

MARKSCHEME

May 2007

ECONOMICS

Standard 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 the signalling and incentive functions of price in a market economy. [10 marks]

Answers **may** include:

- definition of market economy
- description of market forces and how resources are allocated
- explanation of the signalling function in relation to producers and consumers: *e.g.* as consumers increase their demand for a good (shift of demand to the right) the price of the good and profits rise, acting as a “green light” signal to producers to increase their output (movement along the supply curve); as the supply of a commodity becomes more scarce, supply shifts to the left and the rise in price signals to consumers to reduce their demand (movement along the demand curve); these changes in demand and supply bring about changes in resource allocation
- explanation of the incentive function in relation to producers: *e.g.* an increase in demand for a product will raise its price and profitability and provide the incentive for producers to supply more/new firms to enter the market; the higher demand for the product will also lead to an increase in demand for labour to produce the product, causing wages to rise, which will in turn provide an incentive for workers to seek employment in that industry; these changes in demand and supply bring about changes in resource allocation
- use of appropriate diagrams *e.g.* demand and supply

Candidates may not use the specific terms: signalling and incentive but may explain the functions of price using different terminology and they should be fully rewarded for this.

(b) Evaluate the proposition that government intervention in the market for tobacco is justified.

[15 marks]

Answers **may** include:

- tobacco as a demerit good
- definition of demerit good
- explanation of forms of government intervention in the market for tobacco, *e.g.* in terms of an increase in indirect taxation and increased regulation (age restrictions, health warnings, *etc.*)
- arguments in support of the proposition, *e.g.* in terms of overprovision of demerit goods, negative externalities, MSC and MSB and resource allocation
- arguments against the proposition, *e.g.* in terms of distortion of signalling and incentive functions, consumer choice, problems of government intervention, employment in these industries, parallel markets, *etc.*
- use of appropriate diagrams *e.g.* MSC, MSB but not necessarily both – either is sufficient

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) Use AD/AS (aggregate demand/aggregate supply) diagrams to explain the causes of inflation. [10 marks]

Answers **may** include:

- definition of inflation
- definitions of AD and AS
- explanation of cost push
- explanation of the different cost push factors: wage push, raw material prices, *etc.*
- illustration and explanation of cost push in terms of a leftward shift of AS
- explanation of demand pull
- reasons for rising AD *e.g.* low interest rates, rising consumer confidence
- illustration and explanation of demand pull in terms of a rightward shift of AD
- explanation of excess monetary growth, with appropriate transmission mechanism
- illustration and explanation of excess monetary growth in terms of a rightward shift of
- use of appropriate diagrams *e.g.* AD and AS

- (b) Evaluate the view that governments should make the control of inflation their highest priority. [15 marks]

A number of different approaches are possible to this question.

Answers **may** include:

- identification of other goals of economic policy, *i.e.* full employment, economic growth, a satisfactory balance of payments and a more/less equal distribution of income
- inflation should be the priority because of the problems it causes, *e.g.* lack of international competitiveness, redistribution effects, greater uncertainty for businesses
- links between low inflation and economic growth and employment
- the beneficial effects of mild demand pull inflation
- full employment should be the priority in terms of the ill-effects of unemployment, *e.g.* financial costs for the government, economic costs of output foregone, social and personal costs
- economic growth should be the priority in terms of, for example, the benefits of rising living standards, reduction of poverty, government tax revenues
- a satisfactory balance of payments should be the priority in terms of the problems of running a persistent deficit *e.g.* deflationary government responses, potential debt problems, underlying uncompetitiveness
- a more equal distribution should be the priority in terms of, for example, eradicating poverty, promoting development, increasing AD, enabling people to realise their talents
- the possible conflicts between lower inflation and the achievement of other goals of economic policy, *e.g.* lower unemployment and economic growth
- problems associated with the policy instruments available to bring about low inflation, *i.e.* monetary, fiscal and supply-side policies.
- use of appropriate diagrams *e.g.* AD and AS

N.B. The above represent a range of possible approaches that candidates might adopt. It would not be expected that all would be dealt with.

Examiners should remember that the Phillips curve is an HL extension topic and it should not be required for full marks.

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

3. (a) Explain the likely consequences of a deterioration in the terms of trade for a country's balance of payments on current account. [10 marks]

Answers **may** include:

- definition of terms of trade
- definition of balance of payments on current account
- explanation of what is meant by a deterioration in the terms of trade *e.g.* import prices increase relative to export prices
- explanation of the linkage between a deterioration in the terms of trade and the current account; *e.g.* as import prices increase, demand for imports is likely to fall and as export prices decrease, demand is likely to rise causing the balance of payments to improve
- explanation of how a fall in the price of exports caused by a fall in demand for exports could lead to a current account deficit
- explanation of how a rise in the price of imports caused by a rise in demand for imports could lead to a current account deficit
- awareness that the terms of trade is a price relationship between exports and imports, while the current account measures the value of exports relative to imports
- recognition that the extent of the fall in imports and rise in exports will depend upon relative demand elasticities for imports and exports
- use of appropriate diagrams *e.g.* demand and supply of imports and exports

***N.B.** As elasticity of demand for imports and exports in the Marshall Lerner condition is an HL extension topic it is not expected that candidates explain these to earn full marks.*

- (b) Evaluate the view that a deterioration in the terms of trade is the most significant barrier to economic development that a developing country can face in the area of international trade.**

[15 marks]

Answers **may** include:

- definition of economic development
- explanation of barriers to economic development
- explanation of the impact a deterioration of terms of trade in terms of how it could hinder economic development because of : lower export revenues, higher import expenditure, current account deficit
- impact of other barriers to economic development in the area of international trade:
 - overdependence on primary products
 - unstable currency
 - lack of foreign currency
 - narrow range of exports
 - protectionism in international trade, including trade blocs
- assessment of the assertion of “most significant”
- use of appropriate diagrams

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

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
- non-monetary aid *e.g.* food aid
- use of appropriate diagrams *e.g.* AD and AS

(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
 - 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 *e.g.* interest payments even on soft loans
 - is less effective than FDI
 - is less effective than trade related development, *e.g.* through fair trade schemes
 - encourages dependence
 - misuse through corruption
- use of appropriate diagrams

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
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