



# **MARKSCHEME**

**November 2001**

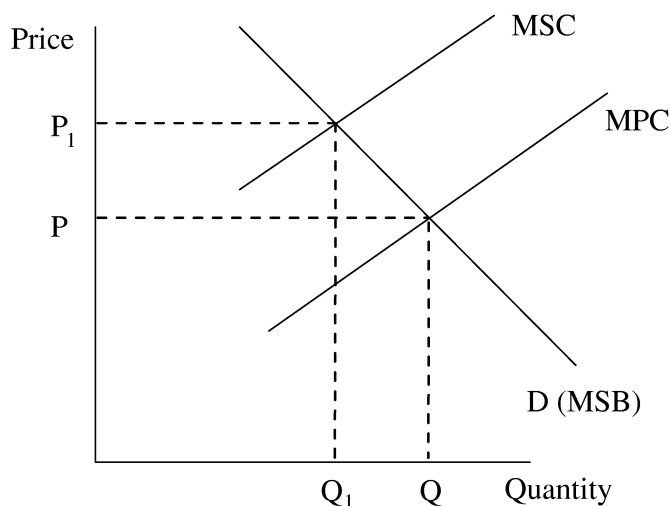
**ECONOMICS**

**Higher Level**

**Paper 2**

**1. Why is pollution an example of market failure? Use a diagram to illustrate your answer.**

Pollution is an external cost of production (exact phrase need not be used). Pollution results in an equilibrium price and quantity (P,Q) that does not fully reflect the external cost to society. The good is therefore underpriced and oversupplied (social equilibrium should be  $P_1, Q_1$ ). Reward any other relevant diagram.



[10 marks]

**2. Using real world examples, illustrate the difference between producer sovereignty and consumer sovereignty.**

This question is concerned with market power and whether producers or consumers determine which goods and services are produced and at what price.

Examples of producer sovereignty might include relevant cases from large multinational corporations, while examples of consumer sovereignty might include local markets for homogeneous products such as a local fruit market.

An alternative theoretical approach might include a diagrammatic comparison of perfect competition and monopoly, where candidates might identify 'difference' in price and output.

[10 marks]

**3. Define 'crowding out'. What is its importance in macroeconomic policy making?**

This requires a definition which conveys the idea that the presence of governmental activity can limit the effectiveness of free markets, with an appropriate example (*e.g.* in the loanable funds market where state borrowing drives up interest rates for the private sector).

Candidates may discuss crowding out in relation to the financial and/or the resource market. Candidates might then be expected to link the concept to the wider Keynesian/monetarist debate, perhaps seeing it as a monetarist's explanation for the limited effectiveness of the multiplier, or a supply sider's justification for attempting to shrink the state sector.

Able candidates might point to the limited relevance of the concept of crowding out.

[10 marks]

**4. A government decides to raise interest rates. How might this affect the external account?**

Candidates could write about the following:

- (a) the effect on the capital balance
- (b) the longer term effect on the invisible balance
- (c) indirect effect on the visible balance through an appreciation of the exchange rate.

Better candidates will mention price elasticities of demand for exports and imports and the Marshall-Lerner condition.

All this assumes exchange rates are free to move (floating) but in any fixed exchange relationship, central banks may have to become active in international exchange markets.

Indirectly, reduced domestic demand resulting from the switch from domestic consumption to saving (due to the increase in interest rates) will imply reduced demand for imports.

Better candidates may discuss the effectiveness or otherwise of using monetary policy to relieve balance of payments problems.

*[10 marks]*

**5. Explain why a deterioration in the terms of trade could bring about an improvement in the balance of payments on current account.**

An accurate distinction between the terms of trade and the balance of payments on current account is required. Give some credit to those candidates who are merely able to explain what is meant by a deterioration in the terms of trade and an improvement in the current account. However, higher marks should be awarded only where clear linkages between the two are made.

To reach Band 4B, students must make use of the concept of price elasticity of demand.

*[10 marks]*

**6. What is human capital? Explain its importance in economic development?**

Again, a definition will be necessary (involving literacy, education, training, entrepreneurship *etc.*) and this will necessarily link to the provision of merit goods and the difficulties of doing this in LDCs. Students who demonstrate economic awareness by referring to particular cases or to indicators which can be used to measure the effectiveness of human capital should be well rewarded. This question involves setting a concept in a broad context, *e.g.* mentioning factors such as technological change, changes in resource allocation, investment in physical capital, or the productivity of labour, so the markscheme must be relatively open ended, with examiners free to reward the quality and feel of the answers.

*[10 marks]*

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