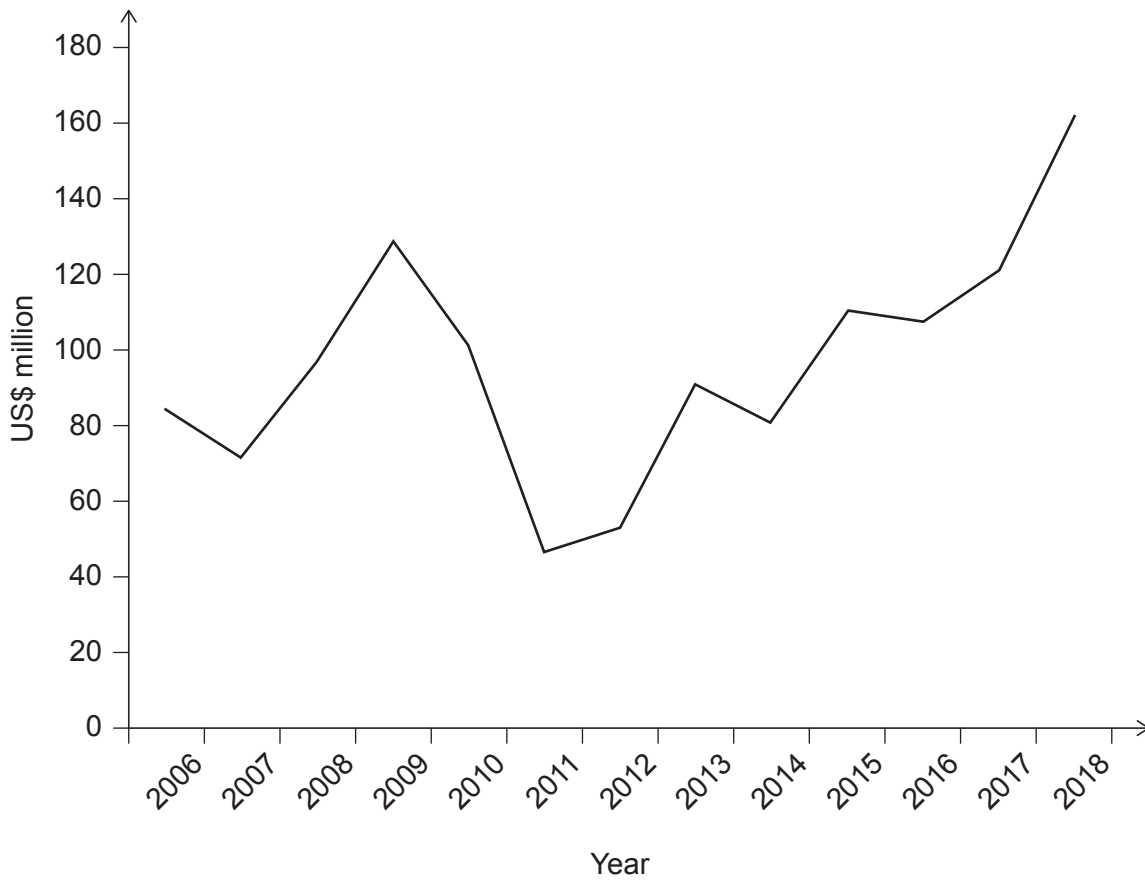
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(Question 3 continued)

Table 2: Personal remittances (debits and credits) in the Honduras balance of payments (US\$ million)

	2012	2013	2014	2015	2016	2017	2018
Paid by Honduras	36.4	40.9	42.1	41.1	41.1	65.1	65.4
Received by Honduras	2920.4	3098.2	3369.5	3667.9	3863.7	4322.8	4776.5

Figure 2: Foreign aid flows from the United States to Honduras (US\$ million)



- (a) (i) List **two** functions of the World Bank (paragraph **3**). [2]
- (ii) Define the term *unemployment* indicated in bold in the text (paragraph **6**). [2]
- (b) Using a demand and supply diagram, explain why the global price of coffee beans dropped when “countries such as Vietnam, Indonesia and Ethiopia increased their exports” (paragraph **2**). [4]
- (c) Using an externalities diagram, explain how coal-fired power plants in the US might be causing market failure (paragraphs **3** and **4**). [4]
- (d) Using information from the text/data and your knowledge of economics, discuss the extent to which foreign aid from the US may assist economic development in Honduras. [8]

Turn over

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

Infrastructure projects in Tanzania

- 1 In 2018, Tanzania's gross domestic product (GDP) grew by 7%. But the trade balance deteriorated, with exports declining and imports increasing. Moreover, limits on government current expenditure and lower levels of inward foreign direct investment (FDI) suggest that GDP growth will weaken to 5% in 2019. Inflation will stay low through 2019, due to lower prices for food and raw materials.
- 2 The government has promised reforms to improve the business environment and fiscal management. However, the **budget deficit** is forecast to increase from 2.3% of GDP to 4% of GDP by 2020.
- 3 Government investment in large-scale projects, such as the construction of railway lines, dams for electricity generation, bridges, roads and airports, could lead to annual economic growth of 10%. These projects, however, are financed mainly by loans from commercial banks with a short repayment period and high interest rates. Therefore, the national debt and the cost of debt servicing are increasing. The national debt has risen from US\$22 billion in 2015 to US\$28.6 billion in 2019.
- 4 The Minister for Finance and Planning is optimistic that the debt is sustainable. "The debt assessment shows we can continue to borrow locally and abroad to finance development activities and pay off matured loans using our internal and external revenue," he said. According to the central bank, the transport and telecommunication sectors received a greater share of the funding, accounting for 26.8% of the debt, followed by social welfare, education, energy and mining.
- 5 All the large infrastructure projects use some materials imported from abroad, such as steel. Therefore, the current account deficit will widen further due to increased imports of resources necessary for production. The government's ability to use its expenditure to stimulate domestic production will be reduced, because funds are being sent overseas to external lenders and construction firms.
- 6 Tanzania is undergoing a structural change with a higher proportion of the labour force working in the manufacturing and service sectors, while agriculture is employing fewer workers. Despite a reduction in the poverty rate, the absolute number of poor people is still high due to population growth. According to a World Bank report, almost half the population lives on less than US\$1.90 per person per day. It concludes that the poor have benefited relatively less from recent economic growth, resulting in an increase in income inequality from 2015 to 2019.
- 7 Further investments in **human capital**, targeted towards the poor, are needed to increase access to higher-skilled jobs. However, government efforts to expand public services, including education, health, and sanitation and clean water facilities, have been undermined by their declining quality as the population rises faster than the supply of the services. Therefore, the levels of education and basic services remain low, particularly for the poorest and those living in rural areas.

(This question continues on the following page)

(Question 4 continued)

- (a) (i) Define the term *budget deficit* indicated in bold in the text (paragraph **2**). [2]
 - (a) (ii) Define the term *human capital* indicated in bold in the text (paragraph **7**). [2]
 - (b) Using an AD/AS diagram, explain how “lower prices for food and raw materials” might put downward pressure on inflation (paragraph **1**). [4]
 - (c) Using a Lorenz curve diagram, explain what is meant by an “increase in income inequality from 2015 to 2019” (paragraph **6**). [4]
 - (d) Using information from the text/data and your knowledge of economics, evaluate the impact on economic development of the Tanzanian government’s policy of spending on infrastructure projects. [8]
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