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Cambridge International Advanced Subsidiary and Advanced Level

MARK SCHEME for the October/November 2014 series

9708 ECONOMICS

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

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Data Response Questions

1 (a) Describe the overall trend in coffee prices between 2007 and 2012 and identify one year in which supply was likely to have exceeded demand in the market for coffee. [2]

The trend is upward, rising or increasing.
The candidates need to recognise the upward trend. Do not accept a summary of year-on-year changes that do not make the overall trend clear. **(1)**

Supply is likely to have exceeded demand in 2009 or 2012. The candidates only need to identify a year; they do not need to provide any further elaboration in terms of a year in which supply was likely to have exceeded demand in the market for coffee. If candidates write 2008 or 2011, but offer an explanation of the idea of a time-lag, this can be accepted. **(1)**

(b) Explain how coffee exports and a thriving tourism sector would contribute to Nepal's current account in the balance of payments. [4]

Coffee: Positive contribution to balance of trade in relation to visibles or goods. **(2)**
Tourism: Positive contribution to invisibles or services. **(2)**

Instead of 'positive', candidates can refer to 'increase' or 'benefit'. The idea of 'more inflows than outflows' can be accepted, as can a reference to the idea of a current account surplus, although we do not know if there is a surplus or not.

(c) With reference to Extract 2, explain how you would classify coffee using the concept of income elasticity of demand. [2]

For explanation that coffee is a normal good **(1)** with positive income elasticity of demand **(1)**. **(up to 2 marks)**

Do not allow 'Demand increases when income increases' for the first mark (i.e. they need to specify that it would be classified as a 'normal good'), but this could be accepted for the second mark.

There is no mark for the income elasticity of demand formula and no mark for references to elastic or inelastic income elasticity of demand.

(d) Using diagrams, explain how changes in demand and supply have affected the coffee market in Colombia and in Nepal. [6]

Colombia: Has faced a decrease in supply whilst supply has increased from competitors. This has resulted in Colombia's share of the market falling. The reference to increased competition also suggests the demand side, so candidates can be credited for shifting the demand curve to the left or for shifting the supply curve to the left or both. **(Up to 4 marks)**

Nepal: Has faced an increase in demand, leading to an increase in price and an increase in quantity. **(Up to 4 marks)**
(6 marks maximum)

In each case, there are up to 2 marks for the diagram (1 mark for a shift and 1 mark for clearly showing the change in equilibrium price and equilibrium quantity) and up to 2 marks for the explanation.

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(e) Discuss the view that Nepal should specialise in the production of coffee and Colombia should specialise in some other product given the changes in costs that have occurred. **[6]**

The discussion should be based upon the Law of Comparative Advantage. It could be argued that because the opportunity cost of producing coffee has fallen in Nepal and risen in Colombia, specialisation and trade in coffee should shift from Colombia and move to Nepal. This view could be challenged.

For the argument supporting production of coffee shifting to Nepal **(up to 4 marks)**
For the argument supporting the production of coffee remaining in Colombia. **(up to 4 marks)**
(6 marks maximum)

For further guidance:
An answer which contains very general comments with no economic theory at all: **(up to 2 marks)**

An answer which contains appropriate application to economics and some economic theory, such as in relation to the maintenance of employment, but no reference to either opportunity cost or comparative advantage: **(up to 4 marks)**

An answer which contains within the discussion references to comparative advantage and opportunity cost: **(up to 6 marks)**

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Essay Questions

2 (a) Using a supply and demand diagram, explain how the imposition of a subsidy on a good would affect the surplus enjoyed by the producers of that good. [8]

For knowledge and understanding of subsidy. **(up to 4 marks)**

The candidate needs to provide a clear explanation of what is meant by a 'subsidy'. This might be successfully achieved with the provision of a diagram to support the explanation, showing the supply curve shifting to the right.

For application using a supply and demand diagram to show how a subsidy affects producer surplus. **(up to 4 marks)**

To score here candidates need to provide a diagram that shows how the producer surplus is affected by the imposition of a subsidy. This should show a shift of the supply curve to the right, a fall in price and an increase in quantity. Although the subsidy will reduce the price to the consumer, the producer benefits because they will receive the price plus the subsidy. This will increase the producer surplus. The benefits of the subsidy will be shared between the consumer and the producer according to the price elasticity of demand**.**

Candidates can be given some marks for showing that they have an understanding of producer surplus before the subsidy:
Explanation of what is meant by a producer surplus **(1)**
Diagram of producer surplus before the subsidy **(1)**
Explanation of producer surplus after the subsidy (including the subsidy) **(up to 2 marks)**

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(b) Discuss whether minimum price legislation or the imposition of an indirect tax is more effective in improving resource allocation when the consumption of a good causes negative externalities. [12]

For analysis explaining how minimum price legislation and indirect taxes affect resource allocation when negative externalities arise from the consumption of a good. **(up to 8 marks)**

Analysis should include an explanation of how negative externalities arising from consumption result in the sub-optimal allocation of resources. The impact of minimum prices and indirect taxes on resource allocation in this case then needs to be explained.

For evaluation of the 'more effective' aspect of the question. **(up to 4 marks)**

Evaluation marks can be awarded for explaining the advantages and disadvantages of each policy, including a consideration of how you measure it, and arriving at a conclusion on which is best or 'more effective'.

NOTE: If a candidate only discusses one, i.e. either minimum price legislation or an indirect tax, they can gain a maximum of 6/8 in the analysis section, but cannot be given any marks in the evaluation section.

3 (a) Explain the factors that determine whether the price elasticity of demand for a product has a high value or a low value. [8]

For knowledge and understanding of price elasticity of demand and the meaning of a 'high value' (elastic) and a 'low value' (inelastic). **(Up to 4 marks)**

The candidate needs to show a firm and accurate understanding of price elasticity of demand. The formula is not essential for full marks, but an accurate explanation will make clear that the concept measures the % change in quantity relative to the % change in price. This is also essential when the candidate is explaining the difference between 'high' and 'low' values (or elastic and inelastic).

For application showing the factors that lead to a high or low value of price elasticity of demand. **(Up to 4 marks)**

Application marks will be awarded for explaining the link between high and low values and for e.g. the availability of substitutes, the proportion of income spent on the product and so on. At least two factors well explained are needed for full marks here.

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(b) Discuss whether it is both possible and beneficial for a business to change the price elasticity of demand for its product. [12]

For analysis explaining how it is worthwhile for a business to change the price elasticity of demand for its product. **(Up to 8 marks)**

Candidates need to explain how and why businesses might attempt to change the price elasticity of demand for their products.

'How' – The price elasticity of demand could be changed through advertising. This aims to make consumers more or less sensitive to price changes. We should also credit explanations based upon the removal of substitutes.

'Why' – Candidates might argue that with a lower price elasticity of demand businesses can raise prices in order to increase sales revenue. With a higher price elasticity of demand businesses might cut prices to increase sales by a larger % (and increase revenues).

For evaluation of whether it is possible and beneficial to change the price elasticity of demand for a product from the perspective of a business. **(Up to 4 marks)**

Evaluation marks will be awarded for any comment that questions either aspect. For example, 'possible' might question the effectiveness of advertising; 'beneficial' might suggest that attempts to shift the curve might achieve aims more effectively than changing the elasticity. Award credit for attempts to reach a conclusion.

NOTE: Candidates can write about either reducing or increasing the PED or both. If elasticity is reduced, this will make it more possible to increase price and, because of the inelastic demand, to increase revenue. On the other hand, the PED could be made more elastic so that a reduction in price would bring in more revenue.

4 (a) Explain how tariffs and an undervalued exchange rate can operate to protect a domestic market from foreign competition. [8]

For knowledge and understanding **(up to 2 marks)** of tariffs and application **(up to 2 marks)** explaining how a tariff operates to protect a domestic market. **(Up to 4 marks)**

Candidates need to show a clear understanding of the meaning of tariffs. Application marks will be awarded for explaining how tariffs protect the home market, raising the price of imports through taxation.

For knowledge and understanding **(up to 2 marks)** of an undervalued exchange rate and application **(up to 2 marks)** explaining how an undervalued exchange rate operates to protect the domestic market. **(Up to 4 marks)**

Application marks will be awarded for explaining the mechanism that protects the home market in the case of an undervalued exchange rate. An undervalued exchange rate raises the price of imports through the foreign exchange rate.

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(b) Discuss whether protectionism disadvantages most people in the protected country. **[12]**

For analysis of the advantages and disadvantages of protectionism. **(Up to 8 marks)**

The analysis should be balanced with reference to both advantages and disadvantages.

Advantages include safeguarding employment in vulnerable industries, protecting infant industries and preventing dumping.

Disadvantages include the prevention of the benefits gained through comparative advantage, reduced choice and so on.

For evaluation of the 'disadvantageous to most people' aspect of the question**. (Up to 4 marks)**

Candidates need to consider the overall impact of protectionism in order to reach a conclusion to score full marks for evaluation. Credit reference to comparative advantage in the candidate's judgement.

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Data Response Questions

1 (a) Compare the rate of inflation in China between 2007 and 2008 with that between 2010 and 2011. [2]

2007–2008 = 6.16% **(1)**, 2010–2011= 5.66%. **(1)**
So it is lower in 2010–2011. **(1)**

2 marks maximum.

(b) Explain briefly how the foreign exchange value of a currency is determined in a free market. [3]

For recognition that the foreign exchange value depends upon supply and demand for the currency in the foreign exchange market. **(1)**

For identification of one source of supply of the currency or one source of demand for the currency. **(Up to 2 marks)**

For diagram showing a shift in supply or a shift in demand and the change in the equilibrium price in the market. **(1)**

3 marks maximum.

(c) The US Treasury report states that China's strong trade surplus has led to a 'huge and rising stock of foreign exchange reserves' in China.
Explain how this justifies the claim that China is manipulating the foreign exchange value of its own currency. [3]

For recognition of the link between a balance of payments surplus and rising foreign exchange reserves. **(1)**

Explanation based upon the rising stock of foreign reserves suggests that China is accumulating reserves of foreign currency by selling the Yuan and keeping its price low. This prevents an appreciation of the Yuan which would make China's exports more expensive and imports dearer which should turn the surplus into a deficit. **(Up to 3 marks)**

(d) Explain why China's current account surplus is expected to increase in 2013, despite the rise in prices in China and the appreciation of the yuan. [6]

For an explanation of why the rise in prices in China and the appreciation of the Yuan might not be expected to be consistent with a rising surplus in China. **(Up to 2 marks)**

Up to 3 marks for each factor that might explain why the surplus is expected to increase.

Possible factors include:
Higher rates of inflation in other countries.
Marshall–Lerner condition not fulfilled (Inelastic demand for imports and exports).
J –curve effect.
Non-trade factors in current account that are not price sensitive.
The Yuan may still be undervalued.
Continuing competitive advantage of Chinese goods.

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(e) Do you agree with the view of the US Treasury that an appreciating currency is 'of overall benefit' to China? [6]

The advantages to China of an appreciating currency include the fact that imports are now cheaper so that Chinese consumers should enjoy cheaper goods and services and Chinese producers should benefit from cheaper capital imports and raw materials. In addition, the fall in net exports that should result would reduce inflationary pressures in China.

The disadvantages include the fact that China's external balance should diminish leading to a threat to production and employment in exporting industries.

For the advantages to China of the appreciating currency **(up to 4 marks)**

For the disadvantages to China of the appreciating currency **(up to 4 marks)**

Reserve one mark for a conclusion.

6 marks maximum.

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Essay Questions

2 (a) With the use of a diagram, explain how prices allocate scarce resources in a market economy. [8]

For knowledge and understanding of the features of a market economy. **(Up to 4 marks)** Features include no government intervention, private ownership, entrepreneurs and the profit motive and supply and demand.

For application using a diagram to show the allocation of scarce resources through the price mechanism. **(Up to 4 marks)**

Allocation of scarce resources explained through the use of a supply and demand diagram is required for full marks here. No diagram implies 2 marks maximum for application.

(b) Discuss whether prices are less important in allocating scarce resources in a mixed economy compared with a market economy. [12]

In a free market economy public goods are not provided because of the 'free rider' problem and other goods are underprovided (merit goods) or overprovided (de-merit goods). In these cases price is not a reflection of marginal social cost and as a result there is a misallocation of resources.

In a mixed economy public goods can be provided although no price can be charged and merit and demerit goods can be provided at the appropriate price through the imposition of indirect taxes on demerit goods and the subsidisation of merit goods.

For analysis showing the role of price in a mixed economy with reference to private goods, public goods, merit and demerit goods. **(Up to 8 marks).**

(Up to six marks for one side allows a 6/2 or 2/6 split).
(If only one side is explained then no marks can be awarded for evaluation.)

For evaluative comment on the 'less important' aspect of the question. **(Up to 4 marks)**

In a mixed economy it could be argued that price is more important because it helps to efficiently allocate resources when taxes and/or subsidies are imposed on demerit and merit goods. Or it could be argued that it is less important because price is the only means of allocation in a market economy.

Quality of the reasoning is more important than the conclusion reached.

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3 (a) Explain why the value of income elasticity of demand for a good can be positive, negative or zero, while the value of its price elasticity of demand is most likely to be negative. [8]

For knowledge and understanding of price elasticity and income elasticity of demand. **(Up to 4 marks)**

What each measures. **(1 mark for each)**
Formula for each. **(1 mark for each)**

Candidates need to show understanding of both measures of elasticity for full marks.

For application to show the values of price and income elasticity outlined. **(Up to 4 marks)**

Explanation of positive income elasticity. Normal good. **(1)**
Explanation of negative income elasticity. Inferior good. **(1)**
Explanation of zero income elasticity. Necessary good. **(1)**
Explanation of price elasticity of demand. Negative. **(1)**

Marks will be awarded here for a clear explanation of the types of good and the related value of income elasticity and for an explanation of the reason that price elasticity usually has a negative value.

(b) Discuss whether price elasticity of demand is a more useful concept than income elasticity of demand for a business that is trying to increase its sales revenue. [12]

For analysis to explain how knowledge of each type of elasticity might be useful to a business that is trying to increase sales revenue. **(Up to 8 marks)**

The analysis should show the link between the types of good produced when there are changes in income in an economy. For example, businesses will enjoy an increase in sales revenue if they produce normal goods when incomes are rising and inferior goods when incomes are falling in an economy.

The link between price elasticity of demand and changes in sales revenue when prices are changed also needs to be clearly explained. For example, businesses will increase prices to increase sales revenue when the price elasticity of demand for their product is inelastic and cut prices when demand is elastic.

(Up to six marks for one side allows a 6/2 or 2/6 split).
(If only one side is explained then no marks can be awarded for evaluation.)

For evaluation on the 'more useful' aspect of the question. **(Up to 4 marks)**

Candidates will gain evaluation marks when they make a judgement on the more useful aspect of the question. For example, they might comment that price elasticity is more useful because prices are set by the business whereas changes in income are beyond the control of the business. Some might argue that the data might be inaccurate or out-of-date. Accept any feasible assertion as long as it is justified by a valid argument.

For full marks for evaluation, a conclusion must be reached.

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4 (a) Explain how a rise in the rate of interest might cause a shift in an economy's aggregate demand curve. [8]

For knowledge and understanding of each component of the aggregate demand curve. **(Up to 4 marks)**

For the AD formula i.e. C + I + G + X – M **(1 mark)**
For the components listed i.e. Consumption, Investment, Government Spending and Net Exports **(1 further mark)**
For explanation of components (any one component explained well can gain both marks) **(Up to 2 marks)**

For application showing how the components might be affected by a rise in the rate of interest resulting in a shift in the aggregate demand curve. **(Up to 4 marks)**

A rise in the rate of interest will cause a fall in consumption and investment. The impact on government expenditure and net exports is less certain. Candidates do not need to explain how a rise in the rate of interest affects all components because the question asks for the impact upon the aggregate demand curve. So the impact upon one component if done in sufficient depth could gain all the marks available.

(b) Discuss whether inflation is more likely to be caused by a shift in an economy's aggregate demand or a shift in its aggregate supply. [12]

For analysis that explains how inflation can be caused by an increase in aggregate demand or a fall in aggregate supply. **(Up to 8 marks)**

A rise in aggregate demand could be caused by an increase in any of its components. For example, consumption could be increased through a fall in the rate of interest, net exports could be increased by a fall in the exchange rate and so on. Candidates may call this demand-pull inflation.
A fall in aggregate supply could be caused by a fall in the resources available to an economy that shifts the production possibility curve inwards. Candidates may call this cost-push inflation.

Credit accurate diagrams although these are not essential for full marks.

(Up to six marks for one side allows a 6/2 or 2/6 split).
(If only one side is explained then no marks can be awarded for evaluation.)

For evaluation offering judgement on the 'more likely' aspect of the question. **(Up to 4 marks)**

Candidates might suggest that either can cause inflation, but should make some judgement on the 'more likely' to reach a conclusion based upon some reasoning. For example, candidates might suggest that demand-pull is most likely when government expenditure is rising, or that cost-push is more likely when resources are depleting.
It also depends upon whether a deflationary gap exists.

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1 (a) (i) What is the overall trend in U.K. real expenditure on alcohol purchased in shops for consumption off the premises between 2008 quarter 1 and 2012 quarter 2? [1]

The trend is downward. (1 mark)

Year-on-year description gets zero marks, but make sure that the answer does not contain trend comment amidst chronological approach.

(ii) Explain how a change in one demand factor might have caused the change in weekly alcohol consumption for the 'average for all age groups' shown in Table 1. [2]

One mark for identifying a valid demand factor, and one mark for elaboration.

E.g. A fall in income (1 mark), means that consumers can afford less alcohol so this will reduce expenditure (1 mark) (ceteris paribus). Allow similar identification and elaboration on other demand factors such as a change in tastes, a fall in the price of substitutes and so on.

(b) (i) Identify the age group that has shown the greatest change in average weekly alcohol consumption between 2006 and 2010. [1]

16-24 age group. (1 mark)

(ii) For the age group you have identified, explain one possible economic reason for the change in its average weekly alcohol consumption compared with the other age groups. [2]

Any feasible, age related reason.

E.g. Rise in unemployment amongst this age group, education campaigns aimed at younger age groups, rise in alternative leisure pursuits. (Up to 2 marks)

The answer must explain why the group identified has the greatest change.

(c) If the minimum price per unit were fixed at 50 pence rather than 45 pence, explain, with the help of a diagram, how the higher price would affect the consumer surplus in this market. [4]

- For clear understanding of consumer surplus. (1 mark)
- For an accurate diagram showing how the consumer surplus falls as the price rises. (Up to 2 marks)
- For elaboration. For example, stating that the extent of the fall depends upon the price elasticity of demand. (1 mark)

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(d) Explain, with reference to the data, how crime and hospital admissions arising from excessive alcohol consumption contribute to social costs. [4]

For knowledge and understanding that social costs are equal to private costs and negative externalities. (1 mark)

For knowledge and understanding of private costs. (1 mark)

For knowledge and understanding of negative externalities. (1 mark)

For evidence drawn from the text, e.g. 'alcohol-related violent crimes or hospital admissions' are spillover effects affecting a third party. (1 mark)

(e) Discuss whether the problems associated with excessive alcohol consumption are better dealt with through a minimum price per unit for alcohol rather than through an education campaign. [6]

For **analysis** of how a minimum price and an education campaign are designed to remove the problems of excessive alcohol consumption with reference to the advantages and disadvantages of each. (Up to 5 marks)

Allow a 3 / 2 or 2 / 3 split.

For **concluding comment** on which approach is better overall. (1 mark)

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Essays

2 (a) Show how the economic problem can be explained with the use of a production possibility curve. [8]

For **knowledge and understanding** of the economic problem and the production possibility curve. (Up to 4 marks)

For an explanation of the economic problem. (Up to 3 marks)

For an explanation of the production possibility curve. (Up to 3 marks)

For **application** explaining how the economic problem can be illustrated through the use of the production possibility curve. (**Up to 4 marks**)

Application marks will be awarded for good use of the production possibility curve in illustrating various aspects of the economic problem.

- For explanation that a movement along the production possibility curve, shows choice and opportunity cost and that this stems from the economic problem. (Up to 3 marks)
- For explanation that the production possibility curve shows the limits to production and that this arises from the fact that resources are scare. (Up to 3 marks)

(b) Discuss whether an outward shift in a country's production possibility curve will always raise the welfare of the citizens of that country. [12]

For **analysis** explaining that an outward shift in the production possibility curve will increase the goods and services produced. This has the potential to raise the welfare of the citizens of a country. There are several reasons, however, why welfare might not be raised despite this increase in goods and services. For example, the shift in the PPC might have occurred because of technology changes which result in negative externalities. In addition, it might be the case that the increase in goods and services might be available only to a few citizens in the country as inequality increases. Candidates need to show a good understanding of why the outward shift in the PPC might not raise welfare for full marks. (Up to 8 marks)

For **evaluative comment** on the 'always raise the welfare' aspects of the question. (Up to 4 marks)

Candidates need to make a judgement based upon an assessment of the likelihood that the benefits of the extra production might outweigh the problems that might arise from the production of the extra goods and services. Some might draw a distinction between the short-term and the long-term effects of the change.

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3 (a) Explain why an increase in the money supply and rising world energy prices are categorised as different causes of inflation in an economy. [8]

For **knowledge and understanding** of demand-pull inflation and **application** to show how this can be caused by an increase in the money supply. (Up to 4 marks)

For **knowledge and understanding** of cost-push inflation and **application** to show how rising world energy prices can cause this. (Up to 4 marks)

Application marks for both types of inflation could be achieved through the use of aggregate demand and aggregate supply curves, although this is not essential.

(b) Discuss whether a floating exchange rate is consistent with the policy objective of a low and stable rate of inflation. [12]

For **analysis** showing how a floating exchange rate affects the rate of inflation. (Up to 8 marks)

Candidates need to explain how both a downward float and an upward float in the exchange rate can affect the rate of inflation in an economy.

An exchange rate that floats downwards leads to a fall in the price of exports and a rise in the price of imports.

An exchange rate that floats upwards leads to a rise in the price of exports and a fall in the price of imports.

For **evaluative comment** upon whether a low and stable rate of inflation can be achieved with a floating exchange rate. (Up to 4 marks)

Marks will be awarded for evaluation for reasoned judgement concerning the likelihood that a stable rate of inflation can be achieved with a floating exchange rate. It could be argued that this is difficult and might lead to pressures for a managed float. Others might argue that if excessive fluctuations in the exchange rate could be avoided there would be no pressure on prices. Reward quality of discussion rather than the conclusion reached.

4 (a) Explain how comparative advantage shows that specialisation and international trade can improve the welfare of consumers in an economy. [8]

For **knowledge and understanding** of the Law of Comparative Advantage. (Up to 4 marks)

Candidates are required to show an understanding of the law of comparative advantage and its assumptions. Reference to opportunity cost is essential.

For **application** showing how the law of comparative advantage shows the benefits of specialisation and trade. (Up to 4 marks)

To gain application marks candidates are likely to use an economic model to demonstrate how specialisation and trade can improve consumer welfare.

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(b) Discuss whether an economy would benefit more from an unfavourable rather than a favourable movement in its terms of trade. [12]

For **analysis** showing how an economy is affected by an unfavourable and a favourable movement in the terms of trade. (**Up to 8 marks**)

For an explanation of the meaning of an unfavourable movement in the terms of trade and the impact upon consumption, employment, prices and so on. (Up to 6 marks)

For an explanation of the meaning of a favourable movement in the terms of trade and the impact upon consumption, employment, prices and so on. (Up to 6 marks)

For **evaluative comment** on the overall benefit of an unfavourable movement compared to a favourable movement in an economy's terms of trade. (**Up to 4 marks**)

For evaluation marks, candidates need to provide reasoned judgement on the relative benefits of each movement. Candidates need to provide a conclusion based upon the discussion.

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