MARKSCHEME

November 2005

ECONOMICS

Standard Level

Paper 1

6 pages

Paper Specific Markscheme

In addition to the assessment criteria, use the paper-specific markscheme below. Award up to the maximum marks indicated. Examiners should be aware that candidates may take a different approach, which if appropriate should be fully rewarded.

1. (a) Explain the importance of price in allocating scarce resources. ***[10 marks]***

- definition of scarce resources
- price is determined by supply and demand
- price acts as a signal to producers and consumers
- price acts as an incentive to producers to reallocate resources

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

(b) Evaluate the possible consequences of implementing maximum and minimum price controls. ***[15 marks]***

- definition of maximum price
- definition of minimum price
- diagrammatic analysis of both maximum and minimum prices
- discussion of price controls as forms of government intervention
- discussion of the problems associated with the shortages that develop due to the setting of maximum prices:
  - queues
  - waiting lists
  - rationing
  - black markets
- discussion of the problems associated with the surpluses that develop due to the setting of minimum prices:
  - producers can ignore price controls and cut their prices
  - firms can become productively inefficient
  - firms are discouraged from producing alternative goods which can be produced more efficiently but which may have a lower free-market price.
  - signaling role of prices is distorted and there is a misallocation of resources.
  - discussion of who “suffers” from price controls

Up to a maximum of ***[7 marks]*** if **only** maximum or **only** minimum price controls are considered.

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2. (a) Explain the costs of inflation and the costs of deflation. ***[10 marks]***

- Definitions of both inflation and deflation
- Costs of inflation include:
  - effects on those who rely on fixed-income or are in a weak bargaining position
  - implications of higher export prices
  - inflation harms lenders and benefits borrowers
  - uncertainty
  - inflation may lead to high nominal interest rates
  - menu costs
  - "shoe-leather" costs

- Costs of deflation include:
  - falling prices may cause consumers to defer spending leading to greater deflationary pressure
  - investment spending is discouraged
  - benefits lenders and harms borrowers.

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(b) Evaluate demand-side policies as a means of reducing inflation. ***[15 marks]***

- definition of demand-side policies: fiscal policy and monetary policy
- explanation of how demand-side policies can be used to reduce inflation
- discussion of the problems associated with deflationary fiscal policy *e.g.* difficulty of fine-tuning, time-lags
- discussion of the problems associated with contractionary monetary policy: an increase in interest rates slows economic growth and negatively affects exports due to increase in exchange rate.
- not effective in reducing cost-push inflation
- an evaluation of demand-side policies versus supply-side policies

For a discussion of only one policy up to ***[7 marks]***.

For a full discussion of two policies (*e.g.* Fiscal and Monetary policy) up to ***[15 marks]***.

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

3. (a) Explain *three* factors which might cause the value of a currency to appreciate. ***[10 marks]***

- definition of appreciation of the value of a currency
- appreciation is caused by either an increase in demand or a decrease in supply of the currency on the foreign exchange market
- increase in domestic interest rates or a fall in foreign interest rates
- favourable investment prospects
- increased demand for a country's exports
- speculation that the currency will rise in value
- increased foreign income
- central bank purchasing of the currency

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

(b) Evaluate the possible effects of such an appreciation on an economy. ***[15 marks]***

Disadvantages include:

- reduced export competitiveness
- imports become more attractive
- higher level of unemployment in export industries and in industries which compete with imports
- lower level of AD
- downward multiplier
- current account repercussions.

Advantages include:

- domestic producers are forced to be more efficient
- imported raw materials become cheaper
- inflationary pressure may be reduced.

Candidates may introduce the concept of elasticity in order to explain the repercussions on a current account. This should not be expected but should be rewarded.

If only advantages **or** disadvantages are considered up to ***[7 marks]***.

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

4. (a) Explain *two* significant barriers to economic growth in LDCs. ***[10 marks]***

Candidates may distinguish between economic growth and economic development, but the focus of the answer must be on economic growth. Barriers could include:

- overdependence on primary products
- low labour productivity
- vicious cycle of poverty
- institutional and political factors
- MDC protectionism
- indebtedness
- social and cultural factors

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

(b) Evaluate strategies that may be used to overcome the two barriers identified in (a). ***[15 marks]***

- Aid
- FDI
- greater access to MDC markets
- reduced subsidies from MDC governments to MDC producers
- inward-oriented strategies
- outward-oriented strategies
- investment in human capital

If a list (*i.e.* without evaluation) up to ***[5 marks]***.

If only one strategy discussed and evaluated up to ***[7 marks]***.

For a full discussion and evaluation of two strategies up to ***[15 marks]***.

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