SCOTTISH
QUALIFICATIONS
AUTHORITY

2003 Economics

Higher

Finalised Marking Instructions

HIGHER ECONOMICS

2003 Marking Scheme

Section A

ITEM A

(a) **(i)** Look for a simple definition in terms of the cost of borrowing money or the money earned on savings (compensating lenders for deferred consumption). Credit references to the fact that is (the base rate) is set by the MPC and this determines the rates set by banks, building societies etc. **2**

(ii) Credit any definition which conveys the idea of a world-wide fall in economic growth rates eg falling GDP, rising unemployment levels, lower economic activity etc. **2**

(b) Good answers will concentrate on the effect of a strong pound on UK competitiveness.

If the UK joined the Euro when the pound was strong this would lock us into a permanently high exchange rate. This would make our exports to the Eurozone relatively expensive and therefore less price competitive (than if the pound fell in value prior to joining). Our imports from the Eurozone however, will be relatively cheap and therefore more price competitive. Both of these factors would mean that UK manufacturers (exporting and domestic) would suffer a decrease in orders. This, in turn could lead to a decrease in output and employment – in both our export industries and our import competing industries.

This is a difficult question, so look for, and credit, any other valid points. **4**

(c) Selling pounds on the foreign exchange markets will increase the supply of pounds (shifting the supply curve to the right). This increase in supply should reduce the value of sterling against other currencies. **2**

(d) **(i)** A fall in interest rates will encourage borrowing (now cheaper) and discourage saving (now less rewarding). Both of these should increase spending/demand. Credit highly references to increases in the real income (and therefore the demand) of eg mortgage holders.

(ii) A fall in interest rates will increase hot money outflows as sterling will be less financially attractive to speculators. The increased selling of sterling will increase its supply on the FOREX and therefore reduce its exchange rate. (Credit candidates who argue that, because of changes in hot money flows, the demand for sterling will fall).

Can mark 2:2, 3:1 or 1:3 **4**

(e) The question refers to 'industry' so look for any macro measure aimed at increasing AMD eg increases in government spending, reductions in taxation (especially corporation tax) as well as measures aimed at increasing efficiency eg R&D grants, government funded training schemes etc. The question asks for suggestions so credit any plausible answer eg subsidies, import controls, joining the Euro etc. **2**

(f) A variety of answers is possible although the obvious (?) answer is that a strong pound makes imports cheaper. This means that the price of imported goods in the shops will not be rising (and UK firms will have to keep their prices down to remain competitive) and also the lower price of imported raw materials and components will reduce industrial costs and help dampen cost push inflation.

Also credit answers which concentrate on the fact that as a strong pound increases imports and reduces exports it will reduce AMD and therefore lessen demand pull inflation.

Only one explanation is necessary for full marks. **3**

(g) Simple answer is 2.5% RPIX. However also credit answers which state that it is the rate of price increases which the government wants to maintain (in the medium term). Also credit references to the role of the MPC. **2**

(h) **(i)** Advantages include:

- Stable exchange rate – reduces risk and encourages trade
- No transaction costs – should increase trade and investment
- Price transparency – easier to compare prices in different countries
- Should enhance London's position as the financial centre of Europe – thus protecting jobs and invisible exports
- FDI levels will be maintained – protecting jobs and income

Look for a clear description for full marks. **2**

(ii) Disadvantages include:

- Loss of monetary independence – MPC cannot set interest rates to suit the UK economy
- Problem of a one-size-fits-all interest rate
- Stability pact will reduce the scope of fiscal policy
- Menu costs of changing over to the euro eg changing accounting systems, tills etc
- World events (eg change in oil prices) likely to impact countries differently
- Devaluation no longer an option – pressure falls on output and jobs

Look for a clear description for full marks. **2**

(25)

Item B

(a)	**(i)**	The holiday market consists of all those people who buy holidays (ie consumers) and all those people who sell holidays (ie producers). It also includes the actual holidays – although mention of this is not necessary for full marks.	**2**
	(ii)	Productivity is output per input and therefore measures the efficiency of the input. In the passage it means increasing efficiency by increasing output per worker (or per plane).	**2**
(b)	**(i)**	Strictly speaking a competitive market is any market other than monopoly ie any market in which producers compete with each other. They therefore consist of duopolies, oligopolies, monopolistic markets and perfect markets. Credit definition of a market eg the situation where buyers and sellers come into contact to exchange goods or a service.	**2**
	(ii)	Look for a simple explanation of how the equilibrium price is established by the interaction of demand and supply (market forces). Credit references to market clearing price, consumer sovereignty, shortages and gluts.	**2**
(c)		Possible reasons include: • Effect of the weather (both here and abroad) • Seasonal price differences • Changes in exchange rates • Income levels • Terrorist activity • Wars • Natural disasters eg earthquakes • Fashion • Prices of substitutes eg new cars, house extensions, UK holidays Credit any plausible reason. ½ mark for reason. 1 mark for explanation.	**3**
(d)		Wide variety of answers possible so accept any plausible examples eg cheaper rates for booking early (January), all-inclusive deals, cheap car hire, free travel insurance, champagne reception, on board meals, transfers to and from airport, flight bags etc	**2**

(e) **(i)** The US is our single biggest export market, therefore an American recession (falling AMD, rising unemployment etc) will reduce their demand for our exports which could lead to falling output and employment in our export industries. American multi-national companies might be forced to close their UK branches in an attempt to cut costs – which will again lead to falling output and employment in the UK. Our tourist industry is likely to suffer and the probable reduction in American visitors will also reduce AMD (and therefore growth) in the UK.

One reason, well explained, for full marks. **3**

(ii) A recession reduces the Government's finances in 2 ways. Taxation revenue falls (fewer people earning, falling profits, reduced consumer spending) but government spending on welfare benefits (eg JSA), rises. Credit references to rising budget deficits and attempts to increase AMD. **3**

(f) The demand is price inelastic as increases in prices led to increased revenue (line 14). This is all that is required for full marks but credit possible reasons for demand being price inelastic eg consumer loyalty and special incentives.

Some candidates might mention that the fall in profits last year could indicate that demand was price elastic. If they relate this to rising prices, they score 2 marks.` **3**

(g) The explanations are found in the information contained in the first paragraph:

- Cut-throat competition – therefore if one company offers cheap last minute holidays, other companies will follow suit.
- Holiday companies have high fixed costs (lines 2 and 3) and low marginal costs. Therefore cheap holidays might still earn enough for marginal revenue to cover marginal cost.
- High profit margins on the 'final' 10%, therefore a price reduction might result in all the 10% being sold and profit increasing.
- The real profit danger to the companies of not being able to sell all their holidays – which they have paid for in advance.

One reason, well explained, for full marks. **3**

(25)

Section B

Question 1

(a) Look for a clear explanation of relative scarcity in terms of unlimited wants (because of greed, new goods, goods wearing out) but limited resources (land, labour, capital) to produce goods which satisfy wants. Scarcity is therefore universal – no country in the world has enough resources to produce enough goods to completely satisfy all the wants of its people. **6**

(b) Credit definition ie opportunity cost is the sacrifice of the next best alternative choice. Look for a clear, well drawn, fully labelled diagram showing 2 different points on the PPC (3 marks). The example can be micro or macro, but credit explanations of how the curve is drawn. Candidates should then explain – using the diagram – how producing more of one good, requires producing less of the other. A PPC is therefore simply a diagrammatical explanation of opportunity cost. Credit explanations of the shape of the curve – although this is not necessary for full marks. **9**

(c) **(i)** Rational consumers attempt to spend their money in a way which gives them the greatest level of satisfaction. To do this they have to buy those goods which give them the greatest value for their money. Credit references to the theory of equi-marginal utility (no matter how badly explained!) and look for a simple example eg if 2 goods cost the same but good A gives the consumer more satisfaction than B, the consumer will buy A. (Maximum 4 marks)

(ii) Producers are motivated by the desire to maximise profit. They will therefore produce those goods which are in greatest demand and will attempt to produce them in the most cost effective way. Credit references to goods which are currently in great demand (computer games?) and methods of increasing efficiency (mechanisation). (Maximum 4 marks)

(iii) Governments spend tax revenue in a way that they think will maximise society welfare. They will therefore have to decide whether the country will benefit more from one more hospital or one more school. Credit other examples. (Maximum 4 marks)

10

(If no examples are given, the maximum is 8 marks. If only one example is given, the maximum is 9 marks).

(25)

Question 2

(a)	Three possible reasons: income effect, substitution effect and diminishing marginal utility. Any 2 well explained reasons can gain full marks. If only one reason is explained, maximum is 6 marks.		

Income effect when the price of a good falls, existing consumers will experience a rise in their real income ie when they buy their usual amount of the good, they will now have some money left over. With this 'extra' money they can now buy more goods – possibly even the good in question. Reducing the price of a good also widens the market for it and means that more consumers can now afford it.

Substitution effect when the price of a good falls, it might become cheaper than its substitutes. Some consumers might now switch and start buying the cheaper substitute. Credit examples.

Diminishing Marginal Utility the more we consume of a good the less satisfaction we get from consuming one more. In money terms this means that the more we consume of a good the less we are willing to pay for one more. When the price of a good falls, it now gives the consumer more satisfaction for the money spent ie it becomes a better buy. Consumers can now increase their total satisfaction by buying more of this good and less of another. **10**

(b) Look for a simple explanation of how the forces of demand and supply create the equilibrium price in a market.
The equilibrium price is the price which equates demand and supply ie the amount consumers wish to buy at that price equals the amount producers wish to sell. Credit diagram. It is the price which 'clears the market' ie at that price there is no unsatisfied demand and no unsold stock. However, at any moment in time the price in the market can be above or below the equilibrium price. But if this happens, the forces of demand and supply will push the price towards the equilibrium level. If the price is above equilibrium, there will be a glut (excess supply). To get rid of this surplus, price will have to fall. Credit diagram. If the price is below equilibrium, there will be a shortage (excess demand). This excess demand will push the price up (credit diagram). (Once the equilibrium price has been established, it will remain unless there is a change in either demand or supply.) **10**

(c) Look for a diagram showing the intervention (minimum) price above the world price – creating a surplus in the market ie at that price, supply is greater than demand. Maximum 3 marks. Candidates should now give a straightforward explanation of the diagram. The CAP sets a minimum/guaranteed price for farming products (credit reasons). However as this price is invariably above the world price for the product, excess supply is created. Credit references to variable import levies. Maximum 3 marks. **5**

(25)

Question 3

(a) Explanation should centre around the concept of variable returns, although other terms eg factor efficiency, may be used instead. Credit definition of the short run eg period of time during which at least one factor input cannot be varied.
Description – ATC curve falls reaches a minimum and then starts to rise (ATC = AFC + AVC)
Average fixed costs decline continuously since fixed costs are being spread over a larger and larger output.
Average variable costs fall at first – increasing returns to the variable factor causes cost per unit to decrease. Eventually the fixed factor becomes overworked and diminishing returns set in which causes average variable cost to rise.
Therefore: ATC falls when both AFC and AVC are falling or when the fall in AFC outweighs the rise in AVC. Eventually the rise in AVC outweighs the fall in AFC and ATC begins to rise.
(Credit diagrams)
(No credit for economies and diseconomies of scale) **10**

(b) Credit definition of the long run eg the period of time long enough for all factors of production to be varied.
Long run ATC curve made up of a series of interesting SR ATC curves.
(Credit diagram)
Average Total cost falls when a firm is experiencing economies of scale (increasing returns to scale) - % increase in scale of production is less than the % increase in output, therefore ATC falls.
Average Total cost rises when a firm is experiencing diseconomies of scale (decreasing returns to scale) - % increase in scale of production is greater than the % increase in output, therefore ATC falls.
Look for clear examples of economies and diseconomies of scale and credit highly candidates who link their examples to ATC.

Can be marked: 5:5, 6:4 or 4:6

If candidate simply lists economies and diseconomies of scale maximum is 6 marks. If they are related to costs, maximum is 8 marks. To gain full marks the economies and diseconomies must be linked to unit costs. **10**

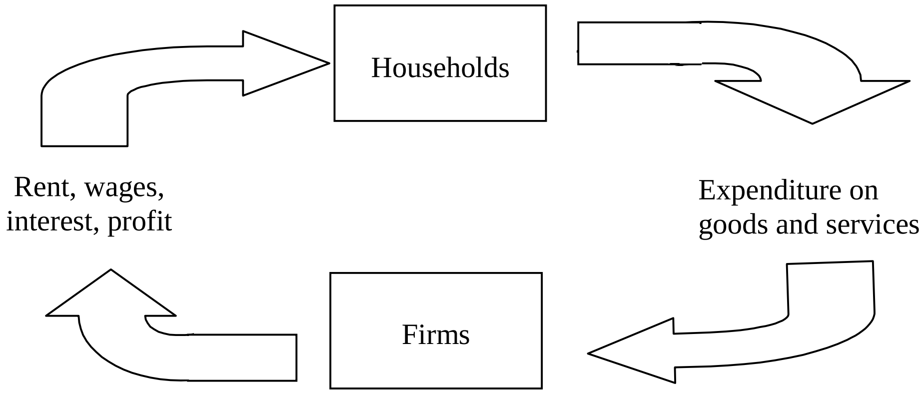
(c) Credit definition of unit wage costs eg labour costs per good produced. An increase in unit wage costs, increases firm's costs of production therefore they are likely to increase their price and sell less. If production is cut back, then demand for workers may fall, therefore unemployment might rise. Credit diagram showing supply curve shifting to the left. **5**

(25)

Question 4

(a)

Diagram:



National income – total (money) value of goods and services produced in an economy over a period of time/the income generated from the production of goods and services.
Look for a simple explanation of how and why money flows from firms to households and back again ie households own the factors of production and supply these in return for payment (rent, wages, interest and profit).
This money is used to buy goods and services. (Expenditure on goods and services). Firms hire the factors of production and use these to produce goods and services which are then sold to households. If the flow of money around the system is constant, the economy is in equilibrium (no tendency to change) ie income = expenditure.
Credit candidates who mention and define leakages and injections and explain that if leakages = injections national income is in equilibrium. **10**

(b)

Look for a straightforward explanation of how an increase in an injection eventually increases national income by a greater amount than the initial increase in the injection ie the multiplier process. Candidates should show an appreciation of how the multiplier process rests on the fact that income and expenditure are interdependent ie when those who receive an increase in income spend it, it becomes income for others who in turn spend and so on. The extra income being generated will create increases in demand, encourage producers to increase output and increase employment. Credit references to the MPC/MPS. **7**

(c) Candidates may describe short or long term factors – both approaches are valid. Short term increases in growth are mainly brought about by increases in AMD, therefore look for reductions in taxation, lower interest rates, easier HP terms etc. Maximum of 4 marks.

Real economic growth (ie increases in productive capacity) can only occur in the long term – as a result of either increases in resources (quantity or quality) or advances in technology. Therefore look for:

- Policies to increase savings (eg tax free savings schemes) to make more funds available for capital investment
- Lower interest rates and increased capital allowances to encourage capital investment
- More private spending on training to increase skills and labour productivity
- Supply side policies to create a more flexible and mobile labour force eg reduce/remove restrictive practices, employment acts to reduce trade union power
- Greater private spending on R&D to 'encourage' advances in technology
- etc **8**

(25)

Question 5

(a) **(i)** Deficit in Trade in goods:

- high propensity to import, especially raw materials and components
- rising real incomes and increased domestic demand meant an increase in imports of consumer durables
- trade problems caused by the strong £ - exports dearer, imports cheaper
- loss of comparative advantage in goods we tend to export (increased competition from Japan, NIC's) and the perception that foreign goods are cheaper/better quality
- UK still tends to concentrate on export of goods for which demand is stagnant and sell in markets that are not expanding

Surplus in Trade in services:

- City of London – expertise in Financial services eg insurance, banking, shares, bonds etc
- UKs comparative advantage in Financial services

(Also credit references to surpluses in IPD – although not really part of Services) **6**

(ii) Look for measures that will either reduce imports or increase exports.

Imports:

- Import controls eg tariff – tax on imports that increases the price, creating a reduction in demand, quota – limit on number of goods, restrict supply therefore increase in price etc (maximum 4 marks?)
- Currency depreciation eg reduce interest rates to reduce exchange rate of sterling, therefore import prices relatively less competitive in relation to UK goods.

Exports:

Anything that increases the efficiency of firms and the competitiveness of UK goods eg:

- Policies to achieve low inflation
- Wage controls
- Increased spending on research and development
- Increased productivity incentives resulting in lower unit costs
- Lower interest rates to encourage investment
- Export rebate schemes
- Trade fairs to promote products abroad
- Etc **6**

(b) Look for an understanding of how the debt overhang facing many LDCs has limited their ability to increase their growth rates. Money spent on loan and interest repayments (often derived from sales of cash crops which destroy the soil) could have been used for internal investment. Debt reductions should give LDCs more money for education, infrastructure development, health care etc.

Faster growth in LDCs (as a result of debt reduction) will increase their ability to buy our goods. The resultant increase in our exports will increase our output, employment and growth rate. **6**

(c) Straightforward question asking for a description of the various forms of overseas aid plus the role of free trade. Good candidates will assess the effectiveness of the various forms of aid in promoting growth, but this is not necessary for full marks.

The assistance can take the following forms:

- Direct gifts of food and consumer goods – short term emergency measure which, in the long run can actually inhibit growth
- Capital equipment, given directly or by grants or loans – invaluable, may enable a country to reach its 'take-off' point. It also includes investment in the infrastructure eg roads, housing, drainage, water supplies, sanitation etc
- Technical assistance eg technical assistants to operate capital equipment, train local technicians and give technical advice – just as important as capital
- Education eg instructors to train administrators, doctors, teachers etc – important in the growth of social services
- Cheap medicines eg HIV drugs – desperately needed in parts of Africa
- Free trade ie no tariffs, quotas etc – complements aid and essential to the continued growth of LDCs. Any long term aid programme would fail to increase growth in LDCs if not accompanied by free trading opportunities **7**

(25)

Question 6

(a) These are macroeconomic instruments, used by governments to try to achieve their economic objectives.
Fiscal – changing the balance between taxation revenue and government spending ie deliberately budgeting for a deficit or surplus. The aim is to influence the economy (inflation, growth, unemployment etc) by altering the level of AMD. The policy is implemented in the annual Budget.
Monetary – altering the supply or cost of money (interest rates) in order to control inflation. Nowadays monetary policy concentrates on the control of interest rates, which is the responsibility of the MPC of the Bank of England (credit references, again, to 2.5% RPIX). **6**

Can be marked 4:2, 3:3 or 2:4

(b) Look for a straightforward explanation of how budget surpluses and increases in interest rates can reduce inflation.
Fiscal Policy – budget for a surplus – by either reducing government spending or increasing taxation (or both). The government is therefore taking more money (and demand) out of the economy than they are putting in. (Credit explanation of how G increases income, whereas T reduces it). The result will be a fall in AMD which should reduce (demand pull) inflation.
Monetary Policy – an increase in interest rates will discourage borrowing (now dearer) and encourage saving (now more rewarding). Both of these should reduce demand and therefore inflation. The real income of borrowers (especially variable interest mortgage holders) will fall, reducing their demand for other goods. The increase in the exchange rate (hot money inflows) will reduce the price of imports which will reduce the price of imported goods (lower RPI) and imported raw materials (lower cost-push). The reduction in borrowing will reduce bank deposits and slow down monetary growth (reduced monetary inflation).
Candidates are unlikely to mention all of the above points, so mark according to overall quality. **12**

Can be marked 7:5, 6:6 or 5:7

(c) Look for an understanding of how falls in demand can result in lower growth and rising unemployment – this is all that is required for full marks.
Falling AMD because of budget surpluses, increased saving and reduced borrowing, will reduce the level of economic activity in the economy. This economic slow down will result in lower output, falling growth and rising unemployment.
Higher interest rates will reduce the level of invest (marginal investment projects will no longer be viable). This will limit future economic growth. Cheaper imports and dearer exports (because of the stronger currency) will cause trade deficits and increased unemployment and reduced profits in our exporting and import competing industries. **7**

(25)

[END OF MARKING INSTRUCTIONS]