Cambridge Assessment International Education

Cambridge International AS & A Level

ECONOMICS **9708/21**

Paper 2 Data Response and Essay **October/November 2020**

1 hour 30 minutes

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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. Blank pages are indicated.

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Section A

Answer this question.

1 Latvia becomes a banking capital between the European Union's (EU's) east and west

Latvia regards itself as a financial bridge between Europe's east and west. Since the Soviet Union's collapse in 1991, Latvia (population 2.2 million) joined the EU (population 510 million) in 2004. It has since built itself into a banking centre for people from all parts of Europe and many other parts of the world, although its reputation as a financial centre has been growing since 1988 when two entrepreneurs founded a private bank, Parex Bank, in the capital, Riga.

In the early years of the 21st century, favourable credit conditions in Latvia contributed to an economic boom, but in the global financial crisis of 2007–2008 Parex Bank, by then Latvia's second biggest bank, needed government assistance and was nationalised.

The financial crisis caused Latvia's annual inflation rate to rise rapidly to 17.7% in May 2008, which was significantly higher than its average annual inflation rate of 3.7% for the period 1998–2018.

In 2008, the Latvian government decided to substantially reduce the size of the budget deficit, in an attempt to reduce the relatively high rate of inflation, through a series of fiscal measures such as increasing taxation and reducing public spending.

Latvia emerged from the global financial crisis to become the EU's fastest-growing economy. The intention was that Latvia would eventually join the EU's common currency (the euro). Fig. 1.1 below shows the exchange rate of Latvian Lats (the country's former currency) per euro from 2007 to 2013.

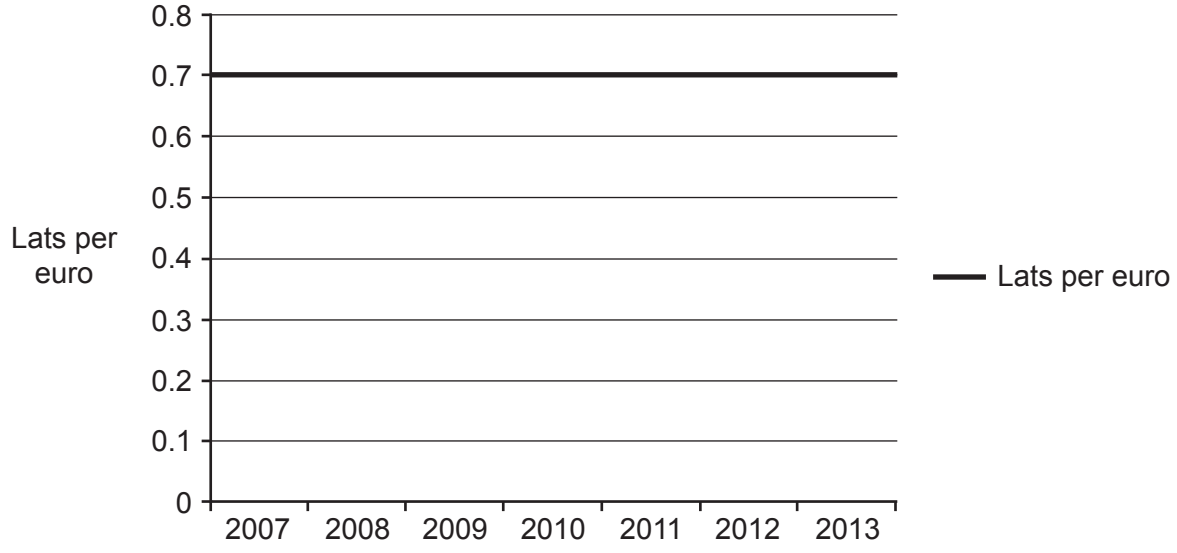


Fig. 1.1 Exchange rate of Latvian Lats per euro, 2007–2013

In January 2014, Latvia did join the euro and this was welcomed by business leaders and economists in Latvia, stating that it would improve Latvia's credit rating and attract foreign investors. The governor of Latvia's central bank said: "The euro brings stability and certainty, definitely attracting investment."

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However, not everybody in Latvia supported the introduction of the euro. Many people thought that Latvia would lose a certain amount of economic independence and that it would lead to an increase in prices and taxes.

Sources: Adapted from The Financial Times 20 February 2018
Latvijas Banka, accessed October 2018

(a) Describe the functions of an entrepreneur in the production process. [2]

(b) When Latvia joined the EU it became part of a customs union.

How does a customs union differ from a free trade area? [2]

(c) As a result of the global financial crisis in 2007–2008 there was a large capital outflow from Latvia.

Use a supply and demand diagram to explain how the exchange rate against the euro was maintained as shown in Fig. 1.1. [4]

(d) **(i)** Explain what is meant by a 'budget deficit'. [2]

(ii) Analyse, using a diagram, how fiscal measures to reduce the budget deficit could be used by the Latvian government to lower the relatively high rate of inflation. [4]

(e) Discuss whether it is better for Latvia to specialise in banking services rather than having a more diversified economy. [6]

Section B

Answer **one** question.

2 **(a)** Explain, with the help of examples, how imperfect information among consumers affects their consumption of merit goods and demerit goods. [8]

(b) Discuss why in most mixed economies, resources are mainly allocated using market forces and the price mechanism. [12]

3 **(a)** Cross elasticity of demand for bread with respect to the price of rice is +1.4 while the cross elasticity of demand for bread with respect to the price of butter is –0.7.

Explain why the cross elasticity of demand figures for bread differ. [8]

(b) Explain the implications of price elasticity of demand and income elasticity of demand for business decisions. Discuss which measure is likely to be more useful to a business. [12]

4 **(a)** Explain, with the aid of a diagram, the impact of a subsidy to domestic producers of a product on the export revenue from that product. [8]

(b) Discuss whether supply-side policies are an effective way of correcting a deficit on an economy's current account of the balance of payments. [12]

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