

Name: _____

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IB Economics — Practice Exam

Instructions: Answer BOTH questions. Each question is worth 29 marks. Use fully labelled diagrams where the question asks for them, show the working for calculations, and in part (e) support your evaluation with information from the text. Time allowed: 1 hour 45 minutes.

Time Limit: 105 minutes

- [29 points] 1. Study the following extract and answer the questions that follow. — "Kessandria's maize price guarantee." Kessandria is a lower-middle-income country in which about 60 percent of the workforce farms, most of them smallholders growing maize. Last year the government introduced a minimum price of 300 kesh per tonne for maize, 25 percent above the previous market price of 240 kesh, and promised to buy any maize that farmers could not sell. At the minimum price farmers supplied 5.2 million tonnes, but millers and households bought only 4.4 million tonnes; the state grain agency purchased the resulting excess supply of 0.8 million tonnes and now holds it in storage, planning to sell some of it abroad at 200 kesh per tonne. Maize flour accounts for 18 percent of the spending of the poorest fifth of households. Large commercial farms, which grow 45 percent of the crop, have expanded their planting, and fertiliser imports have risen. The finance ministry warns that the programme already costs as much as the primary health budget.
- [4 points] (a) Define the following terms from the text: (i) minimum price [2]; (ii) excess supply [2].

- [4 points]** (b) Using a demand and supply diagram, explain the effect of the minimum price on the market for maize in Kessandria.

- [2 points]** (c) Using information from the text, calculate the cost to the government of purchasing the excess supply of maize.

- [4 points]** (d) Explain how the minimum price affects (i) consumers of maize flour in Kessandria and (ii) the efficiency of resource allocation in the maize market.

- [15 points]** (e) Using information from the text and your knowledge of economics, evaluate the view that the minimum price is an effective way of raising the incomes of Kessandria's smallholder farmers.

- [29 points]** 2. Study the following extract and answer the questions that follow. — "Tavoria's currency slide."
Over the past twelve months Tavoria's currency, the tavo, has fallen from 5.00 to 6.25 tavos per

US dollar. The slide began when world copper prices fell by 30 percent, cutting the earnings of Tavoria's largest export industry, and accelerated when the US central bank raised interest rates and short-term capital left Tavoria for dollar assets. Tavoria's central bank spent 4 billion dollars of its foreign reserves trying to hold the tavo up before abandoning the defence. Tavoria runs a current account deficit of 6 percent of GDP and imports all of its fuel and most of its machinery. Garment exporters report that foreign orders are up 12 percent since the depreciation, but fuel prices have risen by 25 percent in tavos and consumer price inflation has reached 9 percent. The finance ministry estimates the price elasticity of demand for Tavoria's exports at 0.6 and for its imports at 0.3 in the first year, rising to 0.9 and 0.5 after three years. Opposition politicians are calling for tariffs on imported consumer goods.

[4 points]

- (a) Define the following terms from the text: (i) depreciation (of a currency) [2]; (ii) current account deficit [2].

[4 points]

- (b) Using an exchange rate diagram, explain how the rise in US interest rates has affected the value of the tavo.

[2 points] (c) Using information from the text, calculate the change in the price, in tavos, of an imported machine costing 40 000 US dollars as a result of the depreciation.

[4 points] (d) Using the elasticity estimates in the text, explain why the depreciation is likely to worsen Tavoria's current account in the first year before improving it.

- [15 points]** (e) Using information from the text and your knowledge of economics, evaluate the view that the depreciation of the tavo will benefit the Tavorian economy.