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ECONOMICS **9708/22**

Paper 2 Data Response and Essay **May/June 2017**

MARK SCHEME

Maximum Mark: 40

Published

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Question	Answer	Marks	Guidance
1(a)	For a clear diagram(s) showing understanding of the concept of a production possibility curve with correctly labelled axes and appropriate output choices (1 mark) For an appropriate representation of the change in Iceland (1 mark) For an appropriate representation of the change in Ireland (1 mark)	**3**	Figure 1 shows a rise in the GDP of Iceland and a fall in the GDP of Ireland. One way in which this could be shown would be a shift outwards of Iceland's PPC and a shift inwards of Ireland's PPC. Alternatively, this could be represented as a movement from within the curve towards the frontier in Iceland or a movement from the frontier to a point inside the frontier in Ireland. Either representation is acceptable.
1(b)(i)	The price level is higher in 2015 than in 2007 (1 mark)	**1**	
1(b)(ii)	For recognition that a fall in the value of the Krona will lead to a rise in the price of Iceland's import (1 mark) and an explanation of how this could cause cost-push inflation in Iceland. (Up to 3 marks) **4 maximum** For recognition that a fall in the value of the Krona will lead to a fall in the price of Iceland's exports (1 mark) and an explanation of how this could cause demand-pull inflation in Iceland. (Up to 3 marks). **4 maximum** **(6 marks maximum)**	**6**	The collapse of the Krona could cause cost-push and/or demand-pull inflation. As the Krona collapses this makes imports more expensive. This might feed into increased costs for Icelandic companies as they import raw materials and components. In addition, there might be increases in the cost of living as imports might comprise foodstuffs and so on. In addition, the fall in the Krona would reduce the price of Iceland's exports and increase the price of her imports that would lead to a rise in net exports and aggregate expenditure causing inflationary pressures. Give due credit to those answers that make good, appropriate use of the aggregate demand and aggregate supply framework although this is not essential for full marks.

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Question	Answer	Marks	Guidance
1(c)	At least **two** factors must be explained for full marks. • For an explanation of any factor that might determine whether a devaluation would turn a deficit into a surplus (Up to 3 marks) **(4 marks maximum)**	**4**	The fall in the value of the Krona has resulted in a change in the price of Iceland's exports and imports. Exports have fallen in price and imports have increased in price. The impact of this Upon the current account depends Upon factors such as the time period under consideration, the price elasticity of demand for Iceland's imports and exports and the price elasticity of supply of Iceland's exports. Also relevant is whether the currencies of other countries lose value against the Krona. Candidates need to explain at least two factors for full marks. Marks will be awarded for development of each factor. The J-curve, the Marshall-Lerner condition and whether Iceland has the capacity to expand exports will be developed in high scoring answers. Identification of relevant factors with no explanation (1 mark only) Please note that this question concerns the factors that determine the impact of devaluation Upon a country's current account. There are no marks for explaining that export prices fall and import prices rise after devaluation.

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Question	Answer	Marks	Guidance
1(d)	• For an explanation of the costs of managing an exchange rate (Up to 4 marks) • For an explanation of the benefits of managing an exchange rate (Up to 4 marks) **(5 marks maximum for costs and benefits)** • For a reasoned conclusion on whether the costs outweigh the benefits. (1 mark)	**6**	Iceland's exchange rate system is under the control of the Icelandic authorities. It is a managed exchange rate system. This means that Iceland has the option to vary the exchange rate to suit economic circumstances. The devaluation of the Krona has resulted in a current account surplus, falling unemployment and a budget surplus. These are the benefits of a managed exchange rate, but there are also costs. In order to manage the exchange rate, it is necessary to hold large quantities of foreign exchange reserves and these may not be sufficient to manage the exchange rate. In addition, in order to maintain a particular exchange rate it might be necessary to sacrifice other economic objectives. Iceland had to raise interest rates to very high levels and this would have resulted in some costs to consumers and businesses. This question does not require specific reference to Iceland. More general explanations of the costs and benefits of managing an economy's exchange rate are acceptable. Identification of a cost with no explanation (1 mark only) Identification of a benefit with no explanation (1 mark only)

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Question	Answer	Marks	Guidance
2(a)	For **knowledge and understanding** of the role of the factor enterprise: • For bearing the risk of production (Up to 2 marks) • For organising the other factors of production (Up to 2 marks) **(4 marks maximum)** For **application:** • An accurate demand and supply diagram will show an increase in demand, a rise in price and an extension in supply. • The diagram will have an accompanying explanation of how enterprise, motivated by profit, allocates more resources to the production of this good. **(4 marks maximum)**	**8**	The factor enterprise has two roles in a market economy. One is taking the risk of production, the other is organising the other factors in the production process. The reward for contributing to production is profit. If there is a rise in the demand for a good in a market economy, its price will rise. The factor enterprise will respond by expanding production in pursuit of more profit. The quantity of goods in the market will expand along the industry supply curve. An 'accurate' diagram will have axes and curves labelled correctly, the shift in the demand curve will be correct and there will be an extension in the quantity supplied. In awarding marks for application allow Up to 3 marks for the diagram. One mark should be reserved for an explanation of the role of enterprise in allocating resources to the production of the good. Please note that some knowledge and understanding of the role of enterprise might be shown in the candidate's explanation of how enterprise responds to an increase in the demand for a good. They might, for example explain how enterprise manages the other factors as the demand for a good increases.

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Question	Answer	Marks	Guidance
2(b)	For **analysis** • of any method of increasing the provision of merit goods such as direct provision or subsidies **explaining the strengths and weaknesses of each approach selected** (Up to 6 marks for each method) **(8 marks maximum)** For **evaluation** that **assesses and compares** • the relative strengths and weaknesses of each approach (3 marks) • to reach a conclusion concerning which policy is more likely to be effective (1 mark) **(4 marks maximum)**	**12**	A number of methods are used to increase the supply of merit goods in a mixed economy. These include direct provision, producer subsidies and education campaigns to increase the demand for the merit good. Each has advantages and disadvantages based Upon for example, the cost of provision, the time period under consideration and the difficulty in implementation. The mark scheme indicates that candidates need to explain two methods to obtain full marks for the analysis. This should include the strengths and weaknesses of each approach. They then need to provide evaluative comment to reach a conclusion on which method is likely to be most effective.
3(a)	For **knowledge and understanding** of the concept of cross elasticity of demand: • For an accurate formula (Up to 2 marks) • For recognition that substitutes have a positive coefficient (1 mark) and that complements have a negative coefficient (1 mark) **(4 marks maximum)** For **application:** • Using the formula to show why two goods with a positive coefficient are substitutes. (Up to 2 marks) • Using the formula to show why two goods with a negative coefficient are complements (Up to 2 marks) **(4 marks maximum)**	**8**	Candidates need to display a strong grasp of the central concept and be able to apply it to explain how economists distinguish between substitutes and complements. An 'accurate formula' is one that refers to the **% change** in quantity and price of the two goods. Allow credit for those candidates who do not provide the formula, but have a clear expression of what cross elasticity measures. Understanding of the measure is essential.

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Question	Answer	Marks	Guidance
3(b)	For **analysis** • of the usefulness to a business when setting its price of any measure of elasticity with due reference to its strengths and weaknesses (Up to 6 marks per type of elasticity of demand) **(8 marks maximum)** For **evaluation** that **assesses and compares** • the relative strengths and weaknesses of at least two measures of elasticity (3 marks) • to reach a conclusion concerning which measure is most useful (1 mark) **(4 marks maximum)**	**12**	Candidates can refer to price, cross or income elasticity of demand. They must consider at least two measures. Many will explain how price elasticity is useful in predicting how total revenue will change as price changes depending Upon the price elasticity. Others might explain how businesses might find cross elasticity useful as the price of complements and substitutes change. Income elasticity might be useful if incomes are changing and businesses consider whether to change the price of normal or inferior goods. Two measures are necessary for the full marks available for the analysis
4(a)	For **knowledge and understanding** of: • Fiscal Policy (Up to 2 marks) • and Monetary Policy (Up to 2 marks) **(4 marks maximum)** For **application:** • Showing how fiscal policy can be implemented to increase aggregate demand (Up to 2 marks) • Showing how monetary policy can be implemented to increase aggregate demand (Up to 2 marks) **(4 marks maximum)**	**8**	Fiscal policy is sometimes called 'budgetary policy'. It involves varying government spending and taxation to affect economic variables through changes in aggregate demand. Monetary policy refers to any government action to manage aggregate demand through control of the quantity of money, the rate of interest or credit terms. It is usually operated through the central bank. Appropriate use of diagrams should be awarded due credit, but is not essential for full marks for application.

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Question	Answer	Marks	Guidance
4(b)	For **analysis** • of how supply-side policy can be applied to correct inflation in an economy with due consideration of the likely success of this approach. (Up to 6 marks) • of how fiscal policy can be applied to correct inflation in an economy with due consideration of the likely success of this approach. (Up to 6 marks) **(8 marks maximum)** For **evaluation** that **assesses and compares** • the relative strengths and weaknesses of each approach (3 marks) • to reach a conclusion concerning which policy is more likely to be successful (1 mark) **(4 marks maximum)**	**12**	The term 'supply-side policy' refers to any action taken by governments to influence aggregate supply. This could include action such as improving education and training, changing tax rates to affect economic activity and improving infrastructure. A shift in the aggregate supply curve to the right reduces inflationary pressure as aggregate demand can be satisfied with an increase in real output rather than an increase in prices. Contractionary fiscal policy will shift the aggregate demand curve to the left and reduce inflationary pressure. The weaknesses of supply-side policy include the pressure on the government budget and the long-time period before it takes effect. The weakness of fiscal policy is that higher tax rates can provide a disincentive effect and reduced government expenditure may cause social unrest.

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