Mock Exam 1

ECONOMICS | **9708**

Paper 2 Data Response and Essay | **1 hour 30 minutes**

You must answer on the enclosed answer booklet.

You will need: Answer booklet (enclosed)

INSTRUCTIONS

- Answer **two** questions in total:
  - Section A: answer Question 1.
  - Section B: answer **one** question.
- Follow the instructions on the front cover of the answer booklet. If you need additional answer paper, ask the invigilator for a continuation booklet.
- You may use a calculator.
- You may answer with reference to any economy you have studied where relevant to the question.

INFORMATION

- The total mark for this paper is 40.
- The number of marks for each question or part question is shown in brackets [ ].

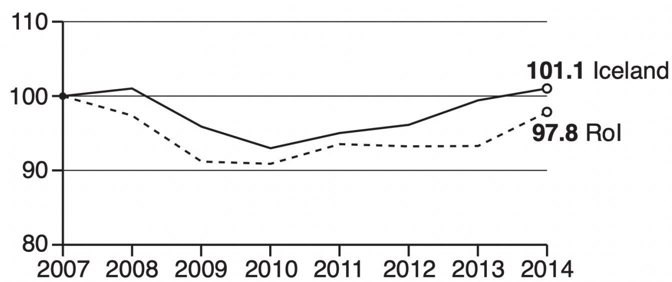
This document has **4** pages.

Section A

Answer all parts of Question 1.

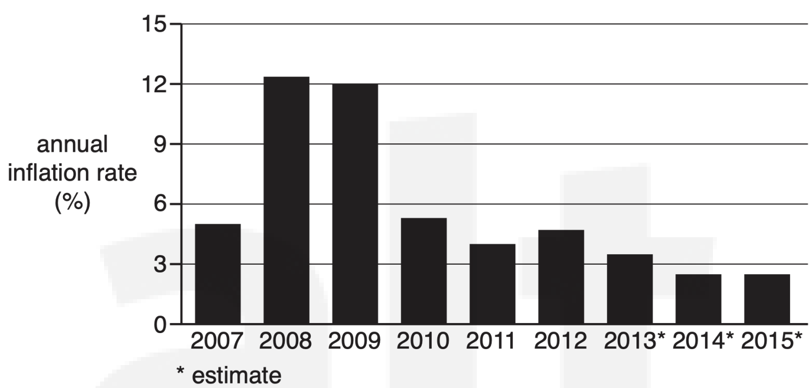
1 **The miraculous story of Iceland**

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



Source: International Monetary Fund (IMF)

Fig. 2: Inflation in Iceland 2007–2015



Source: IMF

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

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

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

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

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

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

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

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

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

Section B

Answer **one** question

EITHER

2 **(a)** Distinguish between regressive and progressive taxes and explain whether you would use an income tax or a specific indirect tax to make post-tax incomes more equal. [8]

(b) Discuss whether income elasticity of demand is the most useful measure of elasticity to a firm. [12]

OR

3 In some countries vaccinations against infectious diseases are offered at a price and payment has to be made.

(a) Use a diagram to explain how a subsidy given to producers in the market for vaccinations will affect the market price and explain the impact of this subsidy upon the consumer surplus in this market. [8]

(b) Discuss whether decision-making is more effective when undertaken by governments in a planned economy rather than by individuals in a free market economy. [12]

Section C

Answer **one** question

EITHER

4 **(a)** Distinguish between structural and frictional unemployment. Consider which would be likely to have the greater negative effect on an economy. [8]

(b) To what extent do you agree that the costs of economic growth are greater than the benefits? [12]

OR

5 **(a)** Show how exchange rates are determined in a freely floating system. Explain how a high rate of inflation in an economy can lead to depreciation in that economy's exchange rate. Use a diagram to support your answer. [8]

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