SECTION A

*Answer **one** question from this section.*

1. *Study the extract below and answer the questions that follow.*

Indian exchange rates

❶ In 1991, India moved from following an import substitution policy to one of export promotion. There was a significant current account deficit and there were not even enough reserve assets to buy three weeks' worth of required imported goods and services. Emergency measures were needed along with a strategy to ensure it did not happen again. The strategy was trade liberalization and the economy was to be opened up to increase domestic competition.

❷ This would be achieved through both **foreign direct investment (FDI)** as well as greater imports of goods and services. It was hoped that these measures would ultimately increase exports so easing the pressure on the balance of payments. The new companies that emerged would attract portfolio investment, further easing the pressures on the balance of payments.

❸ Twenty-one years later, in 2012, it is clear that elements of this strategy have done well. The lowering of tariff and other barriers did increase the availability of imported products and contributed to the growth of the export sector. Trade now accounts for a major share of gross domestic product (GDP). Growth in trade and other services has been self-sustaining and contributed to the high growth rates that Indian officials are proud of.

❹ However, the present crisis in Europe is hurting stock markets across the world and raises the possibility of an outflow of portfolio investment from the Indian stock markets. At the same time, recessions in Europe and the United States will have an impact on Indian exports. This pressure on the balance of payments is already being felt on the **exchange rate** of the Indian rupee (India's currency), which is weakening and has fallen by about 20 % in the period January 2011 to January 2012. The falling rupee has also created inflationary pressures, which has led the government to keep interest rates high.

❺ Currently, India has a large current account deficit which the depreciation of the rupee would be expected to correct. However, recent trade data suggest that this has not happened. Exports have been falling on a month-on-month basis from July 2011, with the slowing demand for Indian goods in Europe and the United States. Some economists say that many exporters rely heavily on imported inputs, so depreciation may increase the cost of inputs more than it lowers the price of the exports.

❻ Exchange rate policy should not aim at export promotion alone, but should balance both export and import growth.

[Sources: adapted from "Europe crisis can unravel the growth strategy of the Indian economy", *Mail Online India*, 24 January 2012 and "Trade data defies traditional view", *Business Standard India*, 23 January 2012]

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ECONOMICS
HIGHER LEVEL
PAPER 2

Wednesday 5 November 2014 (morning)

1 hour 30 minutes

INSTRUCTIONS TO CANDIDATES

- Do not open this examination paper until instructed to do so.
- You are not permitted access to any calculator for this paper.
- Section A: answer one question.
- Section B: answer one question.
- Use fully labelled diagrams and references to the text/data where appropriate.
- The maximum mark for this examination paper is *[40 marks]*.

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(Question 1 continued)

(a) (i) Define the term *foreign direct investment (FDI)*, indicated in bold in the text *(paragraph ❷)*. *[2 marks]*

(ii) Define the term *exchange rate*, indicated in bold in the text *(paragraph ❹)*. *[2 marks]*

(b) Using an appropriate diagram, explain **one** reason why the rupee may have fallen in value "by about 20% in the period January 2011 to January 2012" *(paragraph ❹)*. *[4 marks]*

(c) Using an AD/AS diagram, explain why "the falling rupee has also created inflationary pressures" *(paragraph ❹)*. *[4 marks]*

(d) Using information from the text/data and your knowledge of economics, evaluate the possible economic consequences of the fall in the value of the rupee on the Indian economy. *[8 marks]*

SECTION A

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