International Baccalaureate®
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MARKSCHEME

November 2009

ECONOMICS

Higher Level

Paper 1

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

1. (a) Explain why a firm may practice price discrimination and the necessary conditions for it to take place. ***[10 marks]***

Answers **should** include:
- a definition of price discrimination
- an explanation that the aim of price discrimination is to increase profit
- an explanation of the various conditions; *i.e.* some degree of monopoly control of the market, ability to split the market into different segments and to prevent reselling between the markets, and different elasticities of demand in the different markets.

Answers **may** include:
- appropriate diagrammatic illustration of price discrimination
- reference to the connection between price discrimination and consumer surplus and the supplier's intention of transferring the surplus from consumers to producers
- a distinction between price discrimination and the charging of different prices for the same product/service where distribution and/or production costs are different (price discrimination is not the result of cost differences)
- an explanation of how it is consistent with the objective of profit maximization
- a distinction between first, second and third degree price discrimination.

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

(b) "Although a firm may pursue a range of goals, economists usually assume that profit maximization is the main goal." Discuss this statement. ***[15 marks]***

Answers **may** include:

- a definition of profit of maximization in terms of MC = MR and/or where TR most exceeds TC
- explanation that the conventional theory of the firm assumes the MC = MR profit maximizing rule under the various market structures
- explanation of the setting of prices using MC = MR in different market structures, *e.g.* perfect competition, monopoly, oligopoly, monopolistic competition
- explanation of why firms may not set prices according to MC = MR, *e.g.* may not have the profit maximizing objective, may lack relevant information on costs and revenues
- discussion of how firms may set prices in reality, *e.g.* in terms of sales volume maximization, revenue maximization, environmental concerns
- discussion of influence of government *e.g.* nationalized industries, regulatory bodies, taxation
- assessment of the extent to which the conventional theory of the firm is relevant to the real world
- appropriate theory of the firm diagram.

Effective evaluation may be to:

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

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2. (a) Explain how the rate of inflation might be measured and the factors which might make accurate measurement difficult. ***[10 marks]***

Answers **should** include:

- definition of inflation
- description of the rate of inflation
- explanation of the measurement of inflation through the use of price indices
- factors making accurate measurement difficult such as the problems of establishing typical or average spending patterns, difficulties and errors in data collection, changes in the quality of goods over time, changes in expenditure patterns over time.

Answers **may** include:

- specific reference to particular measures of inflation such as the Consumer/Retail Price Index, the Producer/Wholesale Price Index and the GDP implicit price deflator.

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(b) Evaluate the extent to which an individual government can influence the rate of inflation in its economy. ***[15 marks]***

Answers **may** include:

- measures at a country's disposal to tackle inflation – demand-side (fiscal and monetary policies) and supply-side policies
- how such policies can be used to reduce inflation
- limitations of demand-side and supply-side policies
- internationally generated inflation, *e.g.* through supply-side shocks affecting oil prices, changes in prices of internationally traded commodities
- use of diagrams
- reference to the role of central banks
- non-government forces leading to lower prices through, for example, free trade, technological advances, the spread of technology, economies of scale, lower transport costs and productivity gains
- assessment of the extent to which individual governments are in control of their own domestic inflation rate.

Effective evaluation may be to:

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

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3. (a) Explain *two* possible consequences of a sustained current account deficit in a country's balance of payments. ***[10 marks]***

Answers **should** include:

- definition of current account in a country's balance of payments
- explanation of a sustained current account deficit
- an explanation of any two consequences such as:
  - a deficit will reduce AD
  - the need to counterbalance the deficit with capital inflows, which may lead to future outflows of profits, interest and dividends
  - the need for higher interest rates to attract overseas funds
  - a current account deficit may contribute to rising living standards as more goods and services are being consumed
  - a current account deficit being necessary to build future export potential in terms of vital imports of raw materials and capital goods needed for export production
  - may necessitate deflationary demand policies, with an adverse impact on employment and output
  - may necessitate borrowing from institutions such as the IMF, with unwanted strings attached
  - downward pressure on the currency which may bring inflation.

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(b) Evaluate the methods available to a government to reduce a current account deficit. ***[15 marks]***

Answers **may** include:
- explanation of the use of managed changes in exchange rates and evaluation in terms of the Marshall-Lerner condition and the J-curve effect
- explanation of use of expenditure-reducing policies (decreasing aggregate demand) and evaluation in terms of, for example, the deflationary impact on output and employment, and that reducing AD is essentially a short-term measure
- explanation of the use of supply-side policies to increase competitiveness and evaluation, for example, in terms of the problems of particular supply-side policies and that such policies are only likely to work in the long term
- expenditure reducing policies are short term in nature while supply-side policies are long term in nature
- explanation of use of protectionism/expenditure switching policies and evaluation in terms of, for example, the various drawbacks of protectionism and its lack of availability as a policy instrument in the context of such institutions as the World Bank/IMF.

Effective evaluation may be to:
- consider short-term versus long-term consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritise the arguments.

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4. (a) Explain how buffer stock schemes/commodity price agreements may be used to reduce wide fluctuations in primary commodity prices. ***[10 marks]***

Answers **should** include:

- an explanation of primary commodities
- explanation of the meaning of buffer stock schemes/commodity price agreements
- an explanation of how such schemes operate to reduce price fluctuations
- a diagram to illustrate attempts to reduce price fluctuations through buffer stocks/commodity price agreements.

Answers **may** include:

- examples of such schemes in practice
- demand and supply diagrams to show why prices of primary products tend to fluctuate
- a range of diagrams showing relevant intervention (there are a number of possibilities)
- reference to primary commodity cartel agreements, such as OPEC.

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(b) Evaluate the view that, to achieve greater growth and development, developing countries must lessen their dependence on the production of primary commodities. ***[15 marks]***

Answers **may** include:
- definitions of growth and development
- relationship between growth and development
- the nature of primary product dependence
- examples of primary product dependence
- primary product dependency as an international barrier to economic development
- an explanation that not all developing countries are dependent upon the production of primary products
- greater price stability of manufactured goods
- difficulties involved in trying to administer prices in commodity agreements, *e.g.* in terms of ease of entry, the scattered nature of the producers, the breakdown of attempts to stabilize prices, general problems of buffer stock schemes
- control of the market and dominance of the MNCs
- low income elasticity of demand for primary products
- impact on the ability of developing countries to import essential goods
- higher productivity in manufacturing
- development of synthetic substitutes for agricultural products
- greater multiplier effects from investment in manufacturing
- implications for debt servicing
- the importance of the terms of trade
- dependence on the business cycles of the developed economies to which they export
- the need to provide food stability and food security.

N.B. Reward candidates who demonstrate awareness of the recent (*i.e.* as at July 2008) food/energy crisis, *e.g.* in terms of the switch from traditional agriculture to bio-fuel, and ever rising demand from countries such as China and India.

Effective evaluation may be to:
- consider short-term versus long-term consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritise the arguments.

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