



22125113



**ECONOMICS
STANDARD LEVEL
PAPER 2**

Wednesday 16 May 2012 (morning)

2 hours

INSTRUCTIONS TO CANDIDATES

- Do not open this examination paper until instructed to do so.
- Answer three questions. Each question is worth *[20 marks]*.
- Use fully labelled diagrams and references to the text / data where appropriate.
- The maximum mark for this examination paper is *[60 marks]*.

1. *Study the extract below and answer the questions that follow.*

EU court rules minimum price for cigarettes illegal

- ❶ The European Court of Justice has ruled that Ireland cannot impose a **minimum price** on cigarettes. It said that member countries would have to find other ways to combat smoking. This could be achieved by increasing indirect tax on tobacco, but imposing a minimum price would distort fair competition in the market. The ruling is designed to maintain the freedom of manufacturers and importers to benefit from lower costs and greater efficiency.
- ❷ The judgment said the aim of ensuring that tobacco prices are high can be “adequately” achieved by increasing tax, since any indirect tax rises are, sooner or later, reflected in an increased retail price, without removing the freedom of manufacturers to set prices.
- ❸ The Irish government had claimed that it needed to fix a high minimum price to discourage smoking. This followed government legislation to ban tobacco advertising and promotion in July 2009. According to a spokesperson from the anti-smoking group ASH (Action on Smoking and Health), this measure helped to prevent retail outlets from making young people feel attracted to buying cigarettes. “Close to 30% of our population still smoke and 7000 die from tobacco-related disease each year,” he said.
- ❹ It has been argued that increasing the price of cigarettes is one of the most effective ways of curbing harmful smoking and there is a need to make cigarettes less appealing, particularly to young people. The evidence is that banning advertising, introducing minimum pricing and increasing health warnings can all work.
- ❺ The head of a major retail organization has attacked the idea of minimum pricing for cigarettes. He argued that artificially fixing a minimum price would not be effective. Also, since the demand for tobacco is inelastic, raising the price would not work. Moreover, it was against the **free market** for a government to set prices for any product available to consumers, limiting their freedom to choose.

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(Question 1 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) minimum price (*paragraph 1*) [2 marks]
 - (ii) free market (*paragraph 5*). [2 marks]
- (b) Using an appropriate diagram, explain the possible effect on the market for cigarettes of the ban on tobacco advertising in Ireland. [4 marks]
- (c) Using an appropriate diagram, explain why, if the demand for cigarettes is inelastic, raising the price may not be effective. [4 marks]
- (d) Using information from the text/data and your knowledge of economics, evaluate the economic effects of the imposition of a minimum price for cigarettes. [8 marks]

2. *Study the extract and data below and answer the questions that follow.*

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(Question 2 continued)

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

Eurozone debt crisis

- ❶ A debt crisis in Europe has caused financial markets to watch government plans to deal with the issue of rising government debt.
- ❷ Governments have borrowed heavily to bring the 16 nation eurozone* out of its first **recession** and debt levels are expected to be well above the European Union (EU) limit of 60% of gross domestic product (GDP). Average eurozone government debt could reach 84% of GDP in 2010. Germany, long considered a model of fiscal discipline, forecasts government debt at around 78% of GDP in 2010 while, in Greece, government debt of 120% of GDP is expected.
- ❸ The combination of larger **budget deficits**, low economic growth and support for the banking sector has caused higher public debt levels. Eurozone governments have been urged to reduce debt. The increase in debt is raising the cost of borrowing for many countries and adding to the cost of repayments in future budgets.
- ❹ With unemployment rising and weak growth expected in 2010, officials cannot count on increased tax revenues for much help in paying off debt, much of which is owed to other countries. Possible policy solutions include cutting welfare spending or raising the retirement age to reduce future government costs. Alternatively, the member countries of the EU and the International Monetary Fund (IMF) may need to give money to the countries in danger of default.
- ❺ The debt crisis is limiting government finances and potential growth. Government revenue will be further limited by an aging population that will need expensive health care in the years to come. Many countries have pledged to tighten fiscal and monetary policies. However, this may damage an economic recovery.
- ❻ Failing to act on the deficits and debt may, however, spark a negative reaction from financial markets that will demand higher interest payments on loans. The Prime Minister of Greece has warned: “Either we eradicate the debt, or the debt will eliminate the country”.

* eurozone: the group of countries which use the euro as their common currency

[Source: adapted from: ‘Eurozone debt crisis looms’, by William Ickes, 4th January 2010, <http://www.businessday.com.au/business/eurozone-debt-crisis-looms-20100103-lnap.html>]

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(Question 3 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) recession (*paragraph 2*) *[2 marks]*
 - (ii) budget deficits (*paragraph 3*). *[2 marks]*
- (b) Using an appropriate diagram, explain the likely effect on potential output of an aging population. *[4 marks]*
- (c) Using an AD/AS diagram, explain how tightening fiscal policies could damage an economic recovery. *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate possible policy options for addressing the debt crisis facing many economies in Europe. *[8 marks]*

4. *Study the extract below and answer the questions that follow.*

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[Please refer to www.bbc.co.uk/news/10358146]

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(Question 4 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) protectionism (*paragraph 2*) *[2 marks]*
 - (ii) exchange rate (*paragraph 3*). *[2 marks]*
- (b) Explain how the fixed value of the yuan may have adversely affected US producers. *[4 marks]*
- (c) Using an appropriate diagram, explain how China has prevented its currency from rising in value. *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate the possible effects of a currency appreciation on the Chinese economy. *[8 marks]*

5. Study the extract below and answer the questions that follow.

Micro-credit conflict of interest

- ❶ The idea of giving small loans to poor people, especially women, was hailed as the key to achieving **economic development** for even the poorest citizens. Muhammad Yunus, the economist who pioneered the practice by lending small amounts to basket weavers in Bangladesh, won a Nobel Peace Prize in 2006.
- ❷ The practice has grown so popular, helping establish small businesses such as tailors and hairdressers, that some are now concerned over the direction it has taken. Attracted by the prospect of profits from even the smallest of loans, some banks now dominate micro-credit, with some charging **interest rates** of over 100%.
- ❸ The key question facing the industry remains how much money investors should make from lending to poor people, mostly women, often at hidden interest rates. “Micro-credit should be seen as an opportunity to help people out of poverty, not as an opportunity to make money out of poor people,” Yunus said. “Interest rates should be 10 to 15% above the cost of raising the money and anything beyond that is exploitation. Most micro-credit lenders would fail this test.”
- ❹ How much interest and profit are acceptable and what constitutes exploitation? The interest rates that draw the most concern include those in Nigeria and Mexico, where the demand for small loans from a large population cannot be met by existing lenders. One Mexican lender charges an annual rate of 125%. The average in Mexico is about 70%, compared with a global average of about 37% in interest and fees.
- ❺ There is debate over whether micro-credit loans actually lift people out of poverty. Some researchers conclude that not every poor person is an entrepreneur in waiting but the loans do help relieve some of the worst aspects of poverty.
- ❻ The micro-credit industry has outgrown its charitable beginning. Despite a promise to put the money back into development, analysts say the high interest rates and healthy profits of the largest micro-credit institutions pushed up interest rates across Mexico.

[Source: ‘Micro-credit conflict of interest’

Adapted from <http://www.theage.com.au/world/conflict-of-interest-20100415-shjj.html>, 16 April 2010]

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(Question 5 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) economic development (*paragraph 1*) *[2 marks]*
 - (ii) interest rates (*paragraph 2*). *[2 marks]*
- (b) Using a circular flow diagram, explain how micro-credit increases economic activity in a developing economy. *[4 marks]*
- (c) Using a poverty cycle diagram, explain how micro-credit can “help relieve some of the worst aspects of poverty” (*paragraph 5*). *[4 marks]*
- (d) Using information from the text/data and your knowledge of economics, evaluate micro-finance as a means of promoting economic development. *[8 marks]*
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