

2nd edition

Edexcel **A2** Economics

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Answers

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Unit 3 Business economics and economic efficiency

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Supported choice questions

1 Answer: E

Explanation:

- Definition of horizontal integration: the merger of two firms producing the same or very similar products at the same stage of production.
- Application to the example in the question.
- Reason for the takeover, e.g. to gain economies of scale. (1 + 3 marks)

2 Answer: E

Explanation:

- Definition of backward vertical integration: when a firm merges with another firm in the same industry but at a different stage of production.
- Application: cocoa is used to make chocolate, so cocoa producers are in the same industry.
- This is backward vertical integration because the chocolate manufacturer is taking over a firm at an earlier stage of production. (1 + 3 marks)

3 Answer: C

Explanation:

- Definition of diseconomies of scale: when an increase in the scale of production leads to a less than proportionate increase in output.
- Examples of diseconomies of scale: problems of co-ordination; an increase in costs resulting from an increase in the size of the industry, e.g. raw materials.
- Diagram of long-run average cost curve to illustrate economies and diseconomies of scale. (1 + 3 marks)

4 Answer: D

Explanation:

- Definition of marginal cost: the change in cost resulting from an increase in production by one unit.
- Outline of the relationship between average total cost and marginal cost.
- Identification of the average fixed cost curve (1) and the average total cost curve (2) shown in the diagram. (1 + 3 marks)

5 Answer: B

Explanation:

- X-inefficiency implies that there is 'organisational slack'.
- For example, administrative costs may be excessively high.
- This may be the result of an absence of effective competition. (1 + 3 marks)

6 *Answer:* D

Explanation:

- Definitions of total revenue and total cost.
- An understanding that the level of output that maximises profit will be found where $MC = MR$.
- Diagrammatic representation of profit maximisation either using total revenue and total cost curves or marginal analysis. (1 + 3 marks)

Market structure: perfect competition and monopoly

Chapter 2

Supported choice questions

1 Answer: D

Explanation:

- Average variable cost is variable cost per unit; average revenue is price.
- To remain in business, a firm must be able to cover its variable costs, such as raw materials. If these are not covered, the firm would go out of business immediately.
- Ideally, it should also be able to make a contribution to fixed costs. (1 + 3 marks)

2 Answer: E

Explanation:

- A key feature of perfect competition is that there are many buyers and sellers.
- Therefore, no single firm is large enough to influence the market price: firms are 'price-takers'.
- This could be illustrated with an industry supply-and-demand diagram, determining the price which a firm charges.
- Other characteristics of perfect competition, e.g. homogeneous goods; perfect mobility of resources. (1 + 3 marks)

3 Answer: B

Explanation:

- Supernormal profits imply that average revenue is greater than average total costs.
- In a perfectly competitive industry, there are no barriers to entry so new firms will enter the industry.
- This will cause the industry supply to increase and the market price to fall. Consequently, the supernormal profits will be competed away. The remaining firms will now produce lower outputs than previously. This may be illustrated diagrammatically. (1 + 3 marks)

4 Answer: D

Explanation:

Profits are maximised at the output at which there is the greatest difference between total revenue and total cost. (1 + 3 marks)

Units of output	1	2	3	4	5	6	7	8	9	10
Total cost (pence)	7	13	18	22	25	29	34	40	47	55
Total revenue	6	12	18	24	30	36	42	48	54	60
Profit	-1	-1	0	2	5	7	8	8	7	5

5 Answer: E

Explanation:

- Definition of either marginal cost (MC) or marginal revenue (MR).
- Explanation of why MC must be equal to MR to maximise profits: e.g. if $MR > MC$, the firm could increase profits by expanding output; if $MC > MR$, profits could be increased by reducing output.
- Diagram to illustrate the profit maximising output of a monopolist. (1 + 3 marks)

6 Answer: D

Explanation:

- Definition of barriers to entry: obstacles which prevent or deter new firms from entering the industry.
- Examples of barriers to entry: economies of scale, patents, control of the source of raw materials.
- Analysis of how an increase in barriers to entry would enable a firm to make supernormal profits in the long run. (1 + 3 marks)

Market structure: monopolistic competition and oligopoly

Chapter 3

Supported choice questions

1 Answer: E

Explanation:

- Definition/characteristics of monopolistic competition: e.g. large number of buyers and sellers; differentiated products; no barriers to entry.
- If firms are making supernormal profits in the short run, new firms will enter the industry so competing away these supernormal profits in the long run.
- Firms will not be producing at an allocatively efficient level of output (where price = marginal cost) and not at the productively efficient level of output (the lowest point on the average cost curve).
- Diagram to show long-run profit maximising level of output of a monopolistically competitive firm. (1 + 3 marks)

2 Answer: A

Explanation:

- Definition of sunk costs: costs which cannot be recouped if the firm exits the industry.
- Examples of sunk costs in this context: heavy brand-name advertising; patents.
- Also: significance of economies of scale. (1 + 3 marks)

3 Answer: D

Explanation:

- Definition of oligopoly: a small number of firms responsible for supplying a high proportion of the market.
- Given that a few large firms supply a large proportion of the market, there will be interdependence, i.e. the actions of one firm will affect the decisions of the other firms.
- Examples of industries which are oligopolistic, e.g. aircraft manufacturers. (1 + 3 marks)

Mini-essay questions

- 4 • Understanding of oligopoly: where a few firms supply a high proportion of the market.
- Key characteristic of oligopoly: firms are interdependent, so the actions of one firm will impact on the other firms.
 - In the following matrix, the cells show the amount of profit each firm would make under different scenarios.

Two firms, TALK2ME and MOBPHO: possible profit outcomes

		MOBPHO			
		Low price		Advertising	
TALK2ME	Low price	£5m	£5m	£10m	£2m
	Advertising	£2m	£10m	£7m	£7m

- If the firms collude, the best outcome in the above matrix would be for the companies to avoid price competition and launch advertising campaigns.
- If there is no collusion, both firms will engage in price competition as otherwise one would gain considerably more profit than the other.
- However, in practice, it may be difficult to determine the possible impact on profits of different strategies. Further, other factors may change, which would impact on the expected values in the matrix. (16 marks)

5 Pricing strategies include:

- limit pricing
- predatory pricing
- price discrimination, e.g. different prices being charged to individuals and to fleet buyers
- trade-in deals

Non-pricing strategies include:

- after-sales servicing, e.g. free servicing; breakdown cover
- advertising
- quality and choice available in the retail outlet and/or online

Evaluation points might include:

- the cost of the policy relative to the revenue gained
- the price elasticity of demand (relevant to pricing policies)
- the short-run and long-run impact of the policy
- the perceived quality and reliability of the cars might be the key factor, so the above policies may have little impact (16 marks)

Supported choice questions

1 Answer: D

Explanation:

- Definition of average variable cost: variable cost per unit of output.
- Aim of predatory pricing: to drive out competitors.
- The company was fined because predatory pricing is anti-competitive.

(1 + 3 marks)

2 Answer: D

Explanation:

- Profit maximisation: output at which $MC = MR$.
- Revenue maximisation: output at which MR is zero.
- Diagram to show profit and revenue maximisation.

(1 + 3 marks)

3 Answer: C

Explanation:

- Definition of allocative efficiency: when the value consumers place on a product (its price) equals the cost of the resources used in production.
- Diagram to illustrate a monopolist producing the output at which price = marginal cost.

(1 + 3 marks)

4 Answer: A

Explanation:

- Limit pricing involves setting a price which is sufficiently low to deter the entry of new firms into the industry.
- This would enable firms currently in the industry to avoid an increase in competition.
- In turn, this would enable the incumbent firms to continue to make supernormal profits.

(1 + 3 marks)

5 Answer: C

Explanation:

- Advertising is designed to increase demand and to make demand less price elastic.
- Consequently, advertising should decrease contestability — a contestable market is one in which there are low (or zero) barriers to entry and exit.
- Low contestability makes it more likely that the incumbent firms can make supernormal profits.

(1 + 3 marks)

6 *Answer:* E

Explanation:

- Definition of price discrimination: when a firm charges different prices for the same product to different consumers, where price differences do not reflect differences in the cost of supply.
 - Markets must be kept separate otherwise it will not be possible to charge some consumers a higher price.
 - Other conditions for price discrimination: e.g. different price elasticity of demand in each market.
- (1 + 3 marks)

Government intervention to promote competition

Chapter 5

Supported choice questions

1 Answer: E

Explanation:

- PFI contracts are funded by companies in the private sector.
- Therefore, they do not involve an increase in public expenditure to finance the building of new hospitals so there will be no impact on the budget deficit.
- PFI schemes enable new facilities to be available more quickly than would otherwise be the case. (1 + 3 marks)

2 Answer: B

Explanation:

- $RPI + k$ is a form of price cap regulation designed to prevent monopoly suppliers of water from exploiting consumers.
- In the formula $RPI + k$, RPI represents the rate of inflation while k represents the requirements for capital investment.
- Water companies may require money to fund new reservoirs, water cleansing facilities and to replace infrastructure. (1 + 3 marks)

3 Answer: B

Explanation:

- The main aim of the OFT is to make markets work efficiently for consumers.
- A proposed merger would reduce competition if there is was a horizontal merger.
- A reduction in competition may be regarded as undesirable because firms could exploit consumers by charging higher prices, so reducing consumers' surplus. (1 + 3 marks)

Mini-essay questions

4 • Consideration of the different forms of efficiency:

- allocative efficiency
- productive efficiency
- dynamic efficiency
- Understanding of price cap regulation as used in the water industry.
- A price cap may mean price and output are brought closer to allocative and productively efficient levels. This may be illustrated by a diagram.
- However, much will depend on the price caps and where they were set.
- There is a danger that dynamic efficiency will be reduced because firms may be making less supernormal profit. However, price caps provide an incentive for firms to become more efficient so profits may not fall significantly. (16 marks)

- 5 • This is an example of horizontal integration which would reduce competition. But much will depend on the market share gained from the merger on particular air routes.
- As in question 4, consideration of the possible impact on allocative and productive efficiency.
 - A merger could result in economies of scale and a fall in long-run average costs which would have an impact on allocative and productive efficiency.

(12 marks)

Essay questions

- 1 a** • Role of TNCs in globalisation: e.g. FDI resulting in an increase in trade.
- Consideration of other factors responsible for globalisation:
 - decreased cost of communication
 - decreased cost of transport
 - reduction in trade barriers — role of WTO
 - opening up of China and old Soviet bloc countries (20 marks)
- b** Benefits include:
- Lower prices and more choice for consumers, but TNCs could exert monopsony power and exploit producers in developing economies.
 - Larger markets for firms, enabling them to benefit from economies of scale, but smaller firms in some countries may be unable to compete and go out of business.
 - Increase in economic growth based on increased specialisation and trade, but benefits may be unevenly spread resulting in increased inequality.
- Remember to relate your answer to a specific country. (30 marks)
- 2 a** Essentially, this is a question relating to the causes of globalisation, so the points outlined in 1a above are relevant in answering this question. (20 marks)
- b** • Understanding of trade liberalisation: removal of trade barriers such as tariffs, quotas, subsidies to domestic producers and non-tariff barriers.
- The removal of tariffs could be illustrated by a diagram showing the impact on imports (which will increase) and on domestic production (which will fall).
 - Impact on inflation: the lower cost of imported raw materials leading to a reduction in cost-push inflation. Also, domestic producers will be subject to greater competition, which may have a downward pressure on prices. However, trade liberalisation might lead to an increase in exports, which would increase aggregate demand and could be inflationary.
 - Impact on unemployment: could fall if exports rise but it depends on how much imports increase.
 - Impact on the current account of the balance of payments.
 - Impact on economic growth.
- Both the latter points depend on the relative change in exports and imports. Remember to relate your answer to a specific country. (30 marks)
- 3 a** • Meaning of trading blocs: a group of countries which agree to reduce or eliminate trade barriers.
- Brief consideration of different types of trading blocs with examples: free trade areas; common markets; economic and monetary unions.
 - Explanation of trade creation in trading blocs.

- Explanation of trade diversion relating to countries outside the bloc.
 - Consideration of the impact on resource allocation. (20 marks)
- b**
- Meaning of protectionism: increase in barriers which restrict trade between countries. You could include a diagram showing an increase in tariffs.
 - An increase in protectionism would reduce specialisation and trade, leading to a fall in global growth rates. (Relate this to the law of comparative advantage.) However, some individual countries might benefit if their goods are uncompetitive.
 - Developing countries might suffer disproportionately if the increase in protectionism is by developed economies only.
 - With slower growth, unemployment might increase in the global economy.
 - Inflation might increase as a result of tariffs and a loss of economies of scale. However, if the global economy slows down, demand-pull inflationary pressures would decrease. (30 marks)
- 4 a**
- Outline the role of the World Trade Organisation (WTO):
 - to promote free trade — relate to the law of comparative advantage
 - to resolve trade disputes between countries
 - Discussion of the impact of the removal of trade barriers on the world economy on consumers, firms and economic growth.
 - Outline the problems facing the WTO in securing further agreements to reduce trade barriers and also problems in resolving trade disputes, e.g. the difficulty of proving dumping or other unfair trading practices. (20 marks)
- b** Reasons include:
- to prevent dumping (but this may be difficult to prove in practice)
 - to correct a balance of payments deficit on the current account (but this may not be justified if it could be corrected by a depreciation of the country's currency)
 - to protect infant industries (this may be justified if the country is in the process of industrialisation)
 - to prevent unemployment (but this could result in an inefficient allocation of resources by preventing resources from being allocated to more efficient uses)
 - to raise revenues, e.g. from tariffs
 - to protect industries of strategic importance (30 marks)

The balance of payments and exchange rates

Chapter 7

Data response question

- 1 a**
- Trade in goods deficit: the value of goods imported exceeds the value of goods exported, e.g. £100 billion deficit in 2012.
 - Current account deficit: the sum of goods and services imported, current transfers abroad and income paid abroad is greater than the sum of goods and services exported, current transfers into UK and income from abroad, e.g. £56 billion deficit in 2012. (5 marks)
- b**
- Depreciation, e.g. of the pound sterling, implies that the external value of the pound falls against other currencies.
 - This would cause an increase in the competitiveness of the UK's goods and services because the foreign currency price of UK exports would fall while the domestic price of imports would rise.
 - In turn, this should lead to a reduction in the current account deficit with exports rising and imports falling. (8 marks)
- c** Possible effects include:
- An increase in GDP (caused by an increase in exports and a decrease in imports). However, much will depend on the price elasticity of demand for exports and imports.
 - An increase in the rate of inflation because the costs of imported raw materials (and finished goods) will increase. However, this may not happen if producers reduce their profit margins. (10 marks)
- d** Factors include:
- Continuing slow growth in the UK's major export markets, particularly the EU. Consequently, demand for UK exports have not increased much even though they appear cheaper than before the depreciation. However, some manufacturers have diversified their markets and are increasing sales to countries in Asia and South America.
 - Low productivity in the UK with the result that unit costs are relatively high, so a depreciation will have little impact on the demand for exports. However, this might only be a short-term problem, resulting from firms hoarding labour after the financial crisis. (12 marks)
- e** A concern if:
- it indicates a lack of competitiveness of the country's goods and services
 - it could be difficult to finance
 - it is a long-run issue
 - it can be corrected by a depreciation of the currency
- Not a concern if:
- there is a healthy surplus on the financial account
 - it is only a short-run issue
 - the underlying state of the economy is strong
 - it can be financed easily from reserves of gold and foreign currency (15 marks)

Essay questions

2 a Factors include:

- Interest rates are high relative to those in other countries, but this may be because the inflation rate is high.
- The inflation rate is low relative to other countries, but this may be caused by a fundamental weakness in the economy, e.g. low aggregate demand.
- An increasing current account surplus, but trade is less significant than other currency flows in influencing the value of the currency.
- The strong state of the economy, but this depends on whether it is likely to be sustained in the long run.
- Expectations: e.g. about a rise in interest rates; an improvement in the state of the economy. (20 marks)

b Benefits include:

- No transaction costs arising from exchanging currencies, so membership encourages trade between member states. However, transaction costs only represent a small percentage of GDP.
- Other factors are also significant, e.g. certain types of goods might not be available in the Eurozone.
- Using the same currency means greater certainty, but greater integration means that member countries are more susceptible to external shocks.
- Membership might encourage FDI, but the evidence on this appears weak: e.g. the UK still attracts a large amount of FDI. (30 marks)

3 a Possible causes include:

- an overvalued exchange rate until 2008; loss of the manufacturing base
- low productivity relative to other countries
- high inflation relative to other countries
- non-price factors, e.g. quality, design, reliability

Evaluative points might include:

- the prioritisation of factors
- a discussion of whether the deficit is offset by investment incomes or flows into the financial account (e.g. FDI)
- a discussion of the changes which might lead to a reduction in the deficit (20 marks)

b Measures include:

- Deflationary fiscal and/or monetary policy: by reducing aggregate demand, imports would fall.
- Under a system of floating exchange rates, a depreciation of the currency might be engineered by cutting interest rates or by selling the currency on the foreign exchange market.
- Supply-side policies to increase productivity and competitiveness.
- Trade barriers, e.g. tariffs, quotas, but these may be impossible under WTO rules and/or membership of the EU.

Each policy should be evaluated in terms of its effectiveness. (30 marks)

Data response question

- 1 a**
- Price competitiveness: when a firm's product is sold at a lower price than similar products sold by other firms.
 - Non-price competitiveness: when a firm's product is distinguished from that of competitors on the basis of quality, design, reliability. (5 marks)
- b** Factors include:
- France's unit labour costs have risen at a faster rate than those of its competitors.
 - There are higher taxes on employers than in other countries.
 - There is a larger state sector than in other countries. Some would argue that the state sector is less efficient than the private sector (because there is no profit motive or competition). (8 marks)
- c**
- The Eurozone single currency is currently used by 17 countries.
 - France is tied to this currency so its lack of competitiveness would not automatically cause a fall in the value of the euro — its value depends on the state of all the 17 countries' economies.
 - Therefore, if the value of the euro is relatively high, this would reduce further the competitiveness of France's goods and services.
 - On the other hand, the euro could have fallen in value so improving its competitiveness.
 - Further, increased productivity in France may lead to an improvement in competitiveness. (10 marks)
- d** Measures include:
- Reduce taxes on employers: this would reduce costs and so enable firms to cut prices. However, some firms might just increase their profit margins rather than decrease their prices. Also, tax revenue would fall so the government would have less money to spend on measures to improve productivity, e.g. education.
 - Reduce taxes on workers' incomes to provide an incentive for them to become more productive. However, there is no guarantee that this would increase productivity. (12 marks)
- e** Structural reforms could include:
- Reducing labour market regulations, e.g. maximum working hours. This might enable firms to become more efficient. However, it could lead to the exploitation of workers.
 - Increasing labour market flexibility by making it easier for firms to hire and fire workers. But, once again, there is a danger that workers could be exploited by employers.
 - Improving childcare facilities and subsidising costs for families. This would enable more parents to go out to work so increasing aggregate supply. However, this would involve a cost to the government. (15 marks)

Essay questions

2 a Factors include:

- changes in relative interest rates
- changes in the rate of inflation relative to other countries
- changes in the current account of the balance of payments: e.g. if the country experiences a large deficit, the value of the currency is likely to fall
- speculation: e.g. if there are prospects that the state of the economy will improve, the currency is likely to appreciate in value
- changes in foreign direct investment

Evaluation:

- trade is less significant than other monetary flows between countries
- small changes in interest rates may have little impact
- speculation is often regarded as the most significant factor because this affects confidence in the economy (20 marks)

b Benefits include:

- price transparency
- the absence of transaction costs
- the attractiveness to TNCs when considering FDI
- a large market with a single currency
- no currency fluctuations between member states (because they are using the same currency)

Evaluation:

- membership of the Eurozone means that the country loses the opportunity of operating an independent monetary policy
- the possibility of currency adjustment is lost
- if a country's goods are uncompetitive, adjustment must occur via reductions in wages and prices (30 marks)

3 a Factors include:

- an increase in the country's inflation rate relative to that of its major competitors
- an appreciation in the country's exchange rate
- a fall in non-price competitiveness, e.g. a fall in quality
- a fall in productivity relative to competitors causing a rise in relative unit costs

Evaluation:

- price factors may not be significant if demand is price inelastic
- exchange rate changes may be short term only and have little impact (20 marks)

b Measures include:

- A range of supply-side policies, e.g. education; improvements in infrastructure; measures to improve competition, e.g. legal controls on monopolies; incentives for FDI; tax breaks to promote domestic investment. However, such measures may take a long time and be expensive to implement, and may be ineffective.

- Engineering a depreciation of the exchange rate, e.g. a decrease in the interest rate — but this may be difficult in practice because other factors may be more significant.
- Increasing trade barriers — but this may not be realistic. (30 marks)

Chapter 9

Poverty and inequality in developed and developing countries

Essay question

1 a Factors include:

- education and training
- the wage rate
- the strength of trade unions
- the degree of employment protection
- social benefits, including pension rights
- the tax system, e.g. the progressiveness of the tax system
- patterns of ownership of assets, e.g. houses and shares
- patterns of inheritance

Remember to relate your answer to a specific country.

(20 marks)

b • Distinction between economic growth and economic development.

- Inequality may be regarded as necessary in a capitalist system to provide incentives for entrepreneurs to take risks.
- With the prospect of making high profits, people will be more prepared to start businesses and help to promote economic growth.
- However, inequality may hinder growth and development because the poor will have no collateral. Therefore, they will be unable to borrow from banks in order to start a business.
- Further, the very poor are less likely to be educated to a high standard which is likely to limit growth and development.

(30 marks)

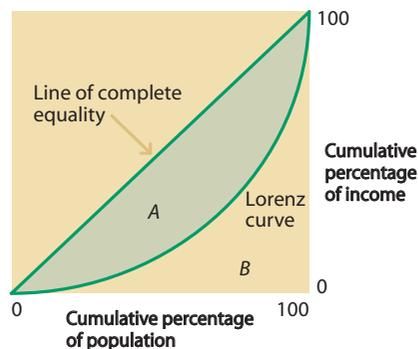
Data response question

2 a • Absolute poverty is when a person has insufficient income to meet their basic needs, such as food, shelter and clothing. It is currently defined as those living on less than \$1.25 a day at 2005 GDP, purchasing power parity.

- Relative poverty may be defined as people who are earning less than a minimum threshold income, e.g. 60% of median income.

(5 marks)

b • Include a Lorenz curve diagram:



- This diagram plots the cumulative percentage of the population against the cumulative percentage of total income. The 45°-line represents perfect equality.
- To determine the degree of inequality, the Gini coefficient may be calculated. The following formula indicates how this may be done:

$$G = \frac{A}{A + B}$$

where A represents the area between the diagonal line and the Lorenz curve, and B represents the area under the Lorenz curve. (8 marks)

- c**
- Inequality may be regarded as necessary in a market economy to provide incentives for entrepreneurs to take risks.
 - With the prospect of making high profits, people will be more prepared to start businesses and help to promote economic growth.
 - However, inequality may hinder growth and development because the poor will have no collateral. Therefore, they will be unable to borrow from banks in order to start a business. (10 marks)
- d**
- Understanding of economic development.
 - Poverty implies that people will have very low incomes.
 - In turn, they are unlikely to be able to afford education and health.
 - Therefore, school enrolment rates and life expectancy are likely to be low.
 - Further, poverty implies that other measures of development will be low: e.g. access to clean water; the proportion of workers in agriculture.
 - These factors are likely to limit development: the poor will be unable to start their own businesses because they do not have the skills or collateral. (12 marks)
- e** Problems include:
- Increased inequality, but this could be alleviated by a progressive tax system and state welfare payments.
 - External costs: damage to the environment associated with industrialisation and urbanisation. However, this could be alleviated by government measures to limit environmental damage.
 - Rapid depletion of resources.
 - An increase in the demand for imported goods as the new middle class demand more consumer goods. (15 marks)

Essay questions

- 1 a**
- Price volatility: demand and supply of most primary products are price inelastic. Therefore, a change in either conditions of supply or demand would cause a large price change.
 - Revenue volatility: given the above analysis, producers' revenue would fluctuate, creating uncertainty.
 - Uncertainty: makes it difficult to plan investment and output.
 - Falling terms of trade: analysis based on the Prebisch–Singer hypothesis. This would make it more expensive for developing countries to import capital goods, oil etc.
 - However, for much of the first decade of the twenty-first century, primary products were rising and manufactured goods prices were falling, causing an improvement in the terms of trade of countries dependent on primary products.
 - Further, some countries have developed on the basis of specialising in the production of primary products whose demand is income elastic, e.g. Chile with copper, blueberries, and grapes for wine. (20 marks)
- b**
- Protectionist policies may be in the form of tariffs or subsidies to domestic producers. The impact of these could be illustrated by appropriate diagrams.
 - Such policies would restrict exports from the developing countries and reduce their incomes.
 - In turn, lower incomes would impact on development.
 - But there is an increasing amount of trade between developing countries. Also, the WTO is working to reduce protectionism by developed countries. Further, there are an increasing number of regional trade agreements which remove trade barriers between member countries.
- Remember to relate your answer to a specific country. (30 marks)
- 2 a**
- Rapid population growth might constrain growth and development if the population is growing at a faster rate than GDP.
 - Further, the population growth rate would be unsustainable if the country has insufficient resources to meet the needs of the increased number of people.
 - You could refer to Malthus's view of the dangers of rapid population growth.
 - The dependency ratio would be increasing, at least in the years in which the population was growing rapidly.
 - However, the higher population would eventually mean an increase in the size of the workforce. This implies an increase in aggregate supply

and could result in economic growth. Further, more workers imply more tax revenue for the government, which could be used for development purposes.

Remember to relate your answer to specific countries. (20 marks)

- b**
- Understanding of human capital: the knowledge and skills embodied in the workforce.
 - Deficiencies in human capital implies that certain skills and knowledge may be lacking.
 - If this is the case, it is likely to result in low productivity relative to countries with high human capital.
 - Low productivity implies a slow rate of growth and a slow rate of increase in real incomes.
 - Consequently, economic development may be limited with, e.g. a low life expectancy and/or high levels of illiteracy.
 - However, some economies have managed to grow and develop despite deficiencies in human capital, especially in manufacturing industries which require very limited skills. Further, other factors may be more significant in limiting development, e.g. the savings gap or the foreign exchange gap.

Remember to relate your answer to a specific country. (30 marks)

3 a Factors include:

- a savings gap, resulting in insufficient money available for investment in manufactured goods
- a foreign exchange gap: the country may have insufficient foreign currency available to import capital goods needed for manufacturing
- geography: a land-locked country might find it difficult to attract FDI, which might be essential if the country is to industrialise
- corruption: this might deter investment
- internal disputes; civil wars
- poor human capital

However, not all these factors are necessarily an obstacle. In practice, some economies have grown and developed on the basis of primary industries or service sector industries. Further, some factors are temporary constraints, while others may be more long-term constraints. (20 marks)

- b**
- Process of industrialisation.
 - Consideration of models of development, e.g. the Lewis model.
 - Understanding that workers moving from the agricultural sector to the manufacturing sector may be more productive, leading to increased economic growth and the prospect of development.
 - Manufactured goods have more added value than basic primary products.
 - Trade in manufactured goods is likely to be more profitable than trade in primary products: e.g. the possibility of export-led growth.
 - However, industrialisation might have a more limited impact if it is focused on low-value products. Also, economic development might be achieved

through focusing on the services sector or by developing the primary sector, especially if the goods have an income elastic demand such as diamonds, gold or exotic fruits.

Remember to relate your answer to specific countries.

(30 marks)

- 4 a**
- Understanding of human capital: the knowledge and skills embodied in the workforce.
 - Deficiencies in human capital implies that certain skills and knowledge may be lacking.
 - If this is the case, it is likely to result in low productivity relative to countries with high human capital.
 - Low productivity implies a slow rate of growth and a slow rate of increase in real incomes.
 - Consequently, economic development may be limited with, e.g. a low life expectancy and/or high levels of illiteracy.
 - However, some economies have managed to grow and develop despite deficiencies in human capital, especially in manufacturing industries which require very limited skills. Further, other factors may be more significant in limiting development, e.g. a savings gap or a foreign exchange gap.

(20 marks)

b For example, differences in:

- geography: this includes factors such as nearness to large markets and physical factors, e.g. affecting the ease of transport, the fertility of the land
- history: colonialism may have had more of a negative impact on development in many African countries compared with Asian economies
- infrastructure: e.g. the amount of FDI
- education: there is a greater emphasis on education in Asian countries
- management: there is poor macroeconomic management in many African countries

For evaluation, consider the significance of each factor in relation to examples.

(30 marks)

Data response question

- 1 a** When the economy has two periods of two quarters of negative economic growth. (5 marks)
- b**
- A fall in real incomes would cause a fall in consumption. Since this is a component of aggregate demand, the *AD* curve would shift to the left, causing a fall in the price level and further fall in real income.
 - Also, lower real incomes would cause a fall in imports so net exports would increase, offsetting the fall in consumption to some extent. (8 marks)
- c**
- Higher unemployment suggests that inequality may increase because more people will have suffered a fall in income.
 - This may be illustrated by a Lorenz curve diagram with a new Lorenz curve drawn further away from the original.
 - However, state benefits, especially means-tested benefits, might prevent inequality from rising significantly. Also, the rise in unemployment may only be a short-term rise. (10 marks)
- d**
- Because Spain is a member of the Eurozone, it has no control over the value of the currency, therefore export-led growth might be difficult.
 - Spain would need to improve its competitiveness by increasing productivity, cutting unit labour costs and improving non-price factors, e.g. design, quality. (12 marks)
- e**
- Examples of reflationary fiscal policy: increase in government expenditure and tax cuts.
 - Explanation of how each of these would stimulate aggregate demand with reference to the multiplier. Example: a cut in income tax would increase disposable income and, in turn, consumption, so *AD* would rise.
 - However, there are problems: fiscal policy may take a considerable time to operate; tax cuts may be saved or spent on imports; the multiplier may be very low; there may be weak demand in the rest of the Eurozone. (15 marks)

Essay questions

- 2 a** Possible causes include:
- an increasing world population, increasing demand
 - rising world real incomes — at least until the financial crisis hit
 - the use of some foods for energy supplies
 - a declining supply, e.g. of oil; climate change affecting crop yields (20 marks)
- b**
- Rising commodity prices cause the aggregate supply curve to shift to the left. Use an *AD/AS* diagram to illustrate the impact on the real level of output (which will fall) and the price level (which will rise).

- Recession: implies two consecutive quarters of negative economic growth.
- The most effective policies in these circumstances are likely to be supply-side policies aimed at shifting the aggregate supply curve to the right through measures to increase competition and competitiveness.
- Examples of specific supply-side policies and how they work, e.g. improvements in education and training. These would cause an increase in productivity and so reduce firms' costs and increase real output. However, these take a considerable time to work and may be ineffective if their quality and relevance to the needs of the economy are poor.
- Demand-side policies could also be employed, e.g. deflationary fiscal policy (raising taxes and cutting public expenditure). These would cause a leftward shift in the aggregate demand curve and so reduce inflationary pressures. However, they would further reduce real output and so would not be appropriate given the information that the economy is in recession.

(30 marks)

- 3 a**
- Definition of national debt: cumulative total of past government borrowing.
 - High budget deficits (when government expenditure is greater than tax revenue in a particular year) are a major factor which have contributed to rising national debts.
 - These have increased because of the financial crisis which led to:
 - recessions with a consequent fall in tax revenues and higher government expenditure (automatic stabilisers)
 - the near collapse of many banks which governments then had to bail out
 - the introduction of fiscal stimulus measures to prevent a 1930s-style depression

For evaluation, these factors have different degrees of significance depending on the country selected. National debt as a proportion of GDP is required to determine its significance for the economy. Further, there could be a discussion of how long the national debts will continue to rise.

Remember to relate your answer to specific countries.

(20 marks)

- b**
- Some arguments for reducing national debt quickly include:
 - the increased interest payments on the national debts which create an opportunity cost in terms of expenditure on public services
 - the dangers of 'crowding out' and inflation if the higher national debt is caused by excessive public expenditure
 - a country could lose its triple A credit rating and may be forced to pay higher interest rates when it sells government securities

Some arguments against reducing national debts quickly include:

- extra debt might prevent the economy suffering a more severe recession
- with low interest rates, governments can borrow cheaply to finance long-term capital projects
- it would require severe cuts in public expenditure and tax increases

(30 marks)

4 a Reasons include:

- recession
- the loss of business and consumer confidence, causing falls in consumption and investment
- the unwillingness of banks to lend money
- a fall in world trade resulting from all of the above
- globalisation which has led to increased integration so there was contagion (20 marks)

- b**
- Monetary policy: changes in interest rates and the money supply to influence the level of economic activity.
 - Discussion of the transmission mechanism by which a cut in interest rates should stimulate economic activity, i.e. through consumption, investment and net exports.
 - The problem that low confidence meant that this did not work. Also, a world slowdown meant that exports did not rise much.
 - Quantitative easing: this policy was aimed at increasing the money supply (with central banks buying securities from banks) but it had limited impact because the banks were risk averse and unwilling to lend. (30 marks)

Essay questions

- 1 a**
- Distinction between growth (increase in real GDP) and development (improvement in welfare).
 - Understanding of FDI: investment in production or in a business in another country.
 - Investment is an injection into aggregate demand so causing a multiplier effect on GDP with associated implications for employment.
 - AD/AS analysis may be used to illustrate the impact on real output.
 - With higher real incomes, economic development might be enabled, e.g. better health and education.
 - Evaluation may related to factors such as the amount of FDI; the value of the multiplier; the problem that interest, profits and dividends would be repatriated to the shareholders in developed economies; higher real incomes might not lead to development if there is corruption or capital flight.

Remember to relate your answer to a specific country.

(20 marks)

- b** The savings gap might be filled by:

- Aid
 - discussion of the types of aid; how aid may fill the savings gap
 - discussion of the problems associated with aid: e.g. dependency; corruption resulting in misuse; tied aid
- Cancellation of debts:
 - discussion of how debt cancellation would fill the savings gap
 - discussion of the problems associated with debt cancellation: e.g. moral hazard; dependency

(30 marks)

- 2 a** International debt may have arisen because:

- money was borrowed when interest rates were very low, and the debt repayments became unsustainable when interest rates rose
- oil prices increased
- the country's currency depreciated
- there were internal problems, e.g. civil wars which resulted in the need to borrow money for military equipment

Remember to relate your answer to a specific country.

(20 marks)

- b**
- Discussion of how debt cancellation would fill the savings gap and enable a country to increase its investment in infrastructure, health and education.
 - Debt cancellation would enable developing countries to be able to afford goods from developed countries.
 - Problems associated with debt cancellation: e.g. moral hazard; dependency; corruption.

(30 marks)

- 3 a** • Role of the World Bank: to provide longer-term funding for projects that will promote development.
- Understanding that loans provided by the World Bank have conditions attached, set out in structural adjustment programmes (SAPs), which were based on free market reforms (e.g. trade liberalisation, privatisation, removal of state subsidies on food). The aim is to ensure that debtor countries do not default on the repayment of debts.
 - However, SAPs were criticised because they:
 - did little to help the world's poor
 - failed to promote development
 - increased inequality
 - caused environmental degradation
 - resulted in social and political chaos in many countries
 - Consequently, the World Bank now focuses on poverty reduction strategies, with aid being directed to:
 - countries following sound economic policies
 - healthcare, broadening education
 - local communities, rather than central government (20 marks)
- b** • Understanding of import substitution: measures taken by the government to replace imported manufactured goods with domestically produced manufactured goods.
- This policy usually involves trade barriers.
 - Industrialisation is seen as a major characteristic of development (e.g. reference to the Lewis model).
 - Consideration of the significance of industrialisation for growth and development: e.g. higher productivity in manufacturing than in agriculture, causing real GDP to increase.
 - However, some countries have achieved rapid growth and development through dependency on primary products; trade barriers might lead to inefficiency and may be difficult to remove; also, trade barriers might act as a deterrent to FDI.
- Remember to relate your answer to specific countries. (30 marks)
- 4 a** • Understanding of fair trade schemes: producers in developing countries are guaranteed a certain price for their produce. With higher incomes, these producers may be able to afford better education and health services for their families so contributing to development.
- But these schemes might just prevent resources from being reallocated to more efficient uses; they could cause oversupply of the commodity and depress prices for producers not in these schemes; retailers in developed countries may make more money from selling fair trade products than the producers.
- Understanding of microfinance schemes: small loans given to people with no collateral to promote enterprise and alleviate poverty. These schemes encourage enterprise and may contribute to an increase in the country's GDP; they increase opportunities for women; they should be self-financing.

But they have been criticised because the interest rates on the loans may be quite high; they may only have a limited impact on development because they are small in scale. (20 marks)

b Market-based approaches to development imply a very limited role for the government. Policies include:

- privatisation
- the removal of state subsidies for food and other goods
- the removal of trade barriers
- allowing the currency to depreciate to find its market level
- balancing the government budget

However, such approaches have drawbacks, e.g.

- externalities may be ignored
- inequality may increase
- prices may rise significantly after subsidies have been removed
- the balance of payments on the current account may deteriorate (30 marks)