UNIVERSITY OF CAMBRIDGE INTERNATIONAL EXAMINATIONS

GCE Advanced Level and GCE Advanced Subsidiary Level

MARK SCHEME for the May/June 2006 question paper

9708 ECONOMICS

9708/02 **Paper 2**

Maximum mark 40

This mark scheme is published as an aid to teachers and students, to indicate the requirements of the examination. It shows the basis on which Examiners were initially instructed to award marks. It does not indicate the details of the discussions that took place at an Examiners' meeting before marking began. Any substantial changes to the mark scheme that arose from these discussions will be recorded in the published *Report on the Examination*.

All Examiners are instructed that alternative correct answers and unexpected approaches in candidates' scripts must be given marks that fairly reflect the relevant knowledge and skills demonstrated.

Mark schemes must be read in conjunction with the question papers and the *Report on the Examination*.

The minimum marks in these components needed for various grades were previously published with these mark schemes, but are now instead included in the Report on the Examination for this session.

- CIE will not enter into discussion or correspondence in connection with these mark schemes.

CIE is publishing the mark schemes for the May/June 2006 question papers for most IGCSE and GCE Advanced Level and Advanced Subsidiary Level syllabuses and some Ordinary Level syllabuses.

1 (a) (i) Calculate the balance of trade in goods between Australia and Thailand in 2002. [2]

Australian deficit (1) or Thai surplus (1) of A$.630m (1)

(ii) What differences were there in the types of goods traded between the two countries? [2]

Australia exports mainly minerals and farm products (1), Thailand exports mainly manufactured or processed (1), credit comment on petroleum, seafood or restricted data.

(iii) Explain what might have caused these differences. [4]

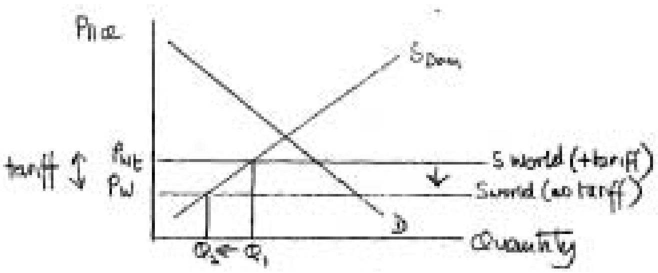
Absolute and comparative advantage (1), meaning (1), differences in factors of production (1), application e.g. Australia land rich, Thailand capital/technology rich (2).

(b) (i) Name two protective measures, other than tariffs, which would restrict free trade. [2]

Quotas, embargoes, VERs, subsidies, exchange control, licences, etc. – any 2

(ii) Explain, with the aid of a demand and supply diagram, how the domestic producers of a good are affected by the removal of a tariff on imports of that good. [4]

Receive lower price (1), supply smaller quantity (1), reduced profit (1), fully labelled diagram with world supply (up to 3), with domestic supply (up to2).



(c) Discuss whether Australia and Thailand should have abolished all tariffs immediately. [6]

Case for based on free trade arguments, welfare and efficiency, with reference to data up to 4 marks.

Case against based on infant industry, need for adjustment, special circumstances etc. with reference to data up to 4 marks. Credit reasoned conclusion up to 2 marks.

2 (a) Explain, with examples, the significance of the value of a good's cross-elasticity of demand in relation to its substitutes and complements. [8]

XED is a measure of the responsiveness of demand for one product to the change in price of another. The formula can be given. For substitutes the value is positive, a rise in the price of a substitute increases demand for the alternative. For complements it is negative, as the price of a complement rises the demand for the associated good will fall. The closer the relationship the greater the value. Examples such as chicken and turkey and cars and petrol may be given.

For knowledge of XED **[up to 2 marks]**

For explanation of the substitute case **[up to 3 marks]**

For explanation of the complement case **[up to 3 marks]**

(b) Discuss whether the demand for mobile phones (cell phones) is likely to be price-elastic or price-inelastic. [12]

PED is a measure of the responsiveness of demand to a change in price. Elastic involves a more than proportionate change (>1), inelastic a less than proportionate change(<1). The influences on elasticity include the existence of substitutes, the proportion of income spent on the good and the time period involved. Candidates may apply these influences to mobile phones according to their own experience and circumstances. Sensible reasoning is what is looked for, whatever the final conclusion.

For knowledge of elastic/inelastic demand **[up to 4 marks]**

For understanding of the influences on elasticity **[up to 4 marks]**

For discussion of the case of mobile phones **[up to 4 marks]**

3 (a) Explain, with examples, the difference between a demerit good and a merit good. [8]

A demerit good, such as cigarettes, has negative externalities e.g. passive smoking. Consumption results from lack of information by the consumer of the full implications of consumption. There is over-consumption which governments are likely to discourage. A merit good, such as education, has positive externalities e.g. improved productivity. The good is under-consumed due to lack of full knowledge and governments are likely to promote consumption. Full marks require clarification of the information gap.

For explanation of nature of demerit good **[up to 4 marks]**

For explanation of nature of merit good **[up to 4 marks]**

(b) Discuss two methods that a government might use to influence the consumption of demerit goods. [12]

Governments would intend to reduce the consumption of demerit goods. The usual methods are taxation to operate through the market system, bans to remove demand, education to influence consumers behaviour through information and subsidies to substitutes. In each case issues of cost, effectiveness, side effects and individual choice may be considered.

For knowledge of the methods and their operation **[up to 4 marks]**

For discussion of the advantages of the methods **[up to 4 marks]**

For discussion of the limitations of the methods **[up to 4 marks]**

4 (a) Explain, with the aid of diagrams, how a government would maintain a fixed exchange rate. [8]

A fixed exchange rate has a set rate against other currencies. This is determined by government action rather than market forces. When there is downward pressure on the intended rate the government will increase demand by the use of foreign currency. When there is upward pressure the supply of the currency would be increased to retain its lower value. This might be done indirectly through interest rate changes. A diagram would show the moves in the demand and supply curves relative to a fixed currency value.

For understanding of a fixed exchange rate **[up to 2 marks]**

For explanation of reaction to downward pressure **[up to 3 marks]**

For explanation of reaction to upward pressure **[up to 3 marks]**

(b) Discuss whether it is better for a country with a floating exchange rate to face an appreciation or a depreciation of its currency. [12]

A floating exchange rate is set by market forces and may fluctuate freely. An appreciation is an increase in its international value and a depreciation a fall.

An appreciation improves the purchasing power of the currency, may boost foreign confidence in the currency and inhibits inflation. It makes exports dearer and imports relatively cheaper which may worsen the balance of trade and cause unemployment. A depreciation works in the opposite direction. Which is preferable depends on the country's position and priorities.

For knowledge of the exchange rate terms **[up to 2 marks]**

For discussion of the effects of appreciation **[up to 3 marks]**

For discussion of the effects of depreciation **[up to 3 marks]**

For a conclusion comparing the two cases **[up to 4 marks]**