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UNIVERSITY OF CAMBRIDGE INTERNATIONAL EXAMINATIONS

GCE Advanced Subsidiary Level and GCE Advanced Level

MARK SCHEME for the May/June 2011 question paper

for the guidance of teachers

9708 ECONOMICS

9708/21 Paper 2 (Data Response and Essay – Core), maximum raw mark 40

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1 (a) (i) Compare the average milk price paid to farmers in the US in August 2008 with that in August 2009? [2]

Fell (1), by €9 or 33% approx (1)
Allow range of figures €8.7–9.5 or 32%–35%

(ii) How far does Fig. 1 suggest that the price of milk is subject to regular seasonal influences? [2]

No / Very little (1), supporting reference to data (1)

(b) (i) Compare the changes in milk prices in the US and in New Zealand between 2007 and 2009. [2]

Both fell overall (1), US price fell continuously, NZ price rose then fell (1), US price fell more in % and absolute terms. NZ prices fell more rapidly 2008–9.
Any two points

(ii) Explain two possible reasons for the different level of milk prices in the US and New Zealand. [4]

Allow two interpretations of the question

1. Why US prices are higher than those in NZ
   The price difference may reflect productivity, costs of production / efficiency, government action, € exchange rate, comparative advantage, demand and supply conditions etc.
   Identified reason (1), explained reason (2).
2. Why are prices falling in US and NZ, as above.

(c) Explain how one group, other than dairy farmers, would lose from lower milk prices and how another group would gain from lower milk prices. [4]

Losers: Government (increased farm support expenditure, reduced tax income); associated activities e.g. farm suppliers (lower sales); local retailers (less demand from farmers); banks (loan defaults); farm workers (wages, employment), producers of substitutes.
Gainers: Consumers (lower prices); producers of milk-based goods (lower costs)

(d) Discuss the case for the use of government subsidies for the production of milk. [6]

Benefits: increase exports, reduce imports, support essential industry and employment, lower prices for basic foodstuff for low incomes, promotion of merit good etc. to max. (4)
Problems: financial cost (taxation), opportunity cost, misdirection of resources, inefficiency, dependence, etc. to max. (4)

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2 (a) Explain the functions of an economic system. [8]

An economic system is the means by which a country answers the basic economic problem. Limited resources and unlimited wants result in scarcity and choices have to be made. The system allows the questions of what?, how?, and for whom? to be answered. It arranges for resources to be employed to meet demands and for producers and consumers to be satisfied. This may be done by the price system, state planning or a mixture of the two.

Understanding of the economic problem	2 marks
Explanation of the role of the economic system	6 marks

(b) Discuss possible reasons why mixed economic systems have replaced most of the former planned economic systems. [12]

Planned economies are based on state control and direction while a mixed economy uses the market system supported by appropriate government intervention. Recent history illustrates the failure of the planned economy to raise living standards and perform as well as mixed economies. Mixed economies proved more efficient, more innovative, more flexible and provided greater choice and higher living standards. Planned economies were unable to coordinate economic decision making, lacked incentives, lacked quality control, were slow to change and caused considerable environmental damage. Despite the attempts of planned economies to provide citizens with security and a minimum standard of living, the advantages of the mixed economy were more highly valued.

Understanding of the two types of system		2 marks		
Analysis of the performance of the planned system	up to	6 marks	}	max. 10
Discussion of the relative merits of the two systems	up to	6 marks	}	

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3 (a) Explain how the effects of a devaluation on the level economic activity differ from those of a deflation. [8]

Devaluation is the lowering by the government of a currency's international value under a fixed exchange rate system. Deflation refers to a persistent fall in the general price level or a lower level of economic activity possibly resulting from government policy. Devaluation should improve the current account and boost the economy with higher demand, employment and growth. Deflation harms confidence, reduces spending and increases unemployment.

Understanding of devaluation and deflation	4 marks
Explanation of the different effects	4 marks

(b) Discuss whether inflation can be both the cause and the result of fluctuations in an economy's exchange rate. [12]

Higher inflation than trading partners may mean a fall in the exchange rate because of increased supply and reduced demand for the currency. This will result from fewer exports, more imports, reduced confidence and outflows of investment. Overall it would mean a worsening of the balance of payments.
A fall in the exchange rate will increase the cost of imports (cost push inflation) and increase the demand for exports (demand pull inflation). A rise in the exchange rate would reduce inflationary pressure.
Whether these effects occur will depend upon the rate of inflation, the relative rates of inflation, the government's ability to control inflation, the nature of the exchange rate system and the direction of the change in the exchange rate.

Understanding of inflation and the exchange rate		2 marks		
Analysis of the impact of the changes	up to	6 marks	}	max. 10
Discussion of the conditions affecting the process	up to	6 marks	}	

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4 (a) Explain how the different international transactions of a country are recorded in its balance of payments accounts. [8]

The transactions involve trade in goods and services, incomes from work and investment, profits and dividends (IPD), government and private transfers (remittances), direct investment, portfolio investment and short term capital flows. The items are recorded as inflows (+) or outflows (-) and divided between the current account (goods and services, income and transfers) and the capital and financial accounts.

Understanding nature of international transactions up to 3 marks
Explanation of the recording of the items in the balance of payments up to 5 marks

(b) Discuss the use of tariffs and quotas as policies to reduce a current account deficit. [12]

Current account deficit means more outflows than inflows on trade, transfers and income. Tariffs are a tax on imports while quotas are a limit on quantity of imports. A tariff will raise revenue and be more effective the higher the price elasticity of demand and will operate through the market system. A quota will be effective when demand and supply are inelastic, will work with more certainty and benefit is more likely to accrue to the importer. Both methods involve intervention in the free market and may attract retaliation, there may be difficulty in setting the right level, they will have administrative costs and will be ineffective if the cause of the deficit is the performance in the income or transfer sections.

Understanding of current deficit, tariff and quota up to 3 marks
Analysis of the operation of tariffs and quotas up to 4 marks
Discussion of their merits and drawbacks up to 6 marks
} max. 12

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1 (a) (i) Calculate and compare the change in the trade balance between 2008–9 and 2012–13 of the Northern Territory with that of Australia. [4]

Both improved (1), Northern Territory (NT) has an increased surplus (1), Australia goes from deficit to surplus (1), supporting calculation NT A$1454 to A$3193, Aus A$-41 665 to A$12 303 (2)
Comparative points without accurate calculation can be rewarded, but the points must relate to the 'balance', not the change in imports or exports alone.

(ii) Explain why exports and imports are often measured at constant prices. [2]

Constant prices exclude the effect of inflation (1), more accurate in real terms or shows the volume of trade.

(b) Explain <u>two</u> additional pieces of information that would be useful in judging Australia's international financial position. [4]

From net income, net transfers, capital account, financial account, foreign reserves, exchange rate, *terms of trade* or alternatives, identification (1), *plus 1 mark for explanation of identified point (1)*

(c) Analyse the change in average weekly earnings in Australia in real terms between 2008–9 and 2012–13. [4]

For an understanding of meaning of 'real terms' (1 mark)

Real earnings will rise (1), earnings rise more rapidly than inflation (1), supporting calculation 14.6% v. 11.2% (2)

(d) With the help of the text and the table, discuss the economic prospects of the Northern Territory. [6]

Good prospects: trade in tourism (income elastic), minerals and oil, rising surplus, relatively low inflation rate, higher real wages, growth of working population.
Poor prospects: rise in unemployment, dependence on narrow range of production, variable demand, externalities of tourism and mining, lack of sustainability of natural resources.

For the identification of points that could affect the economic prospects of the Northern Territories (2 max.)

For explanation of why the identified points are relevant to the economic prospects. (2 max.)

For comment on the economic prospects of the Northern Territories, for example a reasoned summary or conclusion. (up to 2 marks)

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2 (a) Explain the role that a government must fulfil in a mixed economy. [8]

A mixed economy is based on private ownership, the profit motive, demand and supply etc. with a role for the government. The role is to provide the environment in which the market can operate successfully. This includes ensuring law and order, national defence, property rights and the provision of public goods and desirable merit goods. It intervenes with taxes, subsidies etc. to influence the behaviour of the private sector and markets and achieve a better allocation of resources.

For a definition of the mixed economy (2 marks)
For an explanation of the role of government in a mixed economy (6 marks)

(b) Discuss the accuracy of the definition of public and merit goods as 'goods that must be provided by the government'. [12]

Public goods are non-rival and non-excludable such as street lighting. Merit goods are goods underprovided by the market system. The consumers lack full information of the consequences of non-consumption. This might include healthcare and pension provision. Although the government provides public goods because it is not possible for the market due to free riders, merit goods are supplied to a greater or lesser extent by private providers.
The government also provides other goods and services which are neither public nor merit goods. The definition fits public better than merit goods but is inadequate in itself.

For an understanding of public goods and why they are provided by the government (up to 6 marks)
For an understanding of merit goods and why they are provided by the government (up to 6 marks)
(10 marks max.)

Discussion of the accuracy of the definition. (4 marks)

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3 (a) Using economic analysis, explain the possible causes of the increase in the sales of electronic goods such as mp3 players in recent years. [8]

Influences have come from both the demand and supply side. Rising incomes, advertising, changing fashion and tastes have increased demand. Innovation, the introduction of new and improved products and the lowering of costs have increased supply. The fall in the price of the goods has resulted in an extension of demand. More are being sold at lower prices.

Understanding the significance of demand and supply 2 marks
Explanation of demand and/or supply changes 6 marks
(up to 3 marks for each factor explained)

(b) Suggest <u>two</u> possible reasons why a government might increase the indirect tax on such goods and discuss, in the light of these reasons, the likely effectiveness of such a policy. [12]

Possible reasons include raising revenue to finance government expenditure, cutting the purchase of imports to help the balance of trade. It might be argued that the products are demerit goods because of the harm to hearing and disturbance to others. An indirect tax is imposed on spending and raises the price of the good. PED measures the responsiveness of demand to a change in price and affects the impact of an increase in an indirect tax. A tax will best reduce the quantity imported when demand for imports is elastic as there will be a more than proportionate fall in demand. To raise revenue it is better for demand to be inelastic so that the fall in demand is less than proportionate to the price rise. The effectiveness of internalising the negative externality will depend upon setting the tax at the appropriate rate.

For a definition of indirect tax (1 mark)

For an explanation of one reason for an indirect tax and a discussion of 'effectiveness' (up to 6 marks with 4 max. if only one element is considered)

For an explanation of a second reason for an indirect tax and a discussion of 'effectiveness' (up to 6 marks with 4 max. if only one element is considered)

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4 (a) Explain why the successful operation of division of labour depends upon the use of money. [8]

Division of labour involves dividing the production process into a series of stages. This leads to more specialised outputs which are not necessarily final products. Trading these in a barter system would be difficult, inefficient and probably impossible. Money, anything that is generally acceptable as a means of payment, can act as a medium of exchange and a unit of account, so enabling trade to take place and making division of labour effective.

Understanding of division of labour and money 4 marks (one only 3 max.)
Explanation of the link between the functions of money and trade 4 marks

(b) Discuss whether it is the behaviour of producers, consumers or governments that is most likely to cause inflation. [12]

Inflation is a sustained rise in the general price level and is measured by the CPI or RPI. Each of the groups can contribute to inflation although in different ways. Producers may increase prices to raise profit levels or to respond to higher import prices (cost push); consumers may increase their spending and reduce their saving raising AD (demand pull); governments may increase the money supply (monetary inflation), lower direct taxation and run budget deficits (demand pull) and raise indirect taxation (cost push inflation); they may also manipulate the exchange rate. Candidates can argue for any group although government influence may be most widespread.

For a definition of inflation 1 mark
For an understanding of different types of inflation 6 marks
Analysis of the influence of different groups 6 marks
} (10 marks max.)
Discussion of the relative impact of the groups 4 marks

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1 (a) Compare the exchange rate of the S$ against the US$ from the beginning of 1980 to the beginning of 2010. [2]

It appreciated/rose (1), by approx 50% or US$0.24 (1)

(b) Analyse the possible changes in the demand for and the supply of the S$ that could account for the trends in its exchange rate between 1997 and 2007. [4]

A depreciation between 1997 and 2001(1) may be the result of a fall in demand and/ or a rise in the supply of S$ (1), the appreciation between 2002 and 2007 (1) may be the result of a rise in demand and/or a fall in supply of S$ (1)

(c) Explain <u>two</u> ways in which an appreciating exchange rate can help to reduce inflation. [4]

Appreciation will reduce the price of imports (1), lessening cost-push pressure (1)
Exports are more expensive (1), reducing demand-pull pressure (1)

(d) Using the extract, consider whether Singapore has both a floating and a fixed exchange rate system. [4]

Elements of floating include movement within trading band (1), fluctuation of exchange rate shown in data (1)
Fixed includes MAS intervention (1), set limits to movement (1)

(e) Discuss whether an economy will benefit from a fall in its exchange rate. [6]

Benefits: improved balance of trade; more competitive industry; higher employment and income; increased growth
Drawbacks: only works with Marshall-Lerner condition and elasticity of supply; generates inflationary pressure; undermined by retaliation; reduced purchasing power of currency
Max. 4 marks for one side only

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2 (a) Explain how resources are allocated in a free market system. [8]

A free market system relies on demand and supply without government intervention. Resources are the factors of production. Consumer and producer behaviour results in demand and supply changes leading to price changes. Higher prices, profits and rewards draw more resources to that use. Price falls do the opposite.

Understanding of the free market and resources	4 marks
Explanation of the operation of the price mechanism	4 marks

(b) Discuss how the market system might be influenced by government intervention to provide appropriate quantities of goods and services. [12]

Markets may fail by under-provision, over-provision or non-provision of goods and services. This relates to merit goods, demerit goods and public goods. The government can undertake state provision, subsidisation, taxation and product bans and regulation. Each method can be judged by its cost, effectiveness and side effects. State provision will make the goods available but may be costly and inefficient. Subsidisation will reduce the cost of the good but will interfere with the market mechanism and be a burden to taxpayers. Taxation regulates consumption and raises revenue but imposes burdens on producers and consumers. Bans and regulation prevent production but may lose some benefits and create unemployment and enforcement costs.

Understanding of the failings of market provision	4 marks
Analysis of the nature of intervention	4 marks
Discussion of the problems of intervention	4 marks

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3 (a) Explain how and why the price elasticity of supply of agricultural goods differs from that of manufactured goods. [8]

Price elasticity of supply measures the responsiveness of supply to changes in price. Agricultural goods tend to be more price inelastic (PES<1) than manufactured goods. The influences at work are perishability of product, specialised storage, growing period, capacity availability, ability to switch products, nature of additional costs etc.

Understanding of PES in these cases 4 marks
Explanation of influences in the two cases. 4 marks

(b) Discuss whether the payment of government subsidies to farmers is a beneficial policy. [12]

Subsidies are payments to producers which reduce costs. They shift the supply curve to the right, lowering price and increasing quantity. This will raise farm incomes if PED is elastic but not if it is inelastic. Subsidies will lower prices for consumers and help make domestic farmers competitive with foreign producers so helping the balance of trade. They will enable farmers to stay in business with effects on employment and the environment. The benefit will be split between the consumer and farmer depending upon the elasticities involved. Against this, subsidies may undermine the operation of the market, keep resources in an inefficient use, raise the tax burden, reduce government expenditure on other groups and may be ineffective in raising farm incomes.

Understanding of the meaning and effect of subsidies 4 marks
Discussion of the benefits of subsidies 4 marks
Discussion of the drawbacks of subsidies 4 marks

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4 (a) Explain the limitations of the theory of comparative advantage in accounting for of a country's pattern of trade. [8]

Comparative advantage is found when a country can produce at a lower opportunity cost than another. This reflects the country's factor endowment. It is the basis for specialisation, increased output and the benefits of trade. The theory is based on some restrictive assumptions which limit its explanatory value. These include bilateral rather than multilateral trade, absence of transport costs, mobility of factors, constant returns, full employment and reciprocal demand. These assumptions may not exist in practice.

Understanding of comparative advantage	4 marks
Explanation of the limitations of the theory of comparative advantage	4 marks

(b) Discuss whether the introduction of trade barriers to imports can be justified. [12]

Trade barriers include tariffs, quotas, export subsidies, misaligned exchange rates, administrative restrictions, exchange control etc. These are intended to reduce imports and the corresponding outflow of currency. Barriers can be justified in terms of protection of infant industries, prevention of dumping, raising revenue, short-run employment protection, improving the terms of trade and avoiding overspecialisation. On the other hand, barriers will prevent the benefits of international trade which include lower prices, more choice, more efficiency and higher living standards. Barriers may face retaliation and breach international obligations e.g. those of the World Trade Organisation.

Understanding of the types and purpose of trade barriers	4 marks
Discussion of the benefits of trade barriers	4 marks
Discussion of the drawbacks of trade barriers	4 marks

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