

MARKSCHEME

May 2007

ECONOMICS

Higher Level

Paper 1

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In addition to the assessment criteria, use the paper-specific markscheme below. Award up to the maximum marks indicated.

1. (a) Explain how barriers to entry may affect market structure. [10 marks]

Answers **may** include:

- explanation of term barriers to entry
- examples of barriers to entry, such as patents, economies of scale and ownership and control of raw materials
- explanation of term market structure
- identification of the different types of market structure, *i.e.* perfect competition, monopoly, monopolistic competition and oligopoly
- explanation that there are no barriers to entry in perfect competition
- linkages between no entry barriers and perfect competition and monopolistic competition
- explanation that entry barriers exist in the other market forms
- linkages between the existence of entry barriers in monopoly and oligopoly and market structure

(b) Evaluate the view that monopoly is an undesirable type of market structure. [15 marks]

Answers **may** include:

- definition of monopoly
- at least one appropriate diagram
- comparisons between monopoly and perfect competition, *e.g.* price usually higher and output lower
- allocative and productive inefficiency
- failure by monopolist to produce at the socially optimum level of output
- lack of choice for consumers
- lack of innovation and higher unit costs because of absence of competition
- possibility of lower unit costs and prices owing to economies of scale
- long run dynamic efficiency in monopoly
- benefits of natural monopoly
- benefits to some consumers of monopolistic price discrimination
- potential competition and contestable markets

Examiners should be aware that candidates may take a different approach, which if appropriate, should be rewarded.

Effective evaluation may be to:

- consider short run versus long run consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritize the arguments

2. (a) **Explain why a government might find it difficult to maintain a low rate of inflation as the economy approaches full employment** *[10 marks]*

Answers **may** include:

- definition of inflation and full employment
- use of the Phillips Curve (PC) to illustrate the trade off between full employment and price stability (short-run and/or long-run). A relevant diagram referring to AD/AS is also acceptable
- explanation of the PC relationship in terms of possible demand pull factors
- explanation of the PC relationship in terms of possible cost push factors
- explanation in terms of AD/AS analysis
- explanation in terms of the natural rate of unemployment

- (b) **Evaluate the proposition that the priority in economic management should be the maintenance of low unemployment.** *[15 marks]*

Answers **may** include:

- explanation of economic management in terms of fiscal and monetary policies
- support of the proposition in terms of the costs of high unemployment, *e.g.* the economic, social, financial and personal costs
- use of long run PC and the concept of the natural rate of unemployment to illustrate the possible inflationary implications
- other possible policy conflicts, *e.g.* with the balance of payments and economic growth
- the importance of the other goals of economic policy, *i.e.* low inflation, economic growth and a satisfactory balance of payments
- significance of the use of supply-side policies

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Effective evaluation may be to:

- consider short run versus long run consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritize the arguments

3. (a) **Explain the various factors which may affect an exchange rate in a floating exchange rate system.** [10 marks]

Answers **may** include:

- definition of exchange rate and floating exchange rate system
- explanation in terms of the demand for, and supply of, a currency
- an appropriate diagram
- trade flows
- capital flows/interest rate changes
- changes in the level of national income
- inflation
- speculation
- use of foreign currency reserves
- significance of purchasing power parity

- (b) **Evaluate a government decision to adopt a floating exchange rate as opposed to a fixed exchange rate system.** [15 marks]

Answers **may** include:

- distinction between a floating and fixed exchange rate system
- support of the decision in terms of the possible advantages of floating/disadvantages of fixed exchange rates, which **may** include
 - benefits of market forces setting exchange rates rather than governments
 - no need to keep substantial foreign exchange reserves
 - impact on domestic economic policies
 - automatic adjustment of the balance of payments
 - possibility of forward trading to hedge against currency movements
 - greater incidence of crises under fixed schemes
- arguments against the decision in terms of the possible disadvantages of floating/advantages of fixed, which **may** include
 - exchange rate volatility and the impact on business and confidence
 - exchange rate volatility and the impact on inflation and unemployment
 - fixed exchange rates may represent a move towards monetary union with trading partners

Better candidates may make assessment of the two exchange rate systems in light of empirical evidence. This should be rewarded, but is not necessary to achieve the top band.

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Effective evaluation may be to:

- consider short run versus long run consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritize the arguments

4. (a) **Explain the various types of aid which a developing country might receive.** [10 marks]

Answers **may** include:

- definition of a developing country
- definition of aid
- bilateral and multilateral aid
- grant aid and loans
- official and unofficial aid
- tied and untied aid
- debt cancellation

(b) **“Aid is an ineffective means of promoting the development of poorer countries.” Evaluate this statement.** [15 marks]

Answers **may** include:

- definition of development
- arguments against the statement, which **may** include whether aid
 - bridges the savings gap
 - bridges the foreign exchange gap
 - finances provision of merit goods and infrastructure projects in recipient countries
 - is used as a transition strategy
- arguments in favour of the statement, which **may** include whether aid
 - interferes with market forces and encourages reliance on “handouts”
 - is used to promote the exports of donor countries
 - finances military expenditure
 - is used for political purposes
 - is conditional on the implementation of free market/supply side policies
e.g. privatisation
 - increases indebtedness
 - is less effective than trade related development, *e.g.* through fair trade schemes

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Effective evaluation may be to:

- consider short run versus long run consequences
 - examine the impact on different stakeholders
 - discuss advantages and disadvantages
 - prioritize the arguments
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