



MARKSCHEME

November 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) **With the aid of a diagram, explain the difference between actual economic growth and potential economic growth.** *[10 marks]*

Responses **should** include:

- define actual economic growth as an increase in an economy's real GDP over a given time period
- define potential economic growth: the potential rate of economic growth that can be achieved with its resources fully and efficiently employed

Responses **may** include:

- a PPC showing an economy moving towards its PPC as well as showing an outward shift of the PPC
- a linear potential GDP growth function with an actual growth curve fluctuating above and below the potential growth curve
- short-run changes – AS/AD equilibrium etc.

Candidates can achieve full marks by clearly explaining the first three points.

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

(b) Evaluate the extent to which economic growth may contribute to market failure.

[15 marks]

Responses **may** include:

- definition of market failure: situations where markets do not achieve productive, allocative or socially efficient levels of output
- an explanation of the way that increased economic growth may contribute to market failure due to any of the following:
 - increased negative externalities (of production), *e.g.* pollution and overuse of resources due to increased output of goods and services
 - increased negative externalities (of consumption) due to higher incomes
 - increased consumption of demerit goods
 - growing income inequality – more monopoly power as firms grow in size
 - more monopoly power as firms grow in size
- an explanation of the way that increased economic growth may reduce market failure due to any of the following:
 - greater provision of public and merit goods
 - higher incomes may result in “ethically-conscious” consumption
 - higher income countries may have more strict regulations against, for example, the production of goods which cause negative environmental externalities and monopoly power
 - increased economic growth results in increased investment and improved productive efficiency using modern and less polluting technology.

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) **With the aid of diagrams, explain the causes of inflation.**

[10 marks]

Responses **should** include:

- definition of inflation: the continuous and sustained rise in the general level of prices
- explanation of the cost push causes of inflation, which **may** include:
 - rising labour costs
 - rising raw material costs (*e.g.* oil prices)
 - rising capital costs
 - profiteering by businesses
- explanation of the demand pull causes of inflation, which **may** include:
 - rising consumer demand
 - expansionary fiscal policy
 - expansionary monetary policy
- excess monetary growth: responses should explain how an increase in the money supply leads to an increase in the price level (some candidates may include this as a demand pull cause of inflation, which is acceptable).

Application of AD and AS diagrams to illustrate the causes of inflation are expected in order to reach level 3.

Candidates may explain excess monetary growth, but this is not necessary for full marks. In order to reach level 4, an explanation of cost-push and demand pull inflation is necessary.

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

(b) Evaluate the effectiveness of demand-side policies in reducing inflation. [15 marks]

Responses **may** include:

- definition of demand-side policies (trying to reduce inflation by reducing aggregate demand): fiscal policy and monetary policy
- explanation of how demand-side policies can be used to reduce inflation: raising tax and cutting government expenditure, increasing interest rates
- discussion of the problems associated with deflationary fiscal policy, *e.g.* unemployment, time lags
- discussion of the problems associated with contractionary monetary policy, *e.g.* an increase in interest rates slows economic growth and negatively affects exports due to increase in exchange rate. What rate of interest will achieve a desired inflation rate
- an evaluation of demand-side policies versus supply-side policies to reduce inflation
- better candidates may discuss how demand-side policies have an effect on other macroeconomic objectives.

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.

3. (a) **Explain the likely consequences of an increase in a country's current account deficit.**

[10 marks]

Responses **should** include:

- definition of current account deficit: where the value of imported goods and services is greater than the value exported goods and services over a given period of time
- consequences for AD, which **may** include:
 - consequences for unemployment
 - consequences for capital account
 - consequences for exchange rate.

Candidates must describe three consequences in order to reach level 4.

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

- (b) **Evaluate the methods available to a government to correct a current account deficit.**

[15 marks]

Responses **may** include:

- expenditure-switching policies, *e.g.* devaluation of the exchange rate
- expenditure-reducing policies *e.g.* contractionary fiscal and monetary policy
- supply-side policies to increase competitiveness of exports
- explanation of the different methods of correction: devaluation/expenditure switching, deflation/expenditure reducing, protectionism, supply-side policies to increase competitiveness
- discussion of problems associated with devaluation *e.g.* cost-push inflation, only possible in a fixed exchange rate system
- discussion of advantages and disadvantages of deflationary measures *e.g.* reduces growth, causes unemployment, can be beneficial if an economy is already suffering from inflation
- discussion of the problems associated with protectionism *e.g.* loss of international competitiveness as domestic producers are not forced to be efficient, potential retaliation by trading partners, not allowed to practice protectionism (*e.g.* WTO requirements)
- discussion of advantages and disadvantages of supply-side policies *e.g.* tend to be long-term policies, makes domestic producers more competitive internationally. If minimum wages are done away with, then workers may experience lower wages. If unemployment benefits are reduced, the unemployed can suffer.

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 *three* barriers to economic development for developing countries. [10 marks]

Responses **should** define economic development (the continuous and sustained rise in living standards in an economy) and **must** explain any **three** of the following barriers:

- ineffective taxation structure
- lack of property rights
- political instability
- corruption
- unequal distribution of income
- formal and informal markets
- lack of infrastructure
- overdependence on primary products
- adverse movements in the terms of trade/a deteriorating terms of trade
- a narrow range of exports
- protectionism in international trade
- indebtedness
- non-convertible currencies
- capital flight
- social and cultural factors.

In order to reach level 3 candidates must explain each of their three factors in terms of how each of the factors acts as a barrier to economic development, as opposed to economic growth.

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

(b) Evaluate the view that trade is more effective than aid in achieving economic development.

[15 marks]

In order to evaluate effectively, candidates are likely to contrast the positive and negative effects of aid with the positive and negative effects of trade and come to a reasoned conclusion.

Responses **may** include:

Positive effects of aid:

- fills the savings, investment, foreign exchange and technology gaps
- food aid can act as emergency relief
- multilateral aid tied to a specific project is most successful in achieving economic development.

Negative effects of aid:

- aid often is given to governments and never reaches the people
- leads to dependency on donor nations
- food aid damages local agricultural producers
- masks poor government policies which have created large debts
- aid is often directed at urban areas which further worsens uneven income distribution
- aid may be tied, leading to greater benefits to the donor nation.

Positive effects of trade:

- leads to more choice for domestic residents
- increased access to lower priced imports which will help LDCs
- increased access to necessary drugs and sanitation programmes.

Negative effects of trade:

- disadvantages local agricultural producers
- unemployment
- dumping
- LDCs become locked into production of primary goods which limits their income potential and lessens the possibility of a steady source of income.

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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