MARKSCHEME

November 2007

ECONOMICS

Higher Level

Paper 1

10 pages

In addition to the assessment criteria, use the paper-specific markscheme below. Award up to the maximum marks indicated.

1. (a) Explain the difference between short-run equilibrium and long-run equilibrium in monopolistic competition. ***[10 marks]***

Candidates **may** include the assumptions of monopolistic competition, which **may** include:
- large number of firms
- very elastic demand
- firms are small relative to the size of the market
- no or low barriers to entry or exit
- perfect knowledge in the market
- product differentiation
- firms are short-run profit maximisers.

Candidates **may** include the difference between short-run equilibrium and long-run equilibrium, which **may** include:
- distinction between short run and long run
- definition of equilibrium
- explanation of profit maximization
- firms can make abnormal profits (economic profits) in the short-run
- abnormal profits (economic profits) will attract new entrants into the market
- demand for existing firms falls
- the process continues until normal profits (zero economic profits) are made in the long-run.

Diagrams for short-run profit and for long-run normal profit are expected.

If candidates approach the question from the perspective of short-run losses, they can be fully rewarded.

Examiners should be aware that candidates might take a different approach, which should be fully rewarded if appropriate.

(b) "Perfect competition is a more desirable market form than monopolistic competition." Discuss. ***[15 marks]***

Candidates **may** compare the assumptions of perfect competition with those of monopolistic competition.

Candidates **may** discuss the advantages and disadvantages of perfect competition and compare them to monopolistic competition.

Advantages of perfect competition **may** include:
- allocative and productive efficiency
- consumer gains from low prices
- consumer sovereignty.

Disadvantages of perfect competition **may** include:
- firms unable to invest in research and development due to lack of abnormal/ supernormal profits
- lack of choice of products.

Advantages of monopolistic competition **may** include:
- possible economies of scale to be gained
- consumer benefits from greater variety of products to choose from
- non-price competition leads to product development and advertising.

Disadvantages of monopolistic competition **may** include:
- higher price and lower output than under perfect competition
- firms do not produce at the least-cost point
- less efficient allocation of resources than in perfect competition.

Examiners should be aware that candidates may take a different approach, which if appropriate should be rewarded.

Effective evaluation may be to:
- consider short run versus long run consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritize the arguments

2. (a) Using one or more diagrams, explain the difference between the equilibrium level of national income and the full employment level of national income. ***[10 marks]***

Candidates **may** include the following information:

- definition of national income
- equilibrium level of national income as:
  - AS = AD
- diagram showing equilibrium level of national income
- full employment level of national income described as:
  - maximum level of national output, **or**
  - all factors of production are fully utilized, **or**
  - AS = AD on LRAS curve
- diagram showing full employment level of national income
- identification and explanation of the difference between the two concepts

Candidates could show both the equilibrium level of national income and the full employment level of national income on one diagram using the 3-range AS curve intersected by an AD curve on the upward bending range and by another AD curve intersecting the AS curve on its vertical range.

Diagrams showing equilibrium level of national income with a 45 degree diagram are equally acceptable.

Examiners should be aware that candidates might take a different approach, which should be fully rewarded if appropriate.

(b) Evaluate the policies a government may use to increase the full employment level of national income. ***[15 marks]***

Candidates **may** include the following information:
- definition of full employment
- an increase in the full employment level of national income means a shift to the right of the LRAS curve
- explanation that supply-side polices are the most appropriate policies to be implemented in order to increase the full employment level of national income

Candidates should be able to explain a range of supply-side policies and the possible implications of the policies.

Appropriate policies **may** include:
- direct tax cuts to increase incentives to work and invest
- increased expenditure on education and training to increase productivity of labour
- increased spending on R&D to increase the quality of capital
- reducing trade union power to encourage greater flexibility in both wages and working practices and to allow labour markets to clear
- reducing welfare benefits to encourage greater self-reliance and to increase the quantity of labour in the market
- reducing "red tape" and bureaucracy to encourage investment and risk taking
- privatization to encourage competition
- abolishing the minimum wage to reduce labour costs to employers thus increasing their profits and encouraging and enabling more investment.

The evaluation of the policies requires a critical approach, particularly the reduction of welfare benefits and the flexibility of labour markets.

Explanation that demand-side policies are not appropriate because they do not expand the quantity and quality of factors of production.

Examiners should be aware that candidates may take a different approach, which if appropriate should be rewarded.

Effective evaluation may be to:
- consider short run versus long run consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritize the arguments

3. (a) Explain *three* factors that influence the value of a country's exchange rate. ***[10 marks]***

Candidates **may** include the following information:
- definition of exchange rates
- diagram of an exchange rate

Candidates **may** then discuss three factors, which **may** include:
- trade flows where, for example, an increase in export revenue will increase the demand for the currency while a decrease in the demand for imports will decrease the supply of the currency
- capital flows/interest rate changes where, for example, an increase in domestic interest rates will attract short-term speculative capital and increase the demand for the currency
- inflation where, for example, if the rate of domestic inflation is higher than overseas, domestic goods and services become less competitive reducing demand for the local currency. Better answers will refer to the purchasing power parity theory
- domestic speculation where, for example, speculators in anticipation of a depreciation of the currency, withdraw their funds, thereby increasing the supply of the local currency
- foreign speculation where, for example, foreign speculators, in anticipation of a deprecation of the local currency, withdraw their funds, thereby decreasing demand for the local currency and increasing its supply
- use of foreign currency reserves where, for example, the central bank buys and sells currency to have a desired effect on the value of the currency
- government or central bank decision to change the exchange rate parity in cases where there is a fixed exchange rate system
- under currency board regimes the most important factor that influences the value of the currency is the performance of the foreign currency to which the local parity is pegged.

To reach Levels 3 and 4, candidates are expected to explain **three** factors.

Examiners should be aware that candidates might take a different approach, which should be fully rewarded if appropriate.

(b) Evaluate government/central bank intervention in the foreign exchange market to reduce the value of the exchange rate. ***[15 marks]***

Candidates **may** discuss the reasons for the intervention, which **may** include:
- to increase export competitiveness – demand for exports, which may increase if their price (exchange rate) is lowered
- to protect employment/increase employment – export industries will stay in business or expand their business, which means maintaining or increasing employment levels
- to reduce import expenditure – import goods become relatively more expensive and the demand for imports may decrease
- to correct a current account deficit – import expenditure should decrease while export revenues should increase, depending on the elasticity of demand for exports and imports.

Candidates **may** discuss the problems associated with the intervention, which **may** include:
- retaliatory action – a country could find that the gains on the current account from reduced imports are more than matched by losses of exports as a result of retaliation
- inflationary pressures – cost push inflation could result from higher prices of imported raw materials
- inflationary pressures – diversion of domestic supply into the export market leads to relative shortages pushing domestic prices upward
- movement towards a current account surplus – resources are diverted into export industries away from production of goods for domestic consumption
- promotes inefficiencies in export industries – export industries are protected from foreign competition due to the lower relative price of their goods
- time lags – the current account balance is likely to deteriorate before it improves, as the short run demand for imports and exports is inelastic
- the lower value of the exchange rate increases the burden of the foreign debt

Examiners should be aware that candidates may take a different approach, which if appropriate should be rewarded.

Effective evaluation may be to:
- consider short run versus long run consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritize the arguments

4. (a) Explain *three* institutional factors that may contribute to potential economic growth in developing countries. ***[10 marks]***

Candidates **may** include:
- definition of economic growth
- an understanding of the concepts "institutional factors", "potential economic growth" and "developing countries" and the relationship between them

Candidates **may** explain three institutional factors, which **may** include:
- banking system – a stable banking system which can provide funds to small businesses, thus enabling investment
- educational system – investment in human capital which increases the quality of labour
- health care – improvement in the health of the population increases both the quantity and quality of the labour resources available
- infrastructure – investment in infrastructure, especially in rural areas, will enable goods to be brought to markets
- political stability – necessary if domestic businesses and foreign investors are to feel comfortable investing in the economy
- legal system – investors need to know their rights are protected.

Examiners should be aware that candidates might take a different approach, which should be fully rewarded if appropriate.

Candidates who do not explain three institutional factors cannot score above Level 2.

(b) Evaluate the view that economic growth will lead to economic development. ***[15 marks]***

Candidates **may** make a clear distinction between economic growth and economic development.

Benefits of growth which impact development in a positive way **may** include:

- increased levels of income could translate to higher levels of consumption of goods and services by society. This could lead to more choice, more food consumed and better shelter opportunities
- government investment in better health facilities will improve the longevity of the population
- government investment in more educational opportunities will improve the literacy of the population and have positive externalities for society.

Consequences of growth which impact development in a negative way **may** include:

- negative externalities – environmental damage such as soil erosion and desertification can occur as areas are cleared for farming. Depletion of the ozone layer can be caused by industrialization
- income distribution – economic growth can result in uneven distributions of income if the growth requires changes in production (in terms of the goods produced and the techniques used and the skills required) and some people find their skills are no longer needed
- sustainability – if economic growth involves using a greater amount of resources then there will be depletion of non-renewable resources.

Examiners should be aware that candidates may take a different approach, which if appropriate should be rewarded.

Effective evaluation may be to:

- consider short run versus long run consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritize the arguments