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UNIVERSITY OF CAMBRIDGE INTERNATIONAL EXAMINATIONS

GCE Advanced Subsidiary Level and GCE Advanced Level

MARK SCHEME for the May/June 2012 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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International Examinations

1 (a) (i) In which year was Turkey most successful in meeting its inflation target? [1]

2005

(ii) In which year was Turkey least successful in meeting its inflation target? [1]

2008

(b) Explain the likely effect of the depreciation of the New Turkish Lira on Turkey's rate of inflation. [4]

Depreciation reduces export prices (1), raises import prices (1), lower export prices may increase demand inflation (1), higher import prices may raise cost-push pressures (1), higher import prices may raise demand for home produced goods, increasing demand inflation (1)

(c) With reference to Fig. 1, how might differences between the inflation targets and actual inflation rates in Chile and Brazil in 2008 be explained? [4]

Chile had a lower and/or narrower target band (1), a stricter policy towards inflation (1)
Chile had higher inflation (1), Chile less effective in anti-inflationary policy (1), Brazil within target range; Chile exceeded target (1)
May be dealt with from Brazil's angle or Chile's, reward logical assumptions.

(d) How might having a target for inflation affect the causes of inflation? [4]

Cost push: target influences attitudes/expectations (1), workers may limit pay claims (1), producers may restrict price rises (1)
Less direct effect on demand pull and monetary inflation (1)
Government intention may be accompanied by further policy moves (1)
Example with effect on inflation (1)

(e) Discuss the possible problems of constructing an accurate consumer price index. [6]

Understanding of CPI (1 max.)
The problems include limited data, inadequate sampling, inaccurate calculation, incorrect weights, unsound base year and lack of objectivity.
Some problems may have limited importance e.g. the omission of minor goods and services, some may be easily solved e.g. the need for wider sampling while some may undermine the validity of the index e.g. government manipulation of the data.
Recognition of problems (1) and explanation of problems (2) = 3 marks
Comment on problems = 3 marks

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2 (a) Explain how the loss of confidence in money will affect an economy's production possibility curve. [8]

Money is anything that is generally acceptable as a means of payment and has four functions. The production possibility curve (ppc) shows the maximum possible combinations of outputs when an economy operates at full employment. The loss of confidence will prevent money being acceptable and its functions will not operate effectively. This will restrict specialisation and output. The result will be lower potential production so fixing the curve nearer to the origin than one with the use of money.

Understanding of money and the ppc 4 marks
Explanation of the impact on the position of the ppc 4 marks

(b) Discuss the difficulties involved in changing a planned economy to a successful market economy. [12]

A planned economy relies on state control and direction while a market economy involves private activity and operation of demand and supply. To make a successful transfer, markets need to exist, as does the profit motive, competition, incentives, private property, free trade, decentralised activity, limited state intervention, the tolerance of economic failure and support for business casualties. The ease of introducing these varies, some can be done in a short time at low cost e.g. the sale of state assets, while others may take a long time and have limited success e.g. changing attitudes to risk. A range of other difficulties may be considered e.g. provision of public goods, merit/demerit goods, externalities, inequality etc. Some may result in a 'soft landing', others a 'hard landing'. A partial change may face fewer difficulties.

Understanding of the planned and market economy 2 marks
Analysis of the changes necessary 4 marks

Discussion of the difficulties in producing a successful outcome 6 marks

Overall evaluation 1 mark

3 (a) Explain, using elasticity of demand, the possible reasons why in some countries there has been an increased use of private transport instead of public transport. [8]

The pattern is a move from public to private, such as buses to cars. This is the result of rising incomes, higher expectations, the need for greater mobility, lower priced vehicles etc. Relevant concepts to be considered are demand influences including substitutes with positive cross elasticity of demand and inferior goods with negative income elasticity of demand.

Understanding of elasticity of demand 1 mark) 4 max.
Understanding of the influences on the demand for transport 4 mark)
Explanation of the changes in terms of elasticity 4 marks

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(b) Discuss the economic reasons for subsidising public transport and taxing private transport. [12]

The arguments relate to externalities. Public transport may generate positive externalities by reducing congestion and pollution. A subsidy would lower price and increase output, helping to establish a market equilibrium that took social cost and benefit into account. Private transport may generate negative externalities and a tax would raise price and reduce consumption to a level more in line with the economically desirable output. A combination of the two policies should help tackle the problems that arise when a market operates in line with private cost and benefit rather than social cost and benefit. There will be costs involved for the government and problems in altering consumers preferences

Understanding of externalities up to 4 marks) max. 6
Analysis of the market outcome for transport up to 4 marks) marks

Discussion of the effect of tax /subsidies on the market 6 marks

Overall evaluation 1 mark

4 (a) Use economic analysis to explain the benefits of international trade. [8]

The benefits are based on comparative advantage. It exists when one economy can produce a good at a lower opportunity cost than another. This is based on different factor endowments. Specialisation and trade at a rate between the two opportunity costs will increase output and raise living standards. The model is based on assumptions including two products, two countries, no transport costs, constant returns to scale and mobility of labour. The benefit can be shown by a numerical example. An alternative approach would involve explaining more general benefit of trade such as choice, lower prices, higher quality, ending of local monopolies etc.

Understanding of comparative advantage 4 marks

Explanation of the operation of comparative advantage) 4 marks
General benefits of trade)

(b) Discuss whether restrictions on international trade can ever be justified. [12]

Restrictions on trade include tariffs, quotas, subsidies, voluntary export restraints (VERS) and exchange controls. They are intended to raise the price or restrict the quantity of imports and to lower the price of exports. The case against restrictions is that they prevent the benefits of free trade, lower living standards, reduce choice, lower employment and may provoke retaliation. There are some short-term arguments that are considered justifiable. These include arguments for protecting infant industries, preventing dumping, slowing the decline of sunset industries, improving the terms of trade, and raising revenue. Other justifications tend to be non-economic (1 max).

Understanding of trade restrictions up to 4 marks) max. 6 marks
Analysis of the benefits of restrictions up to 4 marks)

Discussion of the limitations of restrictions 6 marks
(At least 2 marks reserved for conclusions or relevant evaluation)

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1 (a) Compare the changes shown in the current account balance of Russia and the United States between 2006 and 2010. [2]

For recognition that Russia had a surplus and that the United States had a deficit (1 mark).
For the second mark we require some statement about the 'change' in each country's balance.
E.g. Russia's surplus was fluctuating, United States deficit was reducing. (1 mark)

(b) Explain <u>two</u> possible economic reasons why China's international trade performance was stronger than that of India. [4]

Up to three marks for any one reason well explained.
E.g. Productivity may have been higher in China (1 mark) because of higher levels of capital in the production process (1 mark) making Chinese goods more competitive on world markets (1 mark).
E.g. China may have an undervalued exchange rate (1 mark) because of the Chinese authorities actions in the foreign exchange market (1 mark) which reduces the price of China's exports, (or increases the price of China's imports) (1 mark).
Four marks maximum.
Notes: The answer could also be explained from the perspective of India.

(c) Explain <u>two</u> likely economic effects of the 2009 recession on international trade. [4]

Up to three marks for any one effect well explained.
E.g. 1 During a recession incomes fall (1 mark), as a result purchasing power falls so that less imports can be afforded (1 mark), as a result the volume of world trade falls (1 mark).
E.g. 2 During a recession incomes fall (1 mark*), as a result the demand for those goods with positive income elasticity falls and the demand for those goods with negative income elasticity rises (1 mark), so some countries will gain and some countries will lose as the pattern of world trade changes (1 mark).
Four marks maximum.
Notes: * Credit this point only once.

(d) Why might a current account surplus be an important economic objective for some countries? [4]

For a clear understanding of 'current account surplus' (1 mark).
and
For the benefits that result from a 'current account surplus'.
E.g.'s include:

- It creates employment via net exports. (Up to 3 marks)
- It avoids the problems that result from a current account deficit. (Up to 3 marks)
- It boosts confidence amongst foreign investors and promotes investment inflows. (Up to 3 marks)
- It results in an inflow of foreign currency that strengthens the exchange rate and foreign currency reserves. (Up to 3 marks)

Notes: The suggested benefit must be fully explained for 3 marks.

(e) Discuss the desirability of using an expenditure-reducing policy to decrease a current account deficit. [6]

For an understanding of 'expenditure-reducing policy'. (1 mark)
and
For the advantages of this approach. (up to 4 marks)
For the disadvantages of this approach. (Credit comment that 'expenditure-switching' policy is an alternative that avoids these disadvantages). (up to 4 marks)
Six marks maximum.

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2 (a) Explain why all types of economic system benefit from the existence and use of money. [8]

For knowledge and understanding of 'types of economic system' and 'money'.
Up to 4 marks

For application showing the benefits of using money in different types of economic system.
Up to 4 marks

(b) Discuss whether an economy's production possibility curve is more likely to move inward or outward over time. [12]

For a knowledge and understanding of the 'production possibility curve'. Up to 2 marks

For analysis explaining the causes of inward and outward shifts of the production possibility curve. Up to 8 marks
(up to 6 marks for analysis of each direction of shift)

For evaluative comment on whether the production possibility curve is more likely to move inward or outward. Up to 2 marks

3 (a) Explain, using elasticity of demand, why a train company might introduce a policy of raising fares at busy travel times and lowering fares at less busy travel times. [8]

For knowledge and understanding of relevant 'elasticity of demand' in this context.
Up to 4 marks

For application of price elasticity of demand showing the link between the effect of raising fares at busy times and changes in total revenue and the effect of lowering fares at less busy times and changes in total revenue. Up to 4 marks

(b) Discuss why some governments decide that it is undesirable to leave the provision of private goods such as train travel, to the private sector. [12]

For a knowledge and understanding of characteristics of a 'private good'. Up to 2 marks

For analysis explaining how leaving the provision of private goods to the private sector can result in various types of economic problem. Up to 8 marks

For evaluative comment; for example on why private sector provision remains despite these disadvantages. Up to 2 marks

4 (a) Explain, with the help of a diagram, how a government can maintain a stable foreign exchange rate. [8]

For a knowledge and understanding of the influence of supply and demand in setting the foreign exchange rate. Up to 4 marks

For application showing how a government can maintain a foreign exchange rate through intervention in the foreign exchange market. Up to 4 marks
(6 marks maximum if no diagram provided)

(b) Discuss whether a government should be more concerned by an unstable foreign exchange rate or by an unstable domestic price level. [12]

For knowledge and understanding of an 'unstable exchange rate' and an 'unstable domestic price level'. Up to 2 marks

For analysis of the disadvantages of an unstable exchange rate and an unstable domestic price level. (up to 6 marks for an analysis of each economic problem)
Up to 8 marks

For evaluative comment on whether the government should be more concerned about an unstable foreign exchange rate or by an unstable domestic price level. Up to 2 marks

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1 (a) (i) Use Table 1 to compare the export performance of the three trade groups in 2003. [2]

EU significantly the largest exporter (1), more than the others combined (1), JACIK more exports than NAFTA (1) any 2 points

(ii) How might the differences you have identified be explained? [3]

Up to **two marks** for any **one** explanation with three marks maximum. Examples of explanations for these differences include:

- The relative economic strength of each trade group. (up to 2 marks)
- The relative openness to trade of each trade group (up to 2 marks)
- The degree of self-sufficiency of each trade group (up to 2 marks)
- The composition of imports and exports of each trade group. (up to 2 marks)

Credit other valid explanations not included above.

(b) (i) State three ways in which an economic union differs from a free trade area. [3]

Directive word is **'state',** so no explanation is required.

Greater degree of integration (1), common external tariff (1), freedom of movement (1), monetary union (1), common policies (1) any 3 points

(ii) Explain two problems that might make economic integration difficult. [4]

Economic sovereignty issues (2), different levels of economic development (2), different features of economic system (2), historical influences (2) any two points explained

(c) Use Table 2 to show whether the free movement of capital or the free movement of skilled workers is estimated to be more beneficial for JACIK. [2]

More impact from free movement of workers (1), + US$ 55 billion against + US$ 5 billion (approx)

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(d) Discuss how the rest of the world might view the formation of JACIK. [6]

The formation of JACIK represents a possible benefit to the rest of the world, but also a potential threat.

The benefits are positive in net terms when the free movement of goods and services, capital and labour occurs in JACIK. This might occur as a result of more efficient resource allocation within JACIK leading to greater productivity, and lower prices of goods and services, which if exported will benefit consumers in the rest of the world. Producers in other economies might also benefit from lower component costs. Rising incomes are also likely in the JACIK economies which will expand the market for the exports of other economies.

The threats include those to other economies with export sectors that will face fiercer competition and this might lead to reduced sales, falling profits and probable job losses.

The data shown in the table need to be interpreted and included as part of the discussion.

Up to 4 marks for benefits and up to 4 marks for threats with 6 maximum.

2 (a) Explain whether the factors of production are always of equal importance within and between economies. [8]

Factors of production are land, labour, capital and enterprise. While all are likely to be needed to some degree their relative importance differs within and between economies. Advanced economies may rely more on capital with more emphasis on enterprise, developing economies may focus on land and labour. An economy relying on manufacturing will have a different pattern from those relying on agriculture and services. The nature and productivity of the factors will also differ between economies. They are unlikely to be of equal importance either within or between countries.

- For knowledge and understanding of the factors of production and their role. 4 marks
- For application that explains the relative importance of the factors. 4 marks

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(b) Discuss whether planned economies should always be replaced by free market economies. [12]

A free market economy is based on demand and supply and private activities. A planned economy is based on state ownership and control. Market economies have performed more successfully in terms of living standards. This is attributed to greater efficiency based on consumer sovereignty, incentive and flexibility. Against this can be set greater instability, more unequal distribution of income, higher likelihood of unemployment and the failure of the market to operate effectively. Some of the latter are avoided by the planned economy. The change in eastern European economies supports the preference for the market outcome although it depends upon individual priorities.

- For knowledge and understanding of planned and market economies. 2 marks
- For an analysis of the advantages and disadvantages of replacing planned economies with free market economies. Up to 8 marks. **(One side only 6 max)**
- For evaluative comment on whether planned economies should always be replaced by free market economies. 2 marks

3 (a) Explain how income elasticity of demand and cross elasticity of demand can be used to classify different types of good. [8]

Income elasticity can relate to inferior good where there is a reduction in demand as consumer income rises e.g. bus travel. This would have a negative income elasticity of demand (YED) as Y rises QD falls. Cross elasticity of demand can relate to complementary goods that is consumed in conjunction with another product e.g. bread and butter. There will be a negative cross elasticity of demand (XED) as a rise in the price of one good causes a fall in the demand for the complement. It can also identify substitute or alternative goods e.g. Pepsi-Cola and Coca-Cola where cross elasticity will be positive. Candidates may offer the formulas.

- For knowledge and understanding of income elasticity and cross elasticity. 4 marks
- For application to different types of goods. 4 marks

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(b) Discuss the effectiveness of government use of maximum and minimum prices to help consumers and producers. [12]

A maximum/minimum price intends to keep prices below/above the market level. The former would benefit consumers, the latter producers. Maximum prices will be ignored and ineffective if set above the market price and minimum will not work if below the market price. A maximum price will benefit those consumers who manage to buy the good but will create a shortage at the set price. This will require government intervention to allocate the restricted supply among the would-be consumers but may result in illegal, black markets that favour the richer consumer. A minimum price will cause an excess supply that will require government action such as storage or destruction with its associated costs. It will favour the producer at the expense of the consumer and taxpayer. Both policies conflict with the market outcome.

- For knowledge and understanding of the motives for the setting of government prices. 2 marks
- For an analysis of the outcome of maximum and minimum prices. Up to 8 marks **(Only one type of government controlled price 6 max)**
- For overall evaluative comment on 'effectiveness' of government prices. 2 marks

4 (a) How does aggregate demand and aggregate supply analysis explain the existence of inflation in the short-run? [8]

Aggregate demand is total spending in an economy and it is shown as a curve sloping downward to the right. Aggregate supply is the total amount of output at a given level of prices in the economy and is shown as a curve sloping upward to the right. This may be shown in a diagram. Their interaction sets the equilibrium level of price and real output in the economy. Inflation can be caused by an increase in AD, from increases in its components (C+I+G+(X-M)), or a reduction in AS from influences such as wage rises or more expensive raw materials.

- For knowledge and understanding of AD and AS. 4 marks
- For application to show how changes in AD and AS can result in inflation. 4 marks

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(b) Discuss whether a period of inflation or a period of deflation is more economically desirable. [12]

Inflation is a sustained rise in the general price level. Deflation is a sustained fall in the general price level or a reduction in aggregate economic activity. Inflation has effects on international competitiveness, shoe leather and menu costs, the distribution of income, the ability to plan and the level of confidence. Deflation is linked to rising unemployment, falling economic growth, lower living standards, changing international competitiveness, changing distribution of income (differently to inflation) and loss of confidence. There is some overlap between the effects, and the effects may depend upon the rate of change. Mild inflation is often thought to be desirable. Governments may favour inflation as it reduces the real value of debt and increases income through higher tax revenue. The desirability will depend on the standpoint adopted.

- For knowledge and understanding of 'inflation' and 'deflation'.
  2 marks
- For an analysis of the effects of inflation and deflation.
  Up to 8 marks
  (Only inflation or deflation considered 6 max)
- For an evaluative comment on the relative desirability of inflation and deflation.
  2 marks

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