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**UNIVERSITY OF CAMBRIDGE INTERNATIONAL EXAMINATIONS**

**GCE Advanced Subsidiary Level and GCE Advanced Level**

# MARK SCHEME for the October/November 2009 question paper for the guidance of teachers

## 9708 ECONOMICS

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

This mark scheme is published as an aid to teachers and candidates, to indicate the requirements of the examination. It shows the basis on which Examiners were instructed to award marks. It does not indicate the details of the discussions that took place at an Examiners' meeting before marking began, which would have considered the acceptability of alternative answers.

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**1 (a) (i) State the formula used to calculate income elasticity of demand. [2]**

Proportionate (%) change in quantity demanded/proportionate (%) change in income, exact (2), no proportionate element or price rather than income or inverted (1)

**(ii) What can be concluded about air travel from Fig. 1? [2]**

It is a normal good (1) it is income elastic or a change in income causes a more than proportionate increase in demand (1)

**(b) Using Fig. 2, explain a likely reason for the different price elasticity values for**

**(i) business flights compared with leisure flights [3]**

Business flights are more inelastic than leisure flights (1), no choice/substitutes exist in time or destinations (2), price rises are borne by the traveller's firm rather than the traveller. (2)

**(ii) long-distance flights compared with short-distance flights. [3]**

Long-distance flights are less elastic than same purpose short-distance (1), fewer substitutes exist for long-distance than short-distance flights (2), long-distance involves longer time periods and higher costs making price rises less significant in total cost (2)

**(c) Explain the significance of the price elasticity values in Fig. 2 for an airline considering a policy of fare cutting. [4]**

Cutting fares will raise revenue when demand is elastic but not when it is inelastic or unit elastic (1). Comment on motive e.g. revenue or profit or sales maximisation (1)
It will raise revenue with short-distance leisure flights (1) but not with long distance leisure flights (unchanged) (1) nor the 2 types of business flights (1).

**(d) Discuss the costs and benefits of an increased demand for air travel. [6]**

Benefits will affect business (expansion, profit, new markets), individuals (mobility, leisure, employment), economies (growth, balance of payments)
Costs include externalities (pollution, noise, visual intrusion), resource depletion, effects on rivals and balance of payments effects. Meaningful conclusion on overall effect.
One side max. (4), identification max. (2), explanation (4)

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**2 (a) Explain, with the help of a diagram, how the price of a product moves to a new equilibrium following a decrease in its supply. [8]**

*A decrease in supply results from rising costs, unfavourable natural influences, higher taxes etc. and causes supply to shift to the left. This will result in a rise in the price of the product. Equilibrium, the tendency not to change when D=S, is restored as the higher price discourages the quantity demanded as consumers adjust their spending levels. Price will continue to rise until the balance is restored.*

| | |
|---|---|
| Knowledge of equilibrium and of decrease in supply | up to 2 marks |
| Diagram showing original and new equilibrium | up to 3 marks |
| Explanation of the process of change | up to 3 marks |

**(b) Discuss whether government intervention always improves the operation of the market. [12]**

*Government may intervene to correct market failures or for non-economic reasons. It may use regulation, price control and taxes and subsidies. It may succeed with the provision of public and merit goods or the discouragement of external costs and demerit goods or subsidies to increase provision and so increase welfare. It may fail because of poor information, costs of administration and misjudgement of policy impacts. There may be interference with the efficiency of the market. Non-economic motivation may cause undesirable side effects.*

| | |
|---|---|
| For understanding of government intervention and market | up to 4 marks |
| For analysis of the success of intervention | up to 4 marks |
| For discussion of the limitations of intervention | up to 4 marks |

**3 (a) Explain why it is usually more difficult to trade internationally than domestically. [8]**

*International trade is usually over greater distance which raises transport costs. The use of different currencies involves transaction costs and risks in exchange. Obstacles to trade such as tariffs, quotas, subsidies and the existence of trade areas reduce free and fair competition. The larger size of the market attracts a wide range of competitors which may undercut domestic producers. Different cultures, languages and tastes may make judgment of the market more difficult.*

| | |
|---|---|
| For knowledge of the differences between international and domestic trade | up to 2 marks |
| For understanding of the differences | up to 3 marks |
| For explanation of the significance of the differences | up to 3 marks |

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**(b) Discuss, with examples, how far the global distribution of factors of production determines what a country imports and exports. [12]**

*Factors of production are land, labour, capital and enterprise and they occur irregularly around the world. Examples are oil and mineral reserves, technology, skilled labour. Factor endowment is the basis of international trade theory, which suggests specialisation in line with lower opportunity cost so reflecting factor distribution. In some cases it may be absolute rather than comparative advantage at work. Other influences such as trade agreements, unequal bargaining power, political issues and the unrealistic assumptions of C A theory may mean that trade does not reflect factor distribution.*

| | |
|---|---|
| For understanding of the diverse distribution of factors | up to 4 marks |
| For application of comparative advantage | up to 4 marks |
| For discussion of comparative advantage and alternative explanations | up to 4 marks |

**4 (a) Explain how a rapid rate of inflation in a country will affect its floating exchange rate. [8]**

*A rapid rate suggests an undesirable rate. A floating exchange rate is fixed by market forces. Assuming other countries have lower rates of inflation the country will lose competitiveness as exports become relatively expensive and imports become relatively cheap. Lack of confidence will deter investment flows. Demand for the currency will fall while supply will rise causing a depreciation.*

| | |
|---|---|
| Knowledge of rapid inflation rate and floating system | up to 2 marks |
| Link of inflation to direction of flows | up to 3 marks |
| Explanation of depreciation | up to 3 marks |

**(b) Discuss whether a government should operate a fixed exchange rate system. [12]**

*A fixed exchange rate is set by the government's use of currency reserves, buying on the prospect of depreciation and selling with a prospective appreciation. There are variations in which systems have an element of fixing e.g. the adjustable peg. A fixed rate, such as the gold standard, brings stability and certainty which should encourage trade. It brings discipline to the government's internal economic policy (particularly inflationary pressure) and forces firms to control costs to remain competitive. It should discourage destabilising speculation.*
*Against this is the need to keep large currency reserves, the need to introduce deflationary policies which may harm other economic aims, the tendency to maintain an overvalued rate and the limits on using monetary policy. Fixed rates have become less common because of the lack of an automatic adjustment and the move to a more robust market system.*

| | |
|---|---|
| For understanding of the operation of a fixed system | up to 4 marks |
| For analysis of the benefits of fixed rates | up to 4 marks |
| For discussion of the drawbacks of fixed rates | up to 4 marks |

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# MARK SCHEME for the October/November 2009 question paper for the guidance of teachers

## 9708 ECONOMICS

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

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**1 (a) (i) What is meant by nominal prices and real prices? [2]**

Nominal relates to the selling/market price (1), real relates to quantities or inflation adjusted value (1)

**(ii) Compare what happened to nominal food prices and real food prices before and after the year 2000. [3]**

Before: real price index declined, nominal more stable (1), indices moved closer together (1)
After: real and nominal prices moved more closely together (1), real and nominal prices rose (1), indices moved in similar manner (1), three points covering before and after

**(b) (i) How might the differences in food weights, shown in Table 1, be explained? [3]**

Low income countries have higher weights (1), food necessity taking much of income (1), higher incomes afford non-food, more luxury expenditure (1), food prices may vary between countries (1) Any 3 points

**(ii) Contrast the effect on the rate of inflation in Kenya and in the UK if there were a 20% rise in food prices in each country. [2]**

Greater effect in Kenya (1), Kenya 5 times as large (2), Kenya 10%, UK 2% rise (2)

**(c) Explain one possible reason for the responsiveness of world food supply to changes in price reported by the IFPRI. [4]**

PES meaning or formula (1), inelastic supply or 0.1 to 0.2 (1), one from growing period, storage problems, limited resources identification (1), explanation (2)

**(d) Discuss the benefits and drawbacks of rising world food prices. [6]**

Rising food prices will help producers, farmers and rural areas, will stimulate food production and help those countries which export food. They will hurt low income earners, food importers and food processors and contribute to inflationary pressure. The poorest subsistence farmers who buy additional food will be hurt. The effects differ according to the production pattern and level of income of countries and individuals. One side 4 marks max. Meaningful conclusion (1)

**2 (a) With the aid of a diagram, explain how a government subsidy to fuel producers will affect the producers and government expenditure. [8]**

*A subsidy will lower costs and shift the supply curve to the right and the outcome will be more traded at a lower market price. Producer revenue made up of price and subsidy will increase. Government expenditure will increase by the amount of the subsidy times the new quantity traded.*

| | |
|---|---|
| Diagram of impact on market | 4 marks |
| Explanation of effect on producer | 2 marks |
| Explanation of effect on government expenditure | 2 marks |

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**(b) Discuss how reduced air fares on low-cost, budget airlines might affect the air travel market and the markets for related goods and services. [12]**

*Within the air travel market a sub-market may emerge with increased supply of services, lower prices and a restricted service. Former rivals may be able to maintain their position with different customers or may respond by cutting their own price. The size of the market should expand with more people able to afford flying. Rivals such as ferry services or railways may face falling demand, depending upon the elasticity involved. Providers of complementary services e.g. airport parking, travel insurance may face increased demand with upward pressure on their prices. Aircraft manufacturers or leasers may benefit as theirs is a derived demand arising from more flying.*

| | |
|---|---|
| Understanding of the impact on market for air travel | 4 marks |
| Discussion of rival transport market effects | 4 marks |
| Discussion of complementary market effects | 4 marks |

**3 (a) Explain why a lighthouse is often given as an example of a public good while a light bulb is not. [8]**

*Public goods have the characteristics of non-rivalry and non-excludability. The use by one ship of the lighthouse signal does not reduce the consumption of other ships. Once a lighthouse is indicating hazard to one ship it cannot stop other ships from being warned and it is not possible to exclude other ships from gaining the benefit. This means that charging for the service is not possible as free riders would be able to benefit. A light bulb is a private good as it can be charged for when sold (excludable) and its use within one person's home prevents others from benefiting (rival). The concept of non-rejectability may also be applied.*

| | |
|---|---|
| Understanding of non-rival and non-excludable | 4 marks |
| Explanation of lighthouse as public good | 2 marks |
| Explanation of light bulb as private/non public good | 2 marks |

**(b) Discuss whether it is likely that the private costs and the social costs of production would be identical. [12]**

*Private costs are borne by the producer who benefits from the action. They may include raw material costs, wages and energy payments. Social costs are the total costs to those directly involved in the activity and to the rest of society (third parties) as well. Social costs include external costs or spillover effects borne by members of society who do not benefit from the action. Various forms of pollution come within this category. Private costs and social costs will only be identical if there are no external costs. Some actions from transport (e.g. road) and production of manufactures (e.g. chemicals) and provision of services (tourism) may have negative externalities. Private cost may be greater than social when there is an external benefit in production such as research and development effects. However while some output may generate few externalities it is unlikely that they produce none and it would not be the case for total production within an economy.*

| | |
|---|---|
| Understanding of the link between private, external and social costs | 4 marks |
| Discussion of the existence of externalities | 6 marks |
| Comment on the existence of zero externalities | 2 marks |

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**4 (a) Compare the aims and features of a free trade area with those of an economic union. [8]**

*A free trade area aims to achieve free trade between it members by the abolition of internal barriers but the retention of individually set barriers to non-members. There is no integration beyond this. An economic union aims at major integration, includes a common external tariff, free movement of factors of production, harmonisation of economic policies and taxes and a common currency. This involves the loss of national sovereignty. The latter is a more comprehensive and ambitious project.*

| | |
|---|---|
| Explanation of a free trade area | 4 marks |
| Explanation of economic union | 4 marks |

**(b) Discuss whether an improvement in a country's terms of trade always works to its benefit. [12]**

*The terms of trade measure the average price of a country's exports against the average price of its imports. This is presented as an index number. A rise in export prices relative to import prices is said to be favourable and may arise from a number of different changes in the two components. This gives the ability to purchase more imports with a given quantity of exports. This may help to raise living standards. The changes in prices may not be favourable from a trade balance perspective. Higher export prices and lower import prices will help more if the goods involved have inelastic demand as net revenue should increase. Elastic demand will worsen the position.*

| | |
|---|---|
| Understanding of measurement of changes in terms of trade | 4 marks |
| Discussion of favourable outcomes | 4 marks |
| Discussion of unfavourable outcomes | 4 marks |

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