

UNIVERSITY OF CAMBRIDGE
INTERNATIONAL EXAMINATIONS General

ECONOMICS 9708/22 Paper 2 Data Response and Essay (Core) **May/June 2010 1 hour 30 minutes**

Additional Materials: Answer Booklet/Paper

READ THESE INSTRUCTIONS FIRST

If you have been given an Answer Booklet, follow the instructions on the front cover of the Booklet. Write your Centre number, candidate number and name on all the work you hand in. Write in dark blue or black pen.

You may use a soft pencil for any diagrams, graphs or rough working.

Do not use staples, paper clips, highlighters, glue or correction fluid.

Section A

Answer this question.
Brief answers only are required.

Section B

Answer any **one** question.

You may answer with reference to your own economy or other economies that you have studied where relevant to the question.

At the end of the examination, fasten all your work securely together.
The number of marks is given in brackets [] at the end of each question or part question.

Section A

Answer this question.

1 Inflation in Paraguay

Paraguay is a small South American country with few of the advantages that bigger, better known economies such as Venezuela and Brazil enjoy.

In January 2008 Paraguay updated its Consumer Price Index (CPI) with new weights based on the latest household budget survey. Table 1 shows the changes in the weights.

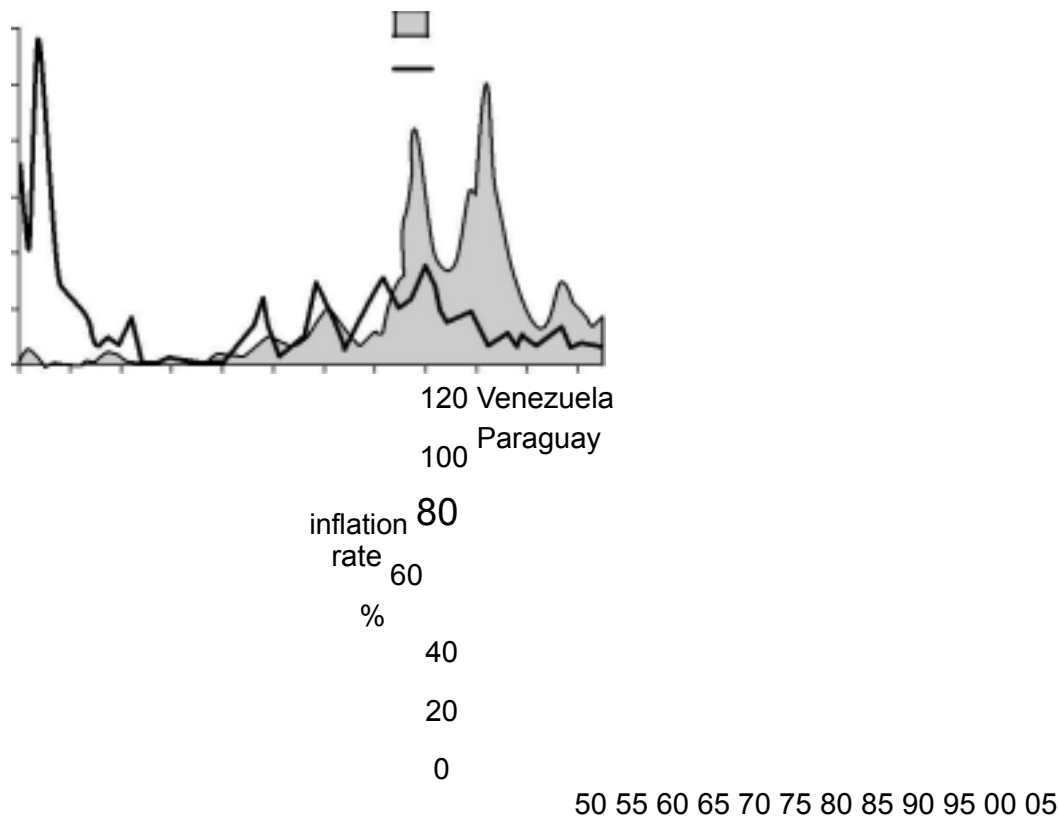
Table 1 Weights in the Paraguayan CPI, 1992 and 2008

	1992	2008
Food	35.1	32.1
Clothing	8.6	4.9
Alcohol and tobacco	2.1	1.2
Furniture	8.0	7.7
Transport	7.4	14.8
Communication	0.7	3.4
Housing	10.4	8.9
Health	4.8	4.1
Entertainment	5.1	6.1
Education	2.7	4.0
Restaurants and hotels	4.8	5.5
Miscellaneous goods and services	10.3	7.3

Paraguay's performance and that of Venezuela in controlling inflation are shown in Fig.

1. Fig. 1 Inflation in Paraguay and Venezuela 1950–2005

Key:



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(a) (i) Why are weights used in constructing a CPI? [2]

(ii) Explain possible reasons why the weights for alcohol and tobacco and transport changed between 1992 and 2008. [4]

(b) (i) What is meant by inflation? [2]

(ii) Using Fig. 1 compare Paraguay's inflation between 1950 and 2005 with that of Venezuela. [2]

(iii) To what extent did Paraguay achieve a low and stable rate of inflation between 1950 and 2005? [4]

(c) Discuss whether all countries should set annual inflation targets of around 3%. [6]

(a) (i) Instead of calculating simple average changes in economy's products' prices to estimate changes in its general price level, economists consider weighted price changes more appropriate to estimate changes in country's general price level. Therefore as opposed to average price changes that assume equal weights for all different products' price changes, weighted price changes assign more weights to products that economists think would have greater impact on citizens' cost of living. Hence assignment of greater weights to education was based upon the idea that Paraguay's citizens' cost of living will be more affected through changes in educational prices and those having lower weights than that of education mean that that product has lesser importance in affecting citizens' cost of living.

(a) (ii) Over the period shown in table 1, alcohol and tobacco experienced fall in their weights from 2.1 to 1.2. On the other hand weights of transport increased from 7.4 to 14.8. This shows that significance of alcohol and tobacco decreased and that of transport increased. Transport weights almost doubled during the period of 1992 to 2008.

This might be because of the fact that Paraguay's citizens have started spending a greater proportion of their incomes on transports and lesser on alcohol and tobacco. If consumers are spending higher percentage of their incomes on certain products then price changes of such products is obviously more expected to adversely affect country's cost of living and vice versa.

Similarly unlike alcohol and tobacco that are not consumed by all citizens; price changes in transport is expected to affect entire population. All people using either public or private transport are expected to be affected by changes in transport prices unlike price changes in alcohol and tobacco that only affects those who consume these products; therefore CPI to be better indicator of cost of living, products that affect masses should have higher weights than products that do not affect all citizens and only affect some people with certain consumption preferences.

(b) (i) Inflation is defined as persistent increase in economy's cost of living. This is when prices for most goods and services is found increasing in an economy. Over time prices for most products is found increasing in economies that are suffering from inflation.

(b) (ii) During 1950 to 1960 Paraguay had higher inflation rates than Venezuela. Later during 1960 to 1970 the two economies had almost similar inflation rates where both the countries had quite low inflation rates. Later from 1985 onwards, Venezuela's inflation rates started increasing at much faster rate than that of Paraguay's. During 1985 to 2005 Venezuela's inflation rates mainly stayed above 40 percent that is quite high of inflation rates and is expected to adversely affect prices' allocative mechanism of related to resource allocation.

(c) (iii) During 1950 to 1955 Paraguay experienced high inflation rates which varied between 60 to 120 percent. This is quite high of inflation rates that distort prices allocative mechanism. Later, during 1955 to 1970, country's inflation rates stayed low. For most years during this tenure inflation rates stayed below 5 percent. Lastly, beyond 1975 to 2005 the inflation rates

varied between 2-3 to 30 percent. Overall, during the period for which Paraguay's inflation rates have been shown, trend shown improvement in economy's inflationary control.

(d) Inflation control is economies one of macroeconomic objectives. Low and stable inflation rates are considered desirable for countries' growth and development. Because of improved future profits' expectations higher general price level increase producers' economic incentives to invest. Unlike deflation that refer to decrease in general price level and high and unstable inflation rates that distort prices' allocative mechanism and therefore limit their ability to effectively distribute economy's resources. Hence deflation and high inflation rates being disastrous for economy's smooth functioning are not considered desirable for country's growth. Therefore it is important for policymakers to explicitly target low and stable inflation rates. Smaller changes in products' prices, due to lower inflation rates, allow prices to effectively undertake their allocative mechanism.

However since low inflation rates are not the only macroeconomic objective that countries wish to pursue and moreover because often countries experience conflict between tehri different macroeconomic objectives therefore they often need to prioritize to ensure achievement of more important objectives. According to some economists unemployment and inflation rates are inversely related. Therefore policymakers' attempts to control inflation might result in higher unemployment level and vice versa. Therefore constant attempts to control inflation might not be possible for economists.

