

[C038/SQP012]

Higher
Economics
Specimen Question Paper

Time: 2 hours 30 minutes

NATIONAL
QUALIFICATIONS

Instructions to candidates.

Candidates must attempt **both** items in Section A and any **two** questions in Section B.

SECTION A

ITEM A

Study the diagrams and passage below, then answer the questions which follow.

Diagram A

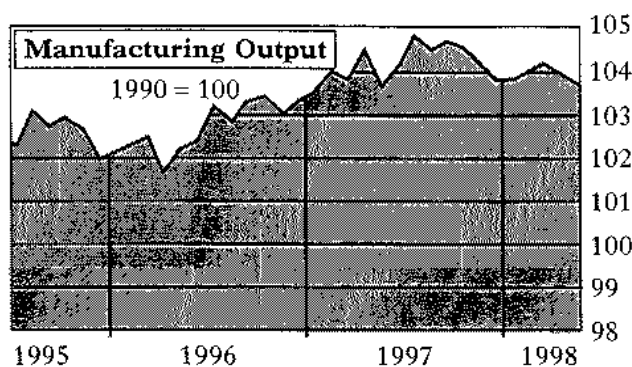
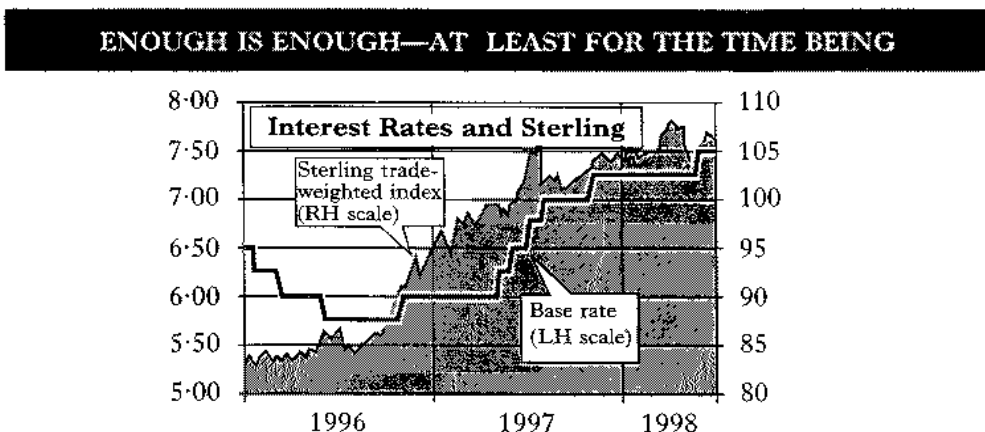


Diagram B



An economic correspondent said last week that there would be no recession in Britain for at least the next year or two. However, one of the items of evidence cited for this conclusion was dramatically overturned yesterday when manufacturing output was revised sharply downwards (Diagram A).

A single data revision is of limited consequence in assessing the economic outlook, so is it reasonable to remain confident about avoiding a recession despite the new evidence of a slowdown, the decline in consumer confidence and the gloomy tenor of media economic coverage?

The same correspondent's answer is still an emphatic, but increasingly conditional, yes. He still believes we can avoid recession as long as one key proviso is fulfilled: the Bank of England must refrain from raising interest rates again in the next few months. With the Monetary Policy Committee (MPC) due to vote in the next few days, and the majority of City analysts expecting another rate rise, he believes this condition needs to be strongly emphasised.

In previous months the MPC was absolutely right to raise interest rates. Unit wage costs were accelerating rapidly and sterling was teetering on the brink of a sharp fall. However, all the arguments which prompted this monetary tightening have been negated. The latest earnings figures showed a modest acceleration and the foreign exchange argument for raising interest rates has also disappeared.

Adapted from *The Times*, 7 July 1998

	<i>Marks</i>
(a) Explain what is meant by the following phrases, as used in the passage :	
(i) sterling index (Diagram B);	2
(ii) unit wage costs (line 12).	2
(b) Other than a fall in manufacturing output, suggest indicators which might show that the economy is in a recession.	3
(c) Describe and account for the relationship between interest rates and exchange rates as shown in Diagram B.	4
(d) Give 2 reasons why an increase in interest rates might reduce manufacturing output.	4
(e) Suggest why the MPC was set up.	2
(f) Explain how rapidly accelerating unit wage costs might persuade the MPC to raise interest rates.	4
(g) Describe 2 measures, other than the control of interest rates, which the government could adopt to slow down the rate of inflation and explain how these measures would work.	4
	(25)

ITEM B

Study the passage below, then answer the questions which follow.

THE EUROPEAN CAR MARKET

The market share of the big four domestic European car makers—Volkswagen, Fiat, Renault and Peugeot—plus Ford and General Motors, has always been approximately equal. However, by adopting a bold multinational manufacturing strategy, Volkswagen has, this year, achieved clear market leadership.

5 Volkswagen is a parent company, which owns Seat and Skoda. The VW Golfs, Polos and Passats that pour off the production lines represent the latest state of the art models, which benefit from the huge investment needed to push the boundaries of technology beyond those of the opposition. Once used for a short time by Volkswagen, the slightly out of date technology is passed down the line, first to Seat in Spain, then to Skoda in the Czech Republic.

10 The lower labour costs in those countries allow these brands to compete for different buyers further down market and, because each operates to VW standards of quality, they compete without compromising the parent company's reputation.

15 However, Europe's booming market is at risk from car makers in the Far East who, because of the current Asian crisis, are tempted to dump their products here. While there remains some semblance of a gentlemen's agreement between Japanese and European manufacturers to restrict the level of sales to around 11 per cent of the market, there are no restrictions on imports from emerging economies such as Malaysia and Korea.

Unless there is some sort of consensus among governments, this opens the door for an all out price war which, with the level of technologies being broadly similar, will inevitably be won by the players who can come up with the lowest prices.

Adapted from *The Scotsman*, 2 July 1998

	<i>Marks</i>
(a) Explain what is meant by the following phrases, as used in the passage :	
(i) market leadership (line 3);	2
(ii) emerging economies (line 15).	2
(b) Suggest reasons for the European car market being dominated by six multinational companies.	4
(c) Explain, in your own words, how the ownership of Seat and Skoda has enabled Volkswagen to become the clear market leader (paragraphs 2 and 3).	4
(d) Explain why dumping by car manufacturers from the Far East would be a risk to European car manufacturers.	3
(e) (i) Explain, using examples, what is meant by "restrictions on imports" (line 15).	3
(ii) Suggest factors which might prevent Europe from imposing restrictions on imports from Malaysia and Korea.	3
(f) What are the likely effects of an all out price war on producers and consumers in the short and long term?	4
	(25)

SECTION B

Attempt any TWO questions

Marks

1. The fact that resources are scarce requires them to be allocated.
 - (a) Explain what is meant by scarcity in economies. 5
 - (b) Explain how the price mechanism allocates resources. 8
 - (c) Describe the role of governments in allocating resources in a mixed economy. 12

(25)

2. (a) Explain what is meant by price elasticity of demand and income elasticity of demand. 6
(b) Explain why:
 - (i) at current prices, the demand for petrol is price inelastic but the demand for any one brand of petrol is price elastic; 4
 - (ii) at current income levels, the income elasticity of demand for smoked salmon is positive but the income elasticity of demand for fish fingers is negative. 4
- (c) Explain why the producers of a brand of petrol might want to make the demand for their product more price inelastic and describe ways in which they could do this. 6
- (d) Explain the likely effects of a reduction in the rate of income tax on the producers of smoked salmon. 5

(25)

3. Although not completely accurate, increases in “real National Income (NI) per capita” are the best measures of increases in standards of living and the rate of economic growth.
 - (a) Explain what is meant by “real NI per capita” and explain why it is an accurate measure of standards of living. 6
 - (b) Explain why a comparison of the real NI per capita of India and of the UK might not give an accurate picture of their relative standards of living. 9
 - (c) Discuss ways in which government policy can be used to influence the rate of economic growth in the UK. 10

(25)

4. Now that the £ (sterling) is floating, its exchange rate will be determined by the demand for it and the supply of it on the foreign exchange markets.
 - (a) Describe those factors which determine the demand for and the supply of sterling. 12
 - (b) Discuss the advantages and disadvantages for the UK economy of having a floating currency. 13

(25)

5. A low rate of unemployment might be economically desirable.
 - (a) Explain why a low rate of unemployment might be economically desirable. 8
 - (b) Explain how governments might attempt to reduce the rate of unemployment in an economy. 9
 - (c) Discuss possible problems for an economy resulting from the government’s attempts to reduce the rate of unemployment. 8

(25)

6. One of the convergence criteria for membership of the European Monetary Union (EMU) is that a country’s currency must have been in the exchange rate mechanism for a minimum of 2 years.
 - (a) What is meant by the exchange rate mechanism and how does it operate? 8
 - (b) Describe the “convergence criteria” (other than exchange rates) necessary for membership of EMU. 8
 - (c) What are the main advantages for a country of joining the European Monetary Union? 9

(25)

[END OF QUESTION PAPER]

[C038/SQP012]

Higher
Economics
Specimen Marking Instructions

NATIONAL
QUALIFICATIONS

Higher Economics

Section A

Item A

	Marks
(a) (i) The sterling index is a measure of the exchange rate of sterling. It values sterling against a basket (16) of the major world currencies.	2
(ii) Unit wage costs are wages per good produced and are therefore determined by the relative increases in labour productivity and wage rates.	2
(b) Other indicators include increases in unemployment, bankruptcies and redundancies; negative growth; falling investment, share prices and house prices.	3
(c) Since the middle of 1996 the relationship has been direct, ie they have tended to rise together. Accept any plausible explanation for this, although the obvious one is that an increase in interest rates encourages an inflow of short term capital ('hot money'). This increases the demand for sterling and, therefore, increases its exchange rate.	4
(d) An increase in interest rates will increase production costs (eg borrowing) and discourage capital investment. Both of these will tend to reduce manufacturing output. Higher interest rates will also reduce the borrowing by, and real incomes of, consumers (especially house owners) and, therefore, reduce demand (and therefore output) in general.	4
(e) The government wanted to increase the credibility of monetary policy and therefore decided to take politics out of decisions on interest rates. Interest rates are, therefore, set by the MPC purely on economic grounds, ie in order to meet the government's inflation target.	2
(f) Increasing unit wage costs often fuel price inflation, ie they are often 'passed on' to the consumer in the form of higher prices. The MPC might, therefore, regard rapidly accelerating unit wage costs as a sign that inflationary pressure is building up in the economy. In order to prevent the inflation rate actually rising, the MPC might raise interest rates. (Give some credit to candidates who explain how higher interest rates slow down inflation - but this is not necessary for full marks.)	4
(g) Wide range of answers possible - but look for a clear explanation of how the measures would actually work. Measures include: higher taxes (reduce disposable income and therefore demand), reduced government spending (reduces AMD) plus all the supply side measures aimed at increasing efficiency and supply (thereby reducing the amount of excess demand in the economy).	4
Total	(25)

Item B**Marks**

- (a) (i) The car company which has the greatest share of the European car market in terms of volume of cars sold. 2
- (ii) Emerging economies (or NIC's) are the ex-LDC's (mainly in Asia) which have experienced (until recently) rapid rates of economic growth. 2
- (b) Possible reasons include: the importance of scale economies in the mass car market, large initial capital investment, expensive research and development and design facilities required to keep up with technology and high costs of launching a new model. Any two, developed points for full marks. 4
- (c) Difficult question. Credit candidates who realise that VW gets a greater return from its investment as it is utilised for a longer period of time (first by VW, then by Seat and finally by Skoda). This increased return not only justifies the initial investment but also provides some of the funding for future investment - allowing VW to lead the market. Seat and Skoda compete in different segments of the market from VW and, therefore, help to enlarge its market share while maintaining its reputation for quality. 4
- (d) Credit explanations of dumping, ie the selling of products in a foreign country at artificially low prices – either to cut losses or to gain a foothold in that country. These ‘cheap’ cars would be very competitive in Europe and would therefore reduce the demand for European built cars. (Credit reference to PED) 3
- (e) (i) Any (artificial) measure which has the effect of making the volume of imports coming into a country lower than it otherwise would be, eg tariffs, quotas, etc. 3
- (ii) Factors include: fear of retaliation, membership of GATT, loss of exports because of reduced income in Malaysia and Korea and to help them out of their present economic crisis. 3
- (f) ‘An all out price war’ implies that companies are reducing their prices in an attempt to undercut their competitors. In the short term consumers should benefit from the reduced prices (increase in real income), ‘special offers’, etc, but in the long term they might suffer from higher prices and a lack of choice – especially if the war is won by one or two firms who will then have significant monopoly power. In the short term producers will experience reduced profit margins and possibly falling demand. In the long term some may go bankrupt, but those who survive should enjoy a larger market share and increased profits. 4
- Total (25)**

Section B

Essay

Marks

- 1 (a) Candidates should explain
- idea of **relative scarcity** – the nature of limited resources with alternative uses in relation to unlimited wants (expanding nature of wants – advertising, new technology, human nature)
 - all resources are scarce, ie no country has enough resources to produce enough goods to satisfy all its consumers completely
- 5
- (b) Candidates should explain
- how, in a market economy, producers are motivated by **profit and consumer sovereignty** exists
 - consumer demand, therefore, provides a signal to producers
 - if consumer demand for a product increases, price increases and more profit is to be made
 - therefore, existing firms use their resources to produce those goods which consumers demand (new firms may also enter the industry, again employing resources to meet consumer demand)
 - if consumer demand for a product falls, price falls and less profit is to be made
 - resources are then moved out of the production of that particular product and used to produce those products which will be more profitable
 - in this way the price mechanism allocates resources
- 8
- (c) Candidates should
- provide some explanation of “mixed economy” in terms of a mixture of market and planned economies (retains **important elements of market forces to signal changing use of factors of production, but also government intervention to modify the market**), ie it has a private sector and a public sector.

Role of governments

- to provide public goods, eg defence, lighting, police
- to provide merit goods, eg health and education
- provide for the economically inefficient, ie old, young, sick, poor
- provide legislation on protection of environment, health and safety, etc
- general state intervention in private sector, eg subsidies, Monopolies and Mergers Commission, protection of environment, trade restraints, location of industry, etc.

- explanation should be given of why it is necessary for governments to intervene related to above role of governments, ie market failure (imperfect competition, externalities, missing markets, equity, labour market failure, etc)

12

Total (25)

2	<p>(a) PED is a measure of the responsiveness of the quantity demanded of a good to a small change in its price (credit formula). Demand can be price elastic, price inelastic or unitary (credit examples). YED is the responsiveness of the demand for a good to a change in (real) income levels (credit formula). YED can be positive (elastic or inelastic), zero or negative – for inferior goods (credit examples).</p>	6
	<p>(b) (i) Good answers will concentrate on the availability of substitutes.</p> <p style="padding-left: 40px;">For car owners with petrol engines, not only is petrol an essential good but there are no close substitutes for it. A small increase in its price, therefore, will not result in a significant fall in the quantity demanded. However, there are close substitutes for any one brand of petrol, eg Shell and Esso, therefore a small increase in the price of one of these brands is likely to result in a significant fall in the quantity demanded of it (despite brand loyalty, etc).</p>	4
	<p>(ii) For most people, smoked salmon is a luxury good, therefore an increase in income will result in an increase in demand for it (ie YED is positive). In contrast, fish fingers are often regarded as being an inferior good, therefore an increase in income levels could result in people buying less of them (ie YED is negative) and more smoked salmon.</p>	4
	<p>(c) If the demand for their brand of petrol becomes price inelastic they can increase the price of it and experience a rise in total revenue and, therefore, profit (because the % increase in price will outweigh the % fall in quantity demanded). To make their demand price inelastic, producers must try and increase consumer loyalty for their brand. This might be achieved by giving buyer bonus points, loyalty cards, special offers, etc – credit any plausible suggestions.</p>	6
	<p>(d) A reduction in the rate of income tax will increase the real incomes of taxpayers. Therefore, as the YED for smoked salmon is positive, there will be an increase in the demand for it. Smoked salmon producers will, therefore, experience a rise in revenue and profit which may induce them to increase their investment and output.</p>	5
	Total	(25)

- 3 (a) Real NI per capita is the NI of a country measured at constant prices divided by the total population of that country. It can be used as a measure of standards of living because it shows the amount of goods/income each person has on average. Any increase in real NI indicates that output (and not just prices) has risen and therefore people are, on average, better off. Credit candidates who explain why nominal total figures are not such accurate measures of the standard of living. 6
- (b) Reasons include: lack of reliable information, eg difficult to accurately measure the output and population of India; different currencies – exchange rates give only a rough measure of the real value of the currencies within the respective countries; the amount of goods which never reach the market (eg subsistence farming) is much greater in India; the hours and conditions of work in the two countries have to be taken into account – as do the different needs (largely because of climatic differences); the figures do not show how the NI is distributed. Three well explained reasons for full marks. 9
- (c) There is a wide range of possible answers but look for policies which will either increase the quantity and/or the quality of the factors or production or promote technical progress. Policies include: increased spending on education and vocational training; lower interest rates and increased capital allowances (to increase the level of capital investment); expansionist monetary and fiscal policies (to stimulate demand and business expectations); reduced corporation tax (to encourage risk taking); increased spending on R and D and policies aimed at producing a favourable economic climate (low inflation, full employment and a stable exchange rate). Credit highly candidates who attempt to discuss the policies and highlight the opportunity costs involved. 10
- Total (25)**

- 4 (a) Demand for sterling determined by
- level of UK exports, long term capital movements (foreign investment in UK – direct and portfolio), speculation, short term capital inflows (hot money) foreign tourists visiting the UK. These determinants are affected by the general state of the UK economy, as well as relative interest and inflation rates.

Supply of sterling determined by

- level of UK imports, long term capital movements (UK investment overseas – direct and portfolio), speculation, short term capital outflows (hot money), UK residents going on holiday abroad. These determinants are affected by the general state of the UK economy, as well as relative interest and inflation rates.

12

- (b) Floating currency – value of sterling determined by supply and demand conditions on the foreign exchange market (no government interference, eg buying sterling)

Advantages for UK economy –

gives a true value to the price of the currency, ie rate of exchange will vary quickly to bring demand and supply of the currency into equilibrium, therefore the system is self regulating (eg if the UK had a trade deficit with Germany, the value of sterling would fall. This fall in value would cause British exports to Germany to become cheaper and imports from Germany more expensive. The fall in value of sterling would cease when trade between the two countries came into equilibrium).

Balance of Payments ceases to be a problem, therefore government can concentrate its efforts on other problems (eg a floating exchange rate makes monetary policy more effective)

no need for government to hold large quantities of gold and foreign currencies

Disadvantages for UK economy –

currency fluctuations, encourage speculation, uncertainty for international business, could be damaging to growth of world trade, possibility of protectionist measures being used if exchange rates are too high or low for a long period of time, effect on unemployment, inflation, Balance of Payments if the exchange rate is too high.

13

Total

(25)

5 (a) Explanation of the meaning of the rate of unemployment (NAIRU), therefore some unemployment in the economy is inevitable. Marks

Desirable because – unemployment is a waste of a scarce resource and, therefore, if unemployment exists resources are not fully utilised, it is costly to the government (unemployment and other benefits and lost tax revenue), can cause social problems, effects of unemployment on other government objectives (eg aggregate demand/economic growth).

8

(b) General unemployment exists because the level of NI and the resultant level of aggregate demand in the economy is not sufficient to support full employment. Therefore, to reduce unemployment governments could

- try to increase consumption by, eg (i) reducing tax – consumers have more disposable income to spend on goods and services; (ii) reducing interest rates, relaxing controls on availability of credit – encourages borrowing, people spend rather than save (MPS decreases), increases disposable income for consumers with mortgages, increases demand for credit, etc. Both measures will cause aggregate demand to shift upwards – as demand for labour is derived from demand for goods and services, demand for labour would increase (NB multiplier, and effect of its actions on national income levels)
- try to increase private investment by, eg (i) reducing corporation tax; (ii) reducing interest rates
- increase government spending on capital projects
- try to reduce imports and increase exports (protect home industry from foreign competition, Buy British, etc)
- supply side policies – increase efficiency of factor markets – causes shift in aggregate supply, increases output and reduces natural rate of unemployment (eg reduce union power, abolish minimum wage legislation, decrease welfare benefits, encourage education and training, deregulation and privatisation, decrease subsidies to inefficient producers, encourage free trade and stimulate export markets, regional/industrial policies, improve labour mobility)

9

Marks

(c) too much money injected into the economy too quickly causes large increase in aggregate demand which cannot be met by increase in supply (short term) – inflation

- inflation – resultant effects on people with fixed incomes etc, effects on competitiveness of goods in home/foreign markets (balance of payments)
- UK has a high propensity to import and instead of buying home produced goods consumers may buy imported goods – effects on balance of payments and exchange rates
- increased government spending/reduced taxation revenue (budget deficit) needs to be financed – increase in PSBR
- fall in savings – less money available for investment

8

Total (25)

6	(a)	The ERM is a managed exchange rate system designed to maintain the currency exchange rates (of member countries) within agreed limits against one another. Its operation is in the hands of individual Central banks who will buy their currency when it is approaching its 'floor' and sell it when it is approaching its 'ceiling'. Credit explanations of how this works. (If this intervention fails to keep the currency within its limits, interest rates can be changed to attract or discourage 'hot money' inflows and therefore strengthen or weaken the currency. As a last resort, the government could agree to currency realignment.)	8
	(b)	There are 4 basic convergence criteria (other than exchange rates). <ul style="list-style-type: none"> (i) Long-term interest rates must be within 2% of the average of the 3 member countries with the lowest interest rates. (ii) Inflation rate must be within 1.5% of the average of the 3 member countries with the lowest inflation rates. (iii) National debt has to be less than 60% of GDP. (iv) Government budget deficit must be no more than 3% of GDP. 	8
	(c)	Advantages include: increased trade between member countries; cheaper trade (no currency exchange costs); greater stability and, therefore, easier long-term planning for companies (removal of exchange rate uncertainty); larger markets; lower long-term inflation and interest rates and increased economic growth and employment opportunities.	9
Total			(25)

[END OF MARKING INSTRUCTIONS]

