

# **MARKSCHEME**

**November 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 as indicated.*

**1. (a) Using supply and demand analysis, explain why the price of agricultural goods tends to fluctuate more than the price of manufactured goods. [10 marks]**

Candidates **may** include the following information:

- explanation of how price is determined
- indication that it is mainly the supply of agricultural products that is very volatile thus resulting in large price fluctuations
- explanation of different price elasticities of demand for agricultural and manufactured goods
- explanation of the different price elasticities of supply for agricultural and manufactured goods
- diagram showing shifts in supply and demand curves for both agricultural and manufactured goods resulting in large change of price for agricultural goods and smaller change of price for manufactured goods.

Candidates **may** refer to:

- income elasticity in connection with agricultural and manufactured goods

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

To reach level 3, an appropriate diagram must be included.

**(b) Evaluate the possible role of price controls in agricultural markets. [15 marks]**

Candidates **may** include the following information:

- description of different types of price controls, that is, minimum/maximum prices, commodity agreements and buffer stock schemes
- explanation of why maximum, minimum prices and buffer stocks might be used *e.g.* protect consumers and producers
- consequences of maximum, minimum prices and buffer stocks *e.g.* shortages, surpluses *etc.*
- use of appropriate diagrams to illustrate: maximum and minimum prices and buffer stocks
- evaluation of the price controls.

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) **Distinguish between cost push inflation and demand pull inflation.** *[10 marks]*

Candidates **may** include the following information:

- definition of inflation
- explanation of cost push inflation, including an awareness of the different sources of cost increases like rising wage and salary rates, higher interest rates, higher profits, increased government taxes (like VAT), dearer imported inputs, rising prices of domestic raw materials
- explanation of demand pull inflation, including awareness of the different components of aggregate demand: consumption, investments, government expenditure and net exports
- use of AD/AS diagrams to illustrate cost push and demand pull inflation.

Candidates **may** refer to:

- role of expectations, business sentiment, the state of the economy and international conditions (like the occurring of an oil supply shock, for example)

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

If a candidate only explains one cause of inflation they are restricted to level 2.

- (b) **Evaluate the view that the consequences of inflation are more harmful to an economy than the consequences of unemployment.** *[15 marks]*

Candidates **may** examine the consequences of unemployment, which **may** include:

- the economy not producing at its potential output, and so actual output is below potential output. Candidates may use a PPC to show this
- a misallocation of resources, which means the economy suffers from allocative inefficiency because consumer welfare is not being maximized
- the loss of potential tax revenue for the government because income tax revenue will fall as less people are working, and consumption-based tax revenue will fall as less goods and services are being purchased
- social costs can increase such as, arguably, crime rates, divorce, stress and suicide
- deterioration of human capital (de-skilling) occurs when people who have been unemployed for long periods of time lose skills and become demotivated
- less investment and a negative multiplier effect because businesses are likely to postpone or cancel plans to expand their productive capacity as they are worried about falling demand.

Candidates **may** examine the consequences of inflation, which **may** include:

- redistribution of income between different sectors of the economy, including between the poor and the wealthy who are able to protect themselves against the harmful effects of inflation
- discourages savings particularly if real interest rates are low or even negative
- misallocates resources away from productive assets as investors direct their finances towards speculative, non-productive assets
- affects fixed income earners because their real income or purchasing power falls as inflation rises and their nominal income stays the same
- encourages borrowing because future loan repayments will be in inflated currency
- reduces international competitiveness, particularly if the domestic inflation rate is higher than inflation rates overseas. This, in turn, could cause balance of payments problems
- creates investment uncertainty and so businesses are unlikely to commit themselves to capital projects.

Candidates **may** provide a reasoned evaluation on which is more harmful.

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 *three* types of protectionism that a government might adopt in the context of international trade.** *[10 marks]*

Candidates **may** provide:

- definition of protectionism.

Candidates **may** explain any **three** of the following types of protection:

- tariffs – taxes placed on foreign goods to make them more expensive and encourage consumers to switch to domestic goods and services
- quotas – place a limit on the number or value of foreign goods and services allowed into a country
- subsidies – make domestic goods and services available at a cheaper price which can then compete with foreign goods and services
- Voluntary Export Restraints (VERs) – one government may pressure another to reduce its exports
- administrative obstacles – administrative procedures which make it difficult for foreign firms to sell their goods in the country
- health and safety standards – higher level of health or safety requirements of one country make it difficult for foreign firms to sell their goods in that country
- environmental standards – higher level of environmental requirements of one country make it difficult for foreign firms to sell their goods in that country

Appropriate diagrams should be used to illustrate methods of protectionism, *e.g.* tariff, quota, subsidy diagrams.

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

Candidates who do not explain three types of protectionism cannot reach beyond Level 2.

- (b) **Evaluate the extent to which protectionism may be justified in international trade.** [15 marks]

Candidates **may** discuss arguments for and against protectionism and come to a conclusion, concerning whether protectionism may be justified in international trade.

Arguments for protectionism **may** include:

- protection of employment/declining industry – protect workers whose industries could not compete with foreign competition
- source of government revenue – tariffs raise revenue for the government
- strategic arguments – some industries (such as defence or agriculture) may need to be kept national for strategic reasons (*e.g.* in case of war)
- means to overcome a current account deficit – lowering import expenditure will reduce the current account deficit
- anti-dumping – to prevent foreign firms from selling goods at below their costs of production, which would destroy the domestic industry
- infant industry argument – small firms need to be protected to give them time to expand and gain economies of scale, which will allow them to compete internationally
- efforts of a developing country to diversify – to prevent overspecialization.

Arguments against protectionism **may** include:

- inefficiency of resource allocation – resources need to be allocated to where they gain the highest yield and this may not be in the protected industry
- costs of long-run reliance on protectionist methods – protection may allow firms to remain inefficient and may reduce their incentive to reduce costs
- increased prices of goods and services to consumers
- the cost effect of protected imports on export competitiveness – imported raw materials become costly, which causes the final price of a country's exports to increase
- retaliation – other countries may start a trade war by imposing trade restrictions
- damage to other economies – restricting the imports from one country means reducing that country's exports. This reduces that country's income and could lead to a multiplied fall in the rest of the world income.

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 *three* institutional factors that may contribute to potential economic growth in developing countries. [10 marks]

Candidates **may** include:

- definition of economic growth
- an understanding of the concepts “institutional factors”, “potential economic growth” and “developing countries” and the relationship between them.

Candidates **may** explain three institutional factors, which **may** include:

- banking system – stable banking system, which can provide funds to small businesses, thus enabling investment
- educational system – investment in human capital, which increases the quality of labour
- health care – improvement in the health of the population increases both the quantity and quality of the labour resources available
- infrastructure – investment in infrastructure, especially in rural areas, will enable goods to be brought to markets
- political stability – necessary if domestic businesses and foreign investors are to feel comfortable investing in the economy
- legal system – investors need to know their rights are protected.

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

Candidates who do not explain three institutional factors cannot score above a Level 2.

- (b) **Evaluate the view that economic growth will lead to economic development.** *[15 marks]*

Candidates **may** make a clear distinction between economic growth and economic development.

Benefits of growth which impact on development in a positive way **may** include:

- increased levels of income could translate to higher levels of consumption of goods and services by society. This could lead to more choice, more food consumed and better shelter opportunities
- increased levels of employment
- government investment in better health facilities will improve the longevity of the population
- government investment in more educational opportunities will improve the literacy of the population and have positive externalities for society.

Consequences of growth which impact on development in a negative way **may** include:

- negative externalities – environmental damage such as soil erosion and desertification can occur as areas are cleared for farming. Depletion of the ozone layer can be caused by industrialization.
- income distribution – economic growth can result in uneven distributions of income if the growth requires changes in production (in terms of the goods produced, the techniques used and the skills required) and some people find their skills are no longer needed
- sustainability – if economic growth involves using a greater amount of resources then there will be depletion of non-renewable resources

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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