



MARKSCHEME

November 2012

ECONOMICS

Higher Level

Paper 3

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

1. (a) Define the following terms indicated in bold in the text:

(i) indirect taxes (paragraph ①) [2 marks]

level

0 *Wrong definition* **0**

1 *Vague definition* **1**

The idea that they are taxes paid indirectly to the government.

2 *Precise definition* **2**

An explanation that they are taxes on goods and services (or expenditure taxes or consumption taxes).

(ii) price inelastic (paragraph ②). [2 marks]

level

0 *Wrong definition* **0**

1 *Vague definition* **1**

The idea that quantity (demanded) is not very responsive to price.

2 *Precise definition* **2**

An explanation of any **one** of the following:

- a change in the price of a product leads to a proportionately smaller change in the quantity (demanded)
- PED is less than one
- % change in quantity (demanded) is less than the % change in price.

(b) Using an appropriate diagram, explain how consumption of unhealthy foods creates negative externalities (paragraph 1). [4 marks]

level

- | | | |
|---|--|------------|
| 0 | <i>Inappropriate answer</i> | 0 |
| 1 | <i>Identification of appropriate theory</i>
For drawing a correctly labelled negative consumption externality diagram with MPB to the right of MSB and an indication of a negative externality or for providing an explanation that the consumption of unhealthy foods creates external costs in the form of higher health care costs for everyone in society. | 1–2 |
| 2 | <i>Correct application of appropriate theory</i>
For drawing a correctly labelled negative consumption externality diagram with MPB to the right of MSB and an indication of a negative externality and for providing an explanation that the consumption of unhealthy foods creates external costs in the form of higher health care costs for everyone in society. | 3–4 |

For full marks, candidates must recognise that there are **external** costs, not just the health costs to the overweight themselves.

Students may provide a negative production externality diagram with the MSC to the left of MPC and the free market equilibrium to the right of the socially efficient level of output. If this is correctly labelled and explained in terms of the **external** costs to society, then full marks may be awarded.

Candidates who incorrectly label diagrams can be rewarded with a maximum of [3 marks].

The vertical axis may be price (or P) or costs and benefits. The horizontal axis may be output or quantity (or Q). A title is not necessary.

- (c) Using an appropriate diagram, explain how a tax on foods with a high fat content is expected to impact on the market for substitute products with a lower fat content (*paragraph 2*). [4 marks]

level

- | | | |
|---|---|------------|
| 0 | <i>Inappropriate answer</i> | 0 |
| 1 | <p><i>Identification of appropriate theory</i></p> <p>For drawing a correctly labelled supply and demand diagram for substitute products showing a rightward shift in the demand curve, resulting in higher equilibrium price and quantity or for explaining that the tax leads to lower quantity demanded of high-fat foods and therefore an increase in demand for substitute products which are now relatively cheaper.</p> | 1–2 |
| 2 | <p><i>Correct application of appropriate theory</i></p> <p>For drawing a correctly labelled supply and demand diagram for substitute products showing a rightward shift in the demand curve, resulting in higher equilibrium price and quantity and for explaining that the tax leads to lower quantity demanded of high-fat foods and therefore an increase in demand for substitute products which are now relatively cheaper.</p> | 3–4 |

Another approach would be to illustrate the effect of a tax on foods with a high fat content (decrease in supply) resulting in a decrease in the quantity of fatty foods demanded and an explanation that this would lead to an increase in demand for substitute products. If this diagram is accurately drawn, with an appropriate explanation, then it may be awarded full marks.

Candidates who incorrectly label diagrams can be rewarded with a maximum of [3 marks].

The vertical axis may be price (or P). The horizontal axis may be output or quantity (or Q). A title is not necessary.

- (d) Using information from the text/data and your knowledge of economics, evaluate the likely consequences of indirect taxes applied to junk food and sugary drinks.

[8 marks]

Responses **may** include:

- explanation of how indirect taxes increase the price paid by consumers, causing a decrease in the quantity demanded and/or a switch to relatively cheaper products
- a diagram illustrating the effect of an indirect tax.

Arguments **in favour** of the indirect taxes on junk food and sugary drinks or arguments why the tax may be effective and/or desirable:

- a suggestion that if junk food has inelastic demand, the burden will fall mainly on the consumers, which is appropriate since they are the ones consuming the products
- higher price of taxed goods may encourage consumers to switch to healthier products, which are substitutes (*paragraph 2*)
- a switch to healthier products (fall in demand for unhealthy foods) reduces the size of the negative externality and lowers health care costs (*paragraph 1*)
- government earns tax revenues (*paragraph 3*) (this may be shown on a diagram)
- government tax revenues can be used to educate the public about the harmful effects of high-fat foods, causing demand for these to decrease (*paragraph 5*)
- low income individuals who are less healthy could become healthier
- government intervention may be necessary since manufacturers are unlikely to voluntarily improve their products (*paragraph 6*).

Arguments **against** the indirect taxes on junk food and sugary drinks or arguments why the tax may not be effective and/or desirable:

- foods and beverages have price inelastic demand (*paragraph 6*) because junk food is addictive (or healthy food is not seen as a substitute for junk food) and so there may be a proportionately smaller decrease in quantity demanded than hoped for
- the tax might have to be very high (and move into the elastic region of the demand curve) to have a significant impact on quantity demanded
- the tax might encourage consumers to buy the high fat content foods in neighbouring countries, which would have the effect of not reducing consumption **and** not contributing to higher tax revenues
- indirect taxes are regressive because they take a higher share of income from low-income households and so they affect low income individuals disproportionately (*paragraph 6*)
- low income individuals are also affected more than the wealthy because they consume more high-fat/sugary foods (*paragraph 4*)
- reduced revenues for producers of high-fat foods and sugary drinks might lead to unemployment in these industries
- low income households may have more price-inelastic demand than high income households because such goods are cheaper (*paragraph 4*) and could respond by increasing their consumption of unhealthy foods and cutting back on their expenditures on healthy foods (*paragraph 4*)

- an increase in demand for healthy foods could increase their price and make them even more unaffordable for low income households
- opposition to the tax (*paragraph 5*) may affect its long term effectiveness.

Level

0	No valid discussion.	0
1	Few relevant concepts recognized. Little discussion or only basic understanding.	1–2
2	Relevant concepts recognized and developed in reasonable depth. Some attempt at application and analysis.	3–5
3	Relevant concepts developed in reasonable depth, demonstrating effective evaluation, supported by appropriate evidence or theory.	6–8

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

If there is no direct reference to the data, then candidates may not be rewarded beyond level 2.

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) Define the following terms indicated in bold in the text:

(i) **cartel** (*paragraph 1*) *[2 marks]*

level

- | | | |
|---|--|----------|
| 0 | <i>Wrong definition</i> | 0 |
| 1 | <i>Vague definition</i>
The idea that it is an agreement between firms. | 1 |
| 2 | <i>Precise definition</i>
An explanation that it is an agreement between firms to fix prices (or output). | 2 |

(ii) **price ceiling** (*paragraph 5*). *[2 marks]*

level

- | | | |
|---|--|----------|
| 0 | <i>Wrong definition</i> | 0 |
| 1 | <i>Vague definition</i>
The idea that it is a price fixed by the government. | 1 |
| 2 | <i>Precise definition</i>
An explanation that it is any two of the following: <ul style="list-style-type: none">• a price set by the government (or an authority)• below the equilibrium price• price cannot go above this price. | 2 |

- (b) Using a supply and demand diagram for the milk market, explain why the elimination of the government monopoly in fodder could result in a lower price of milk (*paragraph 2*). *[4 marks]*

level

- | | | |
|---|---|------------|
| 0 | <i>Inappropriate answer</i> | 0 |
| 1 | <i>Identification of appropriate theory</i>
For drawing a correctly labelled supply and demand diagram showing a rightward shift of the supply curve, resulting in a lower price and larger quantity, or an explanation that the elimination of the government monopoly in fodder will lower costs of production for milk producers, an increase in the supply of milk and hence a lower price of milk. | 1-2 |
| 2 | <i>Correct application of appropriate theory</i>
For drawing a correctly labelled supply and demand diagram showing a rightward shift of the supply curve, resulting in a lower price and larger quantity, and an explanation that the elimination of the government monopoly in fodder will lower costs of production for milk producers, an increase in the supply of milk and hence a lower price of milk. | 3-4 |

Candidates who incorrectly label diagrams can be rewarded with a maximum of *[3 marks]*.

The vertical axis may be price (or P). The horizontal axis may be output or quantity (or Q). A title is not necessary.

- (c) Using an appropriate diagram, explain which market structure comes closest to describing the collusive behaviour practised by the milk companies (processors) (*paragraph 3*). *[4 marks]*

level

- | | | |
|---|---|------------|
| 0 | <i>Inappropriate answer</i> | 0 |
| 1 | <i>Identification of appropriate theory</i>
For drawing a correctly labelled monopoly diagram, or for explaining that collusive behaviour of firms allows them to operate as if they were a monopoly by setting (fixing) a high price for their product. | 1–2 |
| 2 | <i>Correct application of appropriate theory</i>
For drawing a correctly labelled monopoly diagram, and for explaining that collusive behaviour of firms allows them to operate as if they were a monopoly by setting (fixing) a high price for their product | 3–4 |

Some candidates may draw a kinked demand curve diagram. If this model is used to explain why the firms would choose to collude rather than compete, then this may be awarded full marks.

Candidates who incorrectly label diagrams can be rewarded with a maximum of *[3 marks]*.

The vertical axis may be price (or P) or costs and revenue. The horizontal axis may be quantity (or Q) or output. A title is not necessary.

- (d) Using information from the text/data and your knowledge of economics, evaluate the policies the Cyprus government could use to lower prices in the market for milk.

[8 marks]

Responses **may** include:

- diagrams to illustrate the effect of policies.

Policies:

- price ceilings (*paragraph 5*) (on farmers, fodder producers, processors or retailers) to bring down prices of a necessary good quickly
- privatization and creating a competitive market in the provision of fodder leads to more efficient allocation of resources
- encouraging producers to make voluntary price changes (*paragraph 5*) to avoid bureaucracy and opposition
- breaking up the presumed cartel to create more competition (*paragraph 1*)
- reducing tariffs or other trade barriers to encourage the import of low-priced milk
- providing subsidies to milk producers.

Disadvantages/limitations of the policies advocated:

- problems associated with price ceilings (*paragraph 5*) such as excess demand, shortages, parallel markets, high administrative costs
- disadvantages of privatization such as the possibility of higher prices for fodder
- consumers don't seem to care about high milk prices as they buy milk from the higher-price sources (*paragraph 4*) so to regulate the market may be unnecessary
- lower income for farmers.

Level

0	No valid discussion.	0
1	Few relevant concepts recognized. Little discussion or only basic understanding.	1-2
2	Relevant concepts recognized and developed in reasonable depth. Some attempt at application and analysis.	3-5
3	Relevant concepts developed in reasonable depth, demonstrating effective evaluation, supported by appropriate evidence or theory.	6-8

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

If there is no direct reference to the data, then candidates may not be rewarded beyond level 2.

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) Define the following terms indicated in bold in the text:

(i) **multiplier** (*paragraph 4*) [2 marks]

level

- | | | |
|---|---|---|
| 0 | <i>Wrong definition</i> | 0 |
| 1 | <i>Vague definition</i>
The idea that it is when GDP grows by a multiplied amount. | 1 |
| 2 | <i>Precise definition</i>
An explanation that it is: <ul style="list-style-type: none">• the amount by which an injection is multiplied to result in a change in GDP that is higher than the injection OR <ul style="list-style-type: none">• a correct formula for the multiplier. | 2 |

Candidates may describe the multiplier effect here, and if accurate, may be fully rewarded – *e.g.* an injection into the economy is multiplied so that the final addition to national income is larger than the injection itself.

(ii) **crowding out** (*paragraph 4*). [2 marks]

level

- | | | |
|---|---|---|
| 0 | <i>Wrong definition</i> | 0 |
| 1 | <i>Vague definition</i>
The idea that the government competes with firms for money. | 1 |
| 2 | <i>Precise definition</i>
An explanation that it is a situation where the government borrows money, resulting in higher interest rates causing in a fall in aggregate demand (or investment or consumption). | 2 |

(b) Using an appropriate diagram, explain whether the data in Figures 1 and 2 support the theory of the short-run Phillips curve. [4 marks]

level

- | | | |
|---|--|------------|
| 0 | <i>Inappropriate answer</i> | 0 |
| 1 | <i>Identification of appropriate theory</i>
For drawing a correctly labelled short-run Phillips curve diagram, showing two points on the curve or for explaining that the data in Figures 1 and 2 (roughly) support the theory of the inverse relationship between the inflation rate and the unemployment rate during the period July 2008–July 2009. | 1–2 |
| 2 | <i>Correct application of appropriate theory</i>
For drawing a correctly labelled short-run Phillips curve diagram showing two points on the curve and for explaining that the data in Figures 1 and 2 (roughly) support the theory of the inverse relationship between inflation and unemployment during the period July 2008–July 2009. | 3–4 |

Candidates may look at any time frame shown, and could conclude that the theory is not supported. If the theory (of the inverse relationship) is explained and correctly illustrated and the student has used the data correctly, then this may be fully rewarded.

Candidates who incorrectly label diagrams can be rewarded with a maximum of **[3 marks]**.

The vertical axis may be inflation rate or inflation (%). The horizontal axis may be unemployment rate or unemployment (%). A title is not necessary.

- (c) **Using an appropriate diagram, explain how the supply-side policies described in paragraph 5 can contribute to long term economic growth.** [4 marks]

level

- | | | |
|---|--|-----|
| 0 | <i>Inappropriate answer</i> | 0 |
| 1 | <i>Identification of appropriate theory</i>
For drawing a correctly labelled diagram showing the LRAS curve or a Keynesian AS (or a PPC) curve shifting to the right, or for explaining that supply-side policies aim at increasing the quantity of factors of production, or improving their quality or introducing improved technologies, which cause an increase in potential output and therefore a rightward shift of the curve. | 1–2 |
| 2 | <i>Correct application of appropriate theory</i>
For drawing a correctly labelled diagram showing the LRAS curve or a Keynesian AS (or a PPC) curve shifting to the right, and for explaining that supply-side policies aim at increasing the quantity of factors of production, or improving their quality, or introducing new improved technologies, which cause an increase in potential output and therefore a rightward shift of the curve. | 3–4 |

Candidates who incorrectly label diagrams can be rewarded with a maximum of [3 marks].

Candidates may explain that tax cuts act as a reduction in costs and therefore shift the SRAS curve. Since this does not explain **long term** economic growth, it may be awarded a maximum of [2 marks].

For a macro diagram, the vertical axis may be average price level, price level or inflation. The horizontal axis may be real output, national output, real national output, national income (Y) or real GDP. Any appropriate abbreviations such as APL, CPI, RNO or RNY are allowable. A title is not necessary.

For a PPC diagram, the axis labels should be any two categories of goods that compete for the economy's resources.

- (d) Using information from the text/data and your knowledge of economics, evaluate the use of fiscal policy as a method to reduce unemployment in the US.

[8 marks]

Responses **may** include:

- a definition of fiscal policy
- a diagram showing a deflationary gap
- an explanation of demand deficient unemployment
- an explanation of how expansionary fiscal policy may reduce demand deficient unemployment
- use of a diagram to illustrate the effect of expansionary fiscal policy.

Possible advantages of fiscal policy:

- works to directly increase spending and may therefore lead to greater employment
- more effective than monetary policy (*paragraph 2*) if consumer and business confidence are low
- increased government spending (*e.g.* on training) may also have positive supply side effects that allow the labour force to become more occupationally mobile so that unemployment may be reduced in the future (*paragraph 3*)
- increased spending on infrastructure will result in an increase in the demand for labour and promote future economic growth
- multiplier effect of increased government spending
- an explanation that such policies are Keynesian, based on the idea that the economy may be stuck in a deflationary gap.

Possible disadvantages/limitations of fiscal policy:

- increasing the government deficit through higher government spending and lower taxes (*paragraph 2*) will lead to increased government debt which will have to be financed in the future
- may have a small multiplier effect if people save rather than spend (*paragraph 4*)
- may have a small impact on investment if the deficit leads to crowding out (*paragraph 4*)
- may take a long time to take effect by which time the deflationary gap may have already been filled with the result that the increased spending is inflationary
- an explanation that fiscal policy is not appropriate for certain types of unemployment *e.g.* structural
- an explanation that neo-classical economists would say that the economy will move towards full employment on its own and that the government intervention will cause greater problems for the economy
- increased government debt increases the risk of debt default or a downgrade in the credit rating
- with negative implications for future government funding/spending and employment
- an explanation of how alternative policies (such as monetary policy or supply side policies) may be more effective in reducing unemployment (*paragraph 5*).

Level

0	No valid discussion.	0
1	Few relevant concepts recognized. Little discussion or only basic understanding.	1–2
2	Relevant concepts recognized and developed in reasonable depth. Some attempt at application and analysis.	3–5
3	Relevant concepts developed in reasonable depth, demonstrating effective evaluation, supported by appropriate evidence or theory.	6–8

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

If there is no direct reference to the data, then candidates may not be rewarded beyond level 2.

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) Define the following terms indicated in bold in the text:

(i) **deflation** (*paragraph 1*) *[2 marks]*

level

- | | | |
|---|---|----------|
| 0 | <i>Wrong definition</i> | 0 |
| 1 | <i>Vague definition</i>
The idea that it is falling prices. | 1 |
| 2 | <i>Precise definition</i>
An explanation that it is a sustained decrease in the (average or general) price level or an increase in the purchasing power of money. | 2 |

(ii) **depreciation** (*paragraph 2*). *[2 marks]*

level

- | | | |
|---|---|----------|
| 0 | <i>Wrong definition</i> | 0 |
| 1 | <i>Vague definition</i>
The idea that it is a currency losing its value. | 1 |
| 2 | <i>Precise definition</i>
An explanation that it is a fall in the price (value) of a currency plus one of the following: <ul style="list-style-type: none">• in terms of another currency• in a floating exchange rate system. | 2 |

(b) Using an appropriate diagram, explain how cuts in wages can improve Latvia’s export competitiveness (paragraph 3). [4 marks]

level

- | | | |
|---|--|-----|
| 0 | <i>Inappropriate answer</i> | 0 |
| 1 | <i>Identification of appropriate theory</i>
For drawing a correctly labelled supply and demand diagram showing a rightward shift in the supply curve, resulting in a lower price and higher quantity, or for explaining that the fall in wages lowers firms’ costs of production, allowing them to supply more and sell their output at a lower price, thus increasing their export competitiveness. | 1–2 |
| 2 | <i>Correct application of appropriate theory</i>
For drawing a correctly labelled supply and demand diagram showing a rightward shift in the supply curve, resulting in a lower price and higher quantity, and for explaining that the fall in wages lowers firms’ costs of production, allowing them to supply more and sell their output at a lower price, thus increasing their export competitiveness. | 3–4 |

Candidates may use AD/AS diagrams to answer this question (increase in SRAS) and if correctly explained, this may be fully rewarded.

Candidates who incorrectly label diagrams can be rewarded with a maximum of [3 marks].

For a micro diagram, the vertical axis may be price (or P). The horizontal axis may be quantity (or Q) or output. A title is not necessary.

For a macro diagram, the vertical axis may be average price level, price level or inflation. The horizontal axis may be real output, national output, real national output, national income (Y) or real GDP. Any appropriate abbreviations such as APL, CPI, RNO or RNY are allowable. A title is not necessary.

- (c) Using an AD/AS diagram, explain how a devaluation of the lat could help encourage economic growth in Latvia (*paragraph 4*). [4 marks]

level

- | | | |
|---|--|-----|
| 0 | <i>Inappropriate answer</i> | 0 |
| 1 | <i>Identification of appropriate theory</i>
For drawing a correctly labelled AD/AS diagram showing a rightward shift in the AD curve, or for explaining that a lat devaluation can increase exports by lowering their price to foreigners or lower imports by increasing their price to domestic residents, (thus increasing net exports) causing AD to increase, leading to an increased level of real GDP. | 1-2 |
| 2 | <i>Correct application of appropriate theory</i>
For drawing a correctly labelled AD/AS diagram showing a rightward shift in the AD curve, and for explaining that a lat devaluation can increase exports by lowering their price to foreigners or lower imports by increasing their price to domestic residents, (thus increasing net exports) and causing AD to increase, leading to an increased level of real GDP. | 3-4 |

Candidates who incorrectly label diagrams can be rewarded with a maximum of [3 marks].

The vertical axis may be average price level, price level or inflation. The horizontal axis may be real output, national output, real national output, national income (Y) or real GDP. Any appropriate abbreviations such as APL, CPI, RNO or RNY are allowable. A title is not necessary.

- (d) Using information from the text/data and your knowledge of economics, evaluate the decision of the Latvian government to maintain the pegged (fixed) value of the lat.

[8 marks]

Responses **may** include:

- explanation of pegged value of the lat.

Advantages of maintaining the pegged value of the lat:

- it is necessary to maintain the value if Latvia is to join the euro (*paragraph 2*)
- a stable currency helps maintain price stability
- a stable currency supports the competitiveness of firms that are dependent on imported inputs
- a stable currency would make the handling of foreign debt (in euros) more manageable
- a stable currency may prevent widespread bankruptcies which could put a major strain on the financial and banking system (*paragraph 5*)
- a stable lat might help prevent a process of competitive devaluations among currencies pegged to the euro, whereas potential benefits from devaluation would be lost if countries like Bulgaria, Estonia and Lithuania also devalue their currencies (*paragraph 6*).

Disadvantages of maintaining the pegged value:

- the need to implement a highly restrictive fiscal policy (to qualify for IMF and EU loans) requires cuts in spending on merit goods, with long term implications for the population (*paragraph 3*)
- the Latvian government is unable to use expansionary fiscal policy to deal with the deep recession (*paragraph 4*)
- the government is unable to use expansionary monetary policy (lower interest rates) to help the economy come out of the recession (*paragraph 4*)
- the high value of the lat contributes to a continued trade deficit (*paragraph 4*) due to uncompetitive exports and lower price imports
- the need to maintain interest rates at a relatively high level restricts economic growth by raising the cost of borrowed money
- the lower growth makes it hard to finance the public debt (*paragraph 4*)
- the need to maintain high interest rates may be contributing to deflation and may result in a deflationary spiral.

Level

0	No valid discussion.	0
1	Few relevant concepts recognized. Little discussion or only basic understanding.	1–2
2	Relevant concepts recognized and developed in reasonable depth. Some attempt at application and analysis.	3–5
3	Relevant concepts developed in reasonable depth, demonstrating effective evaluation, supported by appropriate evidence or theory.	6–8

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

If there is no direct reference to the data, then candidates may not be rewarded beyond level 2.

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.

5. (a) Define the following terms indicated in bold in the text:

(i) **infrastructure** (*paragraph 2*) [2 marks]

level

0 *Wrong definition* 0

1 *Vague definition* 1

The idea that it is a type of capital good.

2 *Precise definition* 2

An explanation of any **one** of the following:

- essential facilities that add to the capital stock of the economy
- capital typically provided by government to make economic activity possible.

An answer that simply gives examples of infrastructure should not get any marks.

(ii) **multilateral aid** (*paragraph 4*). [2 marks]

level

0 *Wrong definition* 0

1 *Vague definition* 1

The idea that it is money given by countries.

2 *Precise definition* 2

An explanation that it is money that is given by countries to international (or multilateral) institutions which are distributed to countries.

- (b) Using an appropriate diagram, explain how investment in health and education facilities can contribute to economic growth (*paragraph 2*). [4 marks]

level

- | | | |
|---|---|-----|
| 0 | <i>Inappropriate answer</i> | 0 |
| 1 | <i>Identification of appropriate theory</i>
For drawing a correctly labelled AD/AS or PPC diagram showing a rightward shift of the LRAS curve or PPC, or for explaining that an improvement in the quality of labour (improvement in human capital) as a result of investment in health and education facilities, can be expected to result in an increase in potential output and can therefore can contribute to economic growth. | 1–2 |
| 2 | <i>Correct application of appropriate theory</i>
For drawing a correctly labelled AD/AS or PPC diagram showing a rightward shift of the LRAS curve or PPC, and for explaining that an improvement in the quality of labour (improvement in human capital) as a result of investment in health and education facilities, can be expected to result in an increase in potential output and can therefore can contribute to economic growth. | 3–4 |

Either the LRAS or Keynesian AS curves may be shifted. A maximum of [2 marks] may be awarded for the shift of an SRAS.

Another approach would be an explanation that government spending on health and education facilities may increase aggregate demand, shifting the AD curve to the right contributing to economic growth. If this diagram is accurately drawn, with an appropriate explanation, then it may be awarded full marks.

An alternative approach may be to use a poverty cycle diagram to explain how “investment in health and education facilities” may break the poverty cycle and contribute to economic growth. If this diagram is accurately drawn, with an appropriate explanation, then it may be awarded full marks.

Candidates who incorrectly label diagrams can be rewarded with a maximum of [3 marks].

For AD/AS, the vertical axis may be price level, average price level, or inflation. The horizontal axis may be real output, national output, real national output, national income (Y), or real GDP. Any appropriate abbreviations, such as APL, CPI, RNO or RNY are allowable. A title is not necessary.

For a PPC diagram, the axis labels should be any two categories of goods that compete for the economy’s resources.

(c) Explain how low incomes contribute to the poverty cycle in Malawi (paragraph 2). [4 marks]

level

- | | | |
|---|--|-----|
| 0 | <i>Inappropriate answer</i> | 0 |
| 1 | <i>Identification of appropriate theory</i>
For identifying (stating or illustrating) any poverty cycle which begins and ends with low incomes. One common poverty cycle is an explanation that low incomes leads to low savings which leads to low investment which leads back to low incomes. | 1-2 |
| 2 | <i>Correct application of appropriate theory</i>
For identifying (stating or illustrating) any poverty cycle which begins and ends with low incomes. One common poverty cycle is an explanation that low incomes leads to low savings which leads to low investment which leads back to low incomes and for explaining the linkage(s) between low incomes and the other elements of the cycle. | 3-4 |

- (d) Using information from the text/data and your knowledge of economics, evaluate the likely effects of Malawi's trade and development agreement with the EU.

[8 marks]

Responses **may** include:

- an explanation of trade liberalisation
- an explanation of economic development
- a diagram illustrating the effect of trade liberalisation (*e.g.* tariff diagram).

Advantages of a possible agreement on liberalised trade:

- benefits of free trade (*paragraph 4*) including development, growth and job creation
- other benefits of free trade include lower prices, increased choice, gains from specialization, improved political relations, more efficient allocation of resources
- possible increased exports to the EU leading to an improvement in the current account
- growth of manufacturing can contribute to increasing employment as well as economic growth in Malawi
- growth of manufacturing could be encouraged by tariff-free entry of Malawian products into the EU
- opportunity for Malawi to develop comparative advantage
- less potential for corruption.

Advantages of a possible agreement on development:

- provision by the EU of private sector grants, loans and technical assistance can contribute to the growth of a manufacturing sector in Malawi (*paragraph 4*)
- assistance from the EU in the form of aid for trade (building institutions and infrastructure) can also help Malawi take advantage of growing export opportunities, contributing to growth (*paragraph 4*).

Disadvantages of the potential agreement:

- Malawian exports, consisting mainly of agricultural commodities, may not increase much if the EU does not eliminate protection of its farmers
- tariff cuts will reduce the government's tariff revenues, leaving fewer resources to pursue economic development (*paragraph 3*)
- tariff cuts will eliminate protection of infant industries, and may not allow Malawi to develop manufacturing sector (*paragraph 3*)
- existing manufacturing firms in Malawi may not be able to survive because of low-cost manufacturing imports from the EU
- manufacturing exports from Malawi to the EU may be unable to compete with low-priced EU products
- the agreement may make it more difficult for Malawi to diversify into manufacturing, "locking" it into long term reliance on low-value agricultural commodity exports (*paragraph 3*)
- reliance on agricultural commodity exports subjects farmers to unstable incomes (due to low PED and PES for agricultural commodities) as well as long term deteriorating terms of trade (due to low YED) with negative effects on standard of living, investment, employment, the current account and economic growth

- possibility that the EU may not provide enough assistance for development of necessary transport infrastructure as well as health and education facilities and research and development (R&D) leading to the development of appropriate technologies
- aid may not necessarily be directed to the areas where it is most effective.

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

If there is no direct reference to the data, then candidates may not be rewarded beyond level 2.

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.

Level

0	No valid discussion.	0
1	Few relevant concepts recognized. Little discussion or only basic understanding.	1–2
2	Relevant concepts recognized and developed in reasonable depth. Some attempt at application and analysis.	3–5
3	Relevant concepts developed in reasonable depth, demonstrating effective evaluation, supported by appropriate evidence or theory.	6–8
