Cambridge International AS & A Level

Cambridge International Examinations
Cambridge International Advanced Subsidiary and Advanced Level

ECONOMICS **9708/21**

Paper 2 Data Response and Essay **May/June 2017**

MARK SCHEME

Maximum Mark: 40

Published

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Question	Answer	Marks	Guidance
1(a)(i)	• For a diagram showing an increase in supply or a decrease in demand. (1 mark) • For an accompanying explanation giving possible reasons for the shift in supply or demand. (1 mark)	**2**	The fall in price could be caused by either an increase in supply or a decrease in demand.
1(a)(ii)	For an explanation that • the fall in the price of oil has resulted in a fall in export revenues (1 mark) • and a fall in the demand for the peso (1 mark). (2 marks maximum)	**2**	The context of the case study makes it clear that the fall in the price of oil has resulted in a fall in Colombia's export revenues. This has resulted in a fall in the demand for the peso.
1(b)	For a clear diagram of production possibility curves. (Up to 2 marks) For an explanation of the increased possibility of the production of capital goods or the development of human capital that will generate growth in the economy. (Up to 2 marks) Maximum of 2 marks if no diagram.	**4**	The prospects of the end of the rebel insurgency will allow the Colombian government to spend less on the military. Resources can be diverted to the production of capital goods or to enhanced training of labour that will shift the PPC outwards. This is the 'peace dividend'

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1(c)	For explaining how each component is affected with due reference to the data. Consumption has fallen because of the fall in incomes and the rise in taxes. (Up to 2 marks) Investment has fallen because of the fall in activity (Puerto Gaitan). (Up to 2 marks) Government expenditure has fallen because of the fall in government revenues. (Up to 2 marks) Net exports have fallen because of the fall in oil prices and export revenues. (Up to 2 marks) (6 marks maximum) (If only 3 components are explained, then 5 marks maximum)	**6**	**Candidates need to interpret the data to explain how each of the four components has been affected.**
1(d)	At least **two** factors must be explained for full marks. • For any one factor explained (Up to 4 marks) (6 marks maximum)	**6**	The relevant factors include • the price elasticity of demand for Colombia's exports and imports and whether the Marshall-Lerner condition is fulfilled. • The price elasticity of supply of Colombia's exports. • The time period under consideration; J-curve effect. • The reaction of Colombia's competitors in world trade.

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Question	Answer	Marks	Guidance
2(a)	For **knowledge and understanding** • of the meaning of a merit good (Up to 3 marks) • and a public good (Up to 3 marks). **(4 marks maximum)** For **application** showing • understanding of the reasons that profit can be made in the supply of merit goods, • but not in the supply of public goods. **(4 marks maximum)**	**8**	The goods should be distinguished through the qualities of excludability, diminishability and rejectability. The explanation should be based upon the free-rider problem that occurs in the supply of public goods.

Question	Answer	Marks	Guidance
2(b)	For **analysis** that explains: • The way in which an indirect tax is used to reduce the consumption of alcohol with due reference to the strengths and weaknesses of this approach. (Up to 6 marks) • The way in which an awareness campaign is used to reduce the consumption of alcohol with due reference to the strengths and weaknesses of this approach. (Up to 6 marks) **(8 marks maximum)** For **evaluation** that **assesses and compares** • the relative strengths and weaknesses of each approach (Up to 3 marks) • and for reaching a conclusion on which approach is likely to be most effective. (1 mark). **(4 marks maximum)**	**12**	A demerit good should be explained in terms of incomplete information of the harm that it can cause. An indirect tax is designed to reduce supply and increase price. An awareness campaign is designed to decrease demand for the demerit good. Evaluative points include the following: • the fact that the demand for alcohol might be price inelastic • the fact that an awareness campaign might be costly • the fact that an awareness campaign might take a long period to take effect

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Question	Answer	Marks	Guidance
3(a)	For **knowledge and understanding** • of the term equilibrium (Up to 3 marks) • and where it occurs in the context of the market for a normal good.(Up to 3 marks). **(4 marks maximum)** For **application** • showing how price allocates resources when there is an increase in demand. **(4 marks maximum)**	**8**	Equilibrium in a market occurs where there is 'no tendency for price or quantity to change'. In the market for a normal good, it occurs where the demand and supply curves intersect. If there is an increase in demand the demand curve will shift to the right causing an excess demand for the normal good. This will cause market forces to raise equilibrium price and quantity.
3(b)	For **analysis** that explains: • How maximum prices operate when imposed below equilibrium. (Up to 2 marks) • The difficulties that arise when maximum prices operate during a period of high inflation. (Up to 6 marks) **(8 marks maximum)** For **evaluation:** • commenting on whether difficulties can be overcome (Up to 3 marks) • and for reaching a conclusion on the likelihood that this will be successful. (1 mark) **(4 marks maximum)**	**12**	The difficulty in imposing maximum prices below equilibrium is that shortages will occur. These shortages will become more pronounced as inflation occurs unless the maximum prices are continually moved upwards. Other difficulties include the administrative costs and the extent to which the price legislation can be policed. The problems could be overcome, e.g. with rationing, but whether this will be successful depends upon a number of factors.

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Question	Answer	Marks	Guidance
4(a)	For **knowledge and understanding** • of demand-pull inflation (up to 3 marks) • and cost-push inflation (up to 3 marks) **(4 marks maximum)** For **application** • showing how a decline in an economy's exchange rate can cause cost-push inflation (Up to 3 marks) • and demand-pull inflation. (Up to 3 marks). **(4 marks maximum)**	**8**	A fall in the exchange rate will lead to a fall in the price of exports and a rise in the price of imports. This will lead to a rise in net exports and this will increase aggregate demand that could result in inflation. The rise in the price of imports will increase import prices and this might increase input costs leading to cost-push inflation.
4(b)	For **analysis** that explains: • The aims and objectives of supply side policies with appropriate examples. (Up to 6 marks) • How the methods adopted are designed to solve the problem of inflation with due reference to the strengths and weaknesses of these methods. (Up to 6 marks) **(8 marks maximum)** For **evaluation** that **assesses and compares** • the relative strengths and weaknesses of different supply side policies (Up to 3 marks) • and for reaching a conclusion on their likely effectiveness. (1 mark). **(4 marks maximum)**	**12**	Supply side policy is designed to increase the aggregate supply curve of the economy. Methods that might be adopted include • measures to increase the supply of capital goods • measures to increase the labour supply to prevent upward pressure upon costs Evaluative comment might include: • the expense of supply side policy • the fact that it might take a long time to be effective

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1(a)	For a clear diagram(s) showing understanding of the concept of a production possibility curve with correctly labelled axes and appropriate output choices (1 mark) For an appropriate representation of the change in Iceland (1 mark) For an appropriate representation of the change in Ireland (1 mark)	**3**	Figure 1 shows a rise in the GDP of Iceland and a fall in the GDP of Ireland. One way in which this could be shown would be a shift outwards of Iceland's PPC and a shift inwards of Ireland's PPC. Alternatively, this could be represented as a movement from within the curve towards the frontier in Iceland or a movement from the frontier to a point inside the frontier in Ireland. Either representation is acceptable.
1(b)(i)	The price level is higher in 2015 than in 2007 (1 mark)	**1**	
1(b)(ii)	For recognition that a fall in the value of the Krona will lead to a rise in the price of Iceland's import (1 mark) and an explanation of how this could cause cost-push inflation in Iceland. (Up to 3 marks) **4 maximum** For recognition that a fall in the value of the Krona will lead to a fall in the price of Iceland's exports (1 mark) and an explanation of how this could cause demand-pull inflation in Iceland. (Up to 3 marks). **4 maximum** **(6 marks maximum)**	**6**	The collapse of the Krona could cause cost-push and/or demand-pull inflation. As the Krona collapses this makes imports more expensive. This might feed into increased costs for Icelandic companies as they import raw materials and components. In addition, there might be increases in the cost of living as imports might comprise foodstuffs and so on. In addition, the fall in the Krona would reduce the price of Iceland's exports and increase the price of her imports that would lead to a rise in net exports and aggregate expenditure causing inflationary pressures. Give due credit to those answers that make good, appropriate use of the aggregate demand and aggregate supply framework although this is not essential for full marks.

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Question	Answer	Marks	Guidance
1(c)	At least **two** factors must be explained for full marks. • For an explanation of any factor that might determine whether a devaluation would turn a deficit into a surplus (Up to 3 marks) **(4 marks maximum)**	**4**	The fall in the value of the Krona has resulted in a change in the price of Iceland's exports and imports. Exports have fallen in price and imports have increased in price. The impact of this Upon the current account depends Upon factors such as the time period under consideration, the price elasticity of demand for Iceland's imports and exports and the price elasticity of supply of Iceland's exports. Also relevant is whether the currencies of other countries lose value against the Krona. Candidates need to explain at least two factors for full marks. Marks will be awarded for development of each factor. The J-curve, the Marshall-Lerner condition and whether Iceland has the capacity to expand exports will be developed in high scoring answers. Identification of relevant factors with no explanation (1 mark only) Please note that this question concerns the factors that determine the impact of devaluation Upon a country's current account. There are no marks for explaining that export prices fall and import prices rise after devaluation.

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Question	Answer	Marks	Guidance
1(d)	• For an explanation of the costs of managing an exchange rate (Up to 4 marks) • For an explanation of the benefits of managing an exchange rate (Up to 4 marks) **(5 marks maximum for costs and benefits)** • For a reasoned conclusion on whether the costs outweigh the benefits. (1 mark)	**6**	Iceland's exchange rate system is under the control of the Icelandic authorities. It is a managed exchange rate system. This means that Iceland has the option to vary the exchange rate to suit economic circumstances. The devaluation of the Krona has resulted in a current account surplus, falling unemployment and a budget surplus. These are the benefits of a managed exchange rate, but there are also costs. In order to manage the exchange rate, it is necessary to hold large quantities of foreign exchange reserves and these may not be sufficient to manage the exchange rate. In addition, in order to maintain a particular exchange rate it might be necessary to sacrifice other economic objectives. Iceland had to raise interest rates to very high levels and this would have resulted in some costs to consumers and businesses. This question does not require specific reference to Iceland. More general explanations of the costs and benefits of managing an economy's exchange rate are acceptable. Identification of a cost with no explanation (1 mark only) Identification of a benefit with no explanation (1 mark only)

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Question	Answer	Marks	Guidance
2(a)	For **knowledge and understanding** of the role of the factor enterprise: • For bearing the risk of production (Up to 2 marks) • For organising the other factors of production (Up to 2 marks) **(4 marks maximum)** For **application:** • An accurate demand and supply diagram will show an increase in demand, a rise in price and an extension in supply. • The diagram will have an accompanying explanation of how enterprise, motivated by profit, allocates more resources to the production of this good. **(4 marks maximum)**	**8**	The factor enterprise has two roles in a market economy. One is taking the risk of production, the other is organising the other factors in the production process. The reward for contributing to production is profit. If there is a rise in the demand for a good in a market economy, its price will rise. The factor enterprise will respond by expanding production in pursuit of more profit. The quantity of goods in the market will expand along the industry supply curve. An 'accurate' diagram will have axes and curves labelled correctly, the shift in the demand curve will be correct and there will be an extension in the quantity supplied. In awarding marks for application allow Up to 3 marks for the diagram. One mark should be reserved for an explanation of the role of enterprise in allocating resources to the production of the good. Please note that some knowledge and understanding of the role of enterprise might be shown in the candidate's explanation of how enterprise responds to an increase in the demand for a good. They might, for example explain how enterprise manages the other factors as the demand for a good increases.

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Question	Answer	Marks	Guidance
2(b)	For **analysis** • of any method of increasing the provision of merit goods such as direct provision or subsidies **explaining the strengths and weaknesses of each approach selected** (Up to 6 marks for each method) **(8 marks maximum)** For **evaluation** that **assesses and compares** • the relative strengths and weaknesses of each approach (3 marks) • to reach a conclusion concerning which policy is more likely to be effective (1 mark) **(4 marks maximum)**	**12**	A number of methods are used to increase the supply of merit goods in a mixed economy. These include direct provision, producer subsidies and education campaigns to increase the demand for the merit good. Each has advantages and disadvantages based Upon for example, the cost of provision, the time period under consideration and the difficulty in implementation. The mark scheme indicates that candidates need to explain two methods to obtain full marks for the analysis. This should include the strengths and weaknesses of each approach. They then need to provide evaluative comment to reach a conclusion on which method is likely to be most effective.
3(a)	For **knowledge and understanding** of the concept of cross elasticity of demand: • For an accurate formula (Up to 2 marks) • For recognition that substitutes have a positive coefficient (1 mark) and that complements have a negative coefficient (1 mark) **(4 marks maximum)** For **application:** • Using the formula to show why two goods with a positive coefficient are substitutes. (Up to 2 marks) • Using the formula to show why two goods with a negative coefficient are complements (Up to 2 marks) **(4 marks maximum)**	**8**	Candidates need to display a strong grasp of the central concept and be able to apply it to explain how economists distinguish between substitutes and complements. An 'accurate formula' is one that refers to the **% change** in quantity and price of the two goods. Allow credit for those candidates who do not provide the formula, but have a clear expression of what cross elasticity measures. Understanding of the measure is essential.

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Question	Answer	Marks	Guidance
3(b)	For **analysis** • of the usefulness to a business when setting its price of any measure of elasticity with due reference to its strengths and weaknesses (Up to 6 marks per type of elasticity of demand) **(8 marks maximum)** For **evaluation** that **assesses and compares** • the relative strengths and weaknesses of at least two measures of elasticity (3 marks) • to reach a conclusion concerning which measure is most useful (1 mark) **(4 marks maximum)**	**12**	Candidates can refer to price, cross or income elasticity of demand. They must consider at least two measures. Many will explain how price elasticity is useful in predicting how total revenue will change as price changes depending Upon the price elasticity. Others might explain how businesses might find cross elasticity useful as the price of complements and substitutes change. Income elasticity might be useful if incomes are changing and businesses consider whether to change the price of normal or inferior goods. Two measures are necessary for the full marks available for the analysis
4(a)	For **knowledge and understanding** of: • Fiscal Policy (Up to 2 marks) • and Monetary Policy (Up to 2 marks) **(4 marks maximum)** For **application:** • Showing how fiscal policy can be implemented to increase aggregate demand (Up to 2 marks) • Showing how monetary policy can be implemented to increase aggregate demand (Up to 2 marks) **(4 marks maximum)**	**8**	Fiscal policy is sometimes called 'budgetary policy'. It involves varying government spending and taxation to affect economic variables through changes in aggregate demand. Monetary policy refers to any government action to manage aggregate demand through control of the quantity of money, the rate of interest or credit terms. It is usually operated through the central bank. Appropriate use of diagrams should be awarded due credit, but is not essential for full marks for application.

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Question	Answer	Marks	Guidance
4(b)	For **analysis** • of how supply-side policy can be applied to correct inflation in an economy with due consideration of the likely success of this approach. (Up to 6 marks) • of how fiscal policy can be applied to correct inflation in an economy with due consideration of the likely success of this approach. (Up to 6 marks) **(8 marks maximum)** For **evaluation** that **assesses and compares** • the relative strengths and weaknesses of each approach (3 marks) • to reach a conclusion concerning which policy is more likely to be successful (1 mark) **(4 marks maximum)**	**12**	The term 'supply-side policy' refers to any action taken by governments to influence aggregate supply. This could include action such as improving education and training, changing tax rates to affect economic activity and improving infrastructure. A shift in the aggregate supply curve to the right reduces inflationary pressure as aggregate demand can be satisfied with an increase in real output rather than an increase in prices. Contractionary fiscal policy will shift the aggregate demand curve to the left and reduce inflationary pressure. The weaknesses of supply-side policy include the pressure on the government budget and the long-time period before it takes effect. The weakness of fiscal policy is that higher tax rates can provide a disincentive effect and reduced government expenditure may cause social unrest.

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1(a)(i)	The trend in the value of the Kwacha is declining or downward (1 mark)	**1**	
1(a)(ii)	For an explanation of the fall in the demand and the price of copper as a result of China's slowdown (1 mark) For an explanation of how the fall in the price of copper has resulted in a fall in the demand for the Kwacha and a fall in the Kwacha's value as the demand for the currency is less than the sUpply. (Up to 2 marks)	**3**	The slowdown of China's economy has reduced the demand for minerals including copper. The result is a fall in the price of copper shown in Fig.1. Zambia's export earnings have fallen leading to a fall in the demand for the Kwacha and a fall in its value.
1(a)(iii)	Up to 4 marks for an explanation of cost-push inflation in the context of Zambia's economy • For recognition that a fall in the value of the Kwacha will make Zambia's imports more expensive. (1 mark) • For an explanation that this will lead to rising costs for Zambia's producers and consumers (Up to 2 marks) • For clear recognition that this represents cost-push inflation (1 mark) Allow credit for explanations of demand-pull inflation if consistent with the context of the extract.	**4**	The change in the value of the Kwacha is likely to cause cost-push inflation through the rise in import prices. There will be a rise in the price of imported raw materials and components used by Zambian businesses and pressure Upon the components of Zambian household expenditure. Theoretically, the decline in the Kwacha could generate demand-pull inflation, but given the context of the extract, this is unlikely.

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Question	Answer	Marks	Guidance
1(b)	For identification of all the components of aggregate demand: • For C+I+G+X-M (1 mark) • **Or** Consumption + Investment + government spending + net exports (2 marks) **(2 marks maximum)** For explaining: • how consumption might be affected (1 mark) • how investment might be affected (1 mark) • how government spending might be affected (1 mark) • how net exports might be affected (1 mark) **(4 marks maximum)**	**6**	The notation for aggregate demand is worth only one mark. If the components are named then two marks are available. China's declining demand for copper is likely to: • reduce consumption because household incomes fall • reduce investment because business activity declines • increase government spending because welfare payments to the unemployed rise or through counter-cyclical government spending **Or** it may reduce government spending because as tax receipts will fall and the government will tighten its belt. Either is accepted as long as an explanation is included • Net exports will fall in the short-run, but may rise in the long-run as the Kwacha declines. • An explanation of the likely changes is necessary to score a mark here.
1(c)	• For identifying and explaining the relevant economic theory (1 mark) • For a discussion of the costs and benefits of diversification (Up to 3 marks) • For a discussion of the costs and benefits of specialisation (Up to 3 marks) **(5 marks maximum)** For a reasoned conclusion on whether specialisation or diversification is more effective. (1 mark)	**6**	Diversification of the Zambian economy implies that specialisation on copper production should be abandoned and other sectors developed. This runs counter to the principle of comparative advantage which suggests that economies should specialise in producing goods and services that have the lowest opportunity costs. Some candidates might develop arguments that justify diversification, but these should be assessed in terms of underlying economic theory.

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Question	Answer	Marks	Guidance
2(a)	For **knowledge and understanding** of the concept of income elasticity of demand • For statement of what the concept measures (1 mark) • For an accurate formula (Up to 2 marks) • For elaboration e.g. in terms of elastic/inelastic (1 mark) **(4 marks maximum)** For **application**: • showing how inferior goods react when incomes rise. (2 marks) • showing how necessary goods react when incomes rise (2 marks) **(4 marks maximum)**	**8**	Candidates need to display a firm understanding of the concept of income elasticity of demand and how it is used by economists to distinguish between inferior and necessary goods as incomes rise.
2(b)	For **analysis** • of any policy available to business to increase sales when incomes are falling with due reference to the strengths and weaknesses of the policy. (Up to 6 marks for each policy) **(8 marks maximum)** For **evaluation** that **assesses and compares** • the relative strengths and weaknesses of each policy (Up to 3 marks) • to reach a conclusion concerning which policy is most likely to be successful. (1 mark) **(4 marks maximum)**	**12**	Policies that are available include reducing the price of the good, advertising to increase demand and switching production to inferior goods. Reward attempted evaluation. For example, it might be difficult to maintain sales through price cuts if demand is inelastic. Advertising might be expensive. Switching production to inferior goods might be difficult if the business has invested in capital. Allow a mark for the conclusion offered if it is based Upon the evaluative comment.

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Question	Answer	Marks	Guidance
3(a)	For **knowledge and understanding** of: • profit as the reward to the factor enterprise for organising the factors of production and taking the risk of production **(4 marks maximum)** For **application:** • That shows how, motivated by profit, entrepreneurs allocate resources in response to price signals in a market economy. **(4 marks maximum)**	**8**	In this question we are looking for knowledge and understanding of the role of profit as reward to enterprise for the undertaking of the risk and organisation of production and the way in which enterprise responds to price changes in order to receive the reward of profit. Diagrams may be used, but are not essential for full marks.
3(b)	For **analysis** containing: • an explanation of the way in which resources are allocated in a planned economy with due reference to the strengths and weaknesses of allocation in this type of economy (Up to 6 marks) • an explanation of the way in which resources are allocated in a market economy with due reference to the strengths and weaknesses of allocation in this type of economy (Up to 6 marks) **(8 marks maximum)** For **evaluation** that **assesses and compares** • the relative strengths and weaknesses of the allocation of resources in each economy (Up to 3 marks) • and reaches a conclusion on which type of economy allocates resources most effectively (1 mark). **(4 marks maximum)**	**12**	Candidates need to be aware of the way in which resources are allocated in each type of economy and the strengths and weaknesses of each. These include the lack of production of public goods in a market economy. Also, the underproduction of merit goods and the overproduction of de-merit goods. The weakness of a planned economy includes the lack of price signals with the result that there are often shortages and surpluses in the market.

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4(a)	For **knowledge and understanding** of the four functions of money: • Medium of exchange (1 mark) • Store of value (1 mark) • Unit of account (1 mark) • Standard of deferred payment (1 mark) **(4 marks maximum)** For **application** • showing how each function will be affected by a high rate of inflation **(4 marks maximum)**	**8**	If the functions are presented as a list with no explanation 1 maximum for the knowledge and understanding element. Only a brief explanation of how each function of money is affected is required.
4(b)	For **analysis** containing: • an explanation of the way in which monetary policy can be used to solve the problem of inflation with due reference to the effectiveness of such a policy (Up to 4 marks) • an explanation of the way in which monetary policy can be used to solve the problem of deflation with due reference to the effectiveness of such a policy (Up to 4 marks) **(8 marks maximum)** For evaluation that **assesses and compares** • the likely effectiveness of monetary policy in solving inflation with its likely effectiveness in solving deflation (3 marks) • and reaches a conclusion on whether it is likely to be effective in solving only one or both problems (1 mark) **(4 marks maximum)**	**12**	Monetary policy is any action taken by the monetary authorities to change the quantity of money, the rate of interest or credit terms. It is usually operated by the central bank of an economy. When faced with inflation it is likely that the central bank will limit the money supply, raise the rate of interest and tighten credit controls. When faced with deflation these measures would be reversed. Whether the policy is likely to be effective depends Upon the extent to which spending is sensitive to changes in the money supply, the rate of interest and credit terms. If only inflation or deflation considered then 4 maximum.

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