International Baccalaureate®
Baccalauréat International
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MARKSCHEME

May 2012

ECONOMICS

Higher Level

Paper 1

17 pages

In addition to the assessment criteria, use the paper-specific markscheme below. Award up to the maximum marks indicated.

1. (a) Explain the economic factors which may encourage the formation of a monopoly. ***[10 marks]***

Answers **should** include:
- a definition of monopoly
- an explanation of economies of scale
- an explanation of barriers to entry
- the possibility of product differentiation and/or branding
- the non-availability of close substitutes.

Answers **may** include:
- use of a diagram to illustrate monopoly
- consideration of the theory of contestable markets: the presence of sunk costs prevents "hit and run" and allows potential monopolists to focus on supernormal (abnormal) profits
- mention of a legal framework in which merger and acquisition is permissible, or where government may grant exclusive rights, patents and privileges
- exclusive control of necessary resources/factor endowment
- presence of significant price making power
- the market will sustain only one firm
- the presence of abnormal profit may encourage firms in an oligopoly to seek to form a monopoly.

Examiners should be aware that candidates may take a different approach which if appropriate, should be rewarded.

Assessment Criteria

Part (a) 10 marks

Level	Marks		
0		Completely inappropriate answer.	**0**
1		Little understanding of the specific demands of the question. Very little recognition of relevant economic theory. Relevant terms not defined. Significant errors.	**1–3**
2		Some understanding of the specific demands of the question. Some recognition of relevant economic theory. Some relevant terms defined. Some errors.	**4–6**
3		Understanding of the specific demands of the question. Relevant economic theory explained and developed. Relevant economic terms defined. Few errors. Where appropriate, diagrams included.	**7–8**
4		Clear understanding of the specific demands of the question. Relevant economic theory clearly explained and developed. Relevant economic terms clearly defined. No major errors. Where appropriate, diagrams included and explained. Where appropriate, examples used.	**9–10**

(b) Evaluate the view that natural monopoly is a more desirable market structure than perfect competition. ***[15 marks]***

Answers **may** include:
- a definition of natural monopoly
- a definition of perfect competition
- an explanation of natural monopoly in terms of economies of scale and/or a market sufficient to support only one firm
- an explanation of perfect competition in terms of a large number of small firms, freedom of entry, perfect knowledge, homogenous product
- use of diagram to illustrate natural monopoly
- use of diagrams to illustrate perfect competition
- natural monopoly analysed in terms of economies of scale/falling long-run average costs over the relevant range of output
- perfect competition analysed in terms of efficiency
- natural monopoly analysed in terms of efficiency
- possibility of greater R&D expenditure under monopoly leading to lower costs and possible long-run benefit to consumers
- possibility of anti-competitive behaviour by monopolists against the interests of consumers
- reference to cases where a natural monopoly can be broken by privatization with the introduction of competition in the market (e.g. privatization of public utilities such as telephones, electricity, gas supply etc.)
- local examples of natural monopolies, e.g. electricity distribution
- evaluation of above arguments.

Candidates who respond solely in terms of monopoly rather than natural monopoly should be awarded no more than Level 2.

Effective evaluation may be to:
- consider short-term versus long-term consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritize the arguments.

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Assessment Criteria

Part (b) 15 marks

Level		Marks
0	Completely inappropriate answer.	**0**
1	Little understanding of the specific demands of the question. Very little recognition of relevant economic theory. Relevant terms not defined. Significant errors.	**1–5**
2	Some understanding of the specific demands of the question. Some recognition of relevant economic theory. Some relevant terms defined. Some errors.	**6–9**
3	Understanding of the specific demands of the question. Relevant economic theory explained and developed. Relevant economic terms defined. Few errors. Where appropriate, diagrams included. An attempt at evaluation.	**10–12**
4	Clear understanding of the specific demands of the question. Relevant economic theory clearly explained and developed. Relevant economic terms clearly defined. No major errors. Where appropriate, diagrams included and explained. Where appropriate, examples used. Evidence of appropriate evaluation.	**13–15**

2. (a) Explain why governments may view deflation as a threat. ***[10 marks]***

Answers **should** include:
- a definition of deflation
- use of an AD/AS diagram to illustrate "good" and "bad" deflation depending on whether real output increases or decreases
- costs associated with deflation:
  - price reductions squeeze profits and force layoffs leading to unemployment
  - postponed consumption in the expectation of price falls causes further price falls
  - debt may appear to increase in real terms as the value of money increases
  - low investment leading to lower economic growth.

Answers **may** include:
- reference to the vicious circle of falling prices/falling AD e.g. "lost decade" in Japan, deflation in the 1930s in the US
- decreased effectiveness of monetary and fiscal policy as interest rates cannot fall below zero and households prefer to save/postpone spending
- threat to the banking system as loans are not repaid
- reference to a negative multiplier effect
- deflation may cause government debt to be greater in real terms.

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Assessment Criteria

Part (a) 10 marks

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(b) Evaluate the view that a low and stable rate of inflation is beneficial for an economy. ***[15 marks]***

Answers **may** include:
- a definition of a low and stable rate of inflation
- lower inflation and stability increases business certainty, as wage-price expectations become more predictable, boosting investment and economic growth
- impact on resource allocation
- the lower the relative rate of inflation the greater the chance of competitive gain in international markets
- the losses of fixed income earners are reduced as the inflation rate falls
- saving is encouraged as lower inflation makes money a better store of value
- labour unrest may decline because a low inflation rate makes it easier to preserve real wages, thus avoiding wage/price spiral
- interrelationships between low inflation rates and real interest rates
- may only be achieved at the expense of higher unemployment
- implications for government policy
- evaluation of above arguments.

Effective evaluation may be to:
- consider short-term versus long-term consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritize the arguments.

Examiners should be aware that candidates may take a different approach which if appropriate, should be rewarded.

Assessment Criteria

Part (b) 15 marks

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3. (a) Explain the differences in the operation of fixed and floating exchange rate systems. ***[10 marks]***

Answers **should** include:
- a definition of a fixed exchange rate system
- a definition of a floating exchange rate system
- an explanation of a fixed exchange rate system
- an explanation of a floating exchange rate system
- under a floating exchange rate system the exchange rate is determined by the forces of demand and supply
- under a fixed exchange rate system the exchange rate is determined by a central authority
- under a fixed exchange rate system the exchange rate is maintained by the sale or purchase of the currency on the foreign exchange market.

Answers **may** include:
- reference to recent experience and examples in foreign exchange markets
- explanation of factors which affect the demand for, and supply of, a currency
- use of a diagram to illustrate a floating exchange rate system
- use of a diagram to illustrate a fixed exchange rate system
- fixed exchange rate systems can cause speculation prior to devaluation or revaluation, floating rates allow constant adjustment
- fixed exchange rate systems require large foreign exchange reserves to maintain parities, floating exchange rate systems do not
- trade surpluses and deficits may be persistent under fixed exchange rate systems, but can be corrected continually by appreciation or depreciation under floating exchange
- floating exchange rate systems free domestic monetary policy from concern over the external account, but interest rates may have to be raised to defend a fixed exchange rate
- reference to managed/dirty floating.

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Assessment Criteria

Part (a) 10 marks

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(b) Evaluate the view that any imbalance in the current account will be corrected automatically under a freely floating exchange rate system. *[15 marks]*

Answers **may** include:

- a definition of current account imbalance, positive and negative
- a definition of freely floating exchange rate system determined solely by demand for, and supply of, currency, appreciation and depreciation
- theoretically, the exchange rate will adjust itself to keep the current account balanced
- explanation of self-correcting mechanism:
  - under a deficit, export sales lag so demand for the currency is low while supply is greater as imports boom, thus the currency depreciates: this causes increased demand for exports and lower demand for imports correcting the balance of payment deficit
  - in a surplus, exports boom so demand for the currency is high while supply is less as imports are weak, thus the currency appreciates: this causes decreased demand for exports and higher demand for imports correcting the balance of payment surplus
- in reality the adjustment depends on the Marshall-Lerner condition which introduces relative import and export price elasticities, and the J-Curve effect which notes lags in responsiveness to price changes
- freely floating exchange rate systems respond to factors other than supply and demand (e.g. speculation, political uncertainty) and volatility may itself provoke uncertainty, preventing correction
- depreciation in currencies of trading partners may prevent automatic correction
- there is seldom a case of an absolutely free floating exchange rate system as governments tend to interfere either by controlling interest rates or by buying or selling their currencies in the international financial market
- evaluation of above arguments.

Effective evaluation may be to:

- consider short-term versus long-term consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritize the arguments.

Examiners should be aware that candidates may take a different approach which if appropriate, should be rewarded.

Assessment Criteria

Part (b) 15 marks

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4. (a) Explain how *three* of the following factors may act as barriers to development in a less developed country:

- **capital flight**
- **income inequality**
- **ineffective taxation structure**
- **lack of infrastructure.** ***[10 marks]***

Answers **should** include:
- a definition of development
- a definition of a less developed country
- a definition of each of the three economic factors selected
- an explanation of how the three chosen economic factors act as barriers:
  - capital flight: reduces the amount of aid/FDI that remains in the less developed country, reducing investment
  - income inequality: adversely affects the purchasing power and prevents the less affluent from saving and realising their economic potential
  - ineffective taxation structure: prevents the government from maximising its potential tax revenue thus limiting the funds available for public spending
  - lack of infrastructure – raises the costs, and limits the extent of, all forms of economic activity.

Answers **may** include:
- interrelationships between the barriers may reinforce them
- diagrams such as the Lorenz curve to illustrate income inequality
- mention of human as well as physical capital under infrastructure.

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Assessment Criteria

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(b) Evaluate the view that foreign direct investment (FDI) is the key factor in determining whether a developing country will be able to achieve economic growth and development. ***[15 marks]***

Answers **may** include:
- a definition of foreign direct investment (FDI)
- a definition of economic growth
- a definition of economic development
- arguments for FDI: MNCs can fill the savings gap through local investment, can generate export revenues, can generate tax revenues, can boost employment, can improve education and training, but all to a variable extent
- arguments against FDI: MNC profits may be repatriated elsewhere, tax concessions may have to be made (reducing revenues), inappropriate technology may generate little local employment, employment may be for the unskilled only, pressure may be put on government to allow policies favourable to development such as environmental shortcuts
- alternative paths to development, e.g. inward-oriented growth, micro-finance
- case studies of particular FDI show it is not always successful in promoting economic growth and development
- evaluation of above arguments.

Effective evaluation may be to:
- consider short-term versus long-term consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritize the arguments.

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Assessment Criteria

Part (b) 15 marks

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