2009 Economics

Advanced Higher

Finalised Marking Instructions

Marking Instructions
Economics Advanced Higher

Detailed marking instructions/guidelines

These are not solutions

1. The appended marking instructions are guidelines only. Candidates will adopt different ways of tackling particular questions.
2. Differences of interpretation will be resolved at the Markers' meetings in May and June.
3. In essay or extended answers it is not necessary for candidates to include all the points listed in the enclosed mark schemes.
4. Candidates are expected to demonstrate a full appreciation of the topic and a sound understanding of the economic issues under discussion.
5. Marks should not be allocated on a rigid points scoring basis, but on the overall quality of the answer.

Advanced Higher: Marking Scheme

Section A

			Marks
1.	(a)	**Trade weighted index of 80.6.** The value of the pound against a basket of other foreign currencies measured against a given base year has fallen by almost 20%. The weighting takes account of the different sizes of economies and the relative importance of their currencies.	**2**
	(b)	**A run on the pound** occurs when holders of pounds sell them for other currencies because of lower expected returns or perceived weaknesses in the UK economy.	**1**
2.	(a)	**'Hot money'** Money held in UK sterling assets withdrawn by international investors from the economy in pursuit of higher interest rates or a more secure future elsewhere.	**1**
	(b)	Lower interest rates reduce the return on UK held assets. Higher Government borrowing raises fears about the UK's long term future because of inflationary pressure and the consequences of higher loan repayments. There may be a decline in the exchange value of the assets held.	**2**
3.	(a)	**Structural weakness** refers to the long standing deficit in the UK's current account caused by substantial deficits in manufactured and semi-manufactured goods.	**2**
	(b)	**Current account deficits** can be met by inflows of capital and overseas borrowing. As long as international investors retain confidence capital movements are unlikely. Good candidates may mention the role of Chinese and Japanese capital deposits.	**3**
4.	(a)	**A fall in the value of sterling** will improve the competitiveness of both UK imports and UK exports, protect UK jobs and increase firms' revenue during a recession. Much will depend on the price elasticity of demand for UK imports and UK exports to other countries.	**3**
	(b)	Both will reduce a firm's costs of production through cheaper import prices and lower repayment costs on loans and impact on aggregate monetary demand.	**2**
	(c)	If foreign competition becomes more expensive because of sterling's fall in value, UK firms can choose to increase their prices and hence profit margins without losing their price advantage.	**2**
5.	**Living standards might decline** because the cost of imports rises. UK consumers may face higher prices and lower disposable income and UK firms' profit margins may decline because of higher input costs. UK citizens will find overseas travel more expensive.		**3**
6.	**A fall in sterling's value** should lead to keener prices from firms wishing to retain market share or stay in business. Candidates should discuss the relative price elasticities for imports and exports (The Marshall Lerner condition), the worsening of the trade position in the short term (J Curve effect) because buyers take time to adjust to new price levels and the possibility of reduced efficiency as a result of complacency by firms because of the fall in sterling's value. Higher import prices may lead to higher UK inflation cancelling out the benefits of the falling value of sterling. Effects of global recession.		**4**

Section B

Marks

1. (a) **Reasons for the economic success of the BRIC include:**

- political stability
- the importance of export led growth
- size of the economies permitting economies of scale
- rapid industrialisation and the growth of an affluent middle class
- abundance of raw material
- educational levels and work ethic
- encouragement of entrepreneurship through stable government, government initiatives and relative absence of conflict and a common cultural heritage
- inward investment from developed countries
- good candidates will stress that these countries have been the major engine of world growth in recent years. **10**

(b) Candidates are expected to give specific examples to indicate the levels of growth in GDP. Who are they? Africa, Latin America, Middle East and South Asia. In many cases they will lack similar advantages.

- Countries too small to benefit from economies of scale.
- Internal disputes and wars and conflicts with neighbouring states.
- Lack of strong and stable government and exploitation by developed countries.
- Poor communications networks.
- Rurally based.
- Inadequate education and training.
- These countries can prosper through better education and training, developed export markets and greater stability. They can learn from the growing 'economic clout' of the G20 and the fact that over half of the world's GDP economy now emanates from the developing world. Many have extensive debts, have limited resistance to the economic power of the developed world and face unfavourable terms of trade. **8**

(c) Impact of world recession will have many effects.

- Declining export markets.
- Falling commodity prices notably oil.
- The extent of foreign exchange reserves and international investments to draw on.
- The threat of increased trade restrictions by developing countries seeking to protect their firms and workers.
- The extent to which worldwide liquidity problems reduce the availability of loans and credit.
- Extent to which the Doha Round is implemented. **7**

Marks

2. (a)

- Shortage of liquidity in the banking system leading to unwillingness of banks to lend to one another.
- Triggered by US sub-prime failures (high risk loans to those with poor credit history) caused by sharp increase in US interest rates and growing numbers of defaults on housing loans.
- Extent of personal debt in UK (£1.4 trillion) and USA.
- Contagion spread to other markets when loans (collateral debt obligations) were sold to investors globally.
- Crisis leading to bank failures and need to rescue banks all over the world as banks are unable to meet their obligations to their customers and are reluctant to lend to one another.
- Customers begin to withdraw deposits from banks.
- Sharp falls and fluctuations in stock market prices.
- Sharp falls in house prices and the availability of mortgages.
- Cheap Chinese funds.
- Regulation failure. **8**

(b) **Measures include:**

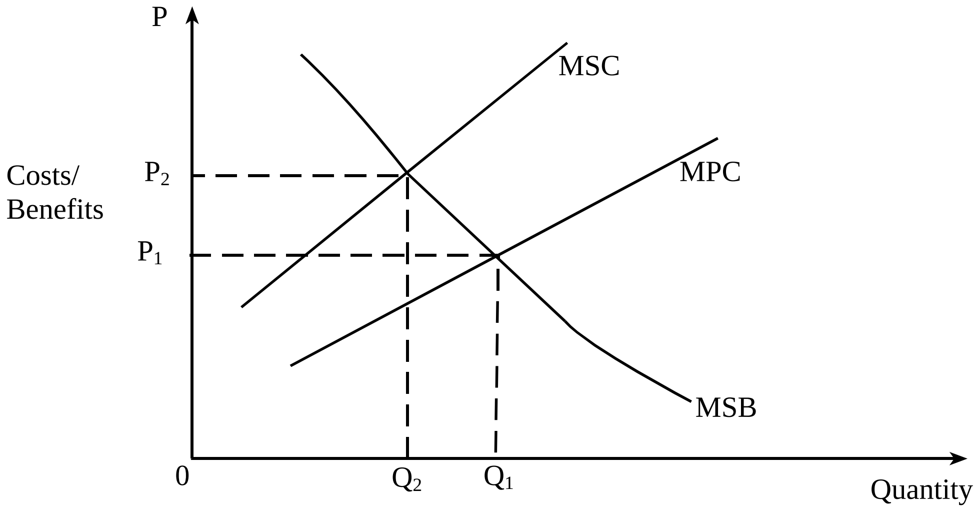
- central banks pumping money into markets to improve liquidity
- nationalisation of ailing banks
- mergers between financial institutions encouraged to protect banks threatened by collapse
- Governments forced to guarantee savers banks deposits
- sharp cuts in interest rates
- recapitalisation of banks
- quantitative easing
- financial stimuli through tax cuts and increases in government expenditure to avoid a severe recession
- candidates expected to give some specific examples to exemplify points made, Northern Rock, HBOS, RBS, Lehman Brothers, Iceland etc
- G7 five point to unfreeze credit markets (October 2008)
- G20 meeting to seek long term reform (November 2008).
- Asset Protection Scheme (insurance). **10**

(c) **Effectiveness of measures**

- Clearly still too early to be certain; are the measures sufficient?
- A complete banking meltdown has been avoided. The mistakes of the Great depression – falling demand accentuated by contacting money supply, government spending cuts and rising trade barriers have been avoided (?).
- A severe recession is pending globally.
- Mistakes have been made; ineffective regulation of the banking system and a failure to act appropriately especially in the USA (Lehman Brothers, Paulsen bailout).
- US housing market may have reached the bottom, but not in UK.
- Confidence in the banks, the financial system and the world economy is fragile despite cuts and the vast amounts of money pumped into the world economy.
- Bank still reluctant to lend.
- Legacy of public debt. **7**

Marks

3. (a) Market failure means that price paid is too low and output too high to reflect the true cost to the environment of climate change.



8

(b) Purpose is to 'internalise' the externalities economic activity levies on world climate. Charge firms and consumers for costs borne by the environment.

- Reduce consumer demand through taxes or regulation/licensing.
- Develop a range of green taxes.
- Increase efficiency.
- Encourage lower carbon technology through subsidies.
- Tradable permits to reward greener firms and penalise the less environmentally friendly.
- Switch to less damaging production, eg by increasing price of non-renewable resources.

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(c) **Problems include:**

- resistance by firms and consumers to higher prices and tighter regulations (eg excise duty on petrol)
- UK is a small contributor to global problem and many other countries did not sign up to Kyoto agreement.
- Governments fear the electoral consequences of imposing short term costs to secure long term benefits (Stern recommendations) – related to issue of intergenerational fairness.
- UK firms may be placed at a disadvantage in world markets if other countries do not take similar action.
- Rapid growth of developing countries to increase living standards, but may be unable or unwilling to take account of environmental considerations.
- Difficulties identifying and measuring climatic effects of economic activity.

8

Marks

4. (a) Definition of recession two successive quarters of negative growth.

- Falling demand in global markets.
- Impact of 'the credit crunch'.
- Loss of consumer confidence.
- Collapse in house prices.
- An adjustment after many years of sustained growth – boom and bust are still here.
- 'When America sneezes the world catches cold'
- MPC too slow to react.
- High food and oil prices. **7**

(b) **Monetarist Policy** concentrates on interest rates or the amount of money in circulation. Lower interest rates will stimulate demand by increasing disposable income and avoiding inflationary stimulation of the economy. Monetary transmission mechanism. Max 6 for monetary or fiscal policy. Min 2 off for no mention of supply side.

Demand Management Policies emphasise the role of government in cutting taxes or increasing government expenditure to increase aggregate demand. These will be subject to a multiplier effect.

Supply Side Policies attempt to improve the productive efficiency of the economy by giving market forces greater rein through deregulation, liberalisation, privatisation and free trade. **12**

(c) **Monetary Policy** may lead to lower levels of economic activity and rising unemployment. At very low rates interest rates may be ineffective (The liquidity trap). Quantitative Easing.
Rate cuts may not be passed on.

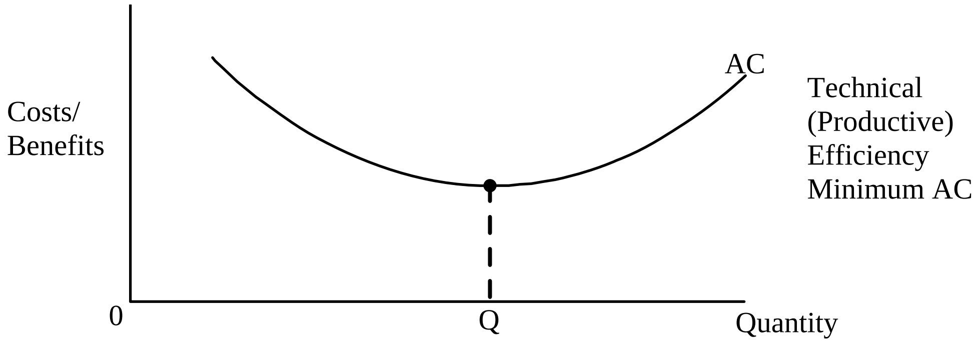
Demand Management Policy may lead to crippling levels of Government and personal debt leading to inflationary pressure.

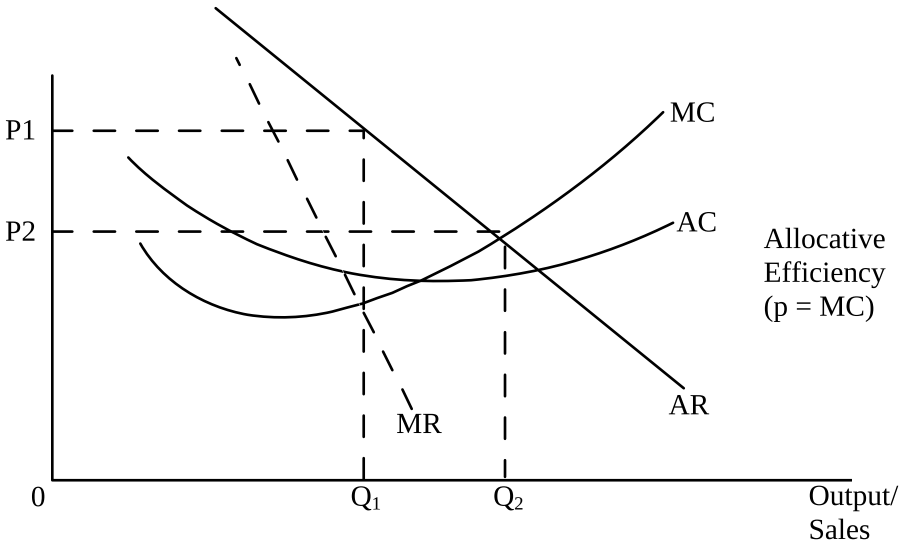
Supply Side Policy may lead to market force distortions with little control, encourage speculation and cause wider levels of wealth and income distribution.

Time Lags (all policies). **6**

Marks

5. (a) Brief discussion of nature of monopoly leading to higher prices and lower levels of output. Candidates may discuss other aspects, such as entry and exit barriers, that contribute to inefficiency. Welfare suffers because price exceeds marginal cost.





Both diagrams should be included for high marks. **7**

(b) Candidates may refer to contested markets in which, despite limited or no competition, it is relatively easy for firms to enter or leave an industry.
Candidates should give examples (supermarkets and broadband technology) and discuss the growing importance of these types of markets because of entrepreneurial innovation, modern technology and competition policy.

4 for contestable markets only.

Efficiency gains will include economies of scale, easier development and funding of new ideas, greater stability and international competitiveness.
The open nature of markets may overcome complacency in monopoly and oligopoly.
Natural monopoly. **6**

Marks

(c) Discussion of UK competition policy expected including limiting or prohibiting restrictive practices, market liberalisation, merger controls and regulation of utilities. Expect reference to Competition and Enterprise Acts and EU articles on competition.

Many of these controls are now operated independently of government through the Office of Fair Trade (OFT). Main guideline is 'substantial lessening of competition'. **6**

(d) **Effectiveness**

Industry has become more concentrated in recent years and markets are dominated by large firms.

The authorities (OFT and regulators) have limited powers to control and punish firms in breach of regulations.

Lack of compliance and informal agreements to restrict competition and fix prices are difficult to prove.

Policy may conflict with other government plans (eg takeover of HBOS by Lloyds TSB). **6**

Marks

6. (a) Knowledge about the extent of public sector debt is expected, including the relevant numbers.

Reasons include the wish to combat a recession and a lack of liquidity by injecting substantial sums into the economy.

To improve the infrastructure; a future generation will benefit from capital expenditure now and appropriately, therefore, bears the burden of higher debt repayments (reproductive debt).

To help an economy recover from the effects of a war or natural disaster. **8**

(b) **Consequences**

- Imposition of debt repayments on future generations.
- Taxes will have to rise in the future.
- The opportunity cost of higher interest repayments on other areas of government spending.
- Lack of confidence by investors about the ability of government to meet higher debt repayments leading to higher interest rates.
- Speculative pressures on the pound.
- The end of the fiscal rules that the governed economic policy for the past decade.
- Higher inflation caused by excessive monetary demand.
- 'Crowding out' of the private sector in the loans markets. **10**

(c) Candidates expected to explain clearly the relationship between an annual public sector deficit and an accumulated national debt.

In 2008 the UK national debt at 41% of GDP was low by historic and international standards. Figures for France, Germany and the USA were higher and for Japan substantially higher. Prospective increases in the budget deficit to around 8% of GDP will increase the UK's national debt to around 57% of GDP by 2013 – similar or slightly higher than in other G7 countries.

The UK's forecast budget deficit at around £78 billion in 2008/9 and £118 billion in 2009/10 (almost 8% of GDP) is much higher than that in other developed countries. Strong candidates will point out that this is almost double the Treasury forecast and blows apart the fiscal rules of the last decade and the EU's 3% guideline under the stability and growth pact. **7**

[END OF SECTION B]

[END OF MARKING INSTRUCTIONS]