



## ADVANCED GCE ECONOMICS

Economics in a European Context

# 2888

Candidates answer on the Answer Booklet

### OCR Supplied Materials:

- 16 page Answer Booklet

### Other Materials Required:

None

**Friday 12 June 2009**  
**Morning**

**Duration:** 1 hour 45 minutes



## MODIFIED LANGUAGE

### INSTRUCTIONS TO CANDIDATES

- Write your name clearly in capital letters, your Centre Number and Candidate Number in the spaces provided on the Answer Booklet.
- Use black ink. Pencil may be used for graphs and diagrams only.
- Read each question carefully and make sure that you know what you have to do before starting your answer.
- Answer **all** the questions.
- Do **not** write in the bar codes.
- A copy of the pre-issued stimulus material is included in the question paper. You must **not** bring your original copy into the examination.

### INFORMATION FOR CANDIDATES

- The number of marks is given in brackets [ ] at the end of each question or part question.
- The total number of marks for this paper is **60**.
- You will be assessed on the quality of your written communication. All answers should be in continuous prose.
- This is the synoptic paper. You will, therefore, gain credit for demonstrating in your answers how individual aspects of the subject can be used to explain and evaluate economic issues and problems raised by the stimulus material.
- This document consists of **12** pages. Any blank pages are indicated.

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Answer **all** questions

- 1 (a) (i) Using Extract 1, compare the trend in the world wholesale price of butter with that in the EU, in 2006 and in 2007. (Figs 1.1 and 1.2)
- (ii) Using Extract 1, describe the trend in farm input costs in the UK 2006 – 07, as shown in Figs. 1.3 and 1.4. [6]
- (b) Assuming constant farm input costs, use a diagram to analyse how the release of EU intervention stocks of butter should have affected the market for butter in the EU. [9]
- 2 Comment on the case for governments setting limits on market prices, such as those on basic foodstuffs in Russia. [10]
- 3 “Energy crops’ ... are eligible for an EU subsidy of €45 per hectare.’  
Comment on the case for subsidies to encourage EU farmers to produce ‘energy crops’. [15]
- 4 Discuss the effectiveness of pollution permits, such as the EU’s Emissions Trading Scheme, in tackling the market failure created by negative externalities. [20]

## Food prices, government intervention and the environment

### Introduction

As a result of the Common Agricultural Policy (CAP), European Union (EU) consumers have traditionally been used to paying high prices for their food. Recent reforms of the CAP have meant a movement away from guaranteed minimum prices for farmers towards direct income supplements. In 2007, as part of continuing reform of the CAP, the EU announced that intervention buying of butter was to be brought to an end and that almost all remaining stocks of butter in intervention stores were to be released onto the EU market. This should have been welcome news for EU consumers, yet global forces of demand and supply resulted in the price of butter, as well as other food prices, rising dramatically.

As agricultural prices in the EU have been influenced more by global forces of demand and supply, there have been dramatic increases in the prices of wheat, corn, barley and meat. Increases in the price of basic agricultural commodities lead inevitably to higher costs for food producers and manufacturers and eventually to higher prices for consumers. It is little wonder that Italian consumers were urged to go on a 'pasta strike' as Italian pasta makers import around 50% of the durum wheat they use to make pasta.

Trends in food prices have worried policy makers in the EU. The rising price of food is adding to the measured rate of inflation and, more importantly, to inflationary expectations. The media has been quick to report on price hikes such as the 40% increase in the retail price of butter in Germany. Despite being a small part of the basket of goods used to measure inflation, these large increases in the price of food are pushing inflation in the euro area and elsewhere up – in October 2007 inflation in the euro area increased from 2.1% to 2.6% and many predict that it could be over 3% by early 2008. Rising inflation, however, is not the only concern of European governments. Politicians throughout Europe fear the social consequences of the increase in food prices at a time when oil prices are also rising. For example, in Russia, the main concern is related to the impact on consumers with the lowest incomes. Policy makers have responded in different ways to rising food prices – the EU has dropped tariffs on cereal imports, whilst the Russian government has set limits on the market prices of bread, rice and dairy products. German leftwing politicians have called for an increase in welfare benefits so that people can cope with price rises. Whatever the relative merits of these different policies, there is no doubt that the alternative, increasing interest rates to control inflation, would only have a very limited effect on food prices which are rising globally.

The rising price of food has called into question environmental policies in many parts of the world, including the US and the EU. In an attempt to reduce emissions of CO<sub>2</sub>, the EU and the US have been encouraging farmers to produce crops for biofuels (which include transport fuels produced from renewable organic materials). In the EU, farmers producing 'energy crops' have been given subsidies and been allowed to use land previously set aside under the CAP to grow them. On a global scale the allocation of land away from food production to 'energy crops' has, however, been partly responsible for the recent increase in food prices. In addition, the impact of this reallocation on CO<sub>2</sub> emissions has recently been called into question.

Some commentators have taken the opportunity arising from the global food 'crisis' to question the arguments for government intervention to correct market failure. They point out that there are a number of unforeseen consequences of such intervention which distort the way in which markets operate and not always for the better. In addition, they argue that there are question marks about the effectiveness of government intervention to correct market failure. This debate happens to come at a time when the European Commission (EC) is setting tougher limits on CO<sub>2</sub> emissions in order to do more to tackle climate change. This action by the EC appears to signal a belief in using the market mechanism to encourage industry to confront the costs of environmental damage.

## Pre-issued stimulus material

**Extract 1      World and EU wholesale prices of butter and selected UK farm input costs 2006 – 2007**  
Milk Development Council (MDC Datum)

**Extract 2      The end of butter mountains**  
Dairy market: management committee votes to clear most remaining butter intervention stocks, EC press release, 29 March 2007

**EU intervention stocks of butter**  
Milk Development Council (MDC Datum)

**Extract 3      Russia freezes food prices**  
Russia bids to freeze food prices, Steven Eke, BBC news, 24 October 2007  
Global food crisis looms as climate change and fuel shortages bite, John Vidal, The Guardian, 3 November 2007

**EU to drop tariffs on cereal imports**  
EU could drop cereal import tariffs, Andrew Bounds, Financial Times, 27 November 2007

**Extract 4 (a)   Global food crisis looms**  
Global food crisis looms as climate change and fuel shortages bite, John Vidal, The Guardian, 3 November 2007

**World oil prices**  
Milk Development Council (MDC Datum)

**Extract 4 (b)   European Union biofuels policy**  
European Union Biofuels Policy and Agriculture: An Overview, Randy Schnepf, Congressional Research Service report for US Congress, 16 March 2006

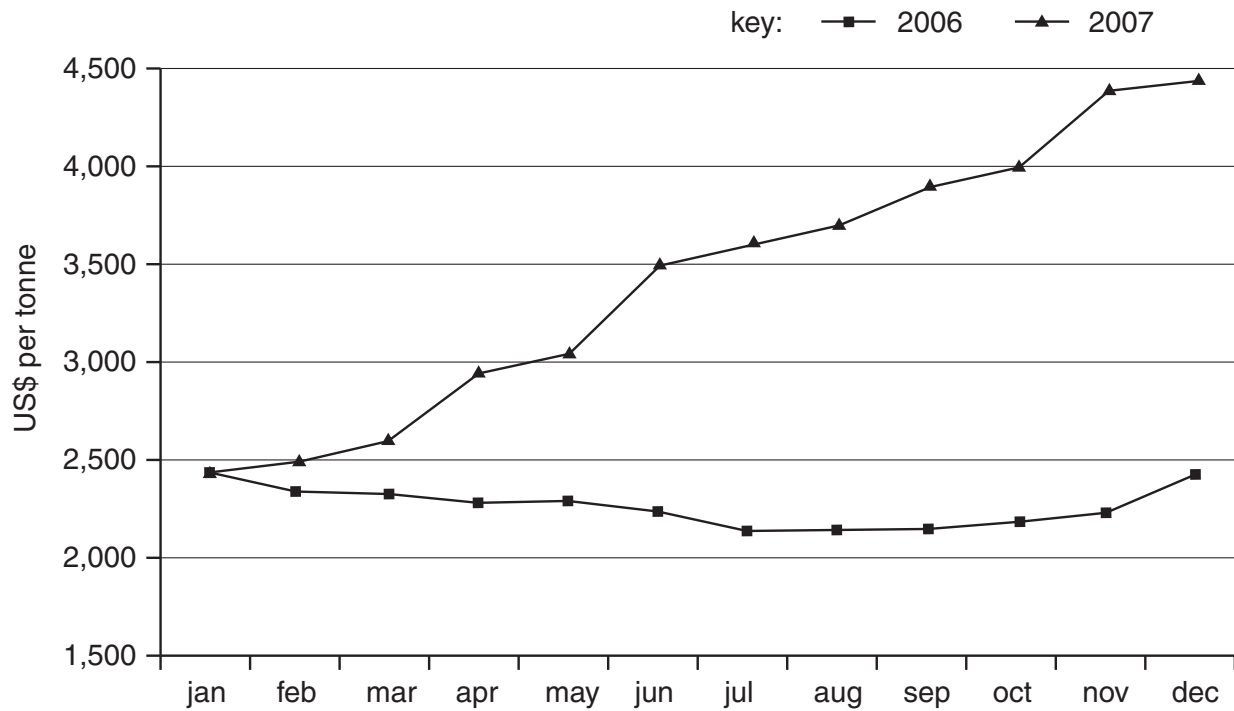
**The hidden costs of biofuels**  
The western appetite for biofuels is causing starvation in the poor world, George Monbiot, The Guardian, 6 November 2007

**Extract 5      EC gets tough on CO<sub>2</sub> emissions**  
Brussels gets tough on CO<sub>2</sub> emissions, Laura Dixon, Financial Times, 26 October 2007

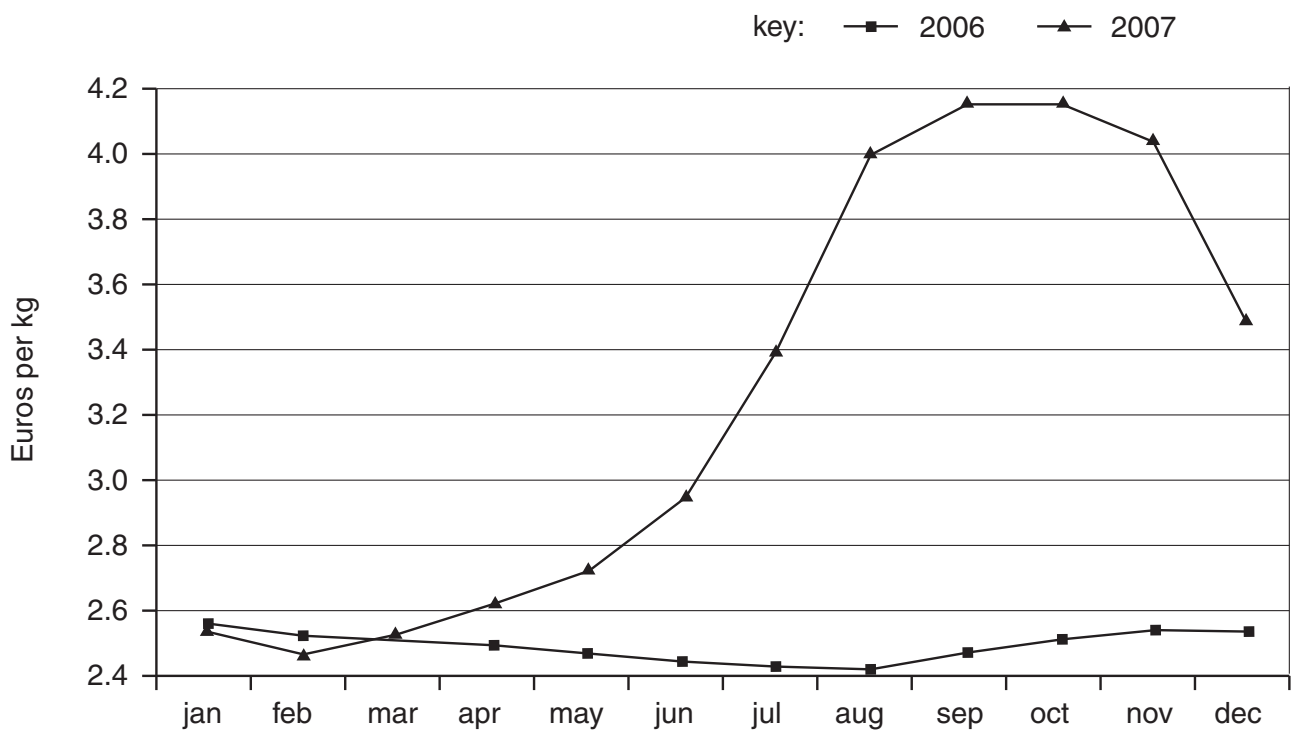
## Extract 1

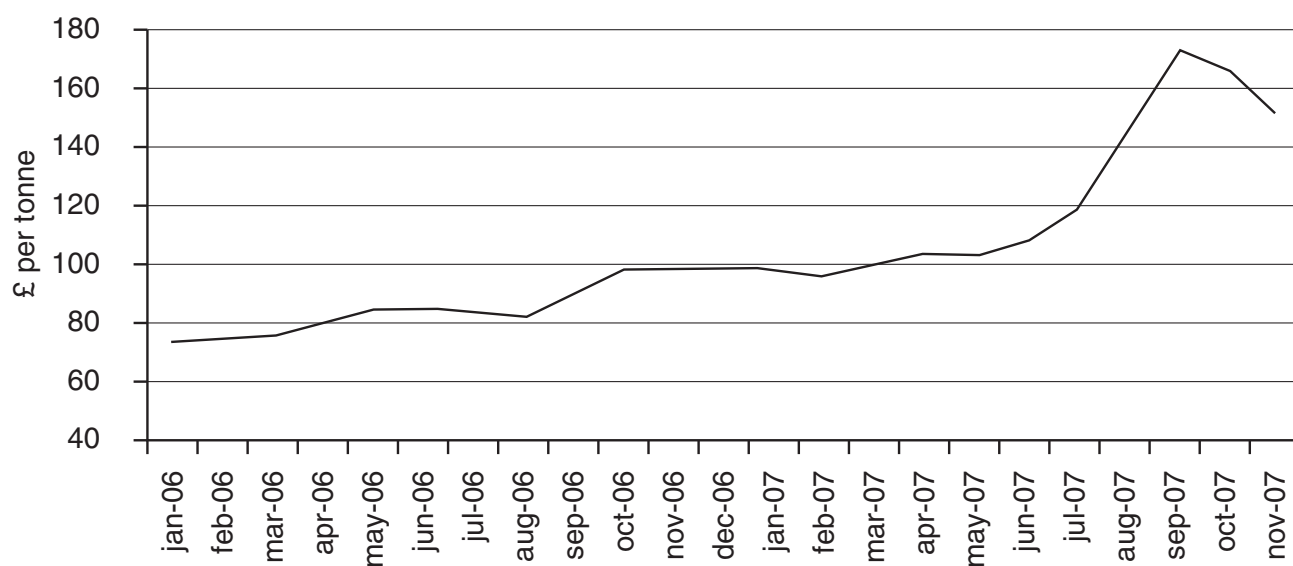
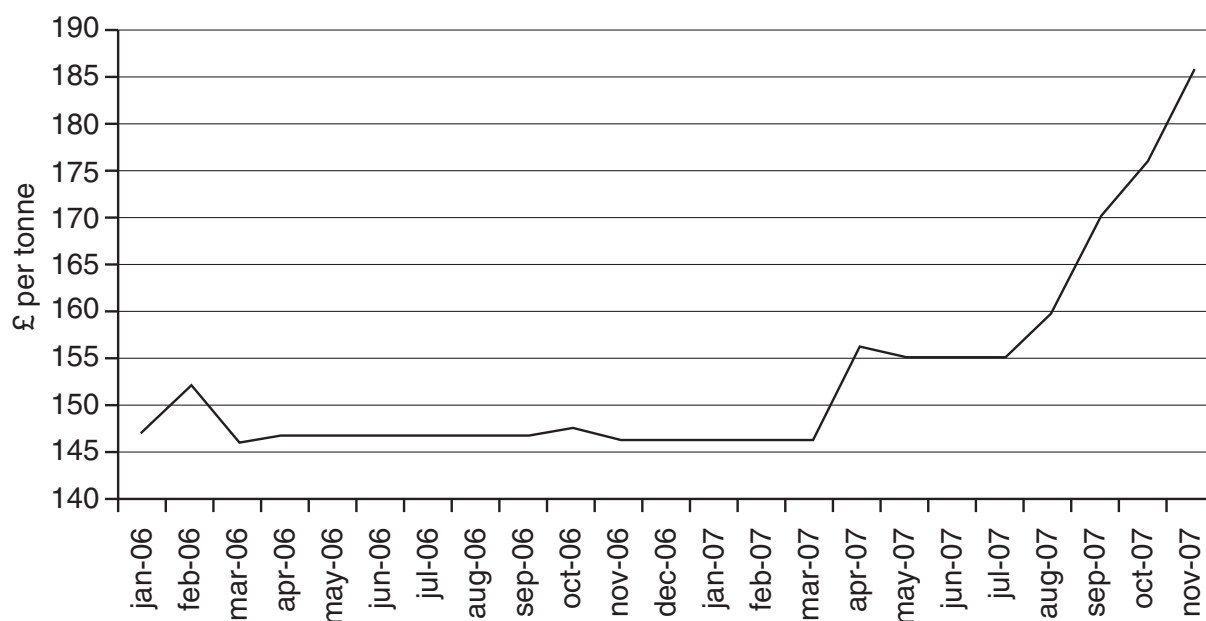
World and EU wholesale prices of butter  
and selected UK farm input costs 2006 – 2007

**Fig. 1.1 World wholesale price of butter**



**Fig. 1.2 EU wholesale price of butter**



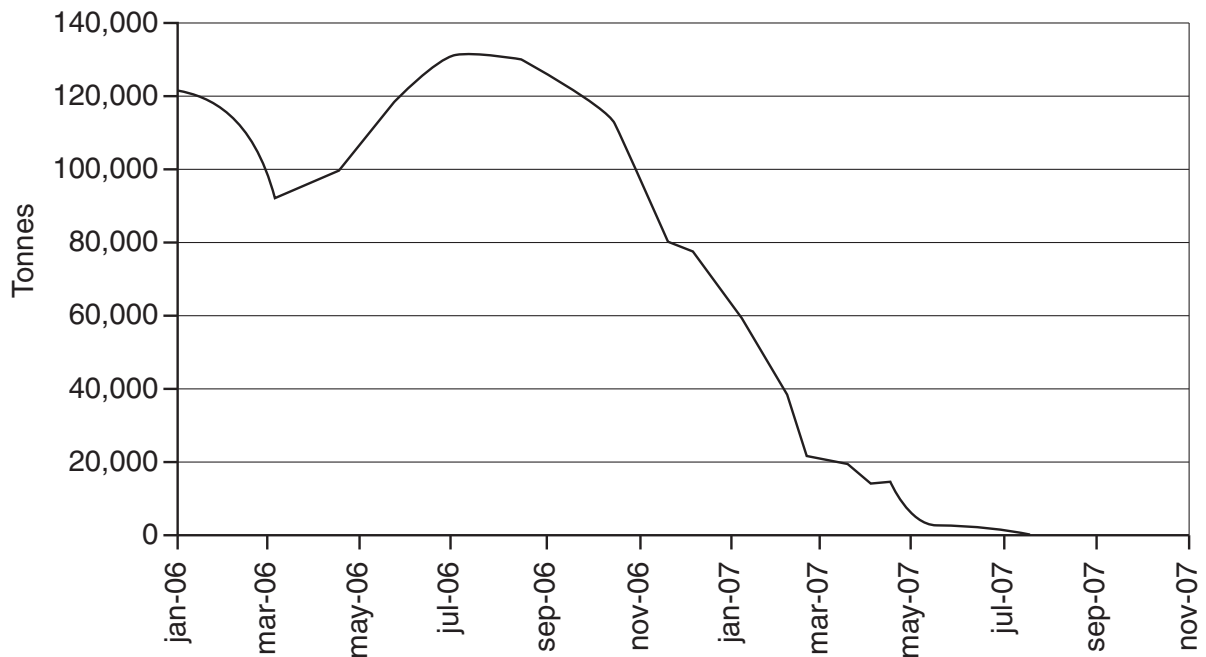
**Fig. 1.3 Average price of feed wheat in the UK****Fig. 1.4 Average price of fertiliser in the UK**

**Extract 2****The end of butter mountains**

Member States agreed unanimously at today's Milk Management Committee to sell almost all remaining stocks of intervention butter onto the European Union (EU) market. Some 6,091 tonnes of butter will be sold - 5,593 tonnes from Spain, 420 tonnes from the Czech Republic and 78 tonnes from Finland. This leaves just some small amounts of butter in intervention stores in Spain, Portugal, Slovakia and the UK. Intervention buying will now cease in the EU.

The EU has had intervention stocks of butter since 1964. At their height (in 1986) stocks totalled 1.3 million tonnes. The end of butter intervention follows the sale of the last milk powder intervention stocks at the beginning of 2006.

**Fig. 2.1 EU intervention stocks of butter**





### Extract 3

#### Russia freezes food prices

Soaring prices for basic foodstuffs are beginning to lead to political instability, with governments being forced to step in to artificially control the cost of bread, rice and dairy products.

Last week, the Kremlin forced Russian companies to freeze the price of milk, bread and other basic foodstuffs until 31 January, for fear of a public backlash with a parliamentary election looming. "The price of goods has risen sharply and that has hit the poor particularly hard," said Oleg Savelyev, of the Levada Centre Polling Institute. This market intervention by the Russian government is aimed at curbing high food inflation which is hitting millions of low-income families.

This intervention has been criticised by some economists as a throwback to Soviet-style central planning. Food prices were then set by the state, staying unchanged for decades. Critics say it is a populist move, aimed at shoring up support for President Vladimir Putin and his allies ahead of parliamentary and presidential elections. Food inflation has become a political issue in many countries over recent months, especially due to record wheat prices. But in Russia, where official statistics show millions of people are still living below the poverty line, it has become a major problem. Even relatively affluent families are complaining bitterly about galloping prices.

Now, the Russian government says it wants food producers and retailers to curb food inflation. From Wednesday, the prices of bread, eggs, vegetable oil, sugar, as well as certain cheese and milk products, will be regulated. The government blames monopoly producers for artificially increasing prices. However, some of the biggest food producers warn the measure will create difficulties for their companies.

It is the widest-reaching direct government intervention in the pricing system since central planning was abolished more than 15 years ago. A number of economists have warned that centralised controls are not an appropriate way of dealing with food inflation.

#### EU to drop tariffs on cereal imports

The European Union (EU) is poised to drop import tariffs on all cereals, except oats, in an attempt to contain food inflation after another poor European harvest.

"I hope this proposal will help facilitate cereals imports from outside the EU and reduce tensions on European grains markets," Mariann Fischer Boel, Farm Commissioner, said on Monday. "We have seen a modest harvest in Europe and high prices both at home and on world markets. Border protection for cereals is relatively low but import duties still apply to certain cereals which are key to assuring EU market balance."

With the price of wheat in the EU having risen to €300 a tonne from €179 a tonne in the past year, the EU is trying to contain pressure on food prices.

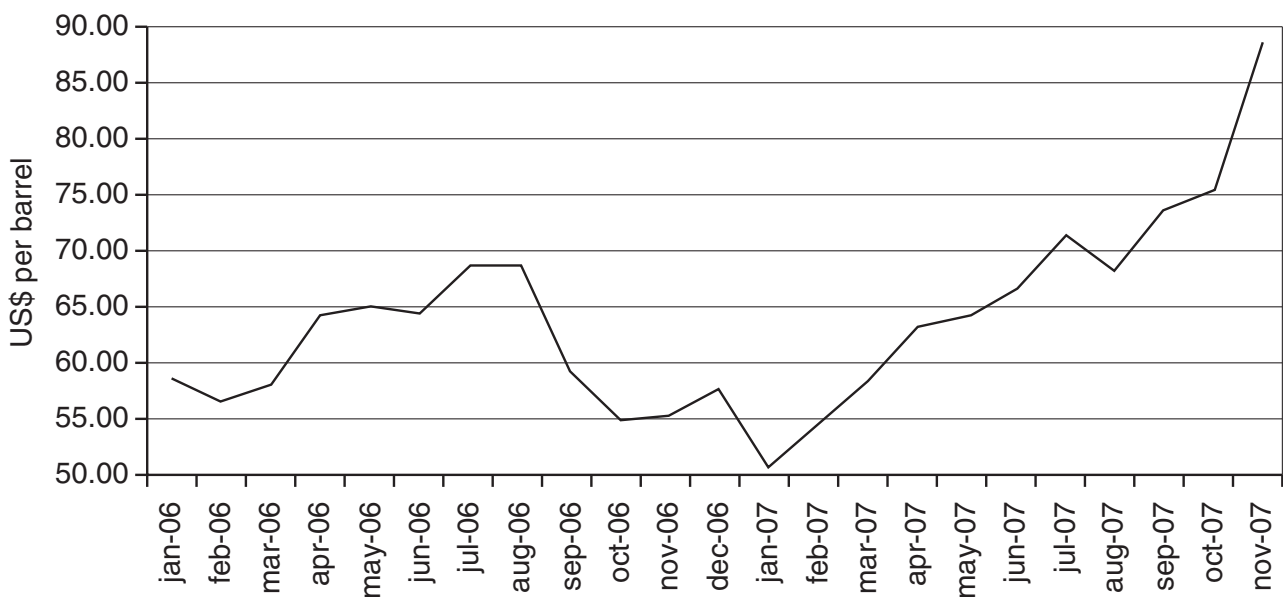
## Extract 4 (a)

### Global food crisis looms

There is no single cause of rising food prices. Instead a number of different factors are coming together to drive up prices. According to the United Nations (UN), rising food prices are a result of record oil prices, US farmers switching out of cereals to grow biofuel crops, extreme weather and growing demand from a number of countries, particularly from India and China. A spokesperson for the UN said that cereal stocks had been declining for more than a decade but now stood at around 57 days. This makes global food supplies vulnerable to an international crisis or big natural disaster such as a drought or flood.

Lester Brown, founder of the Washington-based Worldwatch Institute, said: "The competition for grain between the world's 800 million motorists, who want to maintain their mobility, and its two billion poorest people, who are simply trying to survive, is emerging as an epic issue." Last year, he said, US farmers distorted the world market for cereals by selling 14 million tonnes, or 20% of the whole maize crop, as a biofuel for vehicles. This took millions of hectares of land out of food production and nearly doubled the price of maize. The outlook is widely expected to worsen as agro-industries prepare to switch to highly profitable biofuels, according to Grain, a Barcelona-based food resources group.

Fig. 4.1 World oil prices



**Extract 4 (b)****European Union biofuels policy**

Various policy goals — reducing greenhouse gas emissions, diversifying fuel supply sources, developing long term replacements for fossil oil and diversifying income and employment in rural areas — have motivated the European Union (EU) to promote the production and use of biofuels.

Between 1985 and 2004, fuel consumption by cars and trucks in the EU grew by nearly 50%. By 2000 the then EU15 was importing 75% of its petroleum needs. In 2004, the EU15 consumed over 270 million tonnes of fuel — 60% as diesel and 40% as petrol. Based on a 2001 forecast, the European Commission (EC) expects vehicle fuel use in the EU to reach 325 million tonnes by 2020. In addition, under the Kyoto Protocol, the EU has committed to an 8% reduction in carbon dioxide (CO<sub>2</sub>) emissions by the end of 2012. Various analyses have suggested that biofuels produce substantially less CO<sub>2</sub> emissions than fossil fuels. In 2005, with these facts in mind, the EC set a goal of replacing 20% of diesel and petrol with alternative fuels (e.g., biofuels, natural gas, and hydrogen fuels) by 2020.

Under the Common Agricultural Policy (CAP), EU farmers setting aside 10% of their land qualify for a range of CAP benefits. In addition, EU farmers are allowed to plant oilseeds on the set-aside land as long as it is contracted solely for the production of biofuels and not sold onto either food or feed markets. In 2003, a new round of CAP reforms established special aid for energy crops grown on non-set-aside land. 'Energy crops' — those grown for the production of biofuels — are eligible for an EU subsidy of €45 per hectare.

**The hidden costs of biofuels**

Biofuels offer a means of avoiding hard choices. They create the impression that governments can cut carbon emissions and - as Ruth Kelly, the British Transport Secretary, announced last week - keep expanding the transport networks. New figures show that British drivers crawled past the 500 billion kilometre mark for the first time last year. But it doesn't matter: we just have to change the fuel we use. The demands of the motoring lobby and the business groups clamouring for new infrastructure can be met.

In principle, burning biofuels merely releases the carbon they accumulated when they were growing. Even when you take into account the energy costs of harvesting, refining and transporting the fuel, they produce less net carbon than petroleum products. If you count only the immediate carbon costs of planting and processing biofuels, they appear to reduce greenhouse gases. When you look at the total impacts, however, you find that they cause more global warming than petroleum. A recent study by the Nobel laureate, Paul Crutzen, shows that the official estimates have ignored the contribution of nitrogen fertilisers. They generate a greenhouse gas - nitrous oxide - which is nearly 300 times as powerful as CO<sub>2</sub>. These emissions ensure that biofuel from rapeseed oil generates 1 to 1.7 times the impact of diesel. In addition, the International Monetary Fund warns that using resources to produce biofuels "might further strain already tight supplies of arable land and water all over the world, thereby pushing food prices up even further".

## Extract 5

### EC gets tough on CO<sub>2</sub> emissions

Tougher limits on carbon emissions were set on Friday by the European Commission (EC) in an attempt to strengthen its efforts to combat climate change. The EC cut 10% from the figure requested by EU governments for the second phase of the Emissions Trading Scheme (ETS), running from 2008 to 2012, which was established to implement the Kyoto Protocol. The first phase, from 2005 to 2008, suffered from an over-allocation of permits to emit carbon, resulting in a collapse in their market price. Stavros Dimas, Environment Commissioner, said: "We have assured a robust market with real emission reductions which will constitute an important contribution to meeting our Kyoto target."

Member states had tabled a request for permits amounting to 2.3 billion tonnes of CO<sub>2</sub>, while the Commission has approved 2.1 billion tonnes. Some member states proposed a cap far higher than their current emission levels. Latvia, for example, wanted to more than double its emissions-cap. The levels were fixed following a decision on Bulgaria and Romania's carbon limits. Both countries received levels considerably lower than they proposed. Bulgaria was given 42.3 million tonnes of CO<sub>2</sub> allowance, a reduction of 37% on what it had asked for. Romania has been allocated 75.9 million tonnes, 20% less than it had requested.

Under the ETS, launched in January 2005, companies responsible for about half the EU's emissions are issued with permits to emit CO<sub>2</sub>. 'Cleaner' companies can sell unused permits to businesses that need to emit more CO<sub>2</sub>. One permit gives the holder the right to emit one tonne of CO<sub>2</sub>.

The EC said last year that it would cut down on allocations in order to establish a high price for permits which should stimulate investment in low-carbon technology. On Friday the market price of a permit rose 25 cents to €22.78 a tonne. Climate Change Capital, a specialised London-based investment bank, welcomed the Commission's tougher targets. "This precedent means that there is a real chance that investors will be convinced that the EU is serious enough about global warming to make significant emissions reductions between now and 2020," it said.

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