2008 Economics

Higher

Finalised Marking Instructions

Economics 2008

Higher

SECTION A

ITEM A

			Marks
(a)	**(i)**	The maximum amount/barrels of oil each OPEC member is allowed to produce (per time period). One mark for the explanation and one for relating it to oil.	**2**
	(ii)	Costs that vary directly with output. Credit examples.	**2**

(b) The diagram should show:

- a decrease in the supply of oil
- an increase in the demand for oil
- an increase in the price of oil.

One mark for each but the mark for showing an increase in the price is only granted if the 2 new curves are correctly drawn. **3**

(c) This action increased the supply of oil (it made the supply of oil higher than it would otherwise have been). This brought some relief in that it made the price of oil lower than it would otherwise have been – 2 marks. The diagram should show an increase in the supply of oil and a reduction in the equilibrium price – one mark. **3**

(d) **(i)** Look for one explanation of how China has managed to increase its efficiency/economic capacity. The main reason centres on the market reforms of the '80s and '90s which led to China becoming a much more market economy. The reforms included the growth of privatisation, the extension of property rights and the opening up of markets to the outside world. Other reasons include: the high rate of capital investment; the increased spending on education and training; rapid urbanisation; increased labour mobility; joining the WTO in 2001 and the low value of the Yuan. Do not credit 'their large population'. **2**

(ii) The US is one of our main export markets (for goods and services). If their growth rate is high, their AMD will be rising which will increase their demand for our exports. This will boost our export industries and increase our output, employment and rate of economic growth. **2**

(e) Two possible answers – so credit the logicality of the explanation. As the UK is (still) a major oil exporter, the increase in the price of oil will increase our export revenue (the demand for oil being price inelastic) and therefore increase the value of sterling.

OR

As much of our industry is based on oil, the increase in its price will increase our industrial costs and make our exports less competitive. This will lead to a decrease in the value of sterling. **2**

Marks

(f) High oil prices will encourage consumers of oil to be more efficient in their use of oil which will lead to a reduction in CO_2 emissions.
OR
High oil prices encourage the search for alternative sources of energy – especially renewables. If successful, CO_2 emissions will be reduced. **2**

(g) **(i)** Look for a straightforward definition of external costs eg they are spill-over costs from production (or consumption) imposed on third parties for which no compensation is paid. Credit examples. **2**

(ii) Measures include: taxation, fines, bans, tradable pollution rights. One mark for describing the measure, 2 marks for the quality of the explanation. **3**

(h) The passage equates energy efficiency with reductions in the use of oil/petrol, so look for a description of: car sharing, electric cars, smaller engines, bio-fuels, better public transport etc. Credit any plausible answer. **2**

Total 25

ITEM B

Marks

(a) They rose, because throughout the period, the growth in average earnings was higher than the rate of inflation. Credit the explanation only. If the candidate correctly explains what happened to the growth of earnings, 1 mark. **2**

(b) **(i)** Given the remit of the MPC, the only reason for an increase in interest rates is to reduce inflationary pressure in the economy – one mark. Candidates can gain the other mark by either explaining how increases in interest rate can reduce inflationary pressure or by linking the MPC's decision to the 2.0% inflationary target. **2**

(ii) An increase in the rate of interest will increase Hot Money inflows (credit reasons) which will increase the demand for sterling causing its value to rise. One mark for stating the ER will rise and 2 for the explanation. **3**

(c) If the increase in the size of the working population outweighs/is greater than, the increase in the numbers employed. **2**

(d) **(i)** The growth will slow down/fall – 1 mark, because the increase in unemployment will reduce wage demands – 1 mark. **2**

(ii) They are likely to worsen, because the government will be paying out more on JSA as more people are unemployed, and will be receiving less revenue from income tax and VAT as average incomes (and therefore AMD) will have decreased. Credit explanations only. **4**

(e) **(i)** Marks can be awarded for a variety of points.

- The budget was in deficit.
- The deficit will increase AMD.
- In order to meet this increase in AMD, employers will take on more workers.
- This will reduce the level of unemployment – 1 mark only if the explanation is correct.

Maximum – 3 marks.

(ii)

- Aggregate supply will take time to respond to the increase in AMD.
- The increase in AMD will therefore increase the rate of inflation – 1 mark if the explanation is correct.

Maximum – 2 marks. **4**

Marks

(f) **(i)** Reasons include:

- advances in technology have reduced production costs
- increased global competition – the rise of the BRICs
- the strong pound has reduced the price of imported finished goods, raw materials and components
- China has been ‘exporting deflation’
- weaker Trade Unions
- Labour reforms of the 1980s
- a pro-active MPC
- lower inflationary expectations
- consumers are more price conscious
- a more flexible work force and the growth of part-time and temporary work.

Mark according to the quality of the explanation. **4**

(ii) Advantages include:

- creates a stable economy – encourages FDI
- exports more competitive
- preserves the real income of people on fixed incomes
- enables the MPC to keep interest rates low which encourages investments and growth
- encourages efficiency – inefficient firms cannot hide behind rising prices
- reduces ‘shoe leather costs’.

Mark according to the quality of the description. **2**

Total 25

SECTION B

Marks

1 **(a)** Credit definition of opportunity cost – the sacrifice of the next best alternative choice. (Maximum 2 marks for definition and example).
Look for a clear, well drawn, fully labelled diagram showing two 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 explain (using the diagram) how producing more of one good requires producing less of another.
A PPC is therefore a diagrammatical explanation of opportunity cost.
Credit explanations of the shape of the curve, although not necessary for full marks. **9**

(b) When the marginal cost (ie the cost of producing the additional unit) is below the average total cost the average is pulled down. When the marginal cost is above the average, the average is pulled up. Marginal cost is equal to the average cost when the average is at a minimum ie marginal cost cuts average total cost at its minimum (optimum) point – 4 marks.
Correctly drawn diagram – 2 marks. **6**

(c) **Answers should involve an explanation of the difference between fixed and variable costs and that this situation will only occur in the short run.**

- Fixed costs have to be paid even when there is no production, so only variable costs are saved by temporarily ceasing to produce.
- Firms will continue to produce (in the short run) as long as they are able to cover their variable costs.
- Although they will make a loss by continuing to produce, if they are earning enough revenue to cover their variable costs, there are no cost advantages of temporarily shutting down.
- If their revenue more than covers their variable costs (but is less than their total costs) they will make less of a loss if they remain in production.
- Credit definition of short run and examples of fixed and variable costs.
- All costs must be covered in the long run.

Maximum 10 marks.

Continuing in production will also:

- allow firms to keep the goodwill of their workforce
- maintain the loyalty of their customers
- keep their machinery ticking over
- maintain the profile of their products in the market
- avoid the possible difficulty of restarting their production processes.

Credit candidates who mention that the decision whether or not to close down when variable costs are not being covered will be influenced by the level of the firm's reserves, the expected length of the downturn in demand (recession), the possibility of securing a bank loan etc. **10**

Maximum 4 marks.

Marks

2 **(a)** Technical efficiency – producer is getting maximum output from his/her inputs.

Credit references to optimum output, minimum ATC, point of highest productivity, production possibility curves, X-efficiency and productive efficiency.

Economic efficiency occurs when resources are being used to satisfy as many wants as possible. Credit references to allocative efficiency and Pareto optimum. The relationship is that technical efficiency is a necessary but insufficient condition for economic efficiency. **6**

(b) **Note, the question asks why not how. So the simple answer is to correct market failure – situations where the price mechanism fails to allocate resources efficiently or equitably. Look for at least 4 situations where the market might fail (as far as society is concerned) and explanations of why it might fail. These include:**

- to provide merit goods (credit definition and examples) – which, in a market economy, would be provided only for those who could afford them, and yet most people feel that they should be free at the point of consumption
- to reduce the demand for demerit goods (credit examples) – which would be overprovided in a market economy as they are harmful for consumers
- to provide public goods eg defence, lighting, police – which would be underprovided in a market economy (credit reasons) but are essential for the wellbeing of society
- to internalise externalities (credit definition) – to protect the environment and increase the welfare of society. Credit references to pollution taxes, tradable pollution rights etc
- to control monopolies and therefore prevent reductions in competition and consumer exploitation. A market economy 'encourages' the growth of monopolies by its 'survival of the fittest' ideology
- to provide unprofitable goods (credit examples) – which would be underprovided in a market economy in which producer behaviour is motivated by profit
- to reduce income inequalities and provide for the economically inefficient eg the young, the sick and the poor. In a market economy the underprivileged would have to depend on charity.

Some candidates may go down the road of government intervention in the price mechanism and may write about subsidies, taxation, minimum/ maximum price, quotas etc. This is a valid approach and can gain full marks – provided they concentrate on why the government intervenes. **10**

(c) Look for at least 3 explanations that concentrate on the effectiveness of aid in increasing growth.

- The provision of capital equipment (either given directly or by loans/grants). This is an invaluable source of aid (especially when the capital is 'appropriate' ie intermediate and not state-of-the-art) which can help a country to reach its 'take-off' point. However, unless the loans are 'soft', they can create huge debt problems for the developing country.
- Technical assistance eg technical experts to give advice and training to local technicians on the best way to use existing capital equipment – helps increase productivity and enables the developing country to make full use of its capital equipment.
- Educational support – literacy programmes and basic education for all are essential requirements for economic growth.
- Cheap drugs and medicines – have always been important but are even more so now because of the Aids epidemic and the increase in the number of cases of Malaria in Africa.
- Debt relief – essential as it allows developing countries to spend more on their infrastructure, health care etc instead of spending money on servicing debt.
- Liberal trade policies ie free and fair trade. Economic growth follows increases in trade, therefore developed countries must allow the exports of developing countries free access to their markets and must abolish the subsidies they give to their domestic producers (sugar, cotton, steel etc) which artificially reduce prices on world markets.

Credit real world examples.
One mark for identification, maximum 2 for explanation. **9**

Marks

3 (a) Reasons include:

- trend towards globalisation and increased foreign competition – especially from Asian manufacturing nations, particularly China and the resultant loss of comparative advantage – makes the manufacture of many products uneconomic in the UK
- perception that foreign goods are cheaper/better quality
- many UK businesses have moved manufacturing operations overseas where production costs are lower
- shrinking of the UK manufacturing sector
- trade deficit is possibly structural, deep rooted and not likely to be quickly eliminated by short term changes in conditions relating to the business cycle
- lack of price and non-price competitiveness
- the strong pound – particularly against the dollar
- booming UK consumer demand
- rising real incomes plus increased domestic demand – increased imports of consumer durables
- high UK propensity to import, especially raw materials and components
- the economic downturn in the EU and US – our main trading partners
- reduced production of North Sea oil (due to maintenance)
- continued decline in the manufacturing industry, combined with the inability of services and tourism to close the gap.

Four explanations for full marks. **8**

(b) Look for a diagram showing the flow of factor rewards from firms to households and the subsequent flow of expenditure from households to firms. The diagram should also show injections of income and withdrawals (particularly exports and imports) – 3 marks.

Look for a simple explanation of how injections increase the flow of income in an economy and withdrawals reduce it. (Credit explanations of National Income equilibrium).

Candidates should then explain that a deficit (imports greater than exports) causes a net outflow of income from the circular flow. The decrease in income flowing round the economy creates decreases in demand which encourages producers to decrease output which decreases employment and reduces economic growth. **8**

(c) Credit **description** and **explanation** of any government measure that could possibly increase the competitiveness of our exports or slow down the growth of our demand for imports. These include:

- lower interest rates – to encourage investment
- greater government spending on R and D
- increased spending on education and training
- tight fiscal policy/budget surpluses to reduce demand
- tight monetary policy eg increase interest rates – to discourage spending on imports (reduce demand)
- import controls – eg tariff – tax on imports that increases the price, creating a reduction in demand; quota – limit on the number of goods – restricts supply and therefore increases price; high safety and quality standards; exchange controls; subsidies to home producers (Maximum 4)
- reductions in the value of the pound – eg reduced interest rates (hot money outflows) – imports more expensive, exports cheaper.

Also credit measures to reduce inflation to increase competitiveness of exports, supply side measures, trade exhibitions, export drives, export rebate schemes, increased productivity incentives resulting in lower unit costs, wage controls etc.

9

			Marks
4	(a)	• Loss of monetary independence – the MPC will no longer be able to set interest rates to suit the needs of the UK economy. • One European interest rate will not suit all member countries (especially true for the UK which is at a different stage of the economic cycle to that of most of the rest of the EU). • Devaluation of sterling to correct trade defects is no longer an option (will have to deflate instead). • The UK is more sensitive to interest rate changes because of our high % of variable rate mortgage holders. • Exogenous shocks eg oil price changes will impact the UK economy differently from the rest of the EU economies. • The menu costs of changing over to the Euro will be very high. • Inflationary impact of lower interest rates. • Difficulty of finding "entry rate" of exchange for £ v Euro. • UK economy is currently healthy – if it ain't broke why fix it?	**8**
	(b)	**Reasons include:** • cheaper labour/skilled labour force • quality universities/science parks • lower rents/relatively cheap land • government incentives • to get inside the EU • large UK market • reduced transport costs/efficient infrastructure • common language – if American • stable currency/stable economy • scenery and golf courses. Four reasons for full marks.	**8**

(c) **Advantages include:**

- increased employment and income – with the consequent multiplier effect
- increased competition – leading to lower costs and prices
- exchange of new technology and management techniques
- increased capital inflows and exports – positive effect on balance of payments. reduced prices and wider choice for UK consumers (credit examples).

Maximum 6.

Disadvantages include:

- can be costly for the government to entice these firms to the UK
- the money could have been used to help domestic firms (opportunity cost)
- no guarantee the firms will stay in the UK
- creates unfair competition for UK firms
- jobs created may be mainly screwdriver jobs – the highly skilled jobs tend to stay in the home country
- the danger of becoming a branch economy – branches are first to close in a recession
- adverse effects on local industry
- the heightened conflict between consumers and shareholders when they are different nationalities
- repatriated profits worsens the balance of payments (credit examples).

Maximum 6. **9**

Marks

5 **(a)** **The reasons include:**

- the increase in free trade throughout the world – credit references to the WTO, Doha, Gleneagles etc – has resulted in a large growth in trade which has increased world competition
- the increased integration of global markets – globalisation and advances in communication technology have made it easier for countries to trade and compete globally
- the emergence of new economic giants (the BRICs) on the world scene has greatly increased global competition
- protected national monopolies have given way to competitive prices and wage rates – credit references to the Competition Commission and American anti-trust laws
- opening of financial markets – capital is much more mobile and countries have to be much more competitive if they want to receive FDI
- increases in world productivity have created excess productive capacity which has created a downward pressure on world prices
- growing world labour force – in particular ample supply of low wage unskilled labour – has dampened wage growth
- general deregulation by governments – reduced government intervention in markets and the world wide growth in privatisation, have resulted in greater market freedom and increased competition.

Three reasons for full marks. **8**

(b) **(i)** Price elasticity of demand measures the extent to which the quantity demanded of a good changes (responds) when its price changes (1 mark).
Credit the formula (1 mark) and explanations of when demand is price elastic (>1) etc (2 marks).
Correctly drawn diagrams should also be credited (1 mark).

Look for an understanding of the importance of the relationship between PED and total revenue.
If demand is price inelastic, P and TR move in the same direction.
If demand is price elastic, P and TR move in opposite directions.

Credit references to the importance of PED for producers (when considering price changes) and Chancellors (when deciding tax changes).

Credit highly candidates who mention that PED determines the extent to which the price of a good will change when its supply changes (especially important in agricultural markets, and for developing countries who often face a price inelastic demand for their exports). **10**

Marks

(ii) **The measures include:**

- increased advertising – to make consumers believe that identical products are different
- increase brand loyalty by offering after sales service, guarantees, discounts for repeat purchases, free gifts/competitions etc
- product differentiation – through branding, packaging, increased quality etc
- obtaining patents/copyrights – so consumers have no choice
- easier HP terms – smaller deposit, longer re-payment period, lower interest rates
- take over rival producers to gain a bigger share of the market and increased monopoly power.

Three descriptions for full marks. **7**

Marks

6 (a) **Advantages include:**

- political and economical stability
- the addition of 105 million people and an increase in land should boost economic growth and create new jobs
- the bigger market will create greater opportunities for firms to benefit from economies of scale
- the lower wage costs in the new member states will provide opportunities for firms to cut costs by relocating their operations
- UK skill shortages could be reduced by an inflow of labour from Eastern Europe.

Disadvantages include:

- jobs may be lost if firms relocate to take advantage of the lower wage costs in the new entrant countries (eg Slovakia is now the world's largest car manufacturer per capita)
- a sudden influx of labour from Eastern Europe could dampen wage growth
- the CAP will have to be drastically reformed. To maintain the current levels of EU spending in the enlarged EU would bankrupt the EU
- all the new entrants have living standards below the EU average so the distribution of EU regional funds will have to be altered in favour of the new entrants
- the UK (and particularly Scotland) will not only receive less regional aid, it may also lose its rebate.

Three advantages and three disadvantages for full marks but can mark 6:6, 7:5 or 5:7. **12**

(b) (i) Economic growth is an aim because:

- economic growth is an increase in productive capacity – this usually involves an increase in output, therefore there will be:
  - increased income/increased average standard of living and more leisure time
  - increased employment opportunities
  - increased job security.

Increased economic growth also:

- makes it easier for the government to reduce income inequalities if all incomes are rising
- increases government revenue from taxation – income tax, corporation tax, VAT (credit reasons) so government can afford to spend more on health, education etc
- decreases government expenditure on transfer payments eg jobseekers allowance
- encouraged inward investment.

Three well explained benefits for full marks. **6**

Marks

(ii) High rates of economic growth (credit references to China) can result in aggregate demand growing faster than aggregate supply. This excess demand/overheating can cause serious problems. These include:

- higher (demand-pull) inflation, which will lead to a loss of competitiveness, reduced exports and trade deficits
- increased wage growth, which will further reduce competitiveness
- the growth in demand will 'suck in' imports (credit references to our relatively high marginal propensity to import) and further increase the trade deficit.

High rates of economic growth will also lead to:

- faster resource depletion – credit examples and references to the energy crisis
- increased pollution – credit examples
- increased climate change – credit examples
- increased stress on the workforce.

Four disadvantages for full marks. **7**

[END OF MARKING INSTRUCTIONS]