Paper 2 (SL and HL) markschemes

Examples of markschemes for Exam practice: paper 2 in the *Economics for the IB Diploma* CD-ROM are provided below.

Paper 2 section A: International economics

Chapter 13 International trade

Text/data 1: Removing quotas on United States textiles

Question A.1

(a) **(i)** and **(ii)** See textbook Glossary for definitions.

(b) For drawing a quota diagram showing how the quota restricts the quantity of imports into the United States (see Figure 13.9, textbook, page 369), and for explaining that removal of the quota leads to a larger quantity of Chinese exports to the United States.

(c) For drawing a tariff diagram showing the higher price on imports that results due to the tariff in relation to the world price (see Figure 13.7, textbook, page 366), and for explaining that US producers benefit due to the higher price and higher domestic production, consumers lose due to the higher price and a lower quantity of textiles available in the domestic market, and workers benefit due to greater employment with domestic firms that are producing a larger quantity of textiles.

(d) The command term 'discuss' requires candidates to offer a considered and balanced review that includes a range of arguments, factors or hypotheses. Opinions or conclusions should be presented clearly and supported by appropriate evidence.

Responses **may** include:

- Definition of free trade.
- Possible advantages of free trade:
    - Reference to the benefits of trade, which may be to the advantage of both the US and China (see textbook, pages 354–5).
    - US textile manufacturers have become more efficient as they have learned to compete against products of low-wage countries (paragraph 4).
    - Elimination of still-existing tariffs will result in even lower prices for US consumers (paragraph 6).
    - The US may switch to importing more from China and less from Central America (higher level candidates may note that this is a case of trade creation, where higher cost imports are replaced by lower cost imports).
    - China is a growing market for US exports; therefore Chinese consumers can also benefit from free trade (paragraph 6).
    - If China is dumping its textiles in international markets, free trade in China (meaning the elimination of subsidies that permit dumping to take place) will make trade fairer for US producers (paragraph 4).

  - Putting an end to Chinese dumping could make Chinese producers more efficient as they will have to lower costs and prices to continue to compete in international markets.
  - Greater allocative efficiency in the US and China.
- Possible disadvantages of free trade:
  - Some US textile manufacturers may be unable to compete with the Chinese imports.
  - Structural unemployment due to laid-off textile workers may increase in the US.
  - Some Chinese firms may have to close down if they had export advantages due to dumping.
  - Structural unemployment may increase in China.
  - Central American textile manufacturers may be hurt from Chinese textiles directly imported under WTO rules, which would displace the manufacturers that used imported yarns and threads from the US.
  - Central American textile manufacturers may also be hurt due to a fall in exports to the US.
- Any reasonable discussion.
- Conclusions.

Question A.3

(a) **(i)** and **(ii)** For a list of WTO objectives and functions, see textbook, page 364.

(b) For drawing a supply and demand diagram for the US domestic textile industry showing a leftward shift in the demand curve, **and** for explaining that this is a type of structural unemployment, caused by a fall in demand for domestically produced textiles and therefore a fall in demand for labour in the textile industry, due to the large increase in textile imports following the removal of import quotas.

(c) For drawing a demand and supply diagram for the clothing market in Central American countries showing a leftward shift in the demand curve, **and** for explaining that the increase in Chinese imports into the US is likely to partly replace clothing imports from other countries, thus causing a fall in the demand for Central American clothing exports.

(d) The command term 'compare and contrast' requires candidates to give an account of similarities and differences between two (or more) items or situations, referring to both (all) of them throughout.

Responses **may** include:

- Tariff diagram and quota diagram.
- Similarities between the two with respect to market impacts and the economies:
  - Both protect the domestic US textile industry.
  - Both result in a higher domestic price, fall in quantity demanded, increase in domestic quantity supplied, and decrease in imports.
  - Both restrict the quantity of imports into the US and reduce Chinese exports to the US.

  - Both increase the domestic price faced by consumers and received by producers.
  - Both work to reduce the efficiency of protected US producers.
  - Both result in welfare losses for the US and for China.
  - Both work to reduce allocative efficiency for the US and China.
- Similarities between the two with respect to impact on stakeholders and the economies:
  - Both make producers better off, as they received a higher price and sell a larger quantity of output.
  - Both make consumers worse off, as they must pay a higher price and buy a smaller quantity.
  - Both worsen income distribution, though for different reasons (see below).
  - Both work to increase employment in the textile industry; therefore workers gain.
  - Both work to make Chinese textile producers worse off as Chinese exports to the US decrease.
  - Therefore consumers, producers and workers in the US are indifferent between the use of tariffs or quotas for protection.
  - In the short term the US may gain from increased production and employment in the textile industry.
  - In the long term there may be losses in the US due to inefficiencies in production and loss of allocative efficiency.
  - The Chinese economy is likely to be worse off due to lower exports and lower employment.
- Differences between the two:
  - Whereas with tariffs the government gains the tariff revenues, this does not usually happen with quotas, where the government budget remains unaffected.
  - In the case of quotas, when the exporting countries receive the import licences, they gain the quota revenue and they are therefore better off. This is why quotas are usually preferred to tariffs by the exporting countries.
  - Therefore revenues gained by the government under tariffs are transferred to foreign exporters in the case of quotas, making the social welfare loss under quotas larger than the social welfare loss under tariffs.
  - While income distribution worsens in both cases, with tariffs it worsens because the tariff works as a regressive tax, whereas with quotas it works by giving rise to an increase in the price of the good, which is also regressive.
- Any reasonable discussion.
- Conclusions.

Text/data 2: Corporate fraud: free trade

Question A.5

(a) **(i)** and **(ii)** See textbook, page 375, on administrative barriers.

(b) (higher level) For drawing a diagram as in Figure 13.1 (see textbook, page 357), and for explaining that if Mexico has a lower absolute cost in avocadoes and Maine in blueberries, both will be better off by specialising and exporting the good they produce at a lower cost, as they will both be able to consume outside their *PPC*.

(b) (core) For drawing a tariff, quota or subsidy diagram (see Figures 13.7, 13.9 and 13.11, textbook, pages 366, 369, and 372), and for explaining that the imposition of trade barriers causes imports to fall, corresponding to reductions in trading partners' exports, possibly causing trading partners to retaliate by imposing their own trade barriers.

(c) For drawing a tariff diagram showing the domestic price with the tariff to be higher than the international price (see Figure 13.7, textbook, page 366), and for explaining that the removal of tariffs lowers the domestic price and hence the domestic quantity of goods supplied, leading firms to fire workers.

(d) (higher level) The command term 'evaluate' requires candidates to make an appraisal by weighing up the strengths and limitations.

Responses **may** include:

- Diagram illustrating the theory of comparative advantage (see Figure 13.2, textbook, page 359); it should be noted that it is not possible to know from the text which of the two countries has the absolute advantage in the production of both goods (therefore candidates must make an assumption which of the two countries this is in order to draw their diagram).
- Explanation of the theory of comparative advantage.
- Explanation of the author's perspective that:
  - the theory of comparative advantage is the theoretical basis of free trade agreements pursued by the US government (paragraph 2)
  - these free trade agreements work against what is in the best interests of the US, as they have led to unemployment, a depressed economy and a huge trade deficit (paragraph 4)
  - the US government should impose tariffs and other barriers (such as administrative barriers) in order to save jobs and the environment (paragraph 5).
- Weaknesses of the author's perspective:
  - Ignores the importance of the theory of comparative advantage: gains from trade and specialisation, improvement in global resource allocation, increases in global production and consumption.
  - Trade protection leads to numerous losses for society, particularly over the longer term: inefficiencies in production, allocative inefficiency, welfare losses, etc. (see Table 13.3, textbook, page 376).
  - The imposition of tariffs and other barriers may lead to retaliation from other countries that will worsen global trade relations and make all trading partners worse off; trade wars, which the author does not believe can happen (paragraph 6), are a real possibility.
  - The imposition of such trade barriers is likely to be in violation of WTO rules.
- Strengths of the author's perspective:
  - Explanation of weaknesses of the theory of comparative advantage (unrealistic assumptions, etc.; see textbook, pages 361–2).

  - Free trade may lead to short-term losses in terms of lower output and increased unemployment in industries that do not have any trade protection.
  - Trade protection may be justified under certain special circumstances (see textbook, pages 377–9).
  - Validity of the point that heavy subsidisation of large agricultural producers in the US results in selling their output at low prices to countries (such as developing countries) where local farmers have no such protection, thus driving them out of business (paragraph 3); this practice conflicts with policies based on the theory of comparative advantage and should be abolished.
- Any reasonable discussion.
- Conclusions.

(d) (core) The command term 'discuss' requires candidates to offer a considered and balanced review that includes a range of arguments, factors or hypotheses. Opinions or conclusions should be presented clearly and supported by appropriate evidence.

Responses **may** include:

- Explanation of possible measures to increase trade protection, such as tariffs, quotas, subsidies and administrative barriers.
- If protection is widespread there will be major consequences affecting the economy.
- Possible positive effects:
  - Lower imports will be replaced by increased domestic production, prompted by higher domestic prices.
  - Over the very short term, there may be a higher rate of economic growth due to increased production.
  - Unemployment is likely to fall substantially as firms hire more labour to increase production.
  - The government will enjoy increased revenues from tariffs.
  - The trade deficit may shrink due to decreases in imports.
- Possible negative effects:
  - Consumers will be worse off due to higher prices, lower quantities and less choice.
  - Over the longer term, inefficiency in production is likely to increase.
  - Allocative inefficiency will increase both within the US and globally.
  - There will be social welfare losses.
  - It is likely that WTO rules will be violated, involving the imposition of sanctions if the US does not reduce or eliminate the trade barriers.
  - It is likely that other countries whose exports to the US are being affected will retaliate with their own trade barriers toward the US.
  - Such retaliatory policies by other countries will reduce US exports, making the trade deficit larger rather than smaller.
  - The rate of economic growth in the US may fall due to lower exports.
- Any reasonable discussion.
- Conclusions.

Chapter 14 Exchange rates and the balance of payments

Text/data 3: Vietnam tries to deal with trade deficit

Question A.8

(a) **(i)** See textbook, page 395, on the role of the balance of payments.

(ii) See textbook Glossary for definition.

(b) For drawing an exchange rate diagram for the dong showing a rightward shift of the supply-of-dong curve, and for explaining that expansionary monetary policy involves lowering interest rates, leading to outflows of financial capital and therefore an increase in the supply of dong in the foreign exchange market leading to a lower equilibrium price for the dong (the exchange rate).

(c) For explaining that the current account is a component of the balance of payments including the trade balance on goods and services, income flows and current transfers, and for explaining that a deficit involves an excess of debits over credits (more currency outflows than inflows), while a surplus involves an excess of credits over debits (more currency inflows than outflows).

(d) The command term 'discuss' requires candidates to offer a considered and balanced review that includes a range of arguments, factors or hypotheses. Opinions or conclusions should be presented clearly and supported by appropriate evidence.

Responses **may** include:

- Explanation of a fixed (pegged) exchange rate (see textbook, pages 388, 390–91 and 402).
- Explanation of freely floating exchange rate (see textbook, page 382).
- The pegged dong involves exchange rate stability with the US dollar as well as with all other currencies that are pegged to the dollar.
- Advantages of maintaining the pegged (fixed) dong (see textbook, page 402):
  - Greater degree of certainty for stakeholders because of exchange rate stability:
    - Easier for businesses to plan future investments, exports, imports of inputs.
    - Easier for consumers to plan purchases of imported goods and services, financial investments, travel.
    - Easier for governments to plan payment of interest and capital on foreign loans, imported goods, plan imports, etc.
  - Limited currency speculation.
- Disadvantages of maintaining the pegged (fixed) dong (see textbook, pages 402–3):
  - The central bank needs a sufficient supply of foreign currency reserves to be able to buy the dong if there is a current account deficit.
  - External shocks that create imbalances in the balance of payments cannot be easily handled.

   - Limited flexibility is offered to policy-makers as the central bank and government must pursue policies to maintain the pegged dong that may conflict with domestic policy objectives.
   - This is important in the case of Vietnam, which has a large and growing current account deficit (paragraph 4).
   - Vietnam appears to be financing its current account deficit by borrowing from abroad and this is creating large payments for debt servicing (paragraph 3).
- Advantages of moving to a freely floating dong:
   - No need to maintain foreign currency reserves.
   - Ease of adjustment to external shocks.
   - Flexibility given to policy-makers to pursue policies consistent with domestic objectives, such as pursuing expansionary fiscal and monetary policies (paragraph 4) without worrying about maintaining the pegged value of the dong.
   - Persistent current account deficit can be corrected by dong depreciation, avoiding accumulation of large debts.
   - Dong depreciation will boost exports, needed to maintain growth that is heavily based on exports (paragraph 5).
   - Growth in exports will improve the current account deficit.
- Disadvantages of moving to a freely floating dong:
   - Loss of exchange rate stability with the US dollar and other currencies pegged to the dollar, along with all its advantages (noted above).
   - Higher rate of inflation due to dong depreciation that will likely occur, since it is considered that the dong is overvalued (paragraph 2).
- Any reasonable discussion.
- Conclusion.

Text/data 4: China's trade surplus

Question A.11

(a) **(i)** See textbook Glossary for definition.

(ii) The value of imports is a debit item; the value of exports is a credit item.

(b) For explaining that a current account surplus involves an excess of credits over debits, and that this means that the demand for yuan is larger than the supply of yuan, thus putting an upward pressure on the price of yuan (the exchange rate).

(c) For drawing an *AD-AS* diagram for China showing a leftward shift in the *AD* curve, and for explaining that recession in many of China's trading partners led to a smaller demand for Chinese exports, thus leading to a lower demand for labour in Chinese export industries.

(d) The command term 'evaluate' requires candidates to make an appraisal by weighing up the strengths and limitations.

Responses **may** include:

- Advantages to lowering the value of the yuan:
  - A lower value of the yuan would boost exports, which Chinese officials may find desirable in view of the sharp drop in exports, and the expectation that exports will continue to fall (paragraph 1 and 3).
  - An increase in export production would help increase employment and reverse the job losses experienced in southern China (paragraph 4).
  - China's growth depends heavily on exports; therefore a lower yuan would give a boost to economic growth.
- Disadvantages to lowering the value of the yuan:
  - China's large current account surplus suggests that the yuan should be increased rather than decreased in value.
  - It is believed that the yuan is already undervalued, and the large current account surplus is exerting an upward pressure on the value of the yuan (paragraph 4); therefore efforts to lower it further could result in retaliation by the US which is demanding that China revalues its currency (paragraph 4).
  - A further fall in the value of the yuan may lead to inflationary pressures as the cost of imported inputs rises.
  - This may be especially serious in China, where over 50% of imports consist of raw materials used in the production of export goods (paragraph 2), suggesting an increase in the costs of producing export goods.
  - Increased costs of production of export goods may lead to lower export competitiveness due to cost-push inflation.
  - China does not suffer from lack of export competitiveness but weak foreign demand (paragraph 5), suggesting that the solution to the problem of weak growth is not to try to encourage exports through currency manipulations but through increases in domestic demand (paragraph 5).
- Any reasonable response.
- Conclusion.

Text/data 5: Sri Lanka's reserve assets fall to dangerously low levels

Question A.13

(a) **(i)** and **(ii)** See textbook Glossary for definitions.

(b) For drawing an exchange rate diagram for the rupee showing a rightward shift of the supply-of-rupee curve, and for explaining that outflows of portfolio investment lead to an increase in the supply of rupees in the foreign exchange market, thus lowering its equilibrium value.

(c) For explaining that the managed float system involves elements of both fixed and freely floating exchange rates; exchange rates are free to float to their market levels over long periods of time, but there is central bank intervention periodically (mainly through buying and selling of reserve currencies) in order to stabilise the exchange rate and avoid abrupt fluctuations.

(d) The command term 'discuss' requires candidates to offer a considered and balanced review that includes a range of arguments, factors or hypotheses. Opinions or conclusions should be presented clearly and supported by appropriate evidence.

Responses **may** include:

- Definition of depreciation.
- The government's reasons for wanting to avoid rapid depreciation:
  - To avoid re-igniting inflation which was recently brought down from double digits, through higher import costs (paragraph 4).
  - To avoid pushing up the value of foreign debt (paragraph 4).
- Policy options to avoid rapid depreciation:
  - Sale of reserve assets (currencies) and purchase of rupees.
  - Increases of interest rates.
  - Borrowing from abroad.
  - Limiting imports through trade protection policies or contractionary policies.
  - Imposing exchange controls.
- Sale of reserve assets and purchase of rupees:
  - The central bank appears to have exhausted the possibilities for supporting the rupee this way as it is running out of reserve assets.
- Increasing interest rates:
  - This would attract financial capital into the country, thus creating an inflow of foreign currencies and raising the demand for the rupee.
  - However, the government is doing the opposite by loosening its monetary policy (paragraph 4), possibly to support domestic demand which is falling (paragraph 1) and unemployment is rising (paragraph 3).
  - Higher interest rates would make the recessionary climate worse.
- Borrowing from abroad:
  - This might be an option; however, not to be relied on heavily as there are already fears of the rising value of foreign debt in the event of depreciation (paragraph 4).
- Limiting imports through trade protection policies or contractionary policies:
  - Limiting imports could help by lowering the supply of the domestic currency, thus supporting its price.
  - However, imports are already falling sharply due to lower demand (paragraph 2); therefore it appears unlikely that efforts to lower imports can help in supporting the currency.
  - In any case, protectionist policies have disadvantages (greater inefficiencies, risk of retaliation) and contractionary policies (fiscal and monetary) would worsen the recessionary climate.
- Imposing exchange controls:
  - Cause serious resource misallocation problems.
- Any reasonable response.
- Conclusions.

Text/data 7: Riverland's balance of payments problems

Question A.15

(a) **(i)** and **(ii)** See textbook Glossary for definitions.

(b) For explaining that when an item has a positive sign it has a surplus and when it has a negative sign it has a deficit; therefore the capital account and financial account are in surplus and the current account is in deficit.

(c) For explaining that the item 'income' refers to all the inflows minus outflows of income (wages, rents, interest and profits); the positive sign of this item indicates that income inflows are greater than income outflows. Since GNI = GDP + net income from abroad, and net income from abroad is positive, GNI *per capita* must be larger than GDP *per capita*.

(d) (higher level) The command term 'compare and contrast' requires candidates to give an account of similarities and differences between two (or more) items or situations, referring to both (all) of them throughout.

Responses **may** include:

- Explanation of Riverland's balance of payments problems: it has a large current account deficit, which is due to a large deficit in its balance of trade in goods, and to a lesser extent to its balance of trade in services.
- Therefore Riverland needs policies to correct this deficit (see textbook, pages 408–9)
- Demand-side policies in this instance include 'expenditure-reducing policies' involving contractionary fiscal and monetary policies, the objectives being:
  - to lower aggregate demand and therefore reduce imports
  - to lower the rate of inflation and therefore make exports more competitive, something needed by Riverland as it has a relatively high rate of inflation
  - thus increasing net exports (exports minus imports) and reducing the trade deficit.
- Supply-side policies include:
  - market-oriented policies (encouraging competition, labour market reforms, incentive related policies) with the objective to lower the rate of inflation (by shifting the *LRAS* curve to the right) and therefore make exports more competitive
  - interventionist policies (industrial policies, support for training and R&D) with the additional objective of promoting particular industries that produce for export.
- Both sets of policies come with certain disadvantages.
- Disadvantages of expenditure-reducing policies:
  - Lead to economic contraction.
  - The high rate of unemployment will increase further.
  - The high poverty rate will increase further.
  - The low rate of growth will fall further, possibly becoming negative.
  - High interest rates may lead to currency appreciation, which would discourage exports and encourage imports.

- Disadvantages of supply-side policies:
  - Some market-oriented policies may lead to greater unemployment (for example, privatisation and deregulation), though others may lower the natural rate of unemployment (see textbook, page 344).
  - Market-oriented policies often have a negative effect on equity.
  - Interventionist policies require government spending and Riverland already has a high public debt.
  - Both market-oriented and interventionist policies need a long time to take effect.
- Advantages of supply-side policies:
  - Tend to reduce the rate of inflation, which would increase export competitiveness.
  - Work to increase the rate of growth.
- Advantages of expenditure-reducing policies:
  - Take effect more quickly than supply-side policies.
  - Impact directly on lowering imports.
- Any reasonable response.
- Conclusions.

Question A.17

(a) **(i)** and **(ii)** See textbook Glossary for definitions.

(b) For drawing an exchange rate diagram showing a rightward shift in the demand-for-Rvl curve, and for explaining that item 14 indicates that the Bank of Riverland (the central bank) has been selling reserve assets (reserve currencies) and buying Rvl, thus increasing the demand for Rvl and therefore the price of Rvl.

(c) For explaining that a freely floating exchange rate system is one where the value of a currency in terms of other currencies is determined freely in the foreign exchange market by the forces of demand and supply, and for explaining that in a free market the value of the Rvl would fall to its free market value.

(d) The command term 'examine' requires candidates to consider an argument or concept in a way that uncovers the assumptions and interrelationships of the issue.

Responses **may** include:

- Explanation of overvalued currency.
- Explanation of the possibility that Riverland has an overvalued currency: the central bank is buying the domestic currency (Rvl) in order to support it at a level higher than its free market value (item 14 in the balance of payments).
- Diagram showing overvalued currency (see textbook, page 301, and Figure 14.1, page 382)
- Consequences of Rvl overvaluation:
  - Exports are more expensive to foreigners.
  - More expensive exports tend to make Riverland's balance of trade in goods and balance of trade in services larger.
  - This increases Riverland's payments difficulties, resulting in possibly higher levels of foreign debt.

  - This also hurts export industries, leading to lower levels of production and higher unemployment; Riverland already faces a high unemployment rate.
  - Imports are less expensive for domestic buyers.
  - Cheaper imports have a positive effect on the rate of inflation as they tend to lower it by lowering the cost of imports; this is good for Riverland which has a high rate of inflation partly due to the cost of imported inputs (oil and other commodity imports).
  - Cheaper imports may help domestic producers by allowing them to buy important imported inputs.
  - However, artificially lower priced imports may disadvantage domestic producers of competing goods.
  - This may result in lower levels of production and higher unemployment in these industries.
  - Resource allocation in Riverland will worsen.
- Any reasonable response.
- Conclusion.

Text/data 8: Dilemmas facing the Turkish economy

Question A.20

(a) **(i)** and **(ii)** See textbook Glossary for definitions.

(b) For drawing and *AD-AS* diagram showing the *LRAS* curve shifting to the right, and for explaining that supply-side policies are intended to lead to economic growth, causing long-run aggregate supply to shift to the right, which leads to a lower price level, thus increasing export competitiveness.

(c) For drawing an exchange rate diagram showing the demand-for-lira curve shifting to the right and resulting in a higher equilibrium exchange rate, and for explaining that high interest rates attract financial capital into the country, thus increasing the demand for lira and increasing its value.

(d) (higher level) The command term 'justify' requires candidates to give valid reasons or evidence to support an answer or conclusion.

Responses **may** include:

(Four policies are included here, to demonstrate possible answers.)

- **Expenditure-reducing policies,** or reduction of aggregate demand, involves pursuing contractionary fiscal and monetary policies, which lower incomes:
  - *AD-AS* diagram showing a leftward shift in the *AD* curve, giving rise to a lower equilibrium real GDP (lower income).
  - These policies come with several disadvantages:
    - A lower rate of growth may result, which is undesirable in view of the downward trend in the rate of growth of real GDP in Turkey.
    - There is a possibility of recession and increased unemployment, with all its undesirable consequences.
    - Negative impacts on workers, businesses, consumers and lower income people.

        - Higher interest rates (contractionary monetary policy) may lead to currency appreciation by attracting financial capital into the country, which would have the effect of discouraging exports and encouraging imports, thus partly cancelling out the beneficial impacts of expenditure- reducing policies on imports and exports.
    - However, in spite of the disadvantages these policies can help achieve the objective of reducing the current account deficit because:
        - lower income results in a lower demand for imports, which reduces the current account deficit
        - reduced aggregate demand can also result in a lower rate of inflation, which may make the domestic goods more competitive, thereby increasing exports and reducing the current account deficit
        - lower rate of inflation is desirable as a high rate of inflation is an additional problem in Turkey.
    - Any reasonable response.
    - Conclusions.

- **Trade protection policies**, which are a type of expenditure-switching policy, involve creating or increasing barriers to trade (tariffs, quotas, subsidies, administrative barriers), and switching consumption away from imported goods and toward domestically produced goods:
    - These policies come with several disadvantages:
        - They lead to higher domestic prices of protected goods, which in the case of Turkey is problematic as higher prices can contribute to further increasing the already high rate of inflation.
        - Consumers are worse off because of higher prices and a decrease in quantities of protected goods available domestically.
        - Over the longer term, the economy may be worse off, due to inefficiencies in production and misallocation of resources caused by protectionist measures.
        - Inefficiency leads to higher costs of production, which over the longer term can lead to decreased export competitiveness, worsening the current account balance.
        - There is also a possibility of retaliation by trading partners who impose barriers, which would work to reduce Turkey's exports with negative impacts on the current account.
        - Protectionist policies may not fit in well with Turkey's market-orientation.
    - However, in spite of the disadvantages these policies can help achieve the objective of reducing the current account deficit because:
        - they can reduce the current account deficit by directly restricting imports
        - over the short term, they benefit domestic firms whose production increases as imports fall
        - over the short term, they benefit workers, as employment increases, and this may contribute to a fall in unemployment, which is needed as unemployment is high in Turkey
        - they could be used as a short-term measure to help reduce the current account deficit, at the same time that other measures are used simultaneously (such as expenditure-switching or supply-side measures), to be followed at a later point by elimination of the trade barriers.

  - Any reasonable response.
  - Conclusions.

- **Depreciation**, also a type of 'expenditure switching policy', that encourages exports (which become cheaper to foreigners) and discourages imports (which become more expensive to domestic buyers), switching consumption away from imports and toward domestically produced goods:
  - This comes with several disadvantages:
    - Higher import prices due to the lower value of the currency often result in higher domestic inflation ('imported' inflation), which could increase the already high rate of inflation.
    - If the imported goods include capital goods and other production inputs, firms experience higher costs of production, which may be passed on to consumers in the form of higher prices; this is a type of cost-push inflation.
    - By shifting the SRAS curve to the left, cost-push inflation may reduce the rate of growth, and it may even cause a recession.
    - Lower growth or recession will be associated with a higher rate of unemployment, worsening Turkey's unemployment problem, and additionally hurting businesses and consumers.
    - In the event that the depreciation is caused by 'management' of the exchange rates in the context of a 'dirty float' that intentionally pursues an undervalued exchange rate so as to encourage exports and discourage imports, it creates an unfair competitive advantage; this risks inviting retaliation by other countries that may also depreciate their currencies, in which case the effects of the depreciation cancel out.
  - However, in spite of the disadvantages these policies can help achieve the objective of reducing the current account deficit because:
    - by encouraging exports and discouraging imports, they directly improve the current account balance
    - growth of export industries can result in a reduction in the unemployment rate, benefiting firms and workers
    - growth of export industries may result in increased economic growth. You may show this as an increase in aggregate demand in an *AD-AS* diagram
    - the impacts on the current account balance will depend on the Marshall–Lerner condition. If the sum of the *PED*s for imports and exports is greater than one, depreciation will improve the current account balance. Very likely this will deteriorate over a short period of time and improve over the longer term (J-curve effect).
  - Any reasonable response.
  - Conclusions.

- **Supply-side policies** to increase competitiveness can work to promote production for exports:
  - Market-oriented supply-side policies can include policies that try to increase competition or are aimed at labour market reforms.
  - They may have the effect of making firms more competitive in global markets.
  - Over a long period of time, lower rates of inflation would work to increase exports, thereby addressing the problem of the current account deficit.

- Interventionist supply-side policies, such as support for training, education, research and development and appropriate technology development, can be used to promote industries that produce for export.
- These can be particularly beneficial in the case of Turkey, because they do not come with the negative impacts of other policies intended to improve the current account balance, and can also work to lower unemployment. However, interventionist supply-side policies require government budget funding, which could mean that other activities supported by government budget funds might have to be cut if the budget deficit is not to increase.
- See textbook pages 342–5, for an evaluation of supply-side policies.
- Any reasonable discussion.
- Conclusions.

(d) (core) The command term 'evaluate' requires candidates to make an appraisal by weighing up the strengths and limitations.

The answer to this question can be found in the last part of the higher level answer above.

Chapter 15 Economic Integration and the terms of trade

Text/data 9: Asia free trade zone raises hopes and fears

Question A.22

(a) **(i)** and **(ii)** See textbook Glossary for definitions.

(b) For drawing a trade protection diagram (tariff or quota) showing the domestic price with the tariff or quota being higher than the free trade price, thus causing a higher level of domestic production and lower quantity of imports, and for explaining that when the tariff or quota is eliminated among the countries within the trading bloc, the price falls to the free trade level and imports increase, thus increasing the competition faced by domestic producers.

(c) For drawing a diagram as in part b (you may use the same diagram), showing that elimination of the tariff or quota results in a lower price, which is the price paid by consumers.

(d) The command term 'discuss' requires candidates to offer a considered and balanced review that includes a range of arguments, factors or hypotheses. Opinions or conclusions should be presented clearly and supported by appropriate evidence.

Responses **may** include:*

- Definitions of trading bloc (free trade area has been defined in part a).
- Explanation of the benefits of membership in a trading bloc include (see textbook, page 415):

  - Greater competition leading to increased efficiencies in production (paragraph 2).
  - Possibility to expand into larger markets (paragraph 2).
  - (higher level) Possibility to achieve economies of scale; for ASEAN countries China's huge market is expected to lead to this (paragraph 2).
  - Lower prices for consumers and greater consumer choice (paragraph 2).
  - Increased investment by firms wanting to take advantage of the larger market; this may be internal (from within the trading bloc) or external (outside the bloc) for firms that want to avoid trade barriers on their products.
  - Producers can benefit from greater choice and access to cheaper inputs (paragraph 2).
  - Improved resource allocation, particularly if the trading bloc develops into a common market that allows for the free movement of factors of production (labour and capital).
  - Greater economic growth.
- Explanation of possible costs of membership in a trading bloc:
  - Free (or freer) trade within a trading bloc always involves losers as well as gainers.
  - Losers are mainly some producers as well as workers who lose their jobs when inefficient producers cut back on production or go out of business.
  - There are fears that some poorer ASEAN countries may be unable to compete with Chinese producers (paragraph 3).
  - Cambodian textile producers are fearful of the Chinese garment industry; Vietnamese consumer goods producers may be hurt; Chinese farmers may be hurt by agricultural product imports from Malaysia, Thailand and Vietnam (paragraph 3).
  - The trading bloc is intended to eliminate the less-efficient producers; however, in some cases, inefficient (i.e. higher cost) production may be due to the use of less-advanced technologies, poorer management and marketing capabilities, or very small size of producers, which may be especially common in poorer countries.
  - Widespread closures of firms due to an inability to compete with lower cost imports can lead to:
    - structural unemployment (paragraph 3)
    - increasing poverty
    - greater inequalities in income distribution
    - lower levels of production and lower economic growth
    - lower exports, together with increasing imports, and therefore increasing balance of payments problems.
  - The ability of economically less developed countries to benefit from diversification (see textbook, page 494) often depends on their use of trade protection measures (based on the infant industry argument, see page 377). If they cannot use trade barriers for this purpose, it may be more difficult for them to diversify.
- Conditions for the ability of trading blocs to help countries achieve growth and development include a similar level of development and technological capabilities and similar market sizes (see textbook, page 491).

- If these conditions are not met there is an increased risk that the smaller, and economically and technologically weaker countries may lose from participation in the trading bloc, because they will be subject to less fair competition (see textbook, page 491).
- Any reasonable discussion.
- Conclusions.

* The response here also includes material from Chapter 17, pages 490–94.

Text/data 10: Africa's main trading bloc works on customs union

Question A.24

(a) **(i)** and **(ii)** See textbook Glossary for definitions.

(b) For explaining that a free trade area involves elimination of trade barriers between the member countries, which retain the right to pursue their own trade policy toward third countries, and that a common market is a higher form of integration in that it involves a common external policy as well as freedom of movement of all factors of production; it is therefore unusual that COMESA was called a common market while it was still only a preferential trade agreement.

(c) (higher level) For explaining that trade diversion involves the replacement of lower cost imports by higher cost imports after the creation of a trading bloc, and the statement that this did not occur much following the formation of COMESA is a positive feature for this trading bloc.

(c) (core) For explaining that a free trade area involves the elimination of trade barriers between the member countries, which retain the right to pursue their own trade policy toward third countries, and for explaining that a customs union is a higher form of integration in which the participating countries in addition adopt a common external policy toward all third countries.

(d) The command term 'compare and contrast' requires candidates to give an account of similarities and differences between two (or more) items or situations, referring to both (all) of them throughout.

Responses **may** include:

- Explanation of preferential trade agreement (see textbook, page 413), which is what COMESA replaced; this is not a trading bloc, but sometimes is formed prior to forming a trading bloc (paragraph 2).
- Explanation of free trade area, which is what COMESA initially formed in 1994 (paragraph 2).
- Explanation of customs union, which is a higher form of economic integration compared to a free trade area, and which is what COMESA plans to form in 2012 (paragraph 2).

- Explanation of common market, which is an even higher form of integration compared to a customs union; though there is no mention of this in the text.
- Explanation of monetary union; this is not a trading bloc strictly speaking, but is what COMESA is aiming toward, together with two other African trading blocs (EAC and SADC) (paragraph 7).
- Free trade areas encounter a problem arising from their lack of a common external policy: a good may enter the bloc through the country with the lowest barriers in order to avoid the higher barriers elsewhere, frustrating the trade protection objectives of countries with higher barriers; a solution is to make complicated 'rules of origin'.
- The above problem does not occur with the other trading blocs as they have a common external policy.
- Customs union members must adopt the common external policy agreed upon by all the members, requiring a degree of policy coordination which may give rise to disagreements and conflicts over appropriate levels of protection toward third countries.
- The requirement of a high degree of policy co-ordination to form a customs union may present difficulties, since some countries have still not even participated in the free trade area due to broad differences among countries in income levels (paragraph 5), which possibly lead to disagreements over the adoption of common policies.
- A common market, involving in addition to free trade among members and a common external policy, and also free movement of factors of production (labour and capital), requires a much higher degree of policy co-ordination among members, which is more difficult to achieve as there is far more room for disagreements among members.
- Therefore common markets are encountered far less frequently.
- Explanation that it is unlikely that COMESA can form a monetary union without first establishing a common market (though the formation of a common market is not mentioned in the text).
- Common markets offer far more advantages to their members, as in addition to the benefits of free trade, they offer possibilities for improving resource allocation through the free movement of factors of production.
- Monetary union, involving the adoption of a single currency, is an even higher form of economic integration, requiring member governments to give up an even greater amount of their authority to a supra-national authority, as they lose the possibility of having an independent monetary and exchange rate policy; monetary union strictly speaking is not a type of trading bloc.
- Examples of each of the three types of trading bloc.
- Any reasonable discussion.
- Conclusions.

Text/data 11: Mexico's membership in NAFTA

Question A 25

(a) **(i)** and **(ii)** See textbook Glossary for definitions.

(b) For explaining that a fall in exports appears as a reduction in the balance of trade in goods, which is the value of exports minus the value of imports, and that the balance of trade in goods is included in the current account of the balance of payments, thus contributing to a worsening of the current account, or an increase in the current account deficit.

(c) For drawing an *AD*-*AS* diagram showing a rightward shift of the *AD* curve, and for explaining that a lower value of the peso makes tourism services less expensive to US tourists, thus increasing the demand for Mexican tourism services and causing a decrease in the size of Mexico's deflationary gap.

(d) The command term 'discuss' requires candidates to offer a considered and balanced review that includes a range of arguments, factors or hypotheses. Opinions or conclusions should be presented clearly and supported by appropriate evidence.

Responses **may** include:

Note: the markscheme for this question is very similar to question A.22, adapted to the conditions of Mexico. Apart from the general arguments on advantages and disadvantages of membership in a free trade area, the following points may be added:

- Due to NAFTA, Mexico has become highly dependent on the US for its exports; 80% of its exports are directed to the US (paragraph 3).
- This high dependence has made Mexico highly vulnerable to US economic downturns (paragraph 3).
- The US recession led to a significant drop in imports from Mexico (paragraph 3).
- Mexican farmers are unable to compete with tariff-free food imports from the US (paragraph 5).
- Many domestic firms were wiped out due to imports of inputs rather than purchase from domestic suppliers (paragraph 5).
- These developments have contributed to a major recession in Mexico, with an increase in unemployment and lower incomes (paragraph 3).
- The fall in Mexican exports led to a 25% peso depreciation, leading to fears of cost-push inflation (paragraph 7).
- Whereas the government is making efforts to counteract the effects of the fall in exports (lower interest rates, transfer payments, investment in public goods and merit goods), it is believed that these efforts will not be enough to help the economy come out of the recession (paragraph 3).
- Mexico has ignored trade agreements it has made with other countries, and as a result has fared worse than other Latin American countries (paragraph 4).
- It lost much of the competitive advantage in the US that it had gained through NAFTA when lower-cost Chinese products entered the US (paragraph 6).

- These developments illustrate two important points:
  - Free trade agreements may not result in equal benefits for all member countries if the countries are highly unequal economically without a similar level of development and technological capabilities and similar market sizes (see textbook, page 491).
  - Multiple regional trade agreements risk breaking up the world into blocs that may worsen the global allocation of resources (see textbook, page 416).
- Any reasonable discussion.
- Conclusions.

Text/data 12: Non-oil commodity prices in developing countries

Higher level

Question A.27

(a) **(i)** and **(ii)** See textbook Glossary for definitions.

(b) For explaining the meaning of 'terms of trade', and for explaining that a deterioration involves a decrease in the value of the terms of trade index, which can come about either through a fall in the value of exports (with the value of imports constant) or an increase in the value of imports (with the value of exports constant).

(c) For drawing a diagram as in Figure 3.6 (a) (see textbook, page 57), with inelastic demand, and for explaining that when demand is inelastic, as in the case of primary commodities, supply fluctuations appearing as supply curve shifts cause wide fluctuations in the prices of these commodities, thus leading to fluctuations in the terms of trade of commodity exporting countries.

(d) The command term 'evaluate' requires candidates to make an appraisal by weighing up the strengths and limitations.

Responses **may** include:*

- Explanation of comparative advantage.
- Explanation of the theory of comparative advantage.
- Explanation of the importance of this theory as the theoretical justification of trade policies based on trade liberalisation (see textbook, pages 361 and 485).
- Explanation of the potential benefits of specialisation and trade according to comparative advantage (see textbook, page 361):
  - Increases in global production and consumption.
  - Improved global allocation of resources.
  - Free trade accordingly leads to avoidance of the costs associated with trade protection (see textbook, pages 375–6 for summary).
- Explanation that the unrealistic assumptions on which this theory rests reduce its real world relevance (see textbook, pages 361–2):
  - Immobility of factors of production.
  - Perfect competition.
  - Full employment of all resources.
  - Balance of exports and imports.
  - Free trade.

- Explanation of factors that throw doubt on the desirability of specialisation and trade according to comparative advantage as the basis of trade policies in developing countries (see textbook, page 362):
  - May not allow the necessary structural changes to occur in an economy; if a country specialises in the production of agricultural products it may be unable to diversify into industry and services.
  - May lead to excessive specialisation; leading to excessive dependence on global markets, export price volatility, deteriorating terms of trade.
- The possible negative effects of excessive specialisation are noted in the text:
  - Deteriorating terms of trade for less developed commodity exporters has meant that they are exporting 'more for less' (paragraph 8).
  - While export levels will continue to increase, this is of limited value if the exports can only buy a smaller quantity of imports (paragraph 9).
  - According to UNCTAD, the commodity boom has become the greatest obstacle to achieving development goals (paragraph 10).
- Explanation of the effects of short-term fluctuations in commodity prices (see textbook, pages 431–2):
  - Creation of destabilising uncertainties.
  - Poor resource allocation outcomes due to changing relative prices that affect the signalling and incentive function of prices.
  - Windfall gains create income inequalities.
  - See pages 431–2 for more.
- Explanation of the effects of deteriorating terms of trade (see textbook, page 433):
  - Transfer of income away from exporting countries.
  - Opportunities for importing needed production inputs become more limited.
  - Scarce domestic resources are transferred to production for export making it more difficult to achieve development goals.
  - Growing current account deficits.
  - Increased need to borrow to finance current account deficits.
  - See page 433 for more.
- Any reasonable discussion.
- Conclusions.

* Some parts of this answer depend on material in Chapter 15.

Question A.29

(a) **(i)** See textbook, pages 425–6, for a list of causes.

(ii) See pages 426–7 for a list of causes.

(b) For defining income elasticity of demand (*YED*), and for explaining that the low *YED* of primary products (*YED* < 1) causes demand for these products to grow slowly in comparison with demand for manufactured products and services resulting in a fall in the prices of primary products relative to the price of other goods and services (this does not mean a fall in prices in absolute terms).

(c) For explaining that a deterioration in the terms of trade means that a country can buy the same amount of imports for an increasing amount of exports, and that over the long term this involves a transfer of output and income away from the country and toward other countries (see textbook, page 427).

(d) The command term 'examine' requires candidates to consider an argument or concept in a way that uncovers the assumptions and interrelationships of the issue.

Responses **may** include:

- Definition of deterioration in the terms of trade (TOT).
- Definition of price elasticity of demand.
- Definition of the current account.
- Explanation of the relationship between the TOT and the current account (see textbook, page 427).
- Explanation that the effects of a change in the TOT on the current account depend on the causes of this change.
- If the TOT change as a result of a change in the global demand for a product, the *PED* for imports and exports is not relevant to explaining the effects on the current account
- Diagram, as in Figure 15.1(a) (see textbook, page 429).
- Explanation that the *PED* for imports and exports is relevant if the TOT change as a result of a change in the global supply of a product.
- Explanation that if the country facing deteriorating terms of trade is an exporter (of the commodity that has caused the deterioration), then
  - if $PED_x < 1$, the current account will deteriorate (larger trade deficit or smaller trade surplus)
  - if $PED_x > 1$, the current account will improve (smaller trade deficit or larger trade surplus).
- Explanation that if the country facing deteriorating terms of trade is an importer (of the commodity that has caused the deterioration), then
  - if $PED_m < 1$, the current account will deteriorate (larger trade deficit or smaller trade surplus)
  - if $PED_m > 1$, the current account will improve (smaller trade deficit or larger trade surplus).
- According to the text, in 2009 although the quantity of non-oil exports of least developed countries increased by nearly 6%, the value of these exports fell by nearly 9%; this suggests that the price of these exports fell substantially (more than 6%); this indicates inelastic demand for exports ($PED_x < 1$) (paragraph 8).
- Therefore it is likely that these exporting countries experienced a worsening of their current accounts.
- Any reasonable discussion.
- Conclusions.

Paper 2 section B: Economic development

Chapter 16 Understanding economic development

Text/data 13: Comparing and contrasting economic and development indicators

Question B.1

(a) See textbook, pages 449 and 452–3.

(i) GNI *per capita* is lower than GDP *per capita* because income outflows from these countries are greater than income inflows. The income flows are likely to be the profits of corporations **or** wages of workers.

(ii) GNI *per capita* is higher than GDP *per capita* because income inflows into Japan are greater than income outflows. As above, the income flows are likely to be the profits of corporations **or** wages of workers.

(b) For explaining that making conversions from one currency into another by use of purchasing power parity (PPP) exchange rates takes into account the differences between countries in their price levels, and that since price levels tend to be higher in high-income countries than in low-income countries, it follows that GDP *per capita* (or GNI *per capita*) converted into $ by PPPs appears lower in high-income countries (UK and Japan) and higher in low-income countries (Brazil and Georgia).

(c) For explaining that the figures in column 2 have been converted by market exchange rates while those in column 4 have been converted by purchasing power parity (PPP) exchange rates which take price level differences among countries into account, and that since price levels tend to be lower in low-income countries and higher in high-income countries, conversions of GNI *per capita* by use of PPP exchange rates reduce the GNI differences between high- and low-income countries.*

* Answers to parts b and c are very similar; the purpose of the exercise is that the questions are worded differently.

(d) The command term ‘evaluate’ requires candidates to make an appraisal by weighing up the strengths and limitations.

Responses **may** include:

- Definitions of GDP *per capita* and GNI *per capita*.
- Explanation of the factors that lead to the difference between them.
- Explanation that development is a multi-dimensional process, and that this makes the use of any single indicator incomplete as a measure of development’s many different dimensions.

- Explanation that GNI *per capita* is a better indicator of standards of living in a country, and hence of economic development, as it measures income per person, while GDP *per capita* is a better indicator of the level of output per person produced within a country (see textbook, page 452).
- Explanation that this is the reason why the income component of the human development index (HDI) is measured by GNI rather than GDP (formerly it was measured by GDP but changed to GNI as of 2010).
- Explanation that composite indicators, such as the human development index (HDI), are superior to single indicators (though composite indicators are also incomplete).
- Explanation of the three dimensions of the HDI (achievements in income or GNI *per capita*, health and education).
- Reference to the table, that shows a similar value for the HDI index for the UK and Japan, and for Brazil and Georgia, though the UK has a higher GNI *per capita* than Japan, and Brazil a much higher GNI *per capita* than Georgia (and similarly for GDP *per capita* comparisons).
- Explanation that these figures suggest that Japan has higher achievements than the UK in health and education, and that Georgia similarly has higher achievements in health and education than Brazil.
- Further limitations of GNI and GDP *per capita* as measures of standards of living and hence development include the following (see textbook, pages 224–5):
  - no information on the distribution of income
  - no information on the composition of output (merits goods provision versus other goods)
  - and others (see pages 224–5).
- Limitations of these indicators as measures of the 'true' value of output (see textbook, pages 223–4):
  - exclude non-marketed output
  - exclude the value of negative externalities
  - exclude the value of depleted natural resources
  - do not account for different price levels across countries due to differing price levels (therefore need currency conversions in terms of purchasing power parities)
  - and others (see pages 224–5).
- Because of the above factors, both measures have serious limitations as the basis of measuring economic development and for making cross-country comparisons across countries.
- Any reasonable discussion.
- Conclusions.

Chapter 16 Understanding economic development

Chapter 17 Topics in economic development

Text/data 14 Economic growth and development in Sri Lanka

Question B.3

(a) **(i)** Composite indicators are summary measures of more than one dimension of development, and since development is a process with many different dimensions, they are therefore superior to single indicators that measure only one dimension (see textbook, page 457).

(ii) See textbook, pages 450–51, for a list of all the Millennium Development Goals.

(b) For explaining that the human development index (HDI) is a composite indicator that is constructed on the basis of three individual indicators: (i) long and healthy life measured by life expectancy at birth, (ii) access to knowledge measured by mean years of schooling and expected years of schooling, and (iii) a decent standard of living measured by GNI *per capita* (US$ PPP).

(c) For explaining that since the HDI is composed of indicators that measure GNI *per capita*, health and education, it must be its much higher achievements in health and education that allow it to achieve a comparable level of human development with a much lower GNI *per capita*, and that this is shown in the table in the Life expectancy at birth column and Mean years of schooling column, which in both cases are the highest of all countries shown.

(d) The command term 'evaluate' requires candidates to make an appraisal by weighing up the strengths and limitations.

Responses **may** include:

- Definition of economic growth and economic development.
- Explanation of the importance of credit in any economy (see textbook, page 467):
  - Business people can open, run or expand their businesses.
  - Investments in human capital.
  - Important for poverty alleviation.
- Explanation of micro-credit.
- Explanation of why micro-credit is important in developing countries (see textbook, pages 467–8):
  - Exclusion of poor from access to banking services.
  - Reliance of poor on informal sources of credit, such as 'loan sharks'.
  - Contribution to growth and development that is broad-based and includes the very poor who otherwise have no access to credit.
  - Micro-credit can raise incomes of borrowers and create income stability, helping them emerge from poverty.
  - By focusing on very poor people, micro-credit can help improve income distribution.
  - Micro-credit can improve standards of health, nutrition and school attendance.

    - Micro-credit can improve the social and economic status of women.
    - The focus of micro-credit on women can help improve family well-being because of women's focus on investments in health and education.
  - Sri Lanka appears to be especially well-placed to benefit from micro-credit:
    - Micro-credit has been singled out as a policy that can help achieve more equitable growth (paragraphs 4 and 5).
    - Micro-credit can make a contribution to improving income distribution in Sri Lanka.
    - It can help reduce regional disparities in living standards, health and education (paragraph 3).
    - Sri Lankan workers who return home from abroad have skills but lack capital, and they need credit to acquire capital (paragraph 5).
    - Micro-credit can help achieve growth through the participation of these workers in the economy.
    - It can help improve economic development and human development further by inclusion of the poor in the rural economy where the regional disparities are greatest (paragraph 4).
  - Potential dangers of micro-credit (see pages 468–70):
    - Government policy should be careful not to use micro-credit as a substitute for other government anti-poverty measures (provision of merit goods, protection of vulnerable groups).
    - Micro-credit should not contribute to the growth of the urban informal sector.
    - Candidates for micro-credit should be screened for their appropriateness as borrowers; credit should not be extended to the very highly unskilled or extremely poor people who have very limited possibilities to benefit from micro-credit.
    - Micro-credit interest rates are higher than market rates; governments should consider the possibility of subsidising these in the case of extremely poor people to make these loans more affordable and to increase the chances of loan repayment.
- Any reasonable discussion.
- Conclusions.

Text/data 15 Women in Cambodia

Question B.5

(a) See textbook Glossary for definitions.

(b) For explaining that the poverty cycle involves a situation where low savings leads to low investment and therefore to low levels of physical, human and natural capital, which in turn leads to low growth in income and therefore to low savings again, and that public provision of health care can help break out of the poverty cycle by improving levels of health and therefore increasing human capital, thus making people more employable, more productive and for a longer period of time, thus contributing to increasing incomes.

(c) For explaining that GNI *per capita* is equal to GDP *per capita* plus net income from abroad (i.e. income inflows minus income outflows), and that if migrant Cambodian workers return from neighbouring countries, there will be a loss of income flowing into Cambodia from abroad, thus reducing the level of GNI *per capita*.

(d) The command term 'evaluate' requires candidates to make an appraisal by weighing up the strengths and limitations.

Responses **may** include:

- Explanation that long-term prosperity depends crucially on economic growth and development.
- Definitions of growth and development.
- Explanation of the problem of gender inequalities in economically less developed countries (see textbook, pages 470–71): health and education, the labour market, inheritance and property rights, access to credit, income, wealth and poverty.
- Explanation that 'investment in women and children' could include provision of education and health care services, nutrition programmes at schools, as well as job opportunities for women and legislation enforcing equal property and inheritance rights.
- For Cambodia, these can be especially important, as the recession has hit women, who make up the bulk of the labour force, especially hard, with negative consequences for the children (paragraph 1).
- Explanation of how investment in women can contribute to growth and development:
    - Direct benefits for women and girls from the above: they are more likely to become part of the workforce, become more productive, earn higher incomes and escape poverty.
    - External benefits for society due to positive consumption externalities (see pages 472–3):
        - Improvements in child health and nutrition and lower child mortality due to increased education of mothers.
        - Improved educational attainment of children.
        - Improved human resource quality.
        - Lower birth rates, contributing to lower population growth rates.
        - Higher economic growth.
        - Improved prospects for economic and human development.
- Explanation of how investment in the education and health of children can contribute to growth and development:
    - Direct benefits of education (more productive as adults, less likely to be exploited in child labour, less likely to be unemployed, higher income earning potential) and of health (longer and more productive life).

- External benefits for society due to positive externalities of education and health (see textbook, page 464):
  - Economic growth.
  - Lower unemployment.
  - Greater worker productivity.
  - And more (see page 464).

- These investments appear to be badly needed in Cambodia, where there is no social protection system or free education and health care (paragraph 3), and to avoid having women return to rural areas where there are no jobs or to get work in the urban informal sector where conditions are poor and there is risk of sexual exploitation (paragraph 4).
- In view of the specific problems, including taking children out of school to have them work and cutting back on health care (paragraph 5) as well as acute malnutrition, very high infant and maternal mortality and poor nutrition and poor health care access (paragraph 6), the failure to take action on investments in women and children could be disastrous for Cambodia's long-term prosperity.
- Possible difficulties in a policy of investing in women and children include:
  - Opportunity costs of government spending on provision of the above (spending on these goods and services will involve a sacrifice of other necessary merit goods, such as infrastructure, etc.).
  - The government may not have enough funds available to make the necessary investments.
  - It may be necessary to rely in part on foreign aid or development assistance.
- Any reasonable discussion.
- Conclusions.

Chapter 17 Topics in economic development

Text/data 16 Two views on trade liberalisation

Question B.6

(a) See textbook Glossary for definitions.

(b) For explaining that export promotion is a growth and development strategy that uses strong government intervention and industrial policies to expand exports, and that import substitution is a growth and development strategy that uses strong government intervention to protect domestic industry from foreign competition and support its growth in order to reduce imports and increase domestic production, particularly of industrial products, with a view to becoming self-reliant.

(c) For drawing a tariff or quota diagram showing the price with tariff or with quota being higher than the international price, and for explaining that when the tariff or quota is removed, the domestic price falls to the level of the international price, domestic production falls, therefore leading to layoffs of workers.

(d) The command term ‘discuss’ requires candidates to offer a considered and balanced review that includes a range of arguments, factors or hypotheses. Opinions or conclusions should be presented clearly and supported by appropriate evidence.

Responses **may** include:

- Explanation of trade liberalisation as a trade policy.
- Recommendations of the ‘Washington Consensus’.
- Examples of countries that implemented trade liberalisation.
- Potential benefits of trade liberalisation:
  - Theoretical basis of trade liberalisation and expected benefits of this policy:
    - Trade as an ‘engine for growth’ (paragraph 1) and other gains from trade (see textbook, pages 354–5).
    - Free trade based on comparative advantage (see textbook, page 356).
  - Asian economies achieved rapid growth (paragraph 1).
  - Free trade leads to job gains, though there may be job losses as well, and for this reason need social safety nets (paragraph 2).
  - Trade liberalisation leads to growth, and with this comes poverty reduction, reduction in infant mortality rates and increases in literacy rates and life expectancy (paragraph 3)
- Potential costs of trade liberalisation:
  - Actual experience of trade liberalisation in many countries, especially poorer ones (such as in Sub-Saharan Africa) was disappointing (see textbook, pages 485–7).
  - Limited benefits for export growth and diversification.
  - Limited effects on economic growth.
  - Increasing income inequalities and poverty within developing countries.
  - Mexico’s growth has been slower after it became a member of NAFTA (paragraph 5).
  - There can be no real ‘trade liberalization’ if rich countries do not stop subsidising their farmers, creating unfair competitive conditions for farmers in poor countries; corn farmers in Mexico have been hurt by US-subsidised corn (paragraph 5).
  - Trade liberalisation can have benefits when there is full employment so that workers who lose their jobs can find jobs elsewhere (paragraph 6), but most developing countries have high unemployment and underemployment.
  - Developing countries need protection to compete with modern industrial sectors, otherwise they remain stuck in low value-added, low-growth production (paragraph 6); in such cases trade liberalisation can be harmful as a trade policy.
  - Specialisation and trade according to the theory of comparative advantage does not permit countries to undergo structural change; for example, South Korea did not ‘stick with rice farming’ (as it had been advised to do) and for this reason was able to industrialise and grow (paragraph 6).
  - The countries of Asia that grew rapidly expanded their trade on the basis of industrial policies with strong government intervention, i.e. export promotion (paragraph 7), whereas trade liberalisation goes hand in hand with free market policies and limited government intervention.

- Explanation of the policies recommended by the New Development Consensus, involving trade liberalisation together with government intervention (see textbook, page 487).
- Any reasonable discussion.
- Conclusions.

Text/data 17 Coffee, trade and development

Question B.8

(a) See textbook Glossary for definitions.

(b) For drawing an *AD-AS* diagram showing a leftward shift in the *AD* curve that leads to a lower level of GDP, and for explaining that tariff escalation limits coffee-producing countries' quantity of processed coffee exports, thus leading to lower aggregate demand and therefore a lower level of real GDP.

(c) (higher level) For drawing a diagram as in Figure 7.3(b) (see textbook, page 172) where the firm earns normal profit and a lower price below the initial one (as in Figure 7.3(c)) showing that the firm is now making a loss, and for explaining that when the price falls to a level where it is less than average total cost (*ATC*) the firm makes a loss.

(c) (core) For drawing a diagram as in Figure 3.6(a) (see textbook, page 57) showing inelastic demand ($PED < 1$) and shifting supply curves that lead to large price swings, and for explaining that when demand is inelastic, price volatility is greater than in the case when demand is elastic.

Alternatively, for drawing a diagram as in Figure 3.13(a) (see textbook, page 70) showing inelastic supply ($PES < 1$) and shifting demand curves that lead to large price swings, and for explaining that when supply is inelastic, price volatility is greater than in the case when supply is elastic.

(d) The command term 'evaluate' requires candidates to make an appraisal by weighing up the strengths and limitations.

Responses **may** include the following:

- Explanation of diversification.
- Explanation that the alternative to diversification is specialisation, with explanation of specialisation.
- Arguments in favour of diversification:
  - May avoid long-term declines in commodity terms of trade, which coffee has been experiencing (paragraph 5).
  - May avoid agricultural price fluctuations, or price volatility, which coffee has been experiencing (paragraph 4).
  - May avoid developed country barriers to trade, such as tariff escalation on processed coffee (paragraph 6).
  - Reduces vulnerability to 'shocks' such as extreme weather conditions.
  - Offers protection of export earnings in the event that commodity prices fall.
  - Allows for sustained increases in exports (see textbook, page 493).

  - All of the above offer opportunities to achieve stable growth of export earnings.
  - Discussion of benefits of stable growth in export earnings for economic growth and development.
  - Coffee production is likely to be affected by climate change, requiring the development of new technologies adapting coffee production to new climate conditions (paragraph7).
  - Diversification into manufacturing provides opportunities for increased employment, use of new technologies and development of skills (see textbook, page 493).
  - Diversification allows countries to achieve structural transformation.
  - Diversification could lead to more sustainable development if it cuts back on exploitation of the primary sector which is currently unsustainable.
- Arguments against diversification:
  - Diversification may lead to a loss of the benefits arising from the labour-intensive nature of coffee-production (paragraph 2).
  - Diversification may lead to a loss of the opportunities arising from growth of global coffee consumption of 2.5% per year (paragraph 3).
  - Diversification prevents specialisation according to comparative advantage, and does not allow for increases in productive efficiency and the quantity of output produced over the short term (benefits of specialisation).
  - Diversification may not allow countries to consume outside their *PPC* over the short term (benefit of specialisation according to comparative advantage; see textbook, page 360).
  - Diversification could lead to misallocation of resources if countries try to diversify into high-cost production activities (in which they have a comparative disadvantage).
- Any reasonable discussion.
- Conclusions.

Text/data 18 European Union bilateral trade agreements with Columbia and Peru

Question B.9

(a) See textbook Glossary for definitions.

(b) For drawing a tariff diagram showing the price with tariffs to be higher than the international price, and for explaining that the elimination or reduction of tariffs will lead to a lower domestic price and a higher level of imports, which will increase the quantity of imports and therefore increase the level of competition in the domestic economy, forcing the more inefficient (higher cost) domestic firms to close down.

(c) For drawing an *AD-AS* diagram showing the aggregate demand curve shifting to the right and leading to a higher level of real GDP, and for explaining that increased Colombian and Peruvian exports to the EU work to increase their aggregate demand, causing it to shift to the right and therefore leading to a higher level of real GDP, which represents economic growth.

(d) The command term 'evaluate' requires candidates to make an appraisal by weighing up the strengths and limitations.

Responses **may** include:

- Explanation of bilateral trade agreement.
- Consideration of arguments in favour of free trade, or potential benefits for Colombia and Peru due to the bilateral agreement with the EU, such as:
  - increased competition, leading to more efficient producers
  - achievement of economies of scale
  - lower prices for consumers
  - possible greater variety for consumers through more varied imports
  - provision of aid by the EU to help Columbia and Peru modernise their economies (paragraph 4)
  - growth of manufacturing could be encouraged by tariff-free entry of Colombian and Peruvian industrial products into the EU (65% of products from Colombia and 80% of products from Peru) (paragraph 2)
  - increases in output produced
  - increases in Columbian and Peruvian exports and greater export revenues (paragraph 6)
  - improvement in current account
  - increases in foreign direct investment (paragraph 6)
  - increases in employment in the sectors that experience growth in exports
  - greater allocative efficiency
  - greater economic growth over the longer term
  - economic growth makes resources available that can be used to pursue development objectives (education, health care, etc.)
  - improvements in human rights (paragraph 4).
- Consideration of arguments against the bilateral agreements with the EU, or potential costs for Colombia and Peru (see textbook, pages 491–3):
  - Less tariff revenue for the government, cutting into finances for economic development purposes (investments in public goods and merit goods).
  - Colombian and Peruvian exports of agricultural commodities may not increase much if the EU does not eliminate protection of its farmers.
  - NGOs worry that producers in Colombia and Peru will be unable to compete with EU products (paragraph 3).
  - Tariff cuts in Colombia and Peru will cause less-efficient producers to close down due to the increased competition from the EU, causing hardship for these groups.
  - Tariff cuts will eliminate protection of infant industries.
  - Tariff cuts have different impacts on small and large producers, with large commercial producers that have achieved economies of scale benefiting from the bilateral agreement due to the possibility of increased exports to the EU, while the smaller producers get wiped out.
  - Manufacturing exports from Colombia and Peru to the EU may be unable to compete with lower cost EU products.
  - (higher level) The agreement may result in trade diversion.
  - At least over the short term (and possibly into the long term) there may result some structural unemployment.
  - There may be increased poverty among affected groups.

  - Income distribution may worsen.
  - Possibility that the EU may not provide enough aid to help modernise the economies.
  - Economic growth may be reduced at least over the short term, if the negative impacts of increased EU imports and limited exports by small producers are very strong.
- Comparison with World Trade Organization (WTO) (see textbook, pages 491–3):
  - Bilateral agreements often lead to greater tariff cuts than those required by the WTO. Hurting developing countries.
  - Bilateral agreements do not offer developing countries the same bargaining power as when they bargain as a group in WTO negotiations.
  - Liberalisation of investment (paragraph 2) often requires large concessions on the part of developing countries, and sometimes more than required by WTO agreements.
  - Bilateral agreements divide developing countries and weaken regional agreements.
- Any reasonable response.
- Conclusions.

Chapter 17 Topics in economic development

Chapter 18 Foreign sources of finance and foreign debt

Text/data 19 Banana trade wars

Question B.10

(a) See textbook Glossary for definitions.

(b) For drawing a tariff diagram with a tariff resulting in a price within the EU that is higher than the international price, and for explaining that the reduction of the tariff will lead to a lower price of bananas within the EU, and therefore a smaller quantity of EU banana production and a larger quantity of banana imports, which in turn represent a larger quantity of exports from banana exporting countries such as in Latin America.

(c) (higher level) For drawing a diagram showing a long-run average total cost curve, as in Figure 6.5(c) (see textbook, page 152), and for explaining that as plantation size increases in the long run (with all inputs variable), the average cost of producing bananas falls due to economies of scale.

(c) (core) For explaining that overspecialisation involves production of a narrow range of goods, in this case bananas, and that this increases possible risks arising from price volatility as well as deprives countries of the benefits of diversification (new employment opportunities, higher skill and technology levels), thus holding countries back from growth and development.

(d) The command term ‘discuss’ requires candidates to offer a considered and balanced review that includes a range of arguments, factors or hypotheses. Opinions or conclusions should be presented clearly and supported by appropriate evidence.

Responses **may** include:

- The role of the World Trade Organization (WTO):
  - What it is.
  - Potential contributions of the WTO to trade and development (see textbook, page 488).
  - Potential risks of reliance on WTO rules for trade and development (see textbook, pages 489–90).
- The role of preferential trade agreements in trade and development:
  - What they are.
  - Potential contributions of preferential trade agreements (see textbook, pages 413 and 415–16).
  - Potential risks of reliance on preferential trade agreements for trade and development (see textbook, page 416).
- Positive aspects of the EU–ACP agreement:
  - The ACP countries, among the poorest in the world, benefited from the agreement because they could export tariff-free bananas to the EU (paragraph 2).
  - This provided protection for ACP banana producers because non-ACP banana producers, including large multinational corporations (MNCs), faced tariffs (paragraph 2).
  - This allowed small ACP producers to survive, even though they produce at a higher cost than MNCs.
- Negative aspects of the EU-ACP agreement:
  - Violation of WTO rules because of discrimination (paragraph 3).
  - MNCs are lower cost producers, therefore producing more efficiently (paragraph 2).
  - (higher level) The agreement caused trade diversion.
- Consequences of the WTO ruling that the EU should reduce tariffs on non-ACP bananas, thus ending discrimination:
  - Increased competition will force ACP banana producers to reduce banana production.
  - Some ACP countries that are heavily dependent on bananas will suffer a huge shock to their economy (paragraph 5).
  - Their high levels of unemployment, underemployment and poverty (paragraph 5) are likely to increase.
  - Loss of export revenues may lead to balance of payments difficulties.
  - This may increase their levels of foreign debt.
  - Their growth and development objectives may be endangered (paragraph 5).
  - The development assistance from the EU to help them restructure their economies (paragraph 5) may not be enough to compensate them for the damage.
- Other consequences:
  - Increased allocative efficiency globally.
  - Negative environmental consequences: the MNCs that produce bananas will increase their banana production, even though many do not follow international environmental standards.

  - o Negative ethical consequences: increased MNC banana production may come at the cost of increased exploitation of workers (paragraph 6).
  - o The EU (and other countries) are forced to accept imports of bananas based on production methods that violate environmental standards and that exploit workers (paragraph 7), because the WTO rules do not allow importing countries to refuse imports on these grounds (paragraph 7).
- Any reasonable discussion.
- Conclusions.

Text/data 20 Appropriate technology in rural Africa

Question B.13

(a) See textbook Glossary for definitions.

(b) Two possible answers:

(i) For drawing a *PPC* diagram, showing the *PPC* shifting outward, and for explaining that increased use of technology results in increased production possibilities, which represent possibilities for increased output to be produced and therefore economic growth.

(ii) For drawing an *AD-AS* diagram showing the long-run aggregate supply curve shifting outward, and for explaining that increased use of technology results in greater potential output and hence economic growth.

(c) For drawing a diagram showing a positive production externality where the *MPC* curve lies above the *MSC* curve, as in Figure 5.9 (see textbook, page 113), and for explaining that the difference between the two curves represents the value of the positive production externalities which are the benefits to society in the form of greater economic growth and possibilities for more development.

(d) The command term 'evaluate' requires candidates to make an appraisal by weighing up the strengths and limitations.

Responses **may** include:

- Definition of non-governmental organisations (NGOs).
- Explanation of the role of NGOs as providers of aid.
- Advantages of NGOs (see textbook, page 512):
  - o Strong anti-poverty orientation: Edit Trust in Zimbabwe teaches rural women to work with a donated oil-pressing machine to help them learn how to earn their living (paragraph 2).
  - o Work closely with project beneficiaries: Edit Trust works directly with the women who are to benefit from the project (paragraph 2).
  - o Offer advice and expertise: Edit Trust advises the rural women how to work for the market, teaching them about commercial production, marketing, distribution, etc. (paragraph 2).

- o Innovative: Edit Trust donated an oil-pressing machine and provided training on how to use it as an innovative method to integrate the rural women into the market economy and make them more productive.
- o Enjoy the trust of beneficiaries.
- o Advocacy and raise public awareness and support.

- NGOs may be more effective than Official Development Aid (ODA).
- Explanation of some disadvantages of ODA (see textbook, pages 510–11).
- Because of their success, NGOs are increasingly used by bilateral and multilateral aid donors of ODA to channel their aid funds.
- NGO projects like Edit Trust's in Zimbabwe succeed in (paragraph 2):
  - o helping poor people earn a living and increase their income earning potential
  - o increase food production
  - o diversify their income sources
  - o become integrated in the market economy and produce for local markets and for export
  - o help in the promotion and diffusion of appropriate technologies
  - o help economies grow and develop in ways that include the poor in the development process.
- Potential disadvantages of NGOs (see textbook, pages 512–14).
- Any reasonable discussion.
- Conclusions.

Chapter 18 Foreign sources of finance and foreign debt

Text/data 21 Chinese direct investment in Zambia

Question B.14

(a) See textbook Glossary for definitions.

(b) For explaining that economic growth is a process with a single dimension, involving increased levels of output or increased levels of output *per capita* over a particular period of time (usually measured as GDP or GNI), and that economic development is a process with many dimensions that include improvements in the standards of living of a population, reductions in poverty, increased access to food, shelter, education, health care, sanitation, and others, increasing employment opportunities and reductions of serious inequalities in incomes and wealth.

(c) For explaining that some economic development can occur without growth through a reallocation of resources to provide more merit goods (education, health services, infrastructure, etc.), but over long periods of time growth is necessary because it makes the resources available for the pursuit of further economic development (though growth does not ensure that economic development will occur).

(d) The command term 'discuss' requires candidates to offer a considered and balanced review that includes a range of arguments, factors or hypotheses. Opinions or conclusions should be presented clearly and supported by appropriate evidence.

Responses **may** include:

- Definitions of:
  - foreign direct investment (FDI)
  - growth
  - development.
- Potential advantages of Chinese FDI in copper mining in Zambia (see textbook, pages 502–3):
  - Supplement insufficient foreign exchange earnings.
  - Supplement insufficient domestic savings.
  - Improve on local technical and management skills; improvements in human capital (paragraph 2).
  - Develop infrastructure essential for agriculture, manufacturing services and trade (paragraph 2).
  - Increase government tax revenues.
  - Increase local employment.
  - Increase incomes (paragraph 2).
  - Increase economic growth (paragraph 2).
- Potential disadvantages of Chinese FDI in copper mining in Zambia (see textbook, pages 503–4):
  - The possibility of environmental degradation from copper mining.
  - The infrastructure built by the MNCs may be more appropriate to their own needs rather than what is needed for growth and development in the Zambian economy.
  - There may be transfer of inappropriate technology.
  - MNCs may use their power to bring about policies that are in their own interest rather than Zambia's interests.
  - FDI may not help the Zambian economy unless 'a mechanism is found to transfer benefits from the mining sector to other sectors' (paragraph 3).
  - Benefits may not trickle down to the poor (paragraph 4).
  - Competition between Zambia and other countries to host MNCs may lead to the 'race to the bottom':
    - The record-high copper prices resulted in very high profits for the MNCs, but without a windfall tax, the Zambians will not benefit from the extraction of their own resources (paragraph 4).
    - The windfall tax was not imposed because of fears this may kill investments in mining, and it was suggested that other taxes might be lowered to attract more FDI (paragraph 5).
- Any reasonable discussion.
- Conclusions.

Text/data 23 Aid for Indonesia and South Africa

Question B.17

(a) See textbook Glossary for definitions.

(b) For explaining that GNI *per capita* refers to 'gross national income' per person, which is a measure of the income received in a country by each person on average, and that this is not always a good indicator for separating countries into economically more and less developed because income *per capita* is only one dimension of development while there are several others (levels of health, education, infrastructure) that if taken into account can make a country with a low income *per capita* more developed than another one with a higher income *per capita*.

(c) For explaining that the HDI is a composite indicator of human development that measures development in three dimensions: GNI *per capita*, education and health, and that since South Africa has a much higher GNI *per capita* than Indonesia, it must be the case that Indonesia must have higher achievements in either education or health (or both) in order for the human development indices and ranks of the two countries to be comparable.

(d) The command term 'compare and contrast' requires candidates to give an account of similarities and differences between two (or more) items or situations, referring to both (all) of them throughout.

Responses **may** include:

- Definitions of:
  - foreign aid
  - ODA (Official Development Assistance)
  - bilateral donors
  - human development.
- South Africa has a much higher GNI *per capita* ($PPP) (two and a half times greater) than Indonesia, yet received four times the amount of aid on a *per capita* basis (Table 1).
- This may be an example of aid not being distributed across countries according to need, but rather according to political, strategic or economic priorities/motives of donors.
- Both countries receive about the same amount of total aid ($1050 – $1078 billion) but Indonesia has a much larger population (Table 1).
- Therefore the benefits of aid received on a *per capita* basis are much lower in Indonesia than in South Africa.
- Indonesia has achieved roughly the same level of human development as South Africa with a much lower GNI *per capita*, as indicated by the Human Development Index (HDI) (Table 1).
- This suggests that Indonesia is using its resources more effectively than South Africa with respect to achieving health and education objectives.
- South Africa's comparable HDI and rank with the HDI and rank of Indonesia are due to its relatively high GNI *per capita* (Table 1).
- South Africa has higher achievements than Indonesia in education, but far lower in health due to a much lower life expectancy (Table 1).

- Table 2 shows the widely differing priorities attached to the various sectors in the two countries, which may reflect the differing priorities of donors as well as recipient countries .
- South Africa received a very large share of ODA for health, which may be reasonable considering its very low life expectancy (Table 2).
- Indonesia received a much higher share of ODA for education, which is greater than in proportion to its weaker achievements in education (Table 2).
- The top ten donors of ODA for the two countries differ dramatically, with Japan being by far the largest donor to Indonesia, and the United States being the largest donor to South Africa (Table 3).
- This may be a reflection of differing political priorities of donor countries that determine how they allocate their ODA contributions among recipient countries.
- Any reasonable discussion.
- Conclusions.

Text/data 24 Aid versus trade

Question B.18

(a) **(i)** See textbook Glossary for definition.

(ii) Official Development Assistance (ODA) and non-governmental organisations (NGOs).

(b) For explaining that development aid is intended to help developing countries achieve economic growth and development objectives (project or programme aid and technical assistance as well as debt relief), and that humanitarian aid involves aid extended to regions to deal with emergencies due to violent conflicts or natural disasters (food and medical aid and emergency relief aid).

(c) For explaining that this refers to protection of agriculture in the EU and the US taking the form of subsidies and price floors which lead to a global misallocation of resources by creating too much production in the countries where agriculture receives the protection and too little in countries that do not receive similar protection, and that it leads to an inability of poor country farmers to access EU and US markets, and therefore lower export earnings and reduced livelihood for these farmers, as well as depressed world prices making it difficult for poor farmers to compete successfully.

(d) The command term 'compare and contrast' requires candidates to give an account of similarities and differences between two (or more) items or situations, referring to both (all) of them throughout.

Responses **may** include:

- Definition of foreign aid.
- Definition of economic development.
- Potential contributions of aid to economic development (see textbook, page 510):
  - Aid can help escape the poverty cycle (poverty trap).

- Aid can make resources available for investments in health, education and infrastructure, empowerment for women (paragraph 2).
- Aid can help improve the distribution of income.
- Aid can lead to economic growth.
- Aid is crucially important to the achievement of the Millennium Development Goals (MDGs); the funds made available by rich countries to meet the MDGs has fallen far short of commitments (paragraphs 1 and 2).
- Aid can help countries escape debt traps (aid relief).

- Potential disadvantages of foreign aid:
  - Tied aid.
  - Conditional aid.
  - Aid volatility and unpredictability; aid must be made more predictable (paragraph 3).
  - Unco-ordinated donors.
  - Aid may be used as a substitute for domestic resources rather than supplement them; 'the fundamental problem with the current development aid practice is the danger countries face as they become perpetually reliant on handouts' (paragraph 4).
  - Aid may be associated with corruption.
  - Aid may not reach those most in need.
- To deliver on its commitments aid must be made more effective (paragraph 3).
- Arguments in favour of trade (see textbook, pages 354–5):
  - It allows for increased competition and increased efficiencies in production.
  - It allows for improved resource allocation.
  - Greater consumer choice and improved product quality.
  - It allows countries to acquire needed resources.
  - It makes possible the flow of new ideas and technology.
  - Trade can be an 'engine for growth'.
- According to the 'trade, not aid argument' (see textbook, page 514), growth and development should be based on an expansion of exports; the experience of aid shows that it does not effectively contribute to growth and development:
  - 'While helpful, aid has not contributed to sustainable development. It is clear that trade and investment bring greater opportunity for wealth creation' (paragraph 4).
  - For trade to be effective rich countries should abandon agricultural protection; 'For too long we have been unable to trade fairly with Europe and the US … particularly in agriculture' (paragraph 6).
- According to the 'trade and aid' argument (see textbook, page 514), trade is very important, but by itself without aid it is not enough because:
  - rich-country protection of agriculture does not allow developing countries to have access to their markets
  - some developing countries are too dependent on commodity production that is affected by price volatility and deteriorating terms of trade
  - some countries cannot escape the poverty cycle without aid
  - some countries have little or nothing to export
  - some countries are so geographically isolated that they do not have access to foreign markets.

- According to the 'aid for trade' argument (see page 515), developing countries need aid in order to be able to benefit from trade; aid should be used:
  - 'to create opportunities for trade' (paragraph 5)
  - to develop the necessary transport and power infrastructure
  - to provide credit to all who need it
  - to develop institutions that facilitate border controls
  - to develop the capacity to meet technical and sanitary standards of importing countries.
- Any reasonable discussion.
- Conclusions.

Chapter 18 Foreign sources of finance and foreign debt

Chapter 19 Consequences of economic growth and the balance between markets and intervention

Text/data 25 Malawi's foreign debt and human development

Question B.19

(a) **(i)** See textbook Glossary for definition.

(ii) To acquire the foreign exchange needed to pay for an excess of imports over exports.

(b) For explaining that opportunity costs involve the sacrifice of the next best alternative of a particular action, and that opportunity costs in this instance are all the spending on desirable activities (imports of needed inputs, provision of merit goods, etc.) that are foregone in order for a country to be able to meets its foreign debt servicing obligations.

(c) For explaining that some of the poorest developing countries have been caught in situations of very high foreign debts, often involving debt traps where they must go on borrowing more and more in order to meet their debt servicing obligations, and that the pressure to cancel a portion of these countries' debts arises from the huge opportunity costs of debt servicing that translate into the practical impossibility to emerge from the situation of debt and ever grow and develop.

(d) The command term 'discuss' requires candidates to offer a considered and balanced review that includes a range of arguments, factors or hypotheses. Opinions or conclusions should be presented clearly and supported by appropriate evidence.

Responses **may** include:

- Explanation of the meaning of foreign debt.
- Consequences of high levels of foreign debt (see textbook, pages 521–2):
  - Balance of payments problems, due to debt servicing obligations (repayment of the loans plus payment of interest) that must be paid in foreign exchange.

- Possibility of a debt trap, where debts can only be repaid through more borrowing.
- Opportunity costs of debt service payments because the government has fewer resources to invest in social services, infrastructure, etc.; in Malawi, in 2005, 9.6% of national income was spent on debt servicing and 4.6% on public provision of health care, while 74% of the population was living in extreme poverty (less than $1 a day) (paragraph 3).
- Lower private investment due to uncertainties about economic conditions.
- Lower economic growth, due to lower public and private investment, fewer imports of needed inputs (due to scarce foreign exchange); in Malawi as foreign debt increased to 150% of national income in 2000, the economy stagnated and GNI *per capita* fell (paragraph 2).

- For a country to benefit fully from debt relief, this must be administered effectively; however (see textbook, page 522):
  - the Heavily Indebted Poor Countries (HIPC) initiative takes effect too slowly risking that the benefits may follow too slowly
  - in the case of Malawi, it took six years to take effect (2000–6) (paragraph 3)
  - some measures that are imposed are too severe, such as privatisation, charging fees for schools and hospitals, reductions of government expenditures on social services provision (merit goods)
  - in the case of Malawi, the conditions involved privatisations, cuts in public spending, elimination of agricultural subsidies (paragraph 4), imposition of school fees (implied in paragraph 7)
  - cuts in agricultural subsidies together with drought resulted in food shortages in which thousands died of hunger and millions suffered (paragraph 5).
- Positive effects of debt cancellation:
  - Debt repayments fell from 150% of national income to 25% of national income (paragraph 7), greatly reducing the opportunity costs of debt service payments.
  - Malawi greatly increased spending on social services (paragraph 7).
  - School fees were abolished, helping more than one million children go to school (paragraph 7).
  - Economic growth greatly accelerated, increasing from 2.5% in 2002–5 to 8.5% in 2006–9 (paragraph 7)
  - The possibilities for economic development have improved: the World Bank's development diamond shows Malawi to be performing far better than other countries in the same income group with respect to several indicators: access to improved sanitation is greater, adult literacy rate is greater, and maternal mortality is lower, all while Malawi's GNI *per capita* is lower than the average for its income group.
- Any reasonable discussion.
- Conclusions.

Text/data 26 Ending Tanzania's vicious cycle of poverty

Question B.21

(a) See textbook Glossary for definitions.

(b) For explaining that the poverty cycle involves a situation where low savings leads to low investment and therefore to low levels of physical, human and natural capital, which in turn leads to low growth in income and therefore to low savings again, and that foreign direct investment can help break out of the poverty cycle by supplementing insufficient domestic savings and investment and therefore increasing physical capital, thus contributing to increasing incomes.

(c) For explaining that countries sometimes borrow heavily from foreign creditors; these include many developing countries as well as some transition economies and European economies, in order to finance an excess of imports of exports, or an excess of government spending over revenues, or because their economies were negatively affected by the global financial crisis that began in 2008; and for explaining that a key role of the International Monetary Fund (IMF) is to lend to countries that are experiencing difficulties in making their international payments, i.e. paying back their loans.

(d) The command term 'compare and contrast' requires candidates to give an account of similarities and differences between two (or more) items or situations, referring to both (all) of them throughout.

Responses **may** include:

- Explanation of import substitution policies.
- Objectives of import substitution policies (see textbook, pages 482–3).
    - Desire to modernise and industrialise; Tanazania used these policies in an effort to industrialise and become self-sufficient in food (paragraph 4).
    - Imitate historical experiences of developed countries.
    - Deal with deteriorating commodity terms of trade.
    - Avoid balance of payments problems.
    - Protect infant industries.
- Consequences of import substitution policies (see textbook, page 483):
    - Major inefficiencies in production and allocative inefficiencies resulting from strong government intervention:
        - High levels of trade protection of domestic firms to reduce reliance on exports and increase domestic production.
        - Overvalued exchange rates to allow imports of cheap inputs hurt exports, worsening rural poverty as much of exports consisted of agricultural products.
        - Production subsidies in industries being promoted, wage subsidies, credit subsidies.
        - Tax allowances, price controls.
        - Government-ownership in key sectors.
    - Use of capital-intensive (inappropriate) technologies did not make use of abundant labour supplies.
    - Unemployment and the growth of the urban informal sector increased.

  - Deterioration of balance of payments and debt positions due to rising imports of capital goods (as inputs) and increased need for food imports.
  - Limited possibilities for growth over the longer term.
  - Tanzania's experiments with these policies led to hyperinflation, huge trade deficit and budget deficit, and heavy dependence on foreign aid (paragraph 4).
- Explanation of export promotion policies (see textbook, page 484):
  - Also depended on strong government intervention, but was outward-oriented, focusing on promotion of exports:
    - Government control of financial institutions (banking and insurance).
    - Industrial policies to support export industries.
    - Some protection of domestic industries.
    - Large public investments in education, research and development (R&D), transport and communications infrastructure.
    - Incentives for private sector R&D and high technology products.
- Why export promotion was more successful than import substitution (see textbook, pages 484–5):
  - Growth of exports allowed expansion into foreign markets and taking advantage of economies of scale.
  - Benefits of diversification.
  - Major investments in human capital.
  - Development and use of appropriate technologies.
  - Increased employment.
  - Avoidance of growing trade deficits and balance of payments problems due to growth in export earnings.
- Tanzania did not have the benefit of pursuing export promotion policies as it went straight into market and trade liberalisation (paragraph 5):
  - Lowered import barriers leading to de-industrialisation and loss of jobs due to inability to compete with foreign lower cost producers (paragraph 5).
  - Liberalisation policies determined by the World Bank and IMF (reduction of public spending, privatisation, market-oriented reforms) have not allowed Tanzania to participate in the success of export-promotion policies (paragraph 5).
- Any reasonable discussion.
- Conclusions.

Question B.23

(a) **(i)** See textbook Glossary for definition.

(ii) Any two of the following: policies to increase competition; labour market reforms; incentive-related policies.

(b) For explaining that foreign aid involves the transfer of funds to developing countries to help them with improving their economic and social conditions, extended by (i) Official Development Assistance (ODA) which involves bilateral or multilateral donors; and (ii) non-governmental organisations (NGOs); to qualify as aid, these funds must be either grants or loans made on concessional terms (i.e. below market rates of interest and long repayment periods); and for explaining that multilateral development assistance involves lending for the purpose of assisting developing countries with their growth and development, undertaken by multilateral organisations (such as the World Bank), and where the loans are extended on non-concessional terms (i.e. market rates of interest and repayment periods).

(c) For explaining that economic growth is necessary for economic development over long periods of time because for development to be sustained over a long period this requires resources that are made available by growth; and for explaining that improvements in standards of living for the broader population do not occur automatically but are rather the result of specific policies undertaken to ensure broad participation in the benefits of growth (promotion of human development, infrastructure, appropriate technologies, income redistribution, etc.).

(d) The command term 'examine' requires candidates to consider an argument or concept in a way that uncovers the assumptions and interrelationships of the issue.

Responses **may** include:

- Explanation of the role of the World Bank as a multilateral development assistance organisation (see textbook, page 517):
  - Lending for development assistance, with an increased focus on poverty reduction and institutional development.
- Assessment of World Bank activities in developing countries (see textbook, page 517):
  - Greater awareness of social and environmental concerns than in the past.
  - Governance dominated by more developed countries.
  - Excessive interference in domestic country affairs.
  - Conditional lending.
  - Market orientation of lending may increase income inequalities and poverty.
  - Attention paid to poverty alleviation may be inadequate.
- Explanation of the role of the International Monetary Fund (IMF) as a multilateral financial institution (see textbook, page 518):
  - Lending to countries that experience difficulties in making their foreign payments.
- Assessment of IMF activities (see textbook, pages 518–19):
  - Same factors as in the case of the World Bank: governance dominated by more developed countries, excessive interference in countries' domestic affairs, conditional lending).
  - IMF policies usually create recession in borrowing countries, resulting in higher unemployment and underemployment and increasing poverty:
    - Tight fiscal and monetary policies, intended to lower aggregate demand, reduce the level of economic activity, reduce imports, with higher interest rates intended to encourage inflows of financial capital.
    - Tight fiscal policies result in cuts in provision of merit goods (education, health care, etc.), cuts in food and other subsidies, imposition of fees for school and health care services.
    - Currency devaluations/depreciation to encourage exports and discourage imports.

        - Cuts in real wages.
        - Market liberalisation policies: privatisation, reduction of all forms of government intervention.
    - IMF policies are possibly based on a flawed concept as their success tends to be short-lived; many countries experience low or negative rates of growth and are unable to 'grow' out of their payments difficulties.
- Positive effects of World Bank and IMF policies in Tanzania (paragraphs 6 and 7):
    - World Bank lending to improve provision of merit goods: health, higher education, transport, electricity provision, food security.
    - Increased IMF lending to help Tanzania come out of its balance of payments difficulties caused by the global financial crisis.
    - IMF claims that it no longer imposes unreasonable conditions preventing governments from spending on merit goods.
    - Inflation has fallen.
    - Real GDP is growing rapidly.
    - Exports are increasing.
    - Public finances are under control.
    - Is attracting more foreign direct investment.
- Negative effects of World Bank and IMF policies in Tanzania (paragraphs 5, 6 and 7):
    - According to a recent claim the IMF still imposes conditions that block spending on education.
    - Lower import barriers led to de-industrialisation and growing unemployment as domestic firms were unable to compete with lower cost foreign producers.
    - Conditionality and increased market orientation: loans have been extended on condition that the government reduces public spending, privatises state enterprises and pursues market-oriented reforms.
    - The macroeconomic successes listed above have come at a huge human cost: continued poverty and deprivations in a large part of the population.
    - Economic growth may not be affecting the poor.
    - With respect to MDGs: some progress has been made in school enrolment, gender equality and empowerment; however, infant and under-five child mortality rates remain very high while maternal deaths are rising because of poor health services.
- Any reasonable discussion.
- Conclusions.

Chapter 19 Consequences of economic growth and the balance between markets and intervention

Text/data 27 Economic growth and development in Latin America

Question B.25

(a) See textbook Glossary for definitions.

(b) For explaining that import substitution has an inward orientation to growth and development in that it tries to reduce imports while promoting domestic production, particularly industrial production, and that it is based heavily on a strongly interventionist approach involving high import barriers, overvalued exchange rates, price controls, wage subsidies, production subsidies, credit subsidies, extensive state ownership of firms and industries, and others; the very heavy government intervention came to be associated with serious resource misallocation.

(c) For explaining that whether income distribution improves or worsens with economic growth depends on the particular policies that are pursued to achieve growth; in East Asia where growth policies were accompanied by development of human capital there was broad-based participation in the benefits of growth; whereas a worsening in income distribution experienced in many countries around the world since the 1990s has been due to the impacts of supply-side policies and economic and trade liberalisation that create both winners and losers, consisting of those who can take advantage of new opportunities being created by markets and those who cannot.

(d) The command term 'discuss' requires candidates to offer a considered and balanced review that includes a range of arguments, factors or hypotheses. Opinions or conclusions should be presented clearly and supported by appropriate evidence.

Responses **may** include:

- Explanation of market-oriented policies in development (see textbook, page 531).
- Strengths of market-oriented policies (see textbook, pages 531–2):
  - Good resource allocation results.
  - Self-interest and incentives lead to more work, risk-taking, innovation, and hence greater output and economic growth.
  - Policies that encourage competition, labour market reforms, incentive-related policies, trade liberalisation, freely floating exchange rates and capital liberalisation are all based on the idea that market forces improve the allocation of resources and allow for more economic growth.
- Weaknesses of market-oriented policies (see textbook, pages 532–3):
  - Cannot deal with market failures.
  - Cannot deal with co-ordination failures.
  - Markets cannot function if there are weak or missing institutions.
  - Cannot address the problem of dual economies.
  - Often lead to greater income inequalities.
  - May not lead to improved export performance, economic growth and development.

- Explanation of interventionist policies:
- Strengths of interventionist policies (see textbook, pages 533–4):
  - Can correct market failures and co-ordination failures.
  - Can promote investment in human capital.
  - Can increase provision of infrastructure.
  - Can provide a stable macroeconomic environment.
  - Can provide a social safety net to ensure a minimum standard of living for those who cannot secure an adequate income through the market system.
  - Can redistribute income.
  - Can provide industrial policies to promote industrial expansion and economic growth.
- Weaknesses of interventionist policies (see textbook, pages 536–7):
  - Excessive bureaucracy.
  - Poor planning, leading to greater inefficiencies.
  - Possibilities for greater corruption.
- The importance of good governance in economic development.
- The importance of a balance between interventionist and market-oriented policies (see textbook, pages 536–7):
  - Experience shows that too much reliance on government intervention or on markets does not work well.
  - The experience of import substitution showed that this leads to major resource misallocations and poor growth performance over the long term.
  - The experience of reliance on market-oriented policies (the Washington Consensus) shows that this led to increasing income inequalities and poverty, insufficient investments in human capital and infrastructure, unsustainable development, weak export and growth performance, etc.
- The New Development Consensus outlines an approach that combines interventionist and market-oriented policies for best results in economic growth and development (see textbook pages 487 and 537):
  - Trade and market liberalisation continue to be important, but at the same time there is an important role for government to help create the conditions needed for markets to work well, as well as to carry out policies for activities that markets cannot do well (investments in merit goods, policies for poverty alleviation and income redistribution, provision of micro-credit and a social safety net, policies for appropriate technology, sustainable development, etc.).
  - Countries at a lower level of economic development might benefit more from a more interventionist approach, which can be relaxed and become more market-oriented as countries grow and develop.
- The experience of Latin America is an example of the benefits of such a balance:
  - Abandoned import substitution in favour of trade liberalisation in 1980s and 1990s (paragraph 6).
  - Market-oriented policies include freer trade, lowering restrictions on foreign firms and reducing state ownership of firms (paragraph 6).
  - Has achieved good governance; using commodity windfalls for long-term growth (paragraphs 3 and 4).
  - Interventionist policies include policies to strengthen the social safety net.

  - Future needs include interventionist policies in a market-oriented environment: further strengthening the social safety net, improving equality of opportunity for the less privileged, reforming the tax system to make it less regressive, building infrastructure, and improving public health care and education (paragraph 7).
  - Positive achievements in Latin America due to this balance:
    - Market and trade liberalisation and macroeconomic stability helped transform Latin America (paragraph 6).
    - More rapid economic growth (paragraph 7).
    - Decreasing poverty (paragraph 7).
    - The use of transfer payment programmes, which helped reduce income inequalities, increase school enrolment and attendance, maternal health and vaccinations (paragraph 7).
    - Stronger social safety nets have reduced income inequalities (paragraph 6).
    - Improving living standards (paragraph 8).
    - Lower birth rates allow family income to go further in satisfying needs (paragraph 8).
    - Lower prices of consumers due to trade liberalisation (paragraph 8).
- Any reasonable discussion.
- Conclusion.

