CAMBRIDGE INTERNATIONAL EXAMINATIONS

GCE Advanced Subsidiary Level and GCE Advanced Level

MARK SCHEME for the October/November 2013 series

9708 ECONOMICS

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

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1 (a) With reference to the data identify <u>two</u> features of a command economy in Vietnam. [2]

Price controls/increasing minimum price of exported rice (1) minimum wage (1), state ownership of industries (1).

(b) Explain how the actions of the Vietnamese Government in 2009 might have caused any <u>two</u> different types of inflation to occur in the Vietnamese economy. [4]

- Cost push inflation might have resulted from the **devaluation** if this pushed up the price of imported items and from **higher minimum wages** that increased firms' production costs. **Up to 3 marks**

- Demand pull inflation might have resulted from the greater spending power associated with the **higher minimum wages and state pensions** and from increased borrowing that that fed into greater consumption. The **banking policy** may cause greater lending so increasing money supply and monetary inflation contributing to increased demand in the economy. **Up to 3 marks**

The two types of inflation needed for full marks
No marks for just naming the 2 types of inflation

(c) Suggest <u>two</u> reasons why an inflation rate of 8.9% might <u>not</u> be a cause of concern to a government. [2]

Some reasons why it might **not** be a cause of concern to any government are:
- if it was below its target/is very close to its target (8.9% is close to then 8% target)
- if it was on a downward trend
- if it was lower than rival exporters' inflation
- if reduced inflationary pressures were expected
- if inflation at this rate exists only for a short time period

1 mark per identified point

(d) (i) Compare the contribution to the change in the CPI of the changes in the price of housing with that of education. [2]

Housing rose by 12.8% and had a double digit weighting that would cause significant upward pressure (1).
The price of education rose by more but its lower weighting meant it had less effect (1).

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(ii) Analyse <u>two</u> possible reasons for the Government's selection of the items included for price control. [4]

Possible reasons might include:

- Agricultural supplies such as fertilisers might be selected in order to increase output, lower input costs and keep down food prices. **Up to 3 marks**
- Basic materials for production such as cement and steel may be selected because they are significant inputs for industry and so help competitiveness. **Up to 3 marks**
- Consumer goods such as salt and rice might be selected because they are basic foods that make up a significant part of the spending of poorer families and might be justified in terms of equity. **Up to 3 marks**
- Selection of certain items with the macroeconomics objective of bringing down/ keeping down the rate of inflation
- Accept any well-argued reasons not included above. **Up to 3 marks**

Two reasons needed for full marks.

(e) Discuss the desirability of a policy of widespread price controls. [6]

Arguments for: Price controls may help check the rate of inflation and help in a redistributive way. They may form part of a planning approach to economic management. This approach may work in the short run. **Up to 4 marks**

Arguments against: The problem is that price controls may not tackle the underlying cause of the inflation and pressure may continue to build. It will undermine the operation of the market mechanism and may reduce the efficiency in the economy. Analysis of the imposition of maximum prices in a particular market indicates the need for further government intervention e.g. rationing and the emergence of illegal markets. **Up to 4 marks**

2 (a) Explain, using a diagram, how the social cost of consuming some goods can exceed the private cost of consuming them. [8]

Candidates are often confused on the terms used here. Good answers will be clear and supported with an accurate diagram that is explained.

- For knowledge and understanding that social cost is equal to the sum of private costs negative externalities with terms explained. **Up to 4 marks**
- For application with a diagram showing the divergence between private costs and social costs. **Up to 4 marks**

For correct drawing and labelling of PMC (1 mark); for correct drawing and labelling of SMC (1 mark); for correct drawing and labelling of SMB/correct labelling of both axes (1 mark); for clearly showing the divergence (1 mark).
No diagram = 4 marks out of 8 maximum.

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(b) Discuss, using examples, whether cost-benefit analysis is an effective way of decision making when allocating an economy's resources. [12]

Candidates should be aware of the technique of cost-benefit analysis and should be able to explain the process and provide appropriate examples. They should also be aware of the difficulties that must be overcome if the approach is to result in an efficient allocation of resources.

- For an analysis of the way in which cost-benefit analysis is used with suitable examples. **Up to 8 marks**

  Maximum 6 marks if no examples.

- For an evaluative consideration of whether cost-benefit analysis is an effective way of decision making when allocating an economy's resources. **Up to 4 marks**
  If no conclusion then cap at 3 marks maximum.

3 A firm that produces yoghurt is given the following information about the price elasticity of demand of various flavours: strawberry (–0.8), vanilla (–1.0), pineapple (–2.5).

(a) Explain the pricing policy that the firm should adopt for each of the flavours if it wants to increase total revenue. [8]

The candidate should have a good grasp of the concept of price elasticity of demand and should be able to apply this to the question and explain that the firm should raise the price of strawberry yoghurt, reduce the price of pineapple yoghurt and leave the price of vanilla yoghurt unchanged if it wishes to increase total revenue.

- For knowledge and understanding of the concept of price elasticity of demand.
  Up to 2 marks

- For application of the appropriate policy to increase revenue in each case.
  Up to 6 marks

(b) Explain the factors that would lead to an increase in the demand for all types of yoghurt and discuss the extent to which the firm can influence these factors. [12]

Candidates should be able to identify the factors of demand and apply these to the case of an increase in the demand for yoghurt. In terms of whether these can be influenced by the firm, candidates should be able to recognise that advertising by the firm will affect tastes. Credit other suggestions, such as any complementary goods that might be supplied by the firm that could be reduced in price to increase the demand for yoghurt.

- For analysis of the factors of demand that will increase the demand for yoghurt.
  Up to 8 marks

- For evaluative comment on the ability of firms to influence demand. **Up to 4 marks**

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4 (a) Use a diagram to explain how a fall in the rate of interest in a country can cause its foreign exchange rate to change. [8]

A fall in the rate of interest will cause an outflow of capital and cause an excess supply of foreign currency in the market. This will cause a fall or depreciation in the exchange rate.

- For knowledge and understanding of the process leading to an outflow of capital as a result of a fall in the rate of interest – leading to a shift in the supply curve to the right or the fall in the rate of interest reduces the rate of demand causing the demand curve to shift to the left or both. **Up to 4 marks**

- For application with a clear and accurate diagram, showing a shift of the supply curve of foreign currency to the right, or the fall in the rate of interest reduces the rate of demand causing the demand curve to shift to the left or both in which this process is explained. For the price label must indicate the price of one currency in terms of another (1 mark); for the initial equilibrium showing price (1 mark); for the shift of supply curve to the right, or the demand curve to the left or both (1 mark); for the new equilibrium price (1 mark). **Up to 4 marks**

(b) Discuss whether a rise in its exchange rate or a fall in its exchange rate is more beneficial for an economy. [12]

Candidates should be familiar with the effects of **both** depreciation and appreciation of a currency on an economy. Both have advantages and disadvantages and it is important that candidates have a grasp of **both** if they are to gain a high mark.

- For an analysis of **both** the advantages and disadvantages of a currency appreciation and a currency depreciation. **Up to 8 marks**
  A maximum of 6 marks if only appreciation or depreciation is analysed.

- For evaluative comment on which is more beneficial. **Up to 4 marks**

- If no conclusion then cap at 3 marks maximum.

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Section A

1 (a) (i) What is meant by hyperinflation? [2]

Hyperinflation is a rise in the prices (fall in the value of money) at an extremely rapid (runaway) uncontrolled rate.

For a general definition of inflation **(1)** and for an awareness of the extreme nature of the rate of the increase in the case of hyperinflation. **(1)**

(ii) Describe what happened each day to the real value of money in Zimbabwe in November 2008. [2]

It declined **(1)** by almost 50% or other quantitative statement **(1)**

(b) Explain how a government may cause hyperinflation. [4]

Governments are responsible for the quantity of money in an economy and are usually held responsible for causing inflation when the money supply is allowed to grow excessively.
The theory underpinning this approach is the quantity theory of money.

The quantity theory can be used to explain that an increase in the money supply will cause inflation. If the money supply increases excessively this could become hyperinflation.

For an explanation of the government's role in increasing the money supply excessively **(1)** and with application based on the assumptions of the model, showing that P should increase proportionately when the money supply increases. **(1)**
For the formula: MV = PT **(1)** with the components accurately explained **(1)**

Other possible causes should also be rewarded e.g. excessive increases in non-funded government expenditure/excessive cuts in taxes **(1)** if developed **(1)**; if government brings in very low interest rates **(1)** if developed **(1)**.

Maximum of 3 marks if no discussion of government impact on money supply.
Maximum of 3 marks if no discussion of hyperinflation.

(c) (i) Account for the shopkeepers' treatment of cheque (check) payments. [2]

A cheque cannot become purchasing power immediately **(1)**, to counter the loss of real value due to hyperinflation the shop keeper demands a premium at twice the original cost **(1)**; for an understanding of the shopkeepers' reaction. **(up to 2 marks)**

(ii) Explain how workers and foreign investors might react to hyperinflation. [4]

For an explanation of how workers might react, e.g. why they may ask to be paid more frequently or in kind **(up to 3 marks)**.

For an explanation of how foreign investors might react e.g. why they might defer investment decisions; if investment falls **(1)** explanation of why **(1) (up to 3 marks)**.
The context has to be explicitly hyperinflation for 3 marks.

Must refer to both workers and foreign investors for the full 4 marks.

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(d) Discuss whether the change in Zimbabwe's current account is what would be expected when a country has the highest inflation rate in the world. [6]

For a clear understanding of the changes in Zimbabwe's current account and the reasons for this e.g. increased deficit **(1)**; rise in relative price of exports **(1)**; fall in value of exports **(1)**; fall in relative price of imports **(1)**; rise in value of imports **(1)**; leading to an **increased deficit (up to 3 marks)**.

For an explanation of the way in which the current account would be expected to change given the fact that Zimbabwe has the highest inflation rate in the world e.g. the price elasticity of exports and imports; compensatory falls in the exchange rate; any offsetting government action **(up to 3 marks)**.

A concluding statement. **(1 mark)**.

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Section B

2 In September 2011 the Kenyan government reintroduced price controls to ensure that basic commodities were sold to the citizens at reasonable prices.

(a) With the help of a diagram(s), contrast the impact of a maximum price fixed below equilibrium market price with one that is fixed above it. [8]

This is frequently tested and candidates become confused between the effects of a maximum price above equilibrium and one below.

- For an accurate diagram and explanation of the outcome when price is placed below equilibrium **(up to 4 marks)**.
- For an accurate diagram and explanation of the outcome when price is placed above equilibrium **(up to 4 marks)**.

(b) In view of the problems of allocation that might arise with effective maximum price legislation discuss how these problems might be overcome. [12]

The maximum price might cause an excess demand for the good. This raises the problem with allocation. An alternative means of allocation has to be found. In addition, problems arise in maintaining the maximum price leading to black markets etc.

- For a full analysis of the problems and policies with maximum price legislation **(up to 8 marks)**.
- For an evaluative comment on how these problems can be overcome **(up to 4 marks)**.

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3 (a) Use diagrams to explain the difference between merit goods and demerit goods. [8]

This area often causes confusion amongst students so we are looking for evidence of good understanding of the core concepts.

For knowledge and understanding of merit goods and demerit goods (3/1, 2/2, 1/3 possible splits) i.e. negative externalities (third party effects) associated with demerit goods; positive externalities associated with merit goods; better for consumer then consumer realises so good under consumed and a merit good; worse for consumer than consumer realises so good over consumed and a demerit good. **(up to 4 marks)**.

For application – diagrams showing SMC greater than PMC demerit goods; SMB greater than PMB merit goods (allowance for Q and P/Supply and Demand application see below). **(up to 4 marks)**.

With merit goods P is lower than it should be as does not reflect the true value of the good (i.e. a positive externality) and Q is under consumed in the market.

With demerit goods P is lower than it should be as the true cost is not reflected in the market (i.e. a negative externality) and Q is over consumed.

This could be shown on a demand and supply diagram but the application is unlikely to be sufficient to gain full marks unless there is a full discussion of information failure.

Note: No diagram = 4 marks out of 8 maximum

(b) Discuss whether it would be better if smoking were banned completely or whether it should be subject to an indirect tax. [12]

The approach should be to use the conceptual framework that shows the impact on price and quantity that will occur with each policy. Evaluative comment might include consideration of the correct price i.e. one that recognises all the costs. In addition the question of whether the policies would be evaded might be considered.

- For analysis of the impact of a ban on smoking (up to 6 marks) and the impact of an indirect tax (up to 6 marks) **(up to 8 marks)**.

- For evaluative judgement on the two policies in terms of their impact on consumer welfare and/or the likely effectiveness of each **(up to 4 marks)**.

If no conclusion then cap at 3 marks out of 4 maximum.

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4 (a) Explain, with the help of a diagram, how a policy of expenditure dampening in an economy would affect aggregate demand, prices and output in that economy. [8]

- For knowledge and understanding of expenditure dampening (if only fiscal **or** monetary explanation then 3 marks maximum) **(up to 4 marks)**.

- For application – an accurate diagram showing how aggregate demand is affected by expenditure dampening and the impact on prices and output **(up to 4 marks)**.

A maximum of 2 marks if clearly only a micro diagram. However if there are elements of a macro diagram then if the written explanation is correctly macro based, mark out of 4 marks.

Note: No diagram = 4 marks out of 8 maximum.

(b) Discuss whether a policy of expenditure switching is more appropriate than a policy of expenditure dampening in an economy with a large balance of payments current account deficit and a high rate of inflation. [12]

Candidates should have a firm grasp of both expenditure switching and expenditure dampening and how they are expected to work to cure a deficit. In terms of appropriateness of each policy, we expect students to apply theory to make a judgment.

- For analysis of the impact of expenditure switching (6 marks maximum) and expenditure dampening (6 marks maximum) in the specific economic circumstances of a balance of payments deficit and high inflation **(up to 8 marks)**.

- For evaluative judgement on which policy is more appropriate **(up to 4 marks)**.

If no conclusion then cap at 3 marks maximum.

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1 (a) (i) Give <u>two</u> examples of non-tariff barriers to trade. [2]

Quotas, embargoes, exchange controls, subsidies, quality standards, licensing, administrative procedures, VERs etc. **Any 2 examples.**

(ii) State <u>two</u> changes that would have been necessary within the EAC when it moved from being a common market to being a monetary union. [2]

Changes needed to create a monetary union from a common market include:
- a common currency
- a centrally determined common interest rate
- a central bank for the union
- a single exchange rate. **Any 2 examples.**

(b) Explain <u>two</u> possible reasons for the imposition of different CET rates by the EAC. [4]

Possible reasons include:
- Zero CET rates are imposed on products essential to production such as raw materials and capital goods. These are needed to help economic growth. (Up to 3 marks)

- Zero CET rates are imposed on 'meritorious' goods such as medicines that suggest goods that bring generally accepted 'merit', and have humanitarian benefits. (Up to 3 marks)

- 25% rates are imposed on consumer goods to encourage their production in the EAC. (Up to 3 marks)

- High CET rates, (e.g. 100% on cane sugar), might be imposed on 'sensitive' goods to protect local producers, workers and infant industries. (Up to 3 marks)

(c) With reference to Tables 1 and 2, analyse the impact of the creation of the EAC Customs Union on the trade position of Tanzania. [6]

- **For an analysis of the position with its partners:** this shows deterioration into deficit during the first 2 years. This then improves and produces the largest trade surplus during the period. (1) The improvement has been greater in trade with Kenya than with Uganda (1). A beneficial effect (1) (Up to 4 marks)

  If only look at imports and exports then a maximum of 1 mark. If no references to trade balance 1 mark maximum. If discuss total size of trade (imports and exports added together) then up to 4 marks.

- **For an analysis of the position with the rest of the world:** this has not been improved by the creation of the customs union as the trade deficit continues to grow throughout the period. It might be argued that the increase in deficit was slowing at the end of the period (1). Overall the trade position has worsened (1). Not a beneficial effect (1). (Up to 4 marks)

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(d) Discuss the case for expanding the EAC after 2012 to include other neighbouring countries. [6]

The case for includes:
The inclusion of more members might extend the benefits of free trade, specialisation and comparative advantage. Economies of scale might be gained and trade creation might take place. Choice may be extended and costs may fall. Greater economic influence might result. This may depend upon the economic structure and performance of the new members.
(Up to 4 marks)

The case against includes:
Integration may be a difficult process which generates costs as well as benefits. Trade diversion may result. Some members might be casualties of the changes with reduced production and employment as the economic structure within the EAC changes. A larger more diverse community may be more difficult to regulate and individual states' self-interest might predominate. (Up to 4 marks)

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Section B

2 (a) Explain the role of the enterprise factor of production in a free market economy, and compare this with the role of the other factors in the production process. [8]

The enterprise factor takes the risk of production and in addition organises the other factors.

- For knowledge and understanding of the role of the factor enterprise including both aspects of the function. (Up to 4 marks)

- For application: showing the role of the other factors and how they compare with that of enterprise. For each factor of production (3 × 1 mark) and for a comparative comment (1 mark). (Up to 4 marks)

(b) Explain the key differences between centrally planned and mixed economies, and discuss whether enterprise is a factor of production that is needed in a centrally planned economy. [12]

In a centrally planned economy resources are allocated by the government, often through national, regional and local agencies. In a mixed economy resources are allocated through some degree of government planning, but also through the market. In a mixed economy the factor enterprise takes risk and organises the other factors where the market operates. The reward to enterprise for undertaking these functions is profit. In a centrally planned economy the nature of 'risk' is different and borne by the state. The organisation function of enterprise is still required and undertaken by salaried managers.

- For an analysis of the key differences between centrally planned and mixed economies. (Up to 8 marks)

- For evaluative comment on the need for the factor enterprise in a centrally planned economy. (Up to 4 marks)

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3 (a) Explain the relationship between the quantity of money in an economy and the value of money in that economy. [8]

The quantity theory of money suggests that an increase in the quantity of money in an economy will cause the general price level to rise and the value of money to fall. Candidates should be aware of this relationship and be able to explain the links. We should allow full marks for those who question the relationship as long as it is based upon accurate application of theory.

- For knowledge and understanding of the 'quantity of money' in terms of liquidity in an economy and the 'value of money.' (Up to 4 marks)

- For application: showing the indirect relationship through the quantity theory of money. (Up to 4 marks)

(b) Explain the effects on the functions of money of a significant rise in the general price level and discuss which you consider to be the most damaging for a modern economy. [12]

The functions of money should be familiar to students who should also be able to explain the way in which inflation affects each of them. Most candidates will suggest that the medium of exchange function is most serious, but allow any function if the justification is well argued.

- For an analysis of the impact of a significant rise in the general price level and its effects on the functions of money. Brief explanations only are required of the medium of exchange, store of value, unit of account and standard for deferred payment functions. (Up to 8 marks)
  All 4 functions are needed for 8 marks. Up to 3 marks for any function well analysed.

- For evaluative comment on the most damaging element. Candidates might choose any of the functions as being most seriously affected by inflation. It is important that candidates justify their choice. For example, some might argue that the impact upon money's function as a medium of exchange could be justified because it will undermine trading activity. Others that the impact upon the function of store of value is most damaging because it prevents savings and capital accumulation. (Up to 4 marks)

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4 In October 2011, the Chinese government said that they would not allow a further rise in the international value of China's currency, the yuan, because the Chinese economy would be damaged.

(a) Explain how exchange rates are determined in a free market and how some governments intervene to manage their exchange rate. [8]

- For knowledge and understanding of how exchange rates are determined in a free market. (Up to 4 marks)

- For application: showing how governments intervene to manage the exchange rate. (Up to 4 marks)

(b) Explain the costs and benefits of a rising exchange rate and discuss whether on balance an economy 'would be damaged' by a rising exchange rate. [12]

A rising exchange rate will mean that the price of exports will increase and the price of imports will fall. Candidates should explain this together with the impact of this on an economy. Whether an economy is overburdened by a rising exchange rate depends upon a range of factors including whether the economy has a surplus balance of payments, a high inflation rate and so on. Candidates should be able to consider a number of factors to reach a decision on whether, on balance, the economy would be 'damaged'.

- For analysis of the costs and benefits of a rising exchange rate on the price of exports and the price of imports. (Up to 8 marks)
  Up to 6 marks for only the costs or benefits.

- For evaluative comment on whether an economy would on balance be 'damaged'. (Up to 4 marks)

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