



MARKSCHEME

May 2008

ECONOMICS

Standard Level

Paper 1

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

1. (a) **“The price elasticity of demand and the price elasticity of supply for many primary commodities tend to be low.” Explain what is meant by this statement, and how this contributes to the problem of price instability for primary commodity producers.** **[10 marks]**

Answers **should** include:

- definition of PED and PES
- explanation of “low”, *i.e.* inelastic demand and inelastic supply
- definition of primary commodity
- explanation of price instability
- explanation of how inelastic demand and supply can lead to price instability.

Answers **may** include:

- diagrams showing interaction of inelastic demand with inelastic supply and consequent shifts of demand and/or supply causing large price fluctuations
- an explanation of why demand and/or supply of commodities might shift
- equations for the calculation of PED and PES
- “low”, *i.e.* inelastic demand and supply having values of less than 1
- examples of commodities with unstable prices, *e.g.* oil
- explanations of why PED and PES tend to be low, *e.g.* necessities (PED), growing seasons (PES).

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

- (b) **Evaluate the view that it is best to allow primary commodity prices to be determined purely through the free interaction of market forces.** *[15 marks]*

Answers **may** include:

- explanation of “free interaction of market forces”
- explanation of buffer stock schemes
- explanation of maximum and minimum prices
- explanation of commodity agreements
- advantages of market forces in terms of the signalling and incentive functions of price and how this leads to economic efficiency
- advantages of market forces in terms of the various drawbacks of buffer stock schemes, maximum and minimum prices and commodity agreements
- disadvantages of market forces in terms of price instability and uncertainty of income and employment of primary commodity producers
- disadvantages of market forces in terms of the benefits of buffer stock schemes, maximum and minimum prices and commodity agreements
- disadvantages of market forces for LDCs whose primary commodities are adversely affected in international markets due to subsidies and protectionism in some developed countries.

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

Effective evaluation may be to:

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

2. (a) **Explain how fiscal policy could be used to increase aggregate demand.** *[10 marks]*

Answers **should** include:

- definition of fiscal policy
- definition of AD
- identifying the components of AD: $C+I+G+X$
- an explanation of how expansionary fiscal policy can be used to increase aggregate demand in terms of: increases in government spending and/or reduction in tax.

Answers **may** include:

- how expansionary fiscal policy could lead to a budget deficit
- increases in transfer payments, such as pensions, and the impact on consumption
- the use of subsidies to boost exports
- reductions in direct and indirect taxation and the impact on consumption and investment
- use of AD/AS diagrams to illustrate how fiscal policy will increase AD
- explanation of how expansionary fiscal policy can lead to economic growth and inflation.

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- (b) **“In the long-run, a country’s economic performance can only be improved through the implementation of supply-side policies.” Evaluate this statement.**

[15 marks]

Answers **may** include:

- definition of supply-side policies
- examples of supply-side policies, *e.g.* reducing direct tax to encourage worker incentives, privatization, strong competition policy, *etc.*
- explanation of “economic performance” in terms of the main indicators, *i.e.* employment, price stability, growth, development, the balance of payments, income distribution and efficiency
- explanation of the importance of demand-side policies for improved economic performance, *e.g.* through impact on the above indicators
- use of AD/AS diagrams and analysis involving shifts of AD
- possible drawbacks of demand-side policies *e.g.* higher inflation
- distinction between SRAS and LRAS
- significance of shifts in LRAS for the main indicators of economic performance
- use of AD/AS analysis involving shifts of SRAS and LRAS
- possible drawbacks of supply-side policies *e.g.* the time it takes for supply-side policies to work, difficulties of reducing inflation using supply-side policies.

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Effective evaluation may be to:

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

3. (a) **Identify *three* types of protectionism and explain how each may be used to correct a balance-of-payments deficit on current account.** *[10 marks]*

Answers **should** include:

- definition of balance of payments on current account
- explanation of balance of payments deficit on current account
- identification of three different types of protectionism, *e.g.* tariffs, quotas, subsidies, VERs, administrative obstacles, health and safety standards and environmental standards
- explanation of how each of the three chosen types of protectionism may correct a current account deficit *e.g.* how tariffs raise the price of imports and reduce the demand for them.

Answers **may** include:

- relevant diagrams *e.g.* tariff, subsidy, to show how they reduce the quantity demanded of imports
- examples of when different types of protectionism have been used.

Where only two types of protectionism have been explained the highest marking criteria is level 3; where only one type of protectionism has been explained the highest marking criteria is level 2.

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- (b) Evaluate the extent to which a deficit on a country's current account might be considered an economic problem.

[15 marks]

Answers **may** include:

- the deficit may not be a problem if:
 - the deficit is small or isolated
 - foreign reserves are very large
 - it can be counterbalanced by capital inflows
 - it is a reflection of rising living standards
 - it is used to build future export potential in terms of vital imports of raw materials and capital goods
- the deficit may be a problem if:
 - it is large and persistent
 - it leads to negative net exports reducing AD and economic growth
 - it reflects underlying competitiveness
 - it has to be financed by capital inflows leading to a possible future outflow of profits, interest and dividends and high interest rates to attract the overseas capital
 - it necessitates deflationary demand policies, with an adverse impact on employment and output
 - it requires borrowing from institutions such as the IMF, with painful strings attached
 - it leads to the running down of foreign exchange reserves
 - it finances the purchase of mainly consumption goods as opposed to capital goods
 - it causes a large depreciation of the exchange rate.

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

Effective evaluation may be to:

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

4. (a) **Explain how development might be measured.**

[10 marks]

Answers **should** include:

- definition of economic development, *e.g.* the sustained improvement in living standards of a country's population
- an explanation of how economic development might be measured.

The measures **may** include:

- use of real GDP/GNP per capita figures
- allowances for differences in purchasing power when making comparisons between different countries
- alternative methods of measurement, *e.g.* health, education/literacy, quality of life, environmental indicators, stock of asset indicators, political freedoms, unemployment, proportion of people living below the poverty line, income distribution, composite indices (*e.g.* the HDI).

Where only one measure of development has been explained the highest mark criteria is level 3.

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

- (b) **Evaluate the view that the most effective way that a government could improve the welfare of its citizens is through the pursuit of faster economic growth.**

[15 marks]

Answers **may** include:

- definition of economic growth
- an explanation of the concept of welfare
- an explanation of how faster economic growth could improve welfare *e.g.* higher incomes, rising employment, *etc.*
- consideration of the policies necessary to achieve faster growth *e.g.* demand and supply-side policies
- growth and the ability of the government to increase its spending on welfare enhancing programmes
- how growth leads to negative externalities
- how growth can cause a widening of the income distribution
- an explanation of growth and the problem of sustainability
- consideration of the possible conflicts between growth and other goals such as price stability, a satisfactory balance of payments, low unemployment
- importance of development, as opposed to growth only, in improving living standards
- alternatives to economic growth *e.g.* policies to redistribute income and wealth.

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

Effective evaluation may be to:

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