

Examiners' Report January 2009

O Level

O Level Economics (7120)

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After many years of improvement in students' responses this examination highlighted topics which require some attention by centres.

Candidates too often make incorrect assumptions.

- The relationship between savings and investment is well documented in textbooks but candidates too often assume that an increase in savings will automatically lead to an increase in investment. Their confusion grows as they try to explain why savings increase as the rate of interest increases but investment falls.
- Improvements in technology may lead to positive economic growth but to assume that this will automatically lead to unemployment is incorrect.
- To assume that an increase in population leads to unemployment is incorrect.

In past papers candidates have shown the ability to recognise depreciation /appreciation of a currency but in this paper they demonstrated that they have no depth to their knowledge. Factors affecting exchange rates must be addressed by centres if candidates are to achieve success in future examinations.

Centres can help their candidates by ensuring that they know the importance of

- attempting all parts of the questions
- not attempting more questions than necessary.

Once again there were some very good candidates who could apply examples from their own economies. Hopefully more centres will realise the value of using real life examples from their own countries in order to bring economics to life and to improve the performance of their candidates.

Section A

Question 1

A simple knowledge based question but one which caused many problems for candidates. Part (a) required an example of a trading bloc e.g. NAFTA, EU. Examiners were given a list of all trading blocs and all possible abbreviations but in some cases this was not necessary as some candidates responded incorrectly with "customs union" or with trading blocks e.g. tariffs.

Two main characteristics of a trading bloc are

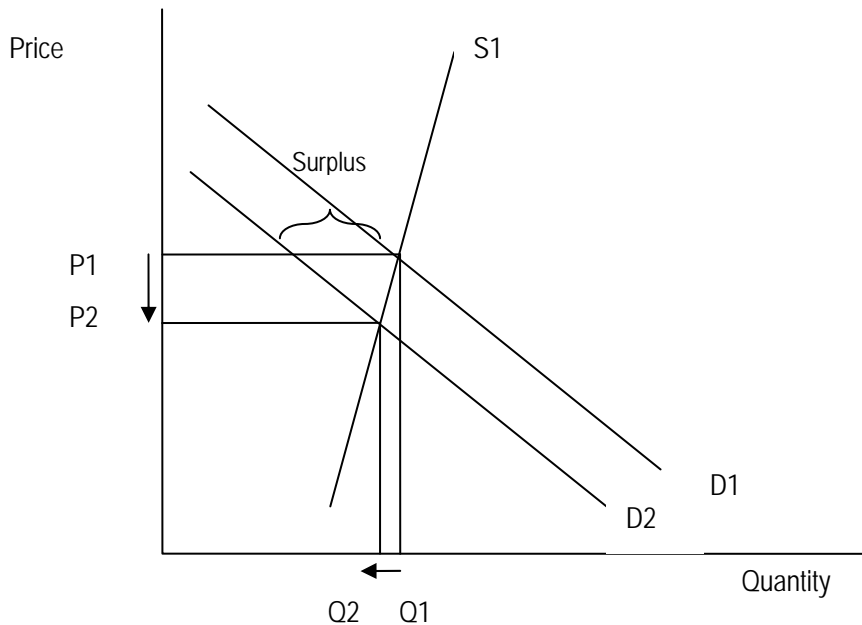
- *"The elimination of tariffs between member countries to promote free trade.*
- *A common external tariff is imposed by members of the bloc on goods and services from non-member countries."*

Monetary union and free movement of labour and capital are characteristics of some trading blocs but not all blocs have these characteristics, therefore candidates who listed these did not achieve full marks.

Question 2

Candidates were asked in part (a) to indicate their answers on Figure 1, a diagram showing the demand and supply of heating oil in the United States. A correct diagram is shown on Figure 1.

Figure 1



A mild winter (a)(ii) would lead to a fall in the demand for heating oil and this can be shown by a shift of the demand curve to the left, D2. Too many candidates also shifted the supply curve. The surplus (a)(iii) is the difference in quantity at P1 between the supply curve, S1 and the new demand curve, D2 **not** the difference between Q1 and Q2. The fall in demand results in the new equilibrium price P2 and quantity Q2.

There are numerous other factors which might lead to a fall in the demand for heating oil e.g. fall in the price of electric heaters (substitutes) and fall in incomes. However a rise in the price only leads to a movement along the curve not a shift of the curve.

Question 3

Diversification 3(a) is not division of labour or a change in ownership. It is *“when a business decides to produce or merge with a firm which produces a completely unrelated type of good e.g. a cigarette manufacturer begins to produce perfume.”*

Reasons for diversification 3(b) include *“to increase profit because it is now producing two types of goods not just one. The main reason is to reduce risk. If the demand for one good falls then the business may still make a profit from the other unrelated good.”*

Question 4

There is no doubt that candidates understand the term “saving”. However they had difficulty in putting this economic term into words. A correct definition would be: *“Savings is that part of income not spent. E.g. if income is \$100 and spending is \$80 then saving is \$20.”*

Ways in which a government can increase the level of saving in the economy 4(b) led to some illogical arguments e.g. “if people have less money they will save more”. A better response would have been: *“The government can increase the rate of interest so that savers will earn more money from their savings - rewards increase. If the government introduces extra incentives like tax free savings schemes then savers will be encouraged to save as once again the rewards for saving increase.”*

The economy 4(c) can be affected both positively and negatively from increased savings. *“Increased savings means reduced spending. This can be good if the economy is suffering from demand pull inflation as it will reduce demand. However, increased saving might lead to less demand for firms and this could lead to unemployment.”*

There is still confusion about the relationship between savings and investment with many candidates incorrectly assuming “if people save more there will be more investment”.

Question 5

This question produced a wide range of responses. Examples of correct responses are given below.

(a)(i)

"Tourism of Australian people is an example of an invisible import for Australia. So if this import rises the demand for Chinese Yuan will increase and the supply of Australian dollars in the market will increase and this will lead to the depreciation of the Australian dollar."

(a)(ii)

"If Australia exports a large amount of coal (visible export) it means more Australian dollars are demanded as China is buying more coal from Australia in Australian dollars. The increase in demand for Australian dollars causes its value to appreciate."

Question 6

A straightforward question which required functions of a central bank and stock exchange. There are a large number of functions to choose from for both institutions but the most popular proved to be:

(a) Central Bank: Government's bank, bankers' bank, lender of the last resort, sole issuer of notes and coins, controls money supply.

(b) Stock Exchange: market for second-hand shares, barometer for share prices/economy, applies strict rules to protect buyers of shares.

Section B

Question 7

This question required knowledge of the factor of production, capital. It was therefore surprising that a large number of candidates who attempted this could not correctly define it in part (a).

“Man made resource used to help in the production of other goods e.g. machinery”

Too many candidates thought that capital refers to investing money in a business which is incorrect although this is how many people with no knowledge of economics might define it.

In (b) the effects, one advantage, one disadvantage, of increasing capital in a factory were required.

(b)(i) For workers:

“An advantage might be the opportunity to learn new skills as they now have to operate machinery. A disadvantage might be that some workers might lose their jobs as machines replace workers.”

(b)(ii) For owners of firms:

“Production might increase as machines are more efficient but a disadvantage is that the firm may have had to borrow money to buy the capital and repay this with interest.”

Part (c) required candidates to identify and explain monetary and fiscal measures which a government might use to encourage capital investment by firms. Most candidates managed to identify one monetary measure - the reduction in the rate of interest - but failed to correctly identify a fiscal measure. A good response is shown below.

“Fiscal measures: a government might use fiscal measures by reducing the rates of taxation and increasing government expenditure.

When the government reduces the rate of direct taxes e.g. corporation tax, the disposable income for firms increases. This may encourage greater capital investment by firms as they now have more disposable income. Moreover, as direct taxes reduce e.g. income tax, even the consumer will have more disposable income which leads to greater demand for goods and services and this could lead to firms investing in more capital equipment to increase production.

The government may increase its expenditure and give subsidies and grants to firms for capital investment.

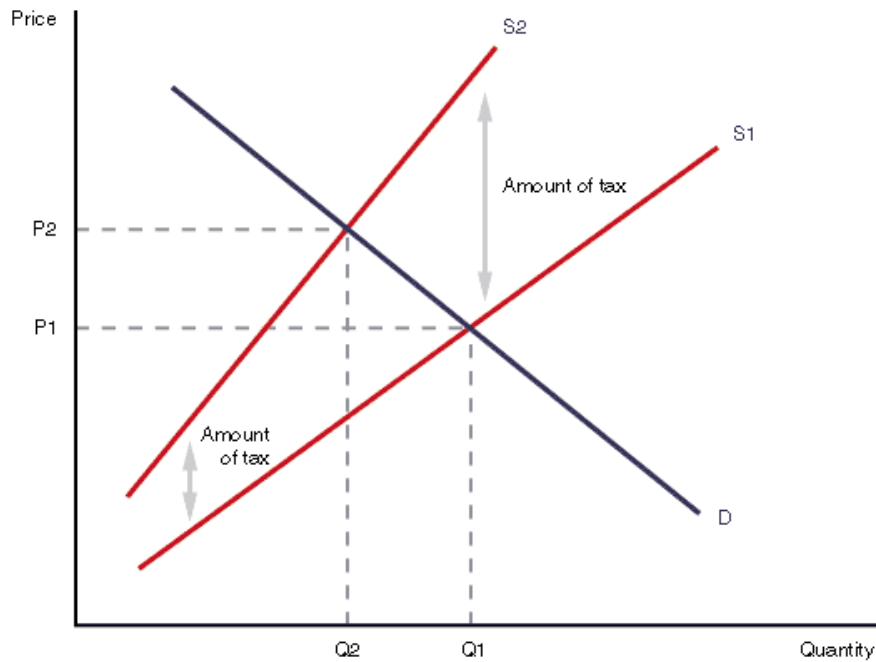
Monetary measures: A government can use monetary measures like reducing the interest rates.

When the interest rate falls firms will be willing to take loans to expand and increase production. This leads to greater capital investment by firms. Consumers too will benefit from a reduction in interest rates. They will be able to borrow money more cheaply and so their expenditure will increase. Thus, as consumers' expenditure rises, demand for goods will rise and this makes firms more willing to invest as demand for its goods rise.”

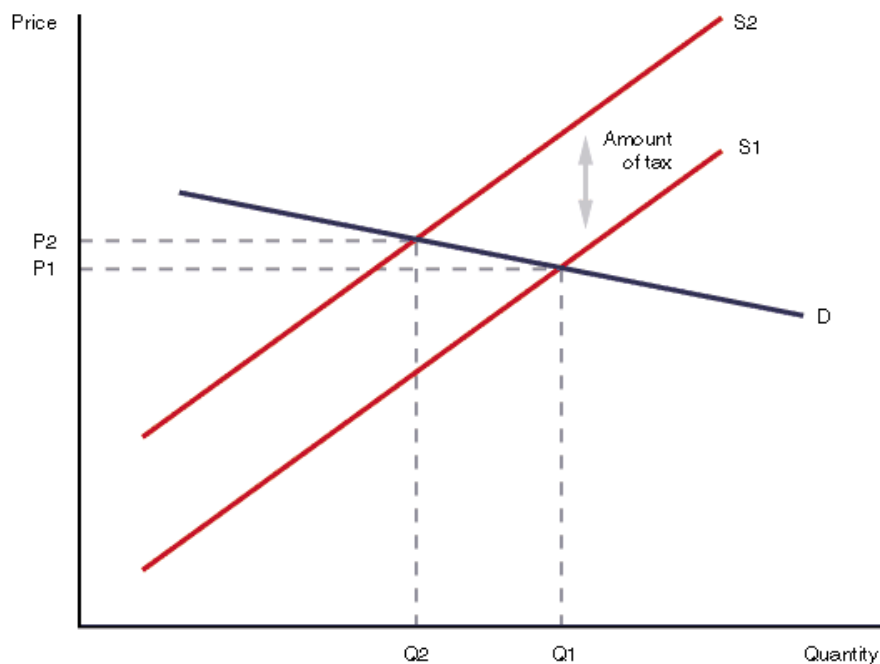
Question 8

This was the least popular question on the paper and for some reason it was often attempted by weaker candidates. Part (a) required a diagram showing the effect of an indirect tax. The tax in the question is a 5% tax and as such is an ad valorem tax. Surprisingly some candidates did draw the perfect diagram shown below.

Ad valorem tax



Candidates who drew a diagram which showed a specific indirect tax but who also indicated the amount of tax (shown below) also gained maximum marks.



Indirect taxes are regressive and do not benefit the poor.

(b)(i)

"I believe it won't benefit the poor since it is traditional in China that everyone uses chopsticks to eat food. Indirect taxes are regressive so the rich and poor pay the same amount but this is a higher proportion of the poor person's income so they suffer as they have less to spend on other things."

Part (b)(ii) proved too difficult for many who attempted this question and so it was often left blank. Redistribution of income can be achieved by the following fiscal measures, introducing progressive direct taxation e.g. income tax, and give tax allowances to the poor. Increase indirect taxes on luxuries and reduce them on necessities. Another part of fiscal policy is government expenditure. By increasing benefits to the poor e.g. unemployment benefit, pensions, the gap between the rich and the poor can be reduced.

Question 9

Where a question asks for examples candidates should try to comply. In (a)(i) candidates omitted examples and often wrote of internal economies of scale rather than external economies of scale.

(a)(i)

"If many firms in an industry all set up in one particular area they enjoy external economies of scale e.g. the car industry in Detroit, USA.

1. Specialist workers: if the firms in an industry locate in an area a new firm has access to a pool of skilled labour as local colleges will have training courses. This will save the firm money as they don't need to train the workers.

2. Ancillary industries: Firms supplying supplementary goods like headrest covers or essential parts like windscreen wipers may also set up in the same area. This will reduce transport costs.

3. Information: The area will become well known for the production of cars and specialist services will evolve e.g. banking and insurance. The car firms themselves will set up organisations so that they can discuss industrial problems."

(a)(ii)

"1. Financial incentives: the government can offer grants, cheap loans and subsidies to firms who set up in particular areas e.g. areas of high unemployment.

2. Advice: firms may need help and advice if they are to set up in a new area. The government can employ experts who can help firms to make the move to a new area successful.

3. Good infrastructure: an efficient road and rail network might influence a firm as this could reduce transport costs."

The topic of multinationals has always been popular and candidates usually achieve high marks for these questions. This was no exception as candidates identified and developed advantages and disadvantages of multinationals.

Question 10

Horizontal integration has benefits to both the merging firms and the consumer.

(a)(i)

"The merging firms will take advantage of economies of scale like bulk buying, and these will reduce the average cost of production. When two firms in the same stage of production merge then their market share will increase and this will give them more power in their market to control price."

(a)(ii)

"Consumers might benefit if the firms pass on their reduced costs to consumers in the form of reduced prices. As the firms merge so they may employ consumer service specialists who will answer any problems or queries of consumers."

Part (b) brought some illogical reasons including "the government gets less tax from the merged company than from the two separate companies."

Good responses centred on the growth of monopolies and the threat of unemployment as the merged firms rationalise their workforce.

In (c) candidates struggled to identify measures the government could take to encourage competition and so many made the mistake of writing about the advantages and disadvantages of competition.

"Mergers can reduce competition so if the government can prevent mergers so it will encourage competition. This can be done by the setting up of commissions which study proposed mergers and prevent them if they do not encourage competition. Privatisation can lead to competition when a state owned industry is sold off to several different companies. Unlike the state owned monopoly the private firms will compete against each other. If the country opens up to foreign trade competition can increase. Joining a trading bloc will reduce trade barriers to countries in the bloc which will make them more competitive."

Question 11

This was the most popular question with the majority of candidates achieving full marks on part (a). Candidates were less successful in (b). Many candidates assumed that an increase in population would lead to unemployment whilst at the same time stating that demand would rise.

(b)(i)

“Russia will face a falling population and this could lead to a fall in the workforce which will increase wages and inflation. As the population falls so too does demand so the country will face falling economic growth.”

(b)(ii)

“Vietnam may be overpopulated and this will lead to a shortage of resources. This may lead to demand push inflation. At the same time there may externalities of pollution and congestion as factories try to satisfy the increasing demand of the population.”

In (c) government policies had to be identified and explained.

“To increase the workforce the government can in the short run increase the retirement age and reduce the school leaving age. Over time it can lower the death rate by improving health care and by giving incentives, e.g. financial benefits to young people to have more children, it can increase the birth rate. It could also encourage immigration of skilled workers by making work permits easier to obtain and advertising in neighbouring countries.”

Question 12

Surprisingly this question was not very popular. Most candidates explained that the introduction of a minimum wage rate would increase unemployment. The firms' wage bill would increase. They would reduce demand for labour but at the same time more workers would like to work at the higher wage rate so unemployment would increase.

Part (a)(ii) showed that candidates do not understand depreciation in any depth with many of them suggesting that unemployment would rise.

(a)(ii)

"If a country's currency depreciates then in the world market the price of the exports of the country will fall. As a result the demand for the exports of the country will rise. Domestic firms will increase production. When production is increased more labour will be required and so unemployment will fall. Imported goods will become more expensive so the people of the country may demand more local products. As a result domestic firms will increase production and more labour will be required resulting in a fall in unemployment."

Some economists would argue that voluntary unemployment is the only type of unemployment. In this specification several types of unemployment are studied and students should be able to define all of them. Voluntary unemployment is when workers are able but unwilling to work and to reduce it the government has to employ particular measures.

(b)(ii)

"The government can reduce unemployment benefits that are provided to an unemployed person in the form of job seeker's allowance to support his income. Hence, this measure would induce the workers to search for jobs more actively as the gap between unemployment benefits and paid jobs is widened. The government can lower the income tax rate. A fall in income tax would increase the return from working. This would encourage the workers who choose to remain unemployed, to take up a suitable job as they may receive more from working than being on benefits."

Question 13

The definition of economic growth (a) has three components. Too many candidates omitted either the inflation element - "real" or the time element. Most managed to include the change in production, GDP.

Problems associated with a high economic growth rate appeared to be more difficult for candidates to identify in part (b) than the problems associated with negative economic growth with some describing an economic growth rate of 17.6% as low.

A good response to part (c) is given below.

"Education: Providing more education to the workers will increase their productivity. Educated people will be able to engage in jobs requiring high skill. They will get a higher salary and their living standards will rise. In Bangladesh, the largest sector of government expenditure is education. Since most of the workers are engaged in primary activities, like farming, the government is trying to increase their skills by setting up training centres, free educational institutes. This will enable more workers to engage in more productive secondary and tertiary services.

Investment: In Bangladesh the government has reduced the interest rates on loans. As a result, people take more loans and invest more in businesses of their own. In recent years, increased investment in the garment industry has given rise to a large number of jobs. More workers are employed in such factories. This has led to an increase in Bangladesh's GDP and also improved people's living standards.

Technology: The government of Bangladesh has increased its funding of research activities like research on hybrid seeds. It has also supported the introduction of automation in primary activities like agriculture. This has increased the speed of production in this industry, and has also allowed more workers to shift from primary to secondary industry like the garment industry and tertiary industry like banks. This has improved the living standards of Bangladeshis and may lead to economic growth in the future."

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