

# **MARKSCHEME**

**November 2004**

**ECONOMICS**

**Higher Level**

**Paper 2**

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*Each question is worth [10 marks]. Award up to the maximum marks indicated.*

- 1. Use a diagram to explain why the under provision of merit goods is considered to be an example of market failure.**

Responses should include

- definitions of both merit goods and market failure
- reference to the existence of positive externalities (external benefits) and examples which illustrate external benefits
- a correctly labelled diagram to illustrate positive externalities
- an explanation of the diagram which refers to the socially efficient level of output and which shows that the free market level of output would predict under provision of the good/service and therefore be an example of market failure (socially inefficient allocation of resources).

If no diagram is used then award up to a maximum of *[4 marks]*.

- 2. Use a diagram to explain how producers and consumers might benefit from a government subsidy to an industry.**

Responses should include

- a definition of a government subsidy
- accurately labelled supply and demand diagram showing a rightward shift of the supply curve
- an explanation of the diagram which illustrates the effect of the subsidy on equilibrium price and quantity
- a vertical line showing the amount of the subsidy
- reference to the effect on both consumers (lower prices paid for greater quantity) and the benefit to producers (greater revenue since higher prices received for greater quantity)
- to reach Band 4, responses must make reference to the fact that the magnitude of the effect will differ depending on the elasticities of demand and supply.

If no diagram is used then award up to a maximum of *[4 marks]*.

- 3. A monopolist decides to maximize profits rather than revenue. Using a diagram, explain how price and quantity will change.**

Responses should include

- a definition of a monopolist
- an explanation of the revenue maximizing level of output ( $MR = 0$ ) and the profit maximizing level of output ( $MC = MR$ )
- an accurately labelled diagram showing the levels of price and output when profit is maximized and when revenue is maximized
- an explanation of the fact that when the change from revenue maximization to profit maximization is made, output will fall and price will rise.

If no diagram is used then award up to a maximum of *[4 marks]*.

**4. Explain *two* policies that a government might use to deal with the problem of demand-deficient (cyclical) unemployment.**

Responses should include

- a definition of demand-deficient unemployment
- reference to the components of aggregate demand ( $AD = C + I + G + X - M$ )
- explanation of possible government policies: expansionary fiscal policy (increase  $G$  and reduce  $T$ ); expansionary monetary policies (decrease interest rates and increase money supply); exchange rate policy (cause depreciation of exchange rate to stimulate exports and reduce imports); trade policy (increase protection to reduce imports)
- better answers will explain how the policies above affect the components of  $AD$

An  $AD/AS$  diagram showing demand-deficient unemployment and the need to shift  $AD$  would be very useful in the explanation but is not required for full marks.

If only one point (policy) is considered then up to **[7 marks]** may be awarded.

**5. How would deterioration in the terms of trade affect the current account of a country?**

Responses should include

- an accurate definition of the terms of trade  $\left( \text{terms of trade} = \frac{\text{index of } \times \text{ prices}}{\text{index of m prices}} \times 100 \right)$
- an accurate definition of the current account
- explanation of a deterioration in the terms of trade
- an awareness that the effect of a deterioration in the terms of trade on the current account depends on the elasticities of demand for exports and imports
- an explanation that a deterioration in the terms of trade will lead to an improvement in the current account if the combined elasticities of demand for imports and exports is greater than 1 but will lead to a worsening in the current account if the combined elasticities is less than 1.

Responses which fail to note the importance of elasticities may not move beyond Band 3.

**6. With the help of a diagram, explain how a buffer stock scheme is expected to work.**

Responses should include

- an explanation of a buffer stock scheme as a means of establishing a minimum and maximum price for a commodity
- a suitable diagram and explanation showing the operation of a buffer stock scheme. The commonly used diagram is one which shows minimum and maximum price and illustrates the management of surpluses and shortages through intervention buying and selling.

An example of a buffer stock scheme would be useful in the explanation.

If no diagram is used then award up to a maximum of **[4 marks]**.

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