Diploma Programme
Programme du diplôme
Programa del Diploma

Economics
Standard level
Paper 2

16 May 2023

Zone A afternoon | **Zone B** morning | **Zone C** afternoon

1 hour 45 minutes

Instructions to candidates

- Do not open this paper until instructed to do so.
- You are permitted access to a calculator for this paper.
- Unless otherwise stated in the question, all numerical answers must be given exactly or correct to two decimal places.
- You must show all your working.
- 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]**.

9 pages

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Answer **one** question.

1. Read the extracts and answer the questions that follow.

Text A — Overview of Uruguay

1 With a population of only 3.5 million, Uruguay is one of the smallest nations in South America. Its membership of the MERCOSUR common market allows Uruguayan producers tariff-free access to 290 million consumers in Argentina, Brazil and Paraguay.

2 Agriculture accounts for 8 % of Uruguay's **gross domestic product (GDP)** and 65 % of its export revenue. Exports have increased since the early 2000s, partly due to China's rising demand for commodities. In particular, Uruguay's soybean producers benefitted from significantly higher prices during the commodity boom. China is now Uruguay's most important export destination, with soybeans accounting for over 50 % of its exports to China.

3 Uruguay's real GDP increased by an average of 5.39 % per year from 2005 to 2014. However, the economy slowed considerably when the commodity boom ended in 2015. It slowed further because of decreased regional demand when the largest members of MERCOSUR, Argentina and Brazil, faced a recession in 2017. Uruguay's real GDP grew on average by 1.04 % per year from 2015 to 2018.

4 With the increasing importance of China and the European Union (EU) as export markets, Uruguay has managed to reduce its dependency on MERCOSUR. However, attempts to diversify its exports away from agriculture have not been successful. The end of the commodity boom contributed to a fall in export revenue and the depreciation of the peso (Uruguay's currency). The currency has lost over 25 % of its value since 2015.

5 Inflation stayed at a relatively high rate of 8 % in 2018 due to the weaker currency. The unemployment rate also increased to 7.9 % as a result of the economic slowdown. The higher cost of living and the lower rates of employment could inhibit efforts to reduce inequality and poverty levels.

6 Despite rising inflation and unemployment, Uruguay's minimal corruption, abundant natural resources and access to a large common market continue to attract foreign direct investment (FDI). Investments in the paper and wood industries have made forestry one of the country's fastest growing industries. Increased FDI inflows have also prevented the peso from depreciating further.

Text B — The EU–MERCOSUR free trade agreement

1 The EU and MERCOSUR are finalizing the terms of a free trade agreement, which would enable Uruguay to increase its exports to the 27 EU member states. The EU currently buys 11 % of all Uruguayan exports, mostly animal products, paper, vegetables and wood.

2 Once the free trade agreement comes into effect, almost all agricultural and industrial tariffs between the EU and MERCOSUR will be removed. The imports of beef, poultry and sugar will not be included in the list of tariff-free products but will be subject to very large quotas. This will allow increased exports of these products to EU countries.

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(Question 1 continued)

3 The free trade agreement may cause bankruptcies in the manufacturing sector and higher structural unemployment in Uruguay. EU exports to Uruguay largely consist of manufactured goods, such as chemicals, machinery, transport equipment and plastics, which are in high demand despite the current tariffs of up to 35 %.

4 One third of FDI into Uruguay comes from the EU. Anticipation of the free trade agreement has led to more EU investments in Uruguay's forestry sector. Environmental organizations have warned that the free trade agreement could be a threat to **sustainability** as South American forests are cleared to create land for cattle farming, paper and wood production. The deforestation might also disrupt water sources that supply rural villages, depriving the villagers of clean water.

Text C — Uruguay seeks trade agreements outside MERCOSUR

1 Members of MERCOSUR have differing views on trade policies. Brazil, Paraguay and Uruguay believe in trade liberalization and want to increase competition through a reduction of the common external tariff. On the other hand, Argentina wants to maintain the high external tariff to protect industries from cheap imports from China and to avoid prolonging its current recession.

2 Uruguay has expressed its desire to seek trade agreements apart from MERCOSUR, which is prohibited by the common market's rules. If Uruguay pursues separate bilateral agreements, it is likely to lose its MERCOSUR membership and the benefits of any existing free trade agreement.

Table 1: Current account data for Uruguay (US$ billion)

	2018	2019
Exports of goods and services	18.72	18.52
Imports of goods and services	19.15	17.88
Net income	–3.66	–3.05
Net current transfers	0.10	0.19

Table 2: Selected income data for Uruguay

	2010	2015	2019
Gross national income (GNI) per capita (PPP US$)	16 190	19 290	22 810
Gini index	44.5	40.1	39.7

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(Question 1 continued)

(a) (i) Define the term *gross domestic product (GDP)* indicated in bold in the text (**Text A**, paragraph 2). [2]

(ii) Define the term *sustainability* indicated in bold in the text (**Text B**, paragraph 4). [2]

(b) (i) Using information from **Table 1**, calculate the change in Uruguay's current account balance between 2018 and 2019. [2]

(ii) Using information from **Table 1**, state whether Uruguay is facing a deficit or a surplus in its balance of trade in goods and services in 2019. [1]

(iii) Using information from **Table 2**, sketch the change in Uruguay's Lorenz curve from 2010 to 2015. [2]

(c) Using a demand and supply diagram, explain how China might have contributed to the Uruguayan soybean producers' higher (total) revenue (**Text A**, paragraph 2). [4]

(d) Using an exchange rate diagram, explain how the end of the commodity boom might have contributed to the depreciation of the peso (**Text A**, paragraph 4). [4]

(e) Using an appropriate diagram, explain how the MERCOSUR–EU free trade agreement may lead to higher structural unemployment in Uruguay (**Text B**, paragraph 3). [4]

(f) Using an AD/AS diagram, explain the likely impact of the reduction of the common external tariff on Uruguay's potential (long-term) output (**Text C**, paragraph 1). [4]

(g) Using information from the text/data and your knowledge of economics, discuss the impact of economic integration on the Uruguayan economy. [15]

2. Read the extracts and answer the questions that follow.

Text D — Overview of Cameroon

1 Cameroon is a country in Central Africa with a population of 25 million. It is rich in natural resources, including oil and mineral ores, and produces a wide range of agricultural products, such as cotton and cocoa. Its economic growth is usually driven by the export of oil. The gross domestic product (GDP) of Cameroon grew by an average of 5.6 % per year between 2013 and 2014 when oil prices were high.

2 Economic growth slowed and the budget deficit increased sharply between 2014 and 2016, when oil prices fell by 45 %. Oil production is a major part of the formal economy and is an important source of tax revenue for the government of Cameroon. Up to 90 % of the workers in other sectors are employed in the informal economy and hence contribute significantly less to tax revenue. Increased military spending in response to recent conflicts in the western regions of Cameroon further widened the budget deficit.

3 Since the collapse of oil prices, economic growth has been supported by expansionary fiscal policy, which has become increasingly difficult to sustain. The budget deficit has increased to around 5 % of GDP and caused government (national) debt to rise to 30 % of GDP.

4 Although there has been some reduction in absolute poverty in Cameroon, the number of people living in **relative poverty** increased by 12 % to 8.1 million between 2007 and 2014. The funds allocated for poverty reduction often go to subsidies for electricity, food and fuel. This reduces available funding for education and healthcare, which is insufficient in rural areas where poverty is most extreme.

5 With an abundance of natural resources, Cameroon has the potential to attract foreign direct investment (FDI). However, weak governance and the poor business environment have deterred foreign investors. Local entrepreneurs are also discouraged by the long wait times for obtaining licenses to operate and the difficulties in securing business loans.

6 Cameroon maintains a fixed exchange rate to the euro, at 1 franc = 0.0015 euro. Because of the persistent trade deficit, the franc (Cameroon's currency) is overvalued at this level. Interest rates are kept high to prevent capital flight, which could increase the currency's overvaluation.

Text E — The Growth and Employment Strategy

1 The Growth and Employment Strategy is a set of policies adopted by the government of Cameroon to encourage diversification and promote efficiency in production. The policies have three broad objectives:

- Create jobs and reduce the size of the informal economy through investment in human capital.
- Increase productivity in agriculture, mining, and selected industries with potential for growth (timber, tourism, and information and communication technologies).
- Encourage private investment and trade through the provision of **infrastructure** (including roads, ports and clean water supply).

2 Productivity is low, especially in the primary sector. Cameroon has one million small farms engaged in traditional agriculture, but has a limited number of workers trained in good farming practices and management skills. Unskilled workers often work in the informal economy.

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(Question 2 continued)

3 Access to imported fertilizer and lower transportation costs could reduce costs of production significantly. Farms also need to increase productivity to reduce labour costs. The monthly agricultural wage averages 20 000 francs but the government has recently increased the minimum wage to 36 270 francs. This could lead to an improvement in the economic well-being of workers in the formal economy but could increase unemployment and force some workers to enter the informal economy.

4 The government remains committed to keeping food prices low in the short term through subsidies. Due to improved farming methods, farmers produced better quality cocoa beans in 2019, allowing them to charge higher prices on the international market. Over time, the increase in productivity should lead to higher incomes, lower prices and higher-quality products.

Text F — Free trade agreements with the European Union (EU) and the United Kingdom (UK)

Cameroon has signed free trade agreements with the EU and the UK, which allow tariff-free access to the EU and the UK markets for products such as bananas, aluminium and processed cocoa products. Tariffs on imports into Cameroon of machinery and equipment, vehicles and fertilizers were also removed. However, tariffs on textiles and strategic agricultural products such as meat products, milk and selected vegetables were maintained.

Table 3: Selected data for Cameroon

	2018	2019
Consumer price index (CPI) (base year = 2010)	115.8	118.6
Nominal interest rate* (%)	6.39	7.94

* charged by financial institutions on loans

Table 4: Cameroon's main export markets (2019)

	Share of export revenue (%)
EU and UK	42.48
China	18.10
India	7.63
USA	6.02

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(Question 2 continued)

(a) (i) Define the term *relative poverty* indicated in bold in the text (**Text D**, paragraph 4). [2]

(ii) Define the term *infrastructure* indicated in bold in the text (**Text E**, paragraph 1). [2]

(b) (i) Using the information in **Table 3**, calculate the inflation rate in Cameroon in 2019. [1]

(ii) Using the information in **Table 3** and your answer to (b)(i), calculate the real interest rate in Cameroon in 2019. [1]

(iii) Using an appropriate diagram, illustrate the unemployment which may arise from the imposition of a minimum wage (**Text E**, paragraph 3). [3]

(c) Using an AD/AS diagram, explain how expansionary fiscal policy has supported economic growth in Cameroon (**Text D**, paragraph 3). [4]

(d) Using an exchange rate diagram, explain how capital flight may increase the overvaluation of the franc (**Text D**, paragraph 6). [4]

(e) Using a demand and supply diagram, explain how government subsidies may help to keep food prices low (**Text E**, paragraph 4). [4]

(f) Using an international trade diagram, explain the effect of removing tariffs on the imports of fertilizer into Cameroon (**Text F**). [4]

(g) Using information from the text/data and your knowledge of economics, discuss the need for a balance between market-oriented policies and government intervention to promote economic development in Cameroon. [15]

Disclaimer:

References:

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Text B European Commission, n.d. [online] Available at: https://ec.europa.eu/trade/policy/countries-and-regions/countries/uruguay/ [Accessed 14 March 2022] Source adapted.

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Text E The World Bank, 2022. *Cameroon – Fostering skills for inclusive workforce development, competitiveness, and growth: a framework for action (French)* [online] Available at: https://documents.worldbank.org/en/publication/documents-reports/documentdetail/862521468001177532/cameroon-fostering-skills-for-inclusive-workforce-development-competitiveness-and-growth-a-framework-for-action [Accessed 15 March 2022] Source adapted. CC BY 3.0 IGO.

Text F Bama, C. E., 2021. *Cameroon signs an Interim Economic Partnership Agreement with the United Kingdom* [online] Available at: https://www.tralac.org/blog/article/15168-cameroon-signs-an-interim-economic-partnership-agreement-with-the-united-kingdom.html [Accessed 15 March 2022] Source adapted.

Table 3 The World Bank, 2022. [online] Available at: https://data.worldbank.org/ [Accessed 14 March 2022] Source adapted.