



22065103

**ECONOMICS
HIGHER LEVEL
PAPER 3**

Tuesday 9 May 2006 (morning)

2 hours

INSTRUCTIONS TO CANDIDATES

- Do not open this examination paper until instructed to do so.
- Answer three questions.
- Use fully labelled diagrams and real-world examples where appropriate.

Answer **three** questions. Each question is worth [20 marks].

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

Drug companies bring hope for HIV/AIDS sufferers

- ❶ “Industry puts the average cost of developing a new drug at around US\$800 million. Were it not for a patent system that rewards companies for risking millions on research, anti-HIV/AIDS drugs would not exist”, said World Trade Organization’s (WTO) director general, Mike Moore.
- ❷ 95 % of individuals worldwide who are infected with the HIV/AIDS virus live in poor countries, with almost no access to life-prolonging treatment because of barriers such as the high cost of drugs.
- ❸ One possible solution to the high cost of drugs seems to be through differential pricing schemes that charge poor countries less than the rich. This form of legal **price discrimination** is already used for vaccines and contraceptives, with prices as low as 1 % of those in the USA. Major pharmaceutical companies have recently promised to cut prices to cost levels in Africa. The aim is to cut the price for HIV/AIDS therapy by as much as 95 %.
- ❹ The big **multinational corporations** (MNCs) do not, in theory, object to differential pricing for their pharmaceutical products. But they still want patent protection and guarantees to prevent the re-entry of low-priced drugs back to developed countries.
- ❺ Delay can spell disaster when dealing with HIV/AIDS. A recent forecast sees South Africa heading for an economic collapse within three generations, as the number of wage-earners is dramatically reduced and parents die before they can teach their children the basics of life. Thankfully, the chance of this problem happening was reduced last week, when the South African government announced a serious, well-funded and long-term plan for treating its sick citizens with HIV/AIDS drugs. If the plan is competently implemented, HIV positive parents should survive long enough to put their children through school, and South Africa should pull back from the brink of catastrophe.

[Source: adapted from Lancet 7 April 2001, Issue 9262 and Time 2 February 2004 Vol 163 Issue 5, Science 17 March 2000, Vol 287, Issue 5460, Lancet, 7 April 2001, Vol 357, Issue 9262, The Economist 29 November 2003 p. 11, Time 2 February 2004, Vol 163 Issue 5 p. 44]

(This question continues on the following page)

(Question 1 continued)

- (a) Define the following terms indicated in bold in the text:
 - (i) price discrimination (*paragraph 3*) *[2 marks]*
 - (ii) multinational corporations (*paragraph 4*). *[2 marks]*
- (b) Explain, using the text and your knowledge of economics, the conditions necessary for pharmaceutical companies to successfully employ “differential pricing schemes” (*paragraph 3*). *[4 marks]*
- (c) Using a production possibility curve diagram, explain the impact on economic growth of any delay in dealing with the HIV/AIDS epidemic in countries such as South Africa. *[4 marks]*
- (d) Using information from the text and your knowledge of economics, evaluate the role of a multinational corporation in assisting the economic development of a less developed economy. *[8 marks]*

2. Study the extract and table below and answer the questions that follow.

Singapore inflation creeps upward

- ❶ Prices have risen in Singapore for the first time in five months, which is an encouraging sign that the island state could avoid the threat of deflation. According to the Singapore Department of Statistics, increases in the cost of food, clothing and housing has resulted in the consumer price index rising by 0.2 % in November, the first upward movement since June.
- ❷ Economists have predicted further falls in the inflation rate, and still believe weak consumer confidence means this current inflationary increase will not last long. The increase in inflation is welcome as the Singapore government last week warned that the state of the world economy means that Singapore’s economic growth would be at a low 2.0 to 2.5 %, and the **unemployment rate** would still continue to increase.
- ❸ While these price rises may not look good for consumers, the low level of economic growth has put policy makers in fear of deflation. There already is excess productive capacity in Singapore’s economy, which is dependent on trade. The disappointing state of the American (US) economy will push Singapore into the slump phase of a **business/trade cycle** again, especially as trade has fallen 30 % from the previous year.
- ❹ In Singapore, the price-conscious consumers have kept inflation low. This raises concerns that Singapore could follow Japan into a deflationary spiral and recession when prices keep falling and businesses find the conditions unfavourable to invest.
- ❺ The Singapore Government plans to raise consumption tax (indirect tax) from 3 % to 5 % at the end of the year, but even this has failed to bring forward consumer spending before the tax is implemented.

Year	Economic Growth rate (%)	Inflation rate (%)	Unemployment rate (%)
2000	10.1	1.3	3.1
2001	–5.6	1.0	3.3
2002	2.8	–0.4	4.4
2003 (estimated)	2.3	0.5	4.7

[Source: adapted from BBC News <http://news.bbc.co.uk/1/hi/business/2600313/stm>, 31 Dec 2003 and data from Singstat and Reserve Bank of Australia]

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(Question 2 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) unemployment rate (*paragraph 2*) *[2 marks]*
 - (ii) business/trade cycle (*paragraph 3*). *[2 marks]*
- (b) Using an appropriate diagram, explain how a government may attempt to close a deflationary gap. *[4 marks]*
- (c) Explain why deflation (a downward movement in the average level of prices) creates conditions that make it “unfavourable” for businesses to invest (*paragraph 4*). *[4 marks]*
- (d) Using information from the text and your knowledge of economics, evaluate the extent to which unemployment would still be a problem if inflation were allowed to increase. *[8 marks]*

3. Study the diagrams and text below and answer the questions that follow.

Retail sales dip

Diagram 1 – Australian official interest rates

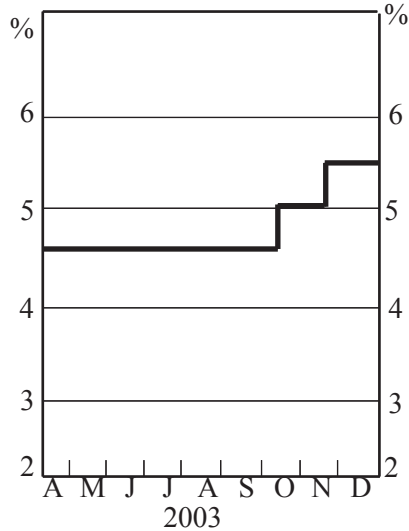
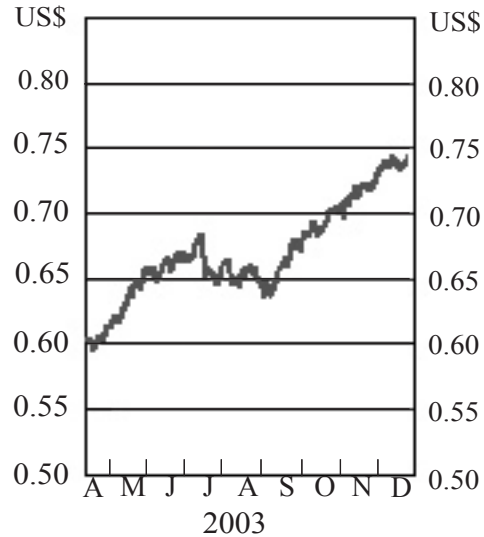


Diagram 2 – Value of Australian Dollar (A\$)



[Source: RBA Reuters]

Text 1:

Australian **interest rates** remained unchanged after the February 2004 meeting of the Reserve Bank (Australia’s Central Bank). Previously, the Reserve Bank had raised official interest rates by 0.25 % in November and again in December 2003.

Text 2:

Australian retail sales dipped in December 2003. This was the first negative result since December 2002 and was driven by a 2.1 % decline in retail sales. Exporters, suffering from a loss in their ability to compete, have encouraged the Reserve Bank to consider the impact of the high Australian dollar on their sales.

Text 3:

The Reserve Bank has expressed concerns about the future inflation risks. Inflation in the non-traded sector of the economy remains relatively high, at over 4 %, reflecting the overall strength of the domestic economy, strong demand conditions in the housing sector and continuing cost pressures in some service industries. At the same time the overall inflation rate is being held down by the impact of the **exchange rate appreciation**, with prices of tradeable items in the Consumer Price Index (CPI) declining slightly in recent quarters.

[Source: adapted from *The Australian* 6 February 2004, *Sydney Morning Herald* 2 February 2004 and SMH 4 February 2004 and RBA Statement on Monetary Policy 5 February 2004]

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(Question 3 continued)

- (a) Define the following terms indicated in bold in the text:
 - (i) interest rates (*Text 1*) *[2 marks]*
 - (ii) exchange rate appreciation (*Text 3*). *[2 marks]*
- (b) Using an appropriate diagram, explain how an increase in interest rates may have caused a decline in retail sales. *[4 marks]*
- (c) With reference to the diagrams, explain the relationship between the level of interest rates in Australia (*Diagram 1*) and the value of the Australian dollar (*Diagram 2*). *[4 marks]*
- (d) Using information from the text and your knowledge of economics, evaluate the use of interest rates as a tool for controlling inflation. *[8 marks]*

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

Protecting shrimp farmers

- ❶ The USA has started talks with Thailand on a free trade area.
- ❷ The US International Trade Commission (ITC) has said it has evidence to suggest that Thailand and five other Asian countries were selling shrimps at below market prices, and gave a warning that it might impose tariffs. This threatens to complicate the free trade talks expected to start soon.
- ❸ The tariffs are being demanded by the Southern Shrimp Alliance that represents thousands of shrimp catchers from the USA. The alliance is seeking tariffs up to 349 % on imported shrimps. Critics of this action argue that it will do little to benefit struggling American shrimp catchers, while making it very difficult for small scale shrimp farmers in these Asian countries.
- ❹ Thailand and the other leading shrimp exporters to the USA insist they are not dumping. They say their labour costs are lower and they are more **productively efficient** because they farm shrimp in ponds rather than fishing in the ocean as the Americans do.
- ❺ If an **anti-dumping** ruling is successful it is estimated that Thailand’s 35 000 shrimp farmers will need to reduce output by 20-30 %, and hundreds of small scale producers and feed producers will go out of business.

Table 1

Increase in Asia’s major shrimp export values to the USA

	2002 (thousands of \$)	2003 (thousands of \$)	% Change
Thailand	399.9	445.3	11.3
Vietnam	282.9	394.4	39.4
India	293.4	327.7	11.7
China	131.6	245.3	86.4
Indonesia	118.0	141.1	19.5
Total US Imports	2075.5	2460.9	18.6

Table 2

Hourly labour costs

	Shrimps (US\$)	Shirts (US\$)
Thailand	0.50	2.00
USA	17.00	26.00

[Source: adapted from *Free Trade runs into Protectionism*, Murray Heibert and Shawn W Crispin
The Far Eastern Economic Review, 4 March 2004]

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(Question 4 continued)

- (a) Define the following terms indicated in bold in the text:
- (i) productively efficient (*paragraph 4*) *[2 marks]*
 - (ii) anti-dumping (*paragraph 5*). *[2 marks]*
- (b) Using an appropriate diagram, explain why a knowledge of comparative advantage is important for a developing country. *[4 marks]*
- (c) Using an appropriate diagram, explain how a knowledge of income elasticity of demand (YED) is useful for exporters in a less developed country such as Thailand. *[4 marks]*
- (d) Using information from the text and your knowledge of economics, evaluate the costs and benefits of membership of a free trade area for a country. *[8 marks]*

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

EU's secret plans target markets in developing countries

- ❶ The European Union (EU) has drawn up secret plans aimed at opening the service sector markets in the world's poorest countries in return for reducing its farm subsidies.
- ❷ The demands made by the European Union would allow European firms to charge for providing water to some of the 1.2 billion people living on less than a dollar a day. Water has always been regarded as a **free good**, but this idea is changing. It would give large gains to European banks, telecommunication businesses and business service firms.
- ❸ The European Union is under intense pressure to remove export subsidies that depress global food prices and impoverish farmers in the developing world. Reform of Europe's agricultural policy is a top demand from developing countries.
- ❹ Supporters for less developed countries argue that the EU proposals are not pro-development, nor do they encourage **sustainable development**. Many poor countries would be tied to unfair and irreversible commitments if they agree to European requests. If these economic decisions go wrong developing countries would be affected for generations to come. A more effective approach would be to encourage export-led growth.
- ❺ While the privatization of water would result in a higher price for the consumer, the advantage is that the water will be clean and filtered, enabling the population to be healthier and live longer, acting as a positive externality. Against this is the cost of implementing the privatization, possible social and economic upheaval, and institutional and political factors that would act as significant barriers to economic growth and development.
- ❻ Among its demands, the EU wants Bolivia to let in more overseas water companies despite a recent case where a multinational company increased water prices by 200 % in one city. The EU is also looking at Panama with similar plans where water privatization plans were scrapped in 1998 after strikes and demonstrations.

[Source: adapted from Gary Duncan, *The Times* 26 June 2003]

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(Question 5 continued)

- (a) Define the following terms indicated in bold in the text:
 - (i) free good (*paragraph 2*) *[2 marks]*
 - (ii) sustainable development (*paragraph 4*). *[2 marks]*
 - (b) Using an appropriate diagram, explain why the demand for water would be price inelastic. *[4 marks]*
 - (c) Using an appropriate diagram, explain how the availability of a safe water supply may improve living standards in less developed countries. *[4 marks]*
 - (d) Using information from the text and your knowledge of economics, evaluate the externalities to be considered in determining whether water should be supplied and sold by the private sector. *[8 marks]*
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