CAMBRIDGE INTERNATIONAL EXAMINATIONS

Cambridge International Advanced Subsidiary and Advanced Level

MARK SCHEME for the October/November 2014 series

9708 ECONOMICS

9708/22 Paper 22 (Data Response and Essay – Core), maximum raw mark 40

This mark scheme is published as an aid to teachers and candidates, to indicate the requirements of the examination. It shows the basis on which Examiners were instructed to award marks. It does not indicate the details of the discussions that took place at an Examiners' meeting before marking began, which would have considered the acceptability of alternative answers.

Mark schemes should be read in conjunction with the question paper and the Principal Examiner Report for Teachers.

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Data Response Questions

1 (a) **Compare the rate of inflation in China between 2007 and 2008 with that between 2010 and 2011.** **[2]**

2007–2008 = 6.16% **(1)**, 2010–2011= 5.66%. **(1)**
So it is lower in 2010–2011. **(1)**

2 marks maximum.

(b) **Explain briefly how the foreign exchange value of a currency is determined in a free market.** **[3]**

For recognition that the foreign exchange value depends upon supply and demand for the currency in the foreign exchange market. **(1)**

For identification of one source of supply of the currency or one source of demand for the currency. **(Up to 2 marks)**

For diagram showing a shift in supply or a shift in demand and the change in the equilibrium price in the market. **(1)**

3 marks maximum.

(c) **The US Treasury report states that China's strong trade surplus has led to a 'huge and rising stock of foreign exchange reserves' in China.**
Explain how this justifies the claim that China is manipulating the foreign exchange value of its own currency. **[3]**

For recognition of the link between a balance of payments surplus and rising foreign exchange reserves. **(1)**

Explanation based upon the rising stock of foreign reserves suggests that China is accumulating reserves of foreign currency by selling the Yuan and keeping its price low. This prevents an appreciation of the Yuan which would make China's exports more expensive and imports dearer which should turn the surplus into a deficit. **(Up to 3 marks)**

(d) **Explain why China's current account surplus is expected to increase in 2013, despite the rise in prices in China and the appreciation of the yuan.** **[6]**

For an explanation of why the rise in prices in China and the appreciation of the Yuan might not be expected to be consistent with a rising surplus in China. **(Up to 2 marks)**

Up to 3 marks for each factor that might explain why the surplus is expected to increase.

Possible factors include:
Higher rates of inflation in other countries.
Marshall–Lerner condition not fulfilled (Inelastic demand for imports and exports).
J –curve effect.
Non-trade factors in current account that are not price sensitive.
The Yuan may still be undervalued.
Continuing competitive advantage of Chinese goods.

(e) Do you agree with the view of the US Treasury that an appreciating currency is 'of overall benefit' to China? [6]

The advantages to China of an appreciating currency include the fact that imports are now cheaper so that Chinese consumers should enjoy cheaper goods and services and Chinese producers should benefit from cheaper capital imports and raw materials. In addition, the fall in net exports that should result would reduce inflationary pressures in China.

The disadvantages include the fact that China's external balance should diminish leading to a threat to production and employment in exporting industries.

For the advantages to China of the appreciating currency **(up to 4 marks)**

For the disadvantages to China of the appreciating currency **(up to 4 marks)**

Reserve one mark for a conclusion.

6 marks maximum.

Essay Questions

2 (a) With the use of a diagram, explain how prices allocate scarce resources in a market economy. [8]

For knowledge and understanding of the features of a market economy. **(Up to 4 marks)** Features include no government intervention, private ownership, entrepreneurs and the profit motive and supply and demand.

For application using a diagram to show the allocation of scarce resources through the price mechanism. **(Up to 4 marks)**

Allocation of scarce resources explained through the use of a supply and demand diagram is required for full marks here. No diagram implies 2 marks maximum for application.

(b) Discuss whether prices are less important in allocating scarce resources in a mixed economy compared with a market economy. [12]

In a free market economy public goods are not provided because of the 'free rider' problem and other goods are underprovided (merit goods) or overprovided (de-merit goods). In these cases price is not a reflection of marginal social cost and as a result there is a misallocation of resources.

In a mixed economy public goods can be provided although no price can be charged and merit and demerit goods can be provided at the appropriate price through the imposition of indirect taxes on demerit goods and the subsidisation of merit goods.

For analysis showing the role of price in a mixed economy with reference to private goods, public goods, merit and demerit goods. **(Up to 8 marks).**

(Up to six marks for one side allows a 6/2 or 2/6 split).
(If only one side is explained then no marks can be awarded for evaluation.)

For evaluative comment on the 'less important' aspect of the question. **(Up to 4 marks)**

In a mixed economy it could be argued that price is more important because it helps to efficiently allocate resources when taxes and/or subsidies are imposed on demerit and merit goods. Or it could be argued that it is less important because price is the only means of allocation in a market economy.

Quality of the reasoning is more important than the conclusion reached.

3 (a) Explain why the value of income elasticity of demand for a good can be positive, negative or zero, while the value of its price elasticity of demand is most likely to be negative. [8]

For knowledge and understanding of price elasticity and income elasticity of demand. **(Up to 4 marks)**

What each measures. **(1 mark for each)**
Formula for each. **(1 mark for each)**

Candidates need to show understanding of both measures of elasticity for full marks.

For application to show the values of price and income elasticity outlined. **(Up to 4 marks)**

Explanation of positive income elasticity. Normal good. **(1)**
Explanation of negative income elasticity. Inferior good. **(1)**
Explanation of zero income elasticity. Necessary good. **(1)**
Explanation of price elasticity of demand. Negative. **(1)**

Marks will be awarded here for a clear explanation of the types of good and the related value of income elasticity and for an explanation of the reason that price elasticity usually has a negative value.

(b) Discuss whether price elasticity of demand is a more useful concept than income elasticity of demand for a business that is trying to increase its sales revenue. [12]

For analysis to explain how knowledge of each type of elasticity might be useful to a business that is trying to increase sales revenue. **(Up to 8 marks)**

The analysis should show the link between the types of good produced when there are changes in income in an economy. For example, businesses will enjoy an increase in sales revenue if they produce normal goods when incomes are rising and inferior goods when incomes are falling in an economy.

The link between price elasticity of demand and changes in sales revenue when prices are changed also needs to be clearly explained. For example, businesses will increase prices to increase sales revenue when the price elasticity of demand for their product is inelastic and cut prices when demand is elastic.

(Up to six marks for one side allows a 6/2 or 2/6 split).
(If only one side is explained then no marks can be awarded for evaluation.)

For evaluation on the ‘more useful’ aspect of the question. **(Up to 4 marks)**

Candidates will gain evaluation marks when they make a judgement on the more useful aspect of the question. For example, they might comment that price elasticity is more useful because prices are set by the business whereas changes in income are beyond the control of the business. Some might argue that the data might be inaccurate or out-of-date. Accept any feasible assertion as long as it is justified by a valid argument.

For full marks for evaluation, a conclusion must be reached.

4 (a) Explain how a rise in the rate of interest might cause a shift in an economy's aggregate demand curve. [8]

For <u>knowledge and understanding</u> of each component of the aggregate demand curve. **(Up to 4 marks)**

For the AD formula i.e. C + I + G + X – M **(1 mark)**
For the components listed i.e. Consumption, Investment, Government Spending and Net Exports **(1 further mark)**
For explanation of components (any one component explained well can gain both marks) **(Up to 2 marks)**

For <u>application</u> showing how the components might be affected by a rise in the rate of interest resulting in a shift in the aggregate demand curve. **(Up to 4 marks)**

A rise in the rate of interest will cause a fall in consumption and investment. The impact on government expenditure and net exports is less certain. Candidates do not need to explain how a rise in the rate of interest affects all components because the question asks for the impact upon the aggregate demand curve. So the impact upon one component if done in sufficient depth could gain all the marks available.

(b) Discuss whether inflation is more likely to be caused by a shift in an economy's aggregate demand or a shift in its aggregate supply. [12]

For <u>analysis</u> that explains how inflation can be caused by an increase in aggregate demand or a fall in aggregate supply. **(Up to 8 marks)**

A rise in aggregate demand could be caused by an increase in any of its components. For example, consumption could be increased through a fall in the rate of interest, net exports could be increased by a fall in the exchange rate and so on. Candidates may call this <u>demand-pull inflation</u>.
A fall in aggregate supply could be caused by a fall in the resources available to an economy that shifts the production possibility curve inwards. Candidates may call this <u>cost-push inflation</u>.

Credit accurate diagrams although these are not essential for full marks.

(Up to six marks for one side allows a 6/2 or 2/6 split).
(If only one side is explained then no marks can be awarded for evaluation.)

For <u>evaluation</u> offering judgement on the 'more likely' aspect of the question. **(Up to 4 marks)**

Candidates might suggest that either can cause inflation, but should make some judgement on the 'more likely' to reach a conclusion based upon some reasoning. For example, candidates might suggest that demand-pull is most likely when government expenditure is rising, or that cost-push is more likely when resources are depleting.
It also depends upon whether a deflationary gap exists.