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UNIVERSITY OF CAMBRIDGE INTERNATIONAL EXAMINATIONS

GCE Advanced Subsidiary Level and GCE Advanced Level

MARK SCHEME for the May/June 2010 question paper

for the guidance of teachers

9708 ECONOMICS

9708/21 Paper 21 (Data Response and Essay), maximum raw mark 40

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International Examinations

Section A

1 (a) How far does the data in Fig.1 confirm that the normal demand curve relationship exists between the price and the quantity demanded of cigarettes? [3]

Normally price and quantity are inversely related (1), true in majority of years in both directions (1), clear exceptions 1992/3 and 2002 onward (1)

(b) (i) What do the three elasticity values in Table 1 tell us about the elasticity of demand for cigarettes? [3]

Short-run (SR) Price elasticity of demand (PED) very inelastic (1), Long-run (LR) PED inelastic but less than SR (1), Income elasticity of demand (YED) elastic (1), PED negative or YED positive with meanings (1) any 3 points

(ii) What might explain these different elasticity values? [4]

Habit/inadequate substitutes makes PED inelastic (1), SR no time to change behaviour (1), LR time for some to give up or find alternatives (1), PED negative-normal inverse relationship (1) Maximum of 3 on PED

YED elastic as cigarettes are a high status/luxury good in Malaysia (1) YED positive – normal good (1)

(c) Explain *two* possible economic reasons why cigarettes are heavily taxed. [4]

To raise revenue (1) based on inelastic demand for cigarettes (1)
or to cover costs of externalities – "polluter pays" principle (1)
To discourage consumption (1), to reduce negative externalities and demerit goods (1)
or to discourage production (1), as above or to improve resource allocation (1)

(d) Discuss the possible economic consequences of making cigarette smoking illegal. [6]

Arguments may include:
Benefits from: reduced death rates, less hospital treatment, less sickness absence, healthier workforce, greater safety (less fires), better environment, reduced Government (G) expenditure
Costs from: enforcement costs, reduced tax revenue, welfare losses, tobacco job losses, growth of illegal activities, more G expenditure on longer lives and pensions.
Maximum of 4 marks for one side of discussion

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Section B

2 (a) Explain how division of labour can affect labour productivity. [8]

Productivity is output per worker. Specialisation involves sub-dividing working processes and concentration on one aspect to raise efficiency. Workers can undertake tasks which match their natural abilities, can become more adept through practice, waste less time through reduced movement and make greater use of machinery which itself is more effective. Lack of division of labour may hold back productivity growth. However, division of labour may create problems which may reduce productivity or limit its growth e.g. boredom.

For understanding of productivity (1) and division of labour (1) 2 marks

For explanation of the effects on labour productivity 6 marks

(b) Discuss how the operation of a barter economy would be affected by the introduction of money. [12]

Barter is the exchange of goods without the use of money and requires a double coincidence of wants. Money is anything generally acceptable as a means of payment and settlement of debt. It has four functions: a medium of exchange, a unit of account, a store of value and a standard of deferred payment. An effective money will have properties such as durability, divisibility etc. Trade will be easier, quicker and more widespread. Specialisation and exchange will become common and can extend to the international level. Credit can be introduced. Economic activity and standards of living will be much higher when money works effectively. However, it may lead to problems such as inflation and counterfeiting.

For understanding of barter and money 4 marks

For analysis of the effects of the introduction of money 4 marks

For discussion of the differences in operation of an economy 4 marks

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3 (a) 'A free market price operates as a rationing and allocating mechanism'. Explain how it does this. [8]

A free market sets price by the operation of demand and supply. The price of a product determines who has the purchasing power to afford the good. A higher income means greater ability to purchase so the price system favours the richer in society. It rations the restricted quantity available between those who might wish to buy. The price also allocates resources between competing uses. The higher the price the greater the potential reward to factor owners. This will attract resources to those activities which pay the highest price so determining the employment of factors.

For understanding of free market price — 2 marks

For explanation of the rationing function — 3 marks

For explanation of the allocating function — 3 marks

(b) Discuss why certain goods and services are usually supplied directly by the government rather than through the market. [12]

Private goods can be supplied by the market system because of excludability and rivalry. Certain other goods will not be supplied in sufficient quantities or not at all if left to the market. Public goods, such as defence, are non-excludable and non-rival so it is not possible to charge for them and 'free riders' can gain benefit without paying. In this case the government provides the good or service and pays for it out of general taxation. Another case is merit goods. These provide a greater benefit than is recognised by the consumer and so will be under-consumed from society's viewpoint. Health and education fall into this category. The government will provide the goods or services from taxation and offer them at a subsidised or at no price. In both cases the government is making the judgement that providing these will raise welfare levels in society. There will be a range of other motives for supply by the government such as prevent exploitation, natural monopolies and reduce unemployment.

For understanding the nature and a discussion of public goods — Max 4 marks

For understanding the nature and a discussion of merit goods — Max 4 marks

For understanding the nature and a discussion of other cases — Max 4 marks

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4 (a) With the aid of a diagram, explain why an economy's floating exchange rate may depreciate. [8]

Depreciation is a fall in the value of a currency which is fixed by market forces. The fall may have been the result of a fall in demand or an increase in supply of the currency. Possible causes include a loss of international competitiveness, loss of foreign confidence and changes in international investment flows. Reference to both supply and demand needed for full marks.

For understanding of a depreciating floating exchange rate 2 marks

For diagram illustrating the depreciation 2 marks

For explanation of the factors behind the depreciation 4 marks

(b) Discuss whether a current account deficit is always a serious economic problem for a country. [12]

A current account deficit occurs when financial outflows from goods, services, income and transfers outweigh inflows. This may be a serious problem if it is the result of a fundamental disequilibrium, if it requires unusual policy measures, if it is long term and if it is not possible to finance it without excessive borrowing or rundown of reserves. However, it may not be significant if it alternates with surplus years, there are sufficient reserves to cover it, if it will enable longer term development (via the importing of capital goods) and if it is a small percentage of GDP. Other economic problems (inflation or unemployment) may be more significant depending upon economic conditions.

For understanding of a current account deficit 4 marks

For discussion of circumstances when it is serious 4 marks

For discussion of circumstances when it is not serious 4 marks

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9708/22 Paper 22 (Data Response and Essay – Core), maximum raw mark 40

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1 (a) (i) Why are weights used in constructing a CPI? [2]

To give an accurate measure of inflation (1), by reflecting the importance of different products to consumers (1).

(ii) Explain possible reasons why the weights for alcohol and tobacco and transport changed between 1992 and 2008. [4]

Alcohol and tobacco prices may have risen, health issues may have reduced consumption (2), transport costs may have changed or income increases may have allowed more relative expenditure (2) to max.

(b) (i) What is meant by inflation? [2]

A continuous/persistent/sustained rise (1) in the general price level (1). A fall in the value of money (1).

(ii) Using Fig. 1 compare Paraguay's inflation with that of Venezuela. [2]

Higher until approx. 1987, lower from approx. 1987 onwards, accept other valid comparisons, 1 mark per comparison.

(iii) To what extent did Paraguay achieve a low and stable rate of inflation between 1950 and 2005? [4]

Generally unstable over whole period (1), relatively high for most of the period (1), particularly high and unstable at start of period to 1960(1), 1962–1970 most successful in controlling inflation (1), credit other valid comments, evidence required to support conclusions.

(c) Discuss whether all countries should set annual inflation targets of around 3%. [6]

Case for includes e.g. stable and low rate desirable, active policy priority, retention of competitiveness, avoidance of unwanted redistribution, maintenance of confidence and risk taking.
Case against includes e.g. unrealistic (current high inflation), unnecessary (current low inflation), more important priorities, ineffective control (lack of institutional framework) and different circumstances in different economies.
4 marks maximum for one side.

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2 (a) Explain how a country's production possibility curve depends upon its factors of production. [8]

A production possibility curve (ppc) shows the combination of outputs that a country can produce when fully employing its resources. Factors include land, labour, capital and enterprise. Some countries have greater quantities and better quality of factors. Land may include a favourable climate and valuable minerals, labour may be skilled,, capital may embody modern technology and, enterprise may be readily available. The way the factors are combined to work productively will determine the quantities of different outputs produced. This will be reflected in the absolute and relative levels of output, which may be shown as diagrams.

Understanding of the ppc and factors of production	4 marks
Explanation of the different impact of the factors	4 marks

(b) Discuss how well comparative advantage explains the pattern of international trade. [12]

A country has a comparative advantage when it can produce a good at a lower opportunity cost than another country. This would reflect its factor endowment. The result is increased total output when both specialise where they have comparative advantage and trade with one another at an exchange rate between their opportunity cost ratios. This works even if a country possesses no absolute advantage in relation to another country. There are no gains from trade if they have identical opportunity cost ratios. The theory is able to explain much of commodity trade which reflects the strength of countries in different resources. The assumptions of the model restrict its conclusions. These include no transport costs, constant costs, perfect factor mobility, no trade barriers and perfect knowledge. It also does not take account of political influences, obligations of trade agreements and trade in non-homogeneous goods.

Understanding of the operation of comparative advantage	4 marks
Discussion of its validity as an explanation of trade	4 marks
Discussion of its weaknesses as an explanation of trade	4 marks

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3 (a) With the help of a diagram, explain why some goods are produced in quantities greater than is socially desirable. [8]

Overproduction is usually associated with production of goods with negative externalities and demerit goods. Negative externalities, such as pollution, impose a cost on third parties which is not reflected in the market outcome where the price is too low and quantity too great. Demerit goods, such as cigarettes, are demanded in quantities which reflect the consumers' lack of information about the effects of consumption or the failure to act upon that information. As the free market sets an equilibrium that only accounts for the private costs and not the external and therefore social costs the socially desirable outcome will not be achieved.

Understanding of externalities and demerit goods	4 marks
Explanation with diagram showing overproduction	4 marks

(b) Discuss whether national defence or a public park is the better example of a public good. [12]

A public good possesses the properties of non-rivalry and non-excludability. Consumption by one does not reduce the availability to others and it is not possible to restrict the benefit of the good to selected groups. Non-rejectability, that is automatically having to consume the good or service, can also apply. Defence is a classic example of a public good, as increases in population do not reduce the protection for current consumers and it is not possible to prevent consumers in some places from getting the benefit as it applies nationally. Everyone is automatically protected. A public park is non-rival up to the (unlikely) point at which its popularity causes it to become so crowded that others cannot enjoy it and the admission of others would reduce the consumption of other users . While public parks are usually free to enter, so no-one is excluded by price, it is possible to exclude people by admission systems and the enforcement of charges. No-one is forced to enjoy the existence of the public park as they are not compelled to use it. While defence always demonstrates the required qualities, a public park usually does but not always or entirely.

Understanding of the properties of a public good	4 marks
Discussion of national defence as a public good	4 marks
Discussion of a public park as a public good	4 marks

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4 (a) Explain, using a normal demand curve, how consumer surplus occurs. [8]

A normal demand curve slopes downward from left to right and shows a negative relationship between price and quantity demanded. Consumer surplus is the difference between what a consumer is willing to pay for a good and what he actually pays for it. It arises because of the downward sloping nature of the demand curve and the fact that the price paid is that for the last worthwhile purchase. The consumer might be willing to pay $10 for one item of a product but the market price is $2, this gives consumer surplus of $8, for the second he might value it at $7 so consumer surplus is $5 and so on until the surplus disappears. Consumer surplus is zero when the market price matches the buyer's valuation. The more elastic the demand curve, the lower the level of consumer surplus. Price changes will directly affect the level of consumer surplus.

Understanding of consumer surplus and demand curve	4 marks
Explanation of varying levels of consumer surplus	4 marks

(b) With the help of diagrams, discuss whether consumers will benefit from the introduction on a product of (i) an indirect tax and (ii) an effective maximum price. [12]

An indirect tax is a tax on consumption. An effective maximum price sets the highest price at which a good can be sold and is below the market price. An indirect tax shifts the supply curve to the left and raises the price. This reduces the amount of consumer surplus with less consumed and surplus per item reduced. The consumer pays a higher price and consumes less of the product. This does not benefit the consumer although the way the tax is spent may be to their advantage and a tax on a demerit good may raise their welfare. An effective maximum price is set below the market price and results in a smaller quantity supplied, greater quantity demanded and excess demand. Unofficial black markets may develop. The reduced consumption will reduce the consumer surplus as less is consumed, while the lower price will increase consumer surplus for those who continue to consume. Some consumers will benefit while others will lose. Whether the overall effect is an increase or decrease will depend on the level of the maximum price and the elasticities of demand and supply. The maximum price has the potential to raise consumer surplus, an indirect tax does not.

Understanding and diagram of an indirect tax and effective maximum price	4 marks
Discussion of tax impact	4 marks
Discussion of maximum price impact	4 marks

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1 (a) (i) Summarise the main changes in bicycle production shown in Table 1. [2]

China's production has increased (1), all other production has decreased (1)

(ii) How might the changing pattern of production be explained? [3]

China has replaced production in the other countries or has achieved comparative advantage in bicycle production (1), this may be based on cheaper labour, advantageous exchange rate, economies of scale etc. (2)
Allow approach from other countries' angle.

(b) Explain the likely effects for Chinese bicycle manufacturers of the anti-dumping import duty introduced by the EU. [3]

Price in EU will rise or now less competitive (1), fewer Chinese bicycles will be sold (1), employment, revenue or profits will reduce (1)

(c) (i) Use Fig. 1 to compare the trend in the world production of bicycles with that of cars. [2]

Bicycle production has grown by a greater amount (1), tenfold rather than fivefold (1), it has shown greater volatility (1), unit bicycle production has always been greater than car production (1). Allow approach from car production angle. Any two points.

(ii) How might the change in Chinese ownership of bicycles and cars between 1995 and 2005 be explained? [4]

Car ownership has grown while bicycle ownership has fallen (1), this was in a period of rising incomes and prosperity (1), relative costs of use may have changed (1), cars are normal goods (explanation) (1), bicycles may be inferior goods (explanation) (1) Any four points.

(d) Discuss the externalities that might arise from the use of bicycles and cars. [6]

Externalities are effects on third parties, they can be positive (beneficial) or negative (harmful) (1), bicycles may have positive externalities e.g. health benefits, safer travel, reduced congestion (to max 4), cars may have negative externalities e.g. pollution, congestion, accidents (to max 4), credit different examples or plausible reversal of cases.

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2 (a) With the help of examples, explain why different economic decision makers face the problem of scarcity. [8]

Scarcity results from limited resources and unlimited wants. This means choice is necessary and an opportunity cost occurs. All economic decision makers including individuals, families, firms and governments are unable to achieve all of their wants. The nature of the sacrifice may differ from case to case but the basis is the same. Examples of the decision makers and their choices must be identified.

Understanding of the basis of scarcity	4 marks
Explanation of the position of different economic decision makers	4 marks

(b) Discuss why the mixed economy is the most common economic system. [12]

A mixed economy draws features from the market and planned system. This includes private ownership, profit and incentive as well as government ownership, public goods and planning. This is meant to gain the advantages of both systems while avoiding their drawbacks. As a result there should be efficiency, choice, flexibility and progress, allied to equality, avoidance of waste, security and social welfare.

Knowledge of features of a mixed economy	4 marks
Discussion of advantages of market/disadvantages of planned	4 marks
Discussion of advantages of planned/disadvantages of market	4 marks

3 (a) Explain why unanticipated inflation is considered more of a problem than anticipated inflation. [8]

Inflation is a persistent rise in the general price level. If it is at the level that economic agents expect it is anticipated, if it differs from this it is unanticipated. When inflation is anticipated appropriate action can be taken to offset its effects. Indexation can be used so that incomes and taxes retain their real value. If it is unanticipated the assumption on which planning by households, firms and governments is made will be wrong, so plans may fail. There will also be arbitrary effects on the distribution of income with some gainers and some losers. This may be thought unjust.

Understanding of anticipated and unanticipated inflation	4 marks
Explanation of the effects of the two types of inflation	4 marks

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(b) Discuss whether inflation is more likely to be caused by domestic or international influences. [12]

Causes of inflation are classified as monetary, cost-push and demand-pull. These can each be affected by domestic and international influences and their importance will depend upon the nature of the individual economy. Monetary will usually be from government creation of money and easy credit although money supply is also affected by international flows of finance. Cost-push may be from domestic wage rates and imported raw materials. Demand-pull may be from domestic demand from consumer and government spending or from demand for exports. An open economy with strong trade links is likely to be more affected by international pressures than a closed economy, as may economies lacking resources and facing a falling exchange rate.

Understanding of the types of inflation	4 marks
Discussion of domestic influences	4 marks
Discussion of international influences	4 marks

4 (a) Explain the relevance of the Marshall-Lerner condition and the J-curve effect to the success of a currency devaluation. [8]

Devaluation is government lowering the value of a currency from one fixed level to another. The J- curve effect shows that there is a time lag between introducing the policy and it having the desired effect. This may be the result of short-term elasticities and contractual obligations. The Marshall-Lerner condition requires a combined elasticity of demand for imports and exports greater than one. If this is not the case devaluation will not necessarily correct a deficit and may worsen the position.

Understanding of devaluation	2 marks
Explanation of J-curve effect	3 marks
Explanation of Marshall-Lerner condition	3marks

(a) There are various influences on the international value of a currency in a floating exchange rate system.
Discuss their relative importance in different economies. [12]

Market forces fix a floating rate of exchange, this can be shown by a demand and supply diagram. With a floating rate changes may depend upon trade flows, investment flows, speculative flows and 'hot money' flows. In turn these reflect competitiveness, confidence, investment opportunities and interest rates and vary between economies. Government may intervene in the market if 'dirty floating' is the system. The relative importance will depend upon the nature and position of the economy. The size of the economy, the importance of trade, the potential for inward and outward investment, the success of the economy, government intervention etc., differ between economies.

Understanding of floating exchange rate movements	4 marks
Discussion of importance of factors influencing floating rate	4 marks
Discussion of varied circumstances in different economies	4 marks

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