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Economics

Higher level

Paper 2

Friday 13 November 2020 (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]**.

Section A

Answer **one** question from this section.

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

South Korea's current account surplus

- 1** South Korea, Asia's fourth-largest economy, has experienced a current account surplus since 2012. South Korea's large working-age population, which tends to save a large portion of its income for retirement, contributes to the surplus. The South Korean government has expressed concerns about the impact of the high savings on domestic demand and the level of imports. However, it has been predicted that as the population ages the surplus will gradually disappear by 2042.
- 2** The South Korean won (South Korea's currency) recorded the second highest appreciation against the United States dollar (US\$) in 2017 among currencies of the G20* nations. The current account surplus, the improved economic conditions and the expectations of an **interest rate** rise have all helped increase the South Korean won's value.
- 3** The South Korean won officially operates under a floating exchange rate system, but the central bank would intervene if there were major fluctuations in the market that needed to be managed. The US is monitoring the exchange rate policy of South Korea due to the significant trade imbalance between the two countries. If the US identifies that a major trading partner like South Korea tries to limit an appreciation of its currency, then the US may consider tariffs to reduce the imbalance.
- 4** South Korea's financial account in the balance of payments recorded a deficit of US\$13 billion in 2018, as Koreans have invested extensively in other countries. Furthermore, foreigners have been reluctant to invest in South Korea due to the trade disputes and the potential of a trade war erupting between the US and China. The US and China are South Korea's largest trading partners, and South Korea, with its export-oriented economy (exports amount to 43 % of gross domestic product [GDP]), is sensitive to external demand shocks.
- 5** South Korea's domestic investment in key areas (such as manufacturing, construction and machinery) fell during 2018, and GDP grew by less than expected. Additionally, private consumption increased only by 0.3 % in 2018, the slowest growth for 4 years. There is also concern about the level of unemployment, especially the high rates of youth unemployment.
- 6** Normally, in a situation of low growth, the central bank would implement expansionary monetary policy. However, the US Federal Reserve (the central bank of the US) and the European central bank are considering monetary tightening. If the South Korean central bank does not raise interest rates in line with the US and the European Union it runs the risk that the South Korean won may depreciate. Therefore, the South Korean government has begun discussions on using fiscal policy to help revive the job market and support domestic demand.

* G20 members include: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea (South Korea), Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the US and the EU

(This question continues on the following page)

(Question 1 continued)

- (a) (i) Define the term *interest rate* indicated in bold in the text (paragraph **2**). [2]
- (a) (ii) List **two** components of the financial account (paragraph **4**). [2]
- (b) Using an exchange rate diagram, explain how South Korea’s current account surplus could have “helped increase the South Korean won’s value” (paragraph **2**). [4]
- (c) Using an AD/AS diagram, explain how the use of fiscal policy could lower “the high rates of youth unemployment” in South Korea (paragraph **5**). [4]
- (d) Using information from the text/data and your knowledge of economics, discuss the possible implications on South Korea’s economy of a current account surplus. [8]

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

The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), Australia and Japan

- 1** In 2018, Australia signed the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP)*. The agreement creates the third largest **free trade area** in the world, covers nearly 500 million people and is worth more than US\$12 trillion. The members of the agreement have stated that economic integration and free trade is important to help foster good political relations and inclusive growth for all nations.
- 2** The trade agreement will aim to gradually eliminate most trade protection within the member countries. The agreement will see tariffs eliminated for Australian cheese and beef exports to Japan, and increased **quotas** for the export of rice to Japan from 4400 to 8400 tonnes. Nikkei Asian Review reported that “Fast-food restaurants in particular are embracing the import as a way to cut costs to cope with rising wages.” Additionally, Japanese food manufacturers will be able to lower production costs for rice-based meals and benefit from increased stability of input prices. The benefits from the agreement for Japan’s economy are projected to exceed US\$70 billion, but some industries would be negatively affected.
- 3** Japanese farmers are worried about the increase in imported food from Australia. Furthermore, the Japanese government is concerned about the effects of the CPTPP on Japan’s food self-sufficiency—Japan relies on other countries for over 60 % of its food. In response to these concerns the Japanese government has offered support for domestic farmers to diversify production into other crops. The government also plans to subsidize the rice farmers through the initial phase of lowering trade barriers.
- 4** The agreement is said to be worth more than US\$37 billion to Australian agricultural exports. It is hoped that CPTPP and the falling value of the Australian dollar will help Australia to reduce its current account deficit, but some economists have argued that this can take a long time. According to some estimations, the short-run price elasticity of demand (PED) for Australian exports is 0.2 and the short-run PED for imports in Australia is 0.4. However, the long-run PED for Australian exports is 1.1 and the long-run PED for imports in Australia is 1.3.
- 5** There have also been concerns about the CPTPP from trade unions in Australia. They argue that it deregulates the labour markets and gives corporations from other countries an ability to take legal action against governments for implementing laws that raise wages or protect the environment, if the foreign corporation can prove that the law hurt their commercial interests. One university lecturer said that the future costs to the taxpayer could be significant if foreign companies take the Australian government to court.
- 6** The trade agreement would allow workers from other countries to work in Australia without employers being required to check if Australian citizens are available to fill the jobs before the migrant workers are employed. It is estimated this may risk 39 000 jobs in Australia. Furthermore, environmental activists have expressed concerns that the negative environmental and social effects of the agreement have not been well considered. This may lead to conflicts with Australia’s commitment to the United Nations’ Sustainable Development Goals.

* The CPTPP includes eleven member countries: Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam.

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(Question 2 continued)

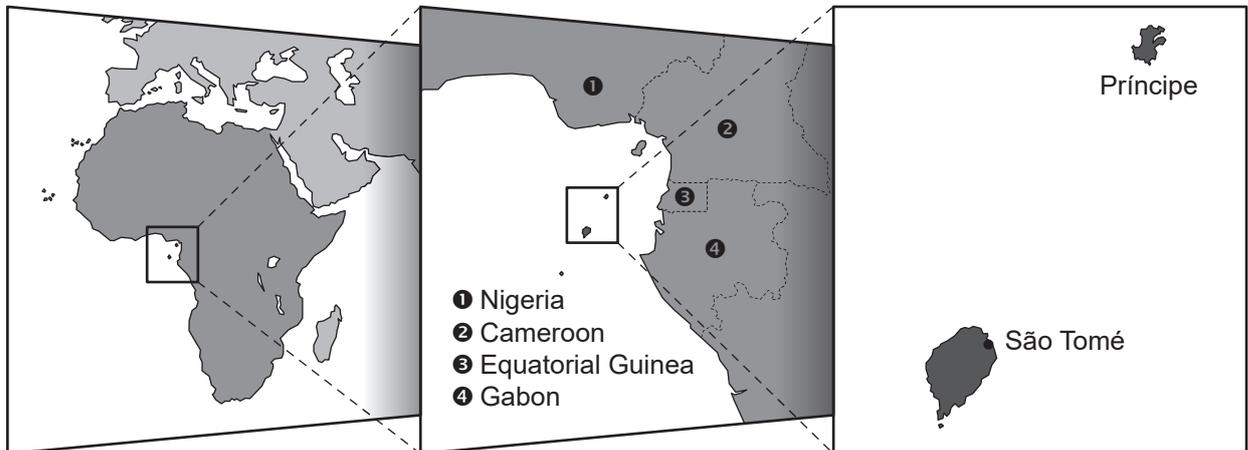
- (a) (i) Define the term *free trade area* indicated in bold in the text (paragraph **1**). [2]
- (ii) Define the term *quotas* indicated in bold in the text (paragraph **2**). [2]
- (b) Using price elasticity of demand (PED) data from the text and the J-curve effect, explain the most likely impact of “the falling value of the Australian dollar” on Australia’s current account (paragraph **4**). [4]
- (c) Using an international trade diagram, explain how “increased quotas for the export of rice to Japan” will affect the price of rice in Japan (paragraph **2**). [4]
- (d) Using information from the text/data and your knowledge of economics, evaluate the view that free trade is beneficial to Japan’s economy. [8]

Section B

Answer **one** question from this section.

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

São Tomé and Príncipe Economic Development Challenges



- 1 São Tomé and Príncipe (STP) is an island nation and is one of the smallest economies in Africa. STP faces many economic development challenges including: a limited range of export products (mostly commodities) and markets, limited human capital, insufficient infrastructure, vulnerability to supply-side shocks due to climate change, limited access to credit, political instability and poor governance. All these challenges have led to a high dependence on foreign aid.
- 2 International organizations estimate that approximately 50% of STP's population is living in **relative poverty**. Its economic growth rate has been consistent at 4–5% between 2013 and 2018, but the International Monetary Fund (IMF) suggests that STP will need an economic growth rate of 6% to have an impact on the poverty rate.
- 3 To increase economic growth and reduce its dependence on foreign aid and cocoa exports (80% of its total exports), STP is planning to extract offshore oil and develop the comparative advantage it has in tourism. Over 50% of its exports go to the European Union. It is hoped that diversifying STP's exports will increase the number of its potential trading partners. To achieve this aim, STP is seeking membership with the World Trade Organization (WTO) and the Central African Economic and Monetary Community. Developing export markets could help STP benefit from **economies of scale** and overcome the restrictions of its geographical remoteness and high transport costs. However, STP will need help from multinational oil companies to exploit its oil reserves, and the government needs to improve transparency to ensure that oil revenues are used to support economic development.

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(Question 3 continued)

- 4** In STP, foreign aid accounts for 57 % of gross domestic product (GDP) and 93 % of public investments, including a significant portion of health and education spending. In addition, concessional loans have been provided by the IMF. However, STP had to agree to decrease the budget deficit as a condition of the loan from the IMF.
- 5** There are some government officials who believe that aid will not solve the economic development challenges in STP. It did not meet the nutrition targets set by the Millennium Development Goals and continues to struggle with providing adequate clean water and nutritional intake for its population. Clean water is becoming scarce in STP due to business pollution and poor household sanitation, which is also spreading diseases. Other environmental concerns are climate change, deforestation and erosion of coastal areas due to the sand extracted for the construction of roads and buildings.
- (a) (i) Define the term *relative poverty* indicated in bold in the text (paragraph **2**). [2]
- (ii) Define the term *economies of scale* indicated in bold in the text (paragraph **3**). [2]
- (b) Question removed for copyright reasons** [4]
- (c) Using an externalities diagram, explain why “business pollution” is leading to market failure in STP (paragraph **5**). [4]
- (d) Using information from the text/data and your knowledge of economics, discuss the role of aid in achieving economic development in STP. [8]

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

Fiji's challenges and opportunities

- 1** In 2016, the island nation of Fiji suffered from cyclone Winston (a tropical storm), costing more than 40 lives and damaging its infrastructure. One of the country's four sugar mills was severely damaged, harming raw sugar processing. Processed sugar is, in addition to bottled water and tourism, a major export in Fiji. A recent study found that the damage from the cyclone continues to have a lasting effect on communities as fisherwomen report fewer and smaller crabs and fishes. The social safety net is limited and there are calls for the government to help the citizens who have been affected by the cyclone. However, the government had to use its budget to rebuild infrastructure.
- 2** The government has prepared several strategies to strengthen the economy. These include financial support for sugar cane producers, diversification of its agricultural produce, better access to finance and encouragement of investment. The government has committed to provide equal opportunities for all: promoting the participation of women in education and political leadership, because Fiji has one of the lowest female participation rates in politics in the world.
- 3** To support its sugar cane farmers, the government provides a 55 % subsidy on pesticides (products that kill weeds) used in farming. However, small farmers are complaining about the excessive paperwork that needs to be completed to receive the subsidy and there is potential for corruption. Fiji competes with Brazil, which has an **absolute advantage**, in the world market for sugar.
- 4** To diversify, the government plans to expand the ginger and coconut industries. Both industries are economically and environmentally sustainable. The industries provide an increased number of Fijians with a worthwhile income. Coconut production plays a very important role in Fiji's economy, particularly in the more isolated rural communities, where formal employment is scarce and where alternative cash crops (crops grown to be sold for profit) do not exist. Coconut is a staple food and is vital for food security (ensuring that people have access to enough food), but is also important for health, economic and cultural reasons. New market opportunities have emerged in high-value products – green coconut products, such as coconut water, are becoming increasingly popular throughout the world.
- 5** The Asian Development Bank encourages Fijian farmers to access “green finance”. These financial investments support economic development through sustainable development initiatives and policies. Under the government's new reforms, farmers are able to use assets such as crops and contracts as collateral for loans, creating improved access to finance. However, to increase incomes, farmers will also need to improve their financial knowledge.
- 6** To create an investment-friendly environment, the government must develop more infrastructure, create market access through greater economic integration and reduce **asymmetric information** between farmers and wholesale buyers. Australia has decided to help Fiji by financing infrastructure through grants and concessional loans.

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(Question 4 continued)

- (a) (i) Define the term *absolute advantage* indicated in bold in the text (paragraph **3**). [2]
- (ii) Define the term *asymmetric information* indicated in bold in the text (paragraph **6**). [2]
- (b) Using a costs diagram, explain how the expansion of the coconut industry could lead to economies of scale (paragraph **4**). [4]
- (c) Using a production possibility curve (PPC) diagram, explain how damage to Fiji’s infrastructure has affected its production possibilities (paragraph **1**). [4]
- (d) Using information from the text/data and your knowledge of economics, discuss the view that government intervention is the best way to achieve economic development in Fiji. [8]
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References:

1. Adapted from: South Korea Current Account, *Trading Economics*, <https://tradingeconomics.com/south-korea/current-account>; and Anon, 2018. S. Korean Won's Appreciation 2nd Highest in G20 Last Year. *KBS World Radio*, http://world.kbs.co.kr/service/news_view.htm?lang=e&Seq_Code=133432.
2. Adapted from Karp, P., 2017. Revived Trans-Pacific trade deal undercuts Australian jobs market, unions say. *The Guardian*, Copyright Guardian News & Media Ltd 2021, <https://www.theguardian.com/australia-news/2017/dec/19/revived-trans-pacific-trade-deal-undercuts-australian-jobs-market-unions-say>; Kodachi, H., 2019. Australian rice finds favor in Japan as cheaper option, *Nikkei Asian Review*, <https://asia.nikkei.com/Business/Markets/Commodities/Australian-rice-finds-favor-in-Japan-as-cheaper-option>.
3. Adapted from Jennings, R., 2018. Taiwan cannot compete with China on Aid to keep foreign allies. *VOA News*. Available at: <https://www.voanews.com/east-asia-pacific/taiwan-cannot-compete-china-aid-keep-foreign-allies>.
4. Adapted from: Chaudhary, F., 2018. Green finance – Ginger farmers explore funding possibilities. *The Fiji Times*, <https://www.fijitimes.com/green-finance-ginger-farmers-explore-funding-possibilities>; and Chaudhary, F., 2018. Risk mitigation in the Pacific's coconut sector. *The Fiji Times*, <https://www.fijitimes.com/risk-mitigation-in-the-pacifics-coconut-sector>.