



MARKSCHEME

May 2009

ECONOMICS

Standard Level

Paper 1

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1. (a) **Using an appropriate diagram, explain how negative externalities are a type of market failure.** [10 marks]

Answers **should** include:

- a definition of market failure
- a definition of negative externality
- an explanation of how a negative externality leads to market failure because it leads to an over allocation of resources in particular market
- a MSC/MSB diagram to illustrate the above.

Candidates can get full marks even if they use the terms social cost and social benefit, but do not use the “marginal” concept.

Answers **may** include:

- examples of negative externalities.

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

- (b) **Evaluate the measures that a government might adopt to correct market failure arising from negative externalities.** [15 marks]

Answers **may** include:

- examples of negative externalities that may call for the attention of the government
- reference to short-term and long-term environmental concerns, with reference to sustainable development
- explanation of ways in which governments can address market failure arising from negative externalities, *e.g.*
 - legislation
 - taxation/subsidies
 - tradable permits
 - extension of property rights
 - advertising to encourage or discourage consumption
 - international cooperation amongst governments
- discussion of the extent to which each of the above is likely to correct market failure/discussion of the limitations of each.

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

Effective evaluation may be to:

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

2. (a) **There are various types of unemployment. Explain how any *three* types of unemployment may cause a rise in the unemployment rate of an economy.** [10 marks]

Answers **should** include:

- definition of unemployment
- an explanation of three of structural, frictional, seasonal, demand deficient (cyclical), real wage unemployment (classical)
- explanation of the term “unemployment rate” and how the three types of unemployment explained could increase the unemployment rate.

Answers **may** include:

- diagrammatic illustration of the above.

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- (b) **Evaluate the view that the unemployment rate can be most effectively reduced through the use of measures designed to increase aggregate demand in an economy.** [15 marks]

Answers **may** include:

- explanation of measures designed to increase AD in terms of fiscal and monetary policy
- use of lower interest rates to increase AD and to combat demand deficient unemployment
- use of higher government spending/lower taxation to increase AD and to combat demand deficient unemployment
- illustration of demand-side policies using AD/AS diagrams
- discussion of ineffectiveness of demand-side measures for structural, real wage, frictional and seasonal unemployment
- discussion of problems of demand-side measures, *e.g.* may lead to a rise in inflation, financing expansionary fiscal policy, time lags associated with monetary policy, *etc.*
- explanation of supply-side measures to deal with non-demand deficient unemployment
- discussion of problems of supply-side measures, *e.g.* it may lead to the exploitation of workers, the cost and effectiveness of government managed training, the time lags associated with the application of supply-side policies.

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

Effective evaluation may be to:

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

3. (a) **Explain *three* factors which may cause changes to occur in a country's exchange rate under a floating exchange rate system.** [10 marks]

Answers **should** include:

- a definition of an exchange rate
- a definition of a floating exchange rate system
- a basic explanation of three of: trade flows, capital flows, interest rate changes, inflation, speculation, use of foreign currency reserves and how they lead to a change in an exchange rate
- a demand and supply diagram to illustrate changes in an exchange rate.

Where candidates discuss one factor correctly they should achieve maximum level 2; for two correct factors maximum level 3.

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

- (b) **Evaluate the likely impact on a country's economic performance of a substantial depreciation of its exchange rate.** [15 marks]

Answers **may** include:

- definition of depreciation
- explanation of effect of a depreciation on export and import prices
- explanation of economic performance in terms of employment, inflation, growth/development and the balance of payments
- importance of PED for exports and imports (specific knowledge of Marshall-Lerner and the J-curve is **not** required at SL)
- possible impact on employment (*e.g.* cheaper exports cause an increase in AD)
- possible impact on inflation (*e.g.* more expensive imports)
- possible impact on growth (*e.g.* increase in short term, actual growth as AD increases)
- possible impact on the balance of payments (*e.g.* demand for exports likely to increase and demand for imports likely to decrease)
- impact on and significance of the terms of trade
- possibility of other countries' exchange rates depreciating at the same time.

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

Effective evaluation may be to:

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

4. (a) **Institutional and political factors such as an ineffective taxation structure, political instability and an unequal distribution of income, as well as social and cultural factors such as gender issues and tradition, may all act as barriers to economic development.**

Explain how any *three* of these factors may act as barriers to economic development.

[10 marks]

Answers **should** include:

- a definition of economic development
- a basic explanation of the significance of three of the above as barriers to economic development *e.g.*:
 - ineffective tax systems make it difficult to raise money for public services
 - political instability leads to civil unrest which deters FDI
 - unequal distribution of income leads to poverty
 - gender issues such as discrimination against women.

If a candidate uses a barrier that is not on the list above, give credit based on the validity of the response.

Answers **may** include:

- a more detailed explanation of the significance of three of the above for economic development.

Where candidates discuss one factor correctly they should achieve maximum level 2; for two correct factors maximum level 3.

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

- (b) Evaluate the view that, in terms of achieving economic development in less developed countries, interventionist strategies, with a role for the government, are preferable to market-led strategies.

[15 marks]

Answers **may** include:

- definitions of economic development and LDCs
- an explanation of interventionist strategies, *e.g.* in terms of the state playing an active role in the management of the economy, economic planning, import and exchange controls, nationalization of industries
- an explanation of market-led strategies, *e.g.* in terms of a belief in the free operation of markets, a minimum role for the state in economic affairs, trade liberalization, privatization, foreign direct investment (FDI)
- use of PPC diagrams to illustrate development
- advantages of interventionist strategies, *e.g.* in terms of greater diversity of economic activity, supply-side improvements as a result of investment in health care and education and training, protectionism allowing existing industries breathing space to grow and infant industries to achieve economies of scale, a more equal distribution of income and wealth, less inequality between rural and urban sectors, higher levels of employment
- disadvantages of interventionist strategies in terms of possible growth of the public sector and government spending, inability to benefit from the gains from free trade, inefficient resource allocation, growth of inefficient monopolies, drawbacks of planning, possible bias against exports
- advantages of market-led strategies, *e.g.* in terms of more efficient resource allocation along the lines of comparative advantage, benefits of MNCs, benefits of free trade, flexible labour and capital markets, greater consumer choice, a reduction in government budget deficits
- disadvantages of market-led strategies, *e.g.* in terms of market failure, increased likelihood of structural unemployment, problems associated with MNCs, problems of structural adjustment programmes, greater wealth and income inequality, problems of capital outflows (*e.g.* profit repatriation) and a general vulnerability with regard to external fluctuations and shocks.

As this question refers to “economic development”, answers cannot obtain full marks if there is no reference to development factors beyond pure economic growth.

Effective evaluation may be to:

- consider short-term versus long-term consequences
- examine the impact on different stakeholders
- prioritize the arguments.

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