Cambridge International AS & A Level

Cambridge International Examinations
Cambridge International Advanced Subsidiary and Advanced Level

ECONOMICS **9708/21**

Paper 2 Data Response and Essay **May/June 2017**

1 hour 30 minutes

No Additional Materials are required.

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Section A
Answer **Question 1**.
Brief answers only are required.

Section B
Answer **one** question.

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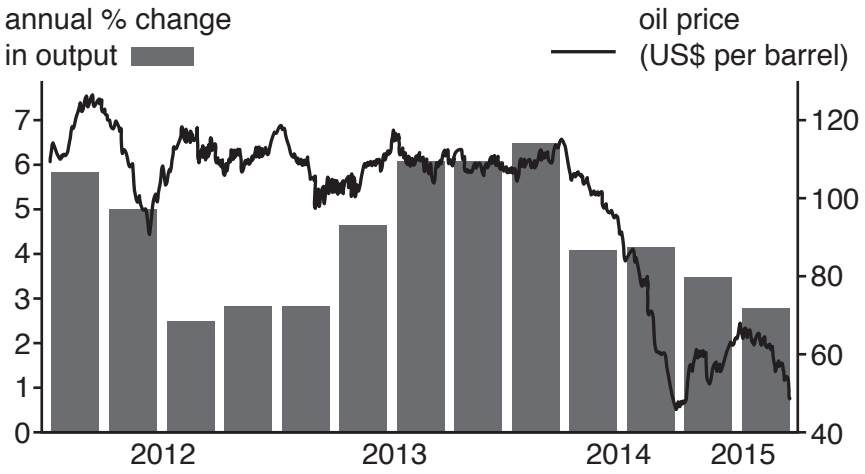
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Section A

Answer this question.

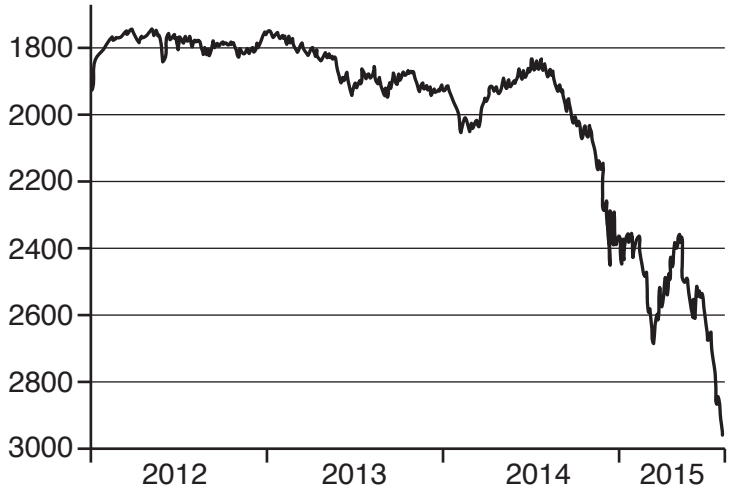
1 **Fall in price of oil but Colombia can look forward to growth**

Fig. 1: Colombia's growth and the oil price



Source: Thomson Reuters Datastream

Fig. 2: Colombian peso against the US dollar (peso per US$), inverted scale



Source: Thomson Reuters Datastream

Over the past year, the halving of crude oil prices has hit Colombia and much of South America hard. Venezuela's economy, for example, is expected to shrink by 7% this year. Colombia's national oil production was running at 1 million barrels a year, accounting for half of its exports and a fifth of government revenues. In Puerto Gaitan, which only a year ago was the centre of Colombia's oil industry, the town's population had tripled to 45 000 in just a few years. Property prices had soared and hotels overflowed. Today, though, business profits have fallen, leading to a fall in spending by entrepreneurs. "For Sale" signs now hang over Puerto Gaitan's closed stores, car parks in shopping malls are empty and 10 000 people have left the town. Towns throughout Colombia are experiencing similar problems.

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Colombia's government is feeling the effects as well. Every US$1 drop in the oil price per barrel cuts an estimated US$200 million from government revenues. As a result, the government has cut spending and raised taxes to keep its budget deficit down. More worryingly, the collapse in the price of oil has opened a large current account deficit equivalent to 7% of national income. Yet not all is bleak. Colombia's economy is forecast to grow this year. And unlike in neighbouring Venezuela, where oil accounts for more than 90% of exports, there is concern but no panic.

Firstly, the peso's depreciation could reverse Colombia's current account problems, boosting traditional exports such as coffee, textiles, car parts and flowers — if not to its immediate neighbours, then to the United States. Colombia produces oil, but it is not only an oil-producing country. Secondly, Colombia's government is having peace talks with Marxist rebels to end the country's five decades of unrest. The government's military expenditure will be reduced and estimates suggest that this 'peace dividend' could add as much as 2 percentage points to growth.

Source: The Financial Times, 2015

(a) **(i)** With the help of a diagram, explain **one** possible cause of the fall in the price of oil shown in Fig. 1. [2]

(ii) Explain how the fall in the price of oil has resulted in the fall in the value of the peso shown in Fig. 2. [2]

(b) With the help of production possibility curve diagram(s), explain how the 'peace dividend' might lead to the growth of Colombia's economy. [4]

(c) Use the information to explain how each of the components of aggregate demand in Colombia has been affected by the fall in the price of oil. [6]

(d) The fall in the value of the Colombian peso shown in Fig. 2 is expected to reduce Colombia's current account deficit.

Discuss any factors that will determine whether the fall in the value of the peso will have this effect. [6]

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Section B

Answer **one** question.

2 **(a)** Using examples, explain the difference between a merit good and a public good. Explain why a profit can be made from the provision of one of these types of good, but not the other. [8]

(b) Discuss whether it is better to impose an indirect tax or conduct an awareness campaign to deal with the problem of demerit goods such as alcohol. [12]

3 **(a)** Explain how equilibrium price and equilibrium quantity change to allocate resources when there is a successful advertising campaign for a normal good. [8]

(b) Discuss the difficulties of introducing a widespread system of maximum prices for essential food to protect low-income families in a period of high inflation. Consider whether this system is likely to be successful. [12]

4 **(a)** Explain how a fall in an economy's foreign exchange rate can cause both cost-push and demand-pull inflation. [8]

(b) Discuss the use of supply side policy as a means of solving the problem of inflation. Consider whether this policy is likely to be effective. [12]

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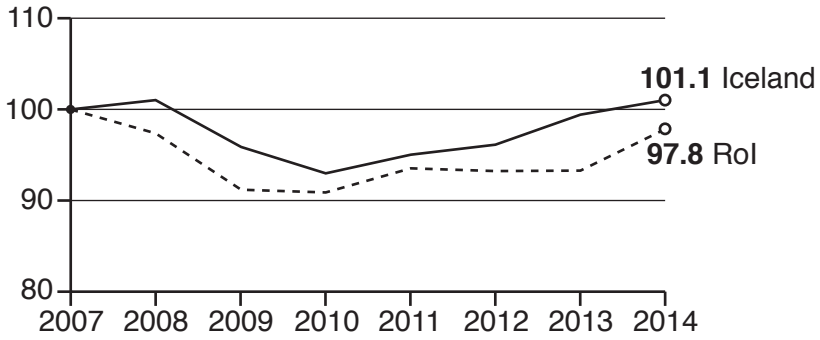
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Section A

Answer this question.

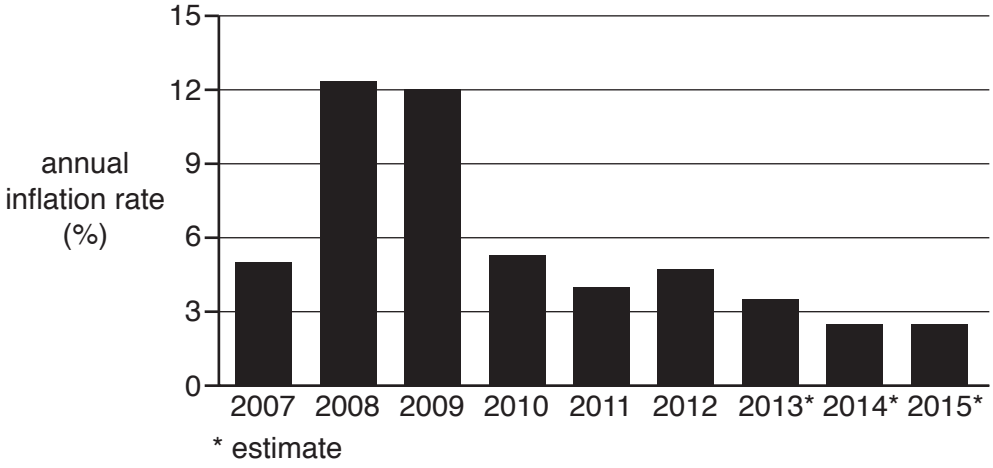
1 **The miraculous story of Iceland**

Fig. 1: Indices of the national output of Iceland and the Republic of Ireland (RoI) 2007–2014 (2007 = 100)



Source: International Monetary Fund (IMF)

Fig. 2: Inflation in Iceland 2007–2015



Source: IMF

As a result of the financial crisis of 2007–2008 both Iceland and the Republic of Ireland (RoI) had to seek help from the International Monetary Fund (IMF). In total, Iceland borrowed US$4.6 billion, with US$2.1 billion of that coming from the IMF and the other US$2.5 billion from neighbouring Scandinavian countries. In exchange for help, Iceland was forced to sharply reduce government spending – introducing more austerity than the RoI did. Not only that, but Iceland also increased interest rates to 18% in the immediate aftermath of the crisis to reduce inflation. It gradually cut interest rates afterward, but it was not until 2011 that they fell to 4.25%.

The biggest difference between the two economies is that Iceland has its own currency, the krona. Iceland manages its foreign exchange rate through intervention in the foreign exchange market and through interest rate changes. Insufficient foreign exchange reserves meant that the value of the krona fell by nearly 60% between the end of 2007 and the end of 2008. The RoI, on the other hand, did not have its own currency that it could devalue. It is part of the eurozone, where each country uses the euro, and the RoI authorities have no control over its value.

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Iceland's recovery has been better than the RoI's despite the fact that Iceland's recession was much more serious than the RoI's. The Icelandic economy has recovered surprisingly strongly since 2010. The large devaluation of the krona against both the US dollar and the euro helped. There has been a big boost from tourism. Unemployment, which peaked at 9% of the workforce at the worst of the crisis, is now back down to 5%. In the RoI, unemployment is falling but is still 9.8% of the workforce. Iceland's economy has now recovered roughly to its pre-crisis peak. The IMF predicts that Iceland's output will grow by 3.5% this year. The current account deficit, which was 25% of national income in 2009, has been eliminated and there is now a current account surplus. The government also ran a budget surplus last year for the first time since the crisis.

Source: Matt O'Brien, The Washington Post, 17 June 2015

(a) Use production possibility curves to compare the changes in the output of the RoI and Iceland shown in Fig. 1. [3]

(b) **(i)** Use Fig. 2 to compare the general price level in Iceland in 2007 and 2015. [1]

(ii) Explain **two** ways in which the fall in the value of the krona between the end of 2007 and the end of 2008 might have caused the rise in the rate of inflation shown in Fig. 2. [6]

(c) Explain the factors that determine whether the devaluation of a currency such as the Icelandic krona would turn a current account deficit into a surplus. [4]

(d) Consider whether the costs to an economy of managing its exchange rate outweigh the benefits of such a system. [6]

Section B

Answer **one** question.

2 **(a)** Explain the role of the factor enterprise in allocating resources in a market economy when there is an increase in the demand for a good. Use a diagram to support your answer. [8]

(b) Discuss **two** methods of increasing the provision of merit goods in a mixed economy. Consider which is more likely to be effective. [12]

3 **(a)** Explain how economists use the concept of elasticity to distinguish between substitute goods and complementary goods. [8]

(b) Discuss which measure of the different types of elasticity of demand is most useful for a business when setting the price for its product. [12]

4 **(a)** Explain the difference between fiscal policy and monetary policy. Show how each can be used to increase aggregate demand. [8]

(b) Discuss whether supply side policy is more likely to be successful than fiscal policy when an economy is faced with inflation. [12]

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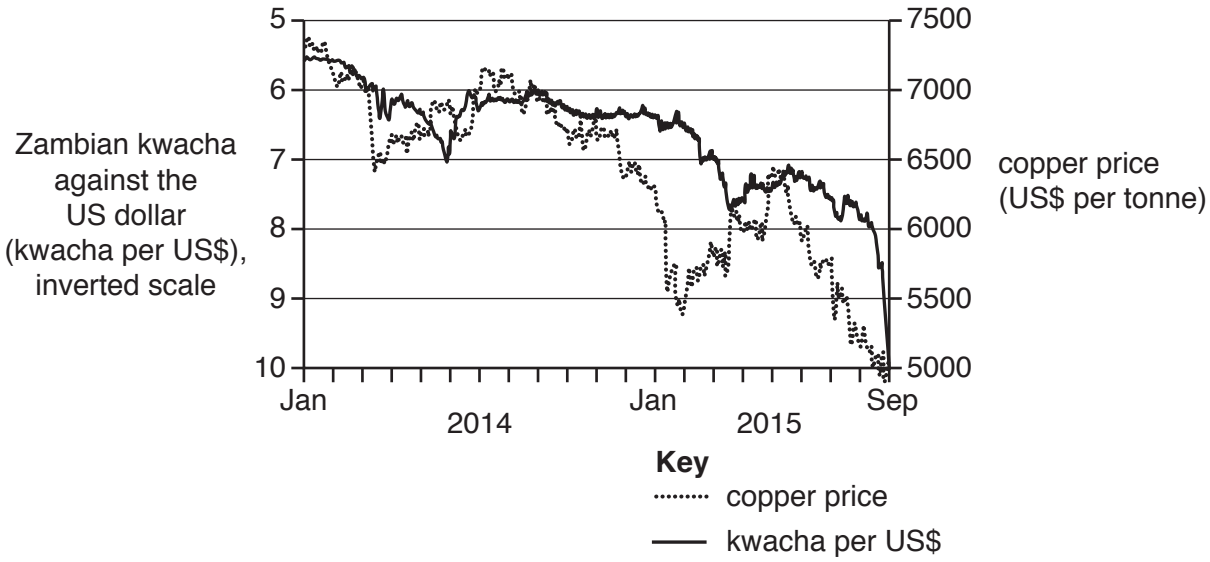
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Section A

Answer this question.

1 **Zambia bears the brunt of China's economic slowdown**

Fig. 1: Zambian kwacha and copper price



Source: Thomson Reuters Datastream

Zambia was one of Africa's main beneficiaries when China's economy was expanding. With copper its key export, China's huge demand for minerals helped the southern African nation enjoy a decade of economic boom. But as China's economy slows down, Zambia finds itself with real problems. A large mining group has announced it is to suspend production for 18 months. In addition, a Chinese-owned company has said it will suspend operations and cut jobs in Zambia because of the copper price. The situation highlights the vulnerability of Africa's resource-dependent nations to the fortunes of China.

Zambia is Africa's second biggest copper producer and depends on the metal for about 70% of its foreign exchange earnings and 25–30% of government revenue. Copper prices have fallen 18% this year, sliding to a six year low of below US$5 000 per tonne last month. As a result, Zambia has been ranked top of an index of African nations most exposed to China's slowdown. In 2012, Zambian exports to China amounted to 4.3% of Zambia's national income.

During the boom years, mining led to billions of dollars of investment. Much of this was foreign direct investment from China. The sector was a key driver of Zambia's economy, which grew by an annual average of 6.4% over the last decade – one of the world's fastest growth rates.

The Zambian government is now struggling to balance its budget. It is expected that the 2015 fiscal deficit will be much greater than previously estimated, and the government has pledged to reduce its spending. A further problem is that the weakness of Zambia's currency, the kwacha, risks feeding through into inflation.

The government has spoken of the need for economic diversification to reduce the country's dependence on copper. This is a tough task which China's slowdown has highlighted for many resource-rich African nations.

Source: Financial Times, 9 September 2015

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(a) **(i)** What is the overall trend in the value of the Zambian kwacha from January 2014 to September 2015 shown in Fig. 1? [1]

(ii) Explain why the economic slowdown in China has resulted in this change in the value of the kwacha. [3]

(iii) Explain how the change in the value of the kwacha might feed into inflation in Zambia. [4]

(b) Explain how the fall in China's demand for copper would be likely to affect each of the components of aggregate demand in Zambia. [6]

(c) Consider whether economic theory would support the view that diversification of the Zambian economy is the most effective way of tackling the problems it faces as a result of the slowdown of China's economy. [6]

Section B

Answer **one** question.

2 **(a)** Use the concept of income elasticity of demand to explain how a rise in incomes would affect the demand for an inferior good and for a necessary good. [8]

(b) Discuss the range of policies that are available to businesses to increase sales when incomes are falling. Consider which is most likely to be successful. [12]

3 **(a)** Explain the role of profit in an economy where the price mechanism operates to allocate resources. [8]

(b) Discuss whether resources are more effectively allocated in a planned economy or in a market economy. [12]

4 **(a)** Explain how the functions of money are affected when there is a high rate of inflation in an economy. [8]

(b) Discuss how effective monetary policy is likely to be in correcting both inflation and deflation when they each occur in an economy. [12]

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