GCE A LEVEL MARKING SCHEME

SUMMER 2018

A LEVEL (NEW)
ECONOMICS - UNIT 4
1520U4-1

INTRODUCTION

This marking scheme was used by WJEC for the 2018 examination. It was finalised after detailed discussion at examiners' conferences by all the examiners involved in the assessment. The conference was held shortly after the paper was taken so that reference could be made to the full range of candidates' responses, with photocopied scripts forming the basis of discussion. The aim of the conference was to ensure that the marking scheme was interpreted and applied in the same way by all examiners.

It is hoped that this information will be of assistance to centres but it is recognised at the same time that, without the benefit of participation in the examiners' conference, teachers may have different views on certain matters of detail or interpretation.

WJEC regrets that it cannot enter into any discussion or correspondence about this marking scheme.

Positive Marking

It should be remembered that learners are writing under examination conditions and credit should be given for what the learner writes, rather than adopting the approach of penalising him/her for any omissions. It should be possible for a very good learner to achieve full marks and a very poor one to achieve zero marks. Marks should not be deducted for a less than perfect answer if it satisfies the criteria of the mark scheme, nor should marks be added as a consolation where they are not merited.

Below are the assessment objectives for this specification. Learners must demonstrate their ability to:

AO1 Demonstrate knowledge of terms/concepts and theories/models to show an understanding of the behaviour of economic agents and how they are affected by and respond to economic issues

AO2 Apply knowledge and understanding to various economic contexts to show how economic agents are affected by and respond to economic issues

AO3 Analyse issues within economics, showing an understanding of their impact on economic agents

AO4 Evaluate economic arguments and use qualitative and quantitative evidence to support informed judgements relating to economic issues.

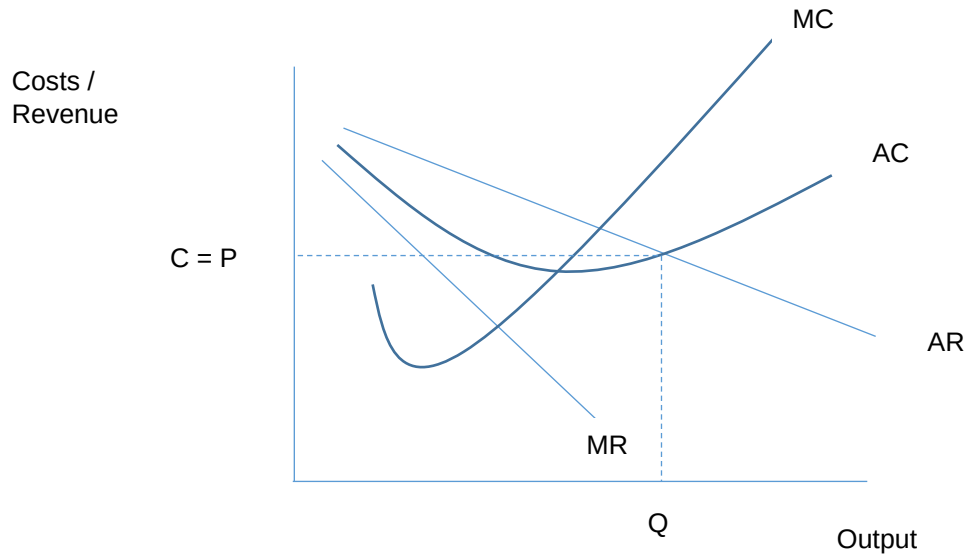
Q1a	**Explain what is meant by a contestable market and, using a diagram, explain why firms in a contestable market tend to earn only normal profit.** **[10]**	
Band	**AO1**	**AO3**
	6 marks	**4 marks**
3	**5 – 6 marks** Excellent understanding of what is meant by a contestable market. Excellent, accurate and comprehensive diagram illustrating why firms in contestable markets operate at the normal profit level of output. Excellent use of relevant terminology such as contestability, barriers to entry/exit, sunk costs, normal profit, limit pricing.	
2	**3 – 4 marks** Good understanding of what is meant by a contestable market. Understanding of the reason why firms in a contestable market operate at normal profit. A relevant diagram is drawn, with errors or omissions.	**3 – 4 marks** An accurate and comprehensive analysis of both the nature of a contestable market, and the reasons why firms in a contestable market operate at the normal profit level of output. At the top of this band, candidates will be able to analyse their diagram dynamically rather than statically.
1	**1 – 2 marks** Some recognition of what is meant by contestability and normal profit. A diagram may be attempted, but with significant errors or omissions.	**1 – 2 marks** Limited analysis of the nature of a contestable market. Limited analysis of the reasons why a firm in a contestable market operate at the normal profit point.
0	**0 marks** No valid diagram. No understanding of contestability or normal profit.	**0 marks** No valid analysis

Indicative content:

Understanding of contestability:

- A market structure in which the number of firms is irrelevant in determining the behaviour of firms (unlike, say, monopoly or oligopoly)
- There is potential for competition, or a 'threat' of competition
- Barriers to entry and exit are low, and particularly there are no sunk costs – this allows 'hit and run' competition to occur

Likely diagram:



n.b. the best candidates will use their diagram to illustrate the abnormal profit earned at any output level less than Q, and hence why operating at Q is the only output level at which new firms won't be attracted. Operating beyond output level Q results in a loss being made, which would cause the firm to leave the industry (due to lack of barriers to exit).

Candidates may also choose to use a perfect competition diagram to illustrate the dynamic process by which supernormal profit in the short-run is appropriated away by the entry of new firms in the long run. This is acceptable, provided candidates make it clear that the key reason for the earning of normal profit is the lack of entry / exit barriers.

Why firms in a contestable market tend to earn normal profit:

Because of the ease with which new entrants to the market can join the market due to the lack of entry barrier, one of the only ways that incumbent firms can prevent new firms from joining is to use limit pricing i.e. pricing as low as they can without making a loss, at the level of output where AR = AC i.e. normal profit. There are then fewer incentives for new entrants to join that market as there is no abnormal profit to appropriate. Incumbent firms can afford to operate at normal profit because of the lack of sunk costs – they do not need to contribute towards huge fixed costs.

Q1b	**Discuss the view that firms in an oligopoly must always be heavily regulated in order to prevent collusion.** **[20]**		
Band	**AO1**	**AO3**	**AO4**
	6 marks	**6 marks**	**8 marks**
3	**5 – 6 marks** Excellent understanding of oligopoly, regulation and the nature of collusion. There is broad and deep coverage of the factors that are relevant with no significant omissions.	**5 – 6 marks** An excellent analysis of the need for regulation in an oligopolistic market structure.	**6 – 8 marks** An excellent critical evaluation of the need for regulation in an oligopoly. Clear judgements are made with supporting statements to build an argument. Very top band responses will address the issue of 'heavy' regulation rather than just regulation *per se*.
2	**3 – 4 marks** Good understanding of oligopoly, regulation and collusion. Answers in this band may omit significant content or the breadth of coverage is good but the depth of understanding is not sufficient to reach the highest band	**3 – 4 marks** A good analysis of the need for regulation in an oligopoly Answers in this band show developed chains of argument with a sensible grasp of why collusion may occur and why this is an issue for regulators to address. Answers in this band may lack depth, diagrams may not always be well-integrated or completely correct (for example 2 x 2 matrices, joint profit diagram etc)	**3 – 5 marks** A good evaluation that includes most of the key issues. At least 2 points are evaluated. The arguments may simply be focused on the pros and cons of regulating firms in an oligopoly, and are unlikely to address the key issue of heavy regulation
1	**1 – 2 marks** Limited understanding of what is meant by oligopoly, regulation and/or collusion Some characteristics of oligopoly may be identified, and there may be some simple knowledge of collusion and why this may be bad for consumers.	**1 – 2 marks** Limited analysis of the need for regulation to tackle collusion in oligopoly. Answer tends to lack key economic concepts and avoid technical analysis	**1 – 2 marks** Limited evaluation; candidates may recognise that there are both costs and benefits but there is no development of the evaluation.
0	**0 marks** No knowledge or understanding present	**0 marks** No relevant analysis	**0 marks** No relevant evaluation

Indicative content:

Understanding of what is meant by oligopoly:

- small number of dominant firms, high concentration ratio, interdependence between firms, possibility of both homogenous and differentiated products, reasonably high barriers to entry/exit, firms have price-taking power

Understanding of collusion:

- a situation in which firms work together to restrict supply and raise prices, acting as a joint monopoly (some candidates may choose to illustrate this using an appropriate diagram) in order to maximise [joint] profits
- collusion is illegal
- collusion can be overt or tacit
- conditions needed for collusion to be a possibility: small number of firms selling homogenous goods, reasonably inelastic PED, good knowledge/information/trust between firms but possibly information asymmetry in terms of consumer knowledge
- Candidates may use a kinked demand curve or a 2 x 2 game theory matrix to illustrate the potential reasons for and gains from collusion in an oligopoly

In discussing regulation, candidates may show an understanding of types of regulation, for examples price capping (RPI – X) in utilities, or the existence of bodies such as CMA to monitor anti-competitive behaviour i.e. behaviour that is not in the interest of consumers, and issue fines or even prison sentences if there is evidence of anti-competitive behaviour

Reasons why firms in an oligopoly should be regulated:

- Collusion can raise prices for consumers, reducing consumer surplus/welfare and redistributing that to producer surplus/profit
- As price is pushed up above MC the market becomes allocatively inefficient
- Protected/easy-to-earn profits as a result of higher prices results in x-inefficiency and non-dynamic industry
- In oligopoly, consumers often have little choice in relation to which company they buy from and so are easily exploited; in many cases e.g. energy tariffs, mobile phone contracts, there is significant information asymmetry making it hard for consumers to see if they are getting the best deal. There may also be significant “switching costs”

Reasons why firms in an oligopoly should not be regulated:

- Collusion is inherently unstable and will eventually fail anyway (the very best candidates may be able to illustrate this scenario using a 2 x 2 matrix)
- Regulation can be expensive, and spotting instances of collusion can be very difficult, especially if there is tacit collusion
- The most likely outcome in an oligopoly is price stability (rather than collusion or price wars)
- Firms in an oligopoly selling differentiated goods are likely to be highly competitive in terms of non-price factors
- Firms in an oligopoly selling homogenous goods may be just as likely to engage in a price war (which can benefit consumers in the short term) as collusion
- Collusion may be the only way to ‘save’ an industry that is unprofitable or has low profit margins i.e. there could be complete market failure without the collusive oligopoly

Other issues for discussion:

- Whether there should be regulation depends on the type of regulation being used e.g. the introduction of whistleblowing regulation has meant that competition authorities spend less on investigations because if one offending party confesses they are relieved from the fine (e.g. Virgin and BA on the Heathrow-New York route) and this causes collusive arrangements to be less stable and last for less time
- Many firms may work together for the common good through collaboration e.g. developing more fuel efficient engines in the car industry, sharing patents / R&D in pharmaceuticals, or, may work together to keep costs low i.e. economies of scale

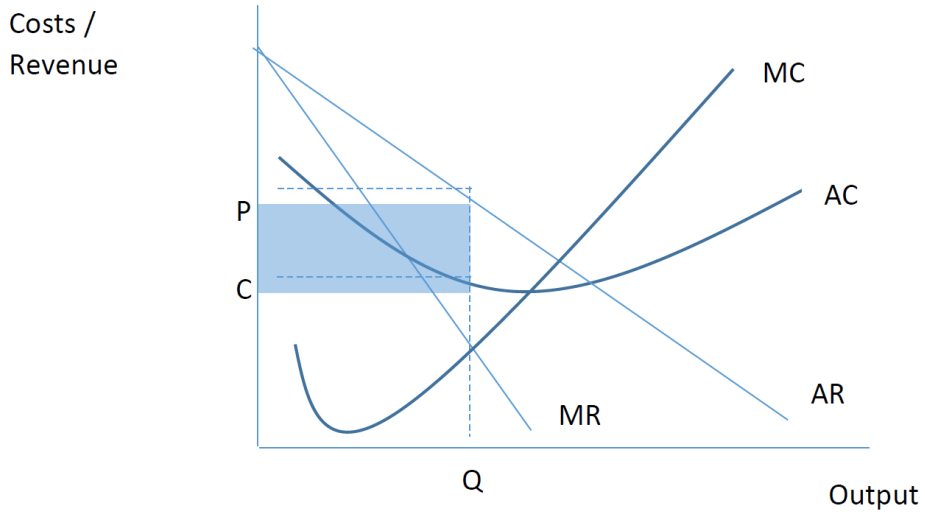
Q2 a	**Explain what is meant by monopoly and, using a diagram, explain why a monopoly may have lower average costs of production than a firm in perfect competition.** **[10]**	
Band	**AO1**	**AO3**
	6 marks	**4 marks**
3	**5 – 6 marks** Excellent understanding of what is meant by monopoly. Accurate and comprehensively labelled relevant diagram; excellent understanding of the link between monopolies and low average costs. Excellent use of relevant terminology throughout the answer. Candidates at the top of this band are likely to refer to a number of reasons why firms in monopoly may have lower average costs than firms in perfect competition.	
2	**3 – 4 marks** Good understanding of monopoly. A relevant diagram which should be largely correct with no significant errors or omissions. Candidates will show good understanding of cost theory in relation to why monopoly firms may experience lower average costs than perfectly competitive firms.	**3 – 4 marks** Very good, clear, comprehensive and accurate explanation of monopoly, and excellent analysis of how this market structure can be linked with lower average costs. At the very top of this band, candidates will analyse at least one way in which a firm in monopoly will have lower average costs than firms in perfect competition.
1	**1 – 2 marks** Some understanding of monopoly or perfect competition or average costs, with some attempt at a relevant monopoly diagram which is likely to display significant errors or omissions.	**1 – 2 marks** Limited analysis, with unconvincing explanation of monopoly and/or how monopoly may result in lower average costs.
0	**0 marks** No valid diagram and no valid understanding.	**0 marks** No valid analysis

Indicative content:

Understanding of monopoly:

- Pure monopoly has a single dominant firm, with high barriers to entry/exit resulting in significant price-making power
- Legally, a monopoly has over 25% market share
- Earn abnormal profits in both the short run and long run

Likely diagram:



Understanding of cost theory

- Average cost = cost per unit; a measure of productivity, synonymous with higher average product
- Diminishing returns
- Economies of scale
- Economies of scope

Understanding of perfect competition

- Many buyers and sellers i.e. no market power in consumption or production
- Homogeneous products
- Price takers
- Minimal barriers to entry and exit

Explanation of how monopolies may achieve lower average costs

- Monopolies may be large and this can lead to them benefitting from economies of scale i.e. low LRAC as compared with smaller firms
    - Candidates may consider different types of economies of scale i.e. purchasing, financial, marketing, technical etc
- Monopolies may be dynamically efficient and use their abnormal profits to invest in innovative production techniques which shifts their LRAC downwards
- Monopolies may also have monopsony power / be vertically integrated – this can reduce the cost of inputs to the production process and cause AC to fall

Q2 b	**"Concentrated markets are always better for the economy than non-concentrated markets." Discuss.** **[20]**		
Band	**AO1**	**AO3**	**AO4**
	6 marks	**6 marks**	**8 marks**
3	**5 – 6 marks** Excellent knowledge of the nature of and outcomes in concentrated and non-concentrated markets, with reference to market structures such as monopoly, perfect competition etc. There is broad and deep coverage of the factors that are relevant with no significant errors or omissions. There are likely to be some valid, accurate diagrams that are well integrated into the answer.	**5 – 6 marks** An excellent analysis of the reasons why concentrated markets are better for the economy than non-concentrated markets, considering both microeconomic and macroeconomic issues. A well-developed argument is made that fully supports either the view that concentrated markets are better for the economy than non-concentrated markets. Relevant examples are integrated throughout the answer.	**6 – 8 marks** An excellent critical evaluation of whether concentrated markets are better for the economy than non-concentrated markets. The very best answers will consider the discriminator word "always". Clear judgements are made with supporting statements to build an argument that is well justified. The best answers will identify that there are a number of factors that determine whether or not concentrated markets are better for the economy.
2	**3 – 4 marks** Good identification of likely outcomes of concentrated and non-concentrated markets Answers in this band may omit significant content or the breadth of coverage is good but the depth of understanding is not sufficient to reach the highest band. There may be some valid diagrams attempted, but they may not be well integrated or wholly accurate.	**3 – 4 marks** A good analysis of the reasons why concentrated markets are better for the economy than non-concentrated markets Answers in this band generally show good chains of argument using relevant examples to illustrate key points. Some chains may lack depth and any diagrams used may not always be well-integrated or completely correct, or key points are missing. Candidates are likely to either consider just microeconomic or just macroeconomic issues.	**3 – 5 marks** A good evaluation that includes most of the key issues, although the evaluation may be one-sided. At least 2 points are evaluated with a clear discussion of whether concentrated markets are or are not better for the economy than non-concentrated markets No clear judgement is reached, or a judgement is reached but with a weak underpinning argument.
1	**1 – 2 marks** Limited understanding of what is meant by concentrated and non-concentrated markets There may be brief references to examples of different market structures but with no integration of those examples into the body of the answer. Limited use of appropriate technical vocabulary.	**1 – 2 marks** Limited analysis of the impact of concentrated markets on the economy. Answer tends to lack key economic concepts, and avoids technical analysis	**1 – 2 marks** Limited evaluation, that is one-sided and unbalanced, and limited in terms of depth or breadth.
0	**0 marks** No valid knowledge or understanding of market concentration present	**0 marks** No relevant analysis of the impact of concentrated markets on the economy.	**0 marks** No relevant evaluation of the impact of concentrated markets on the economy

Indicative content:

Key knowledge / understanding:

- Concentrated markets – could include monopolies / oligopolies i.e. market structures in which there is a small number of dominant firms. Stronger candidates may also include examples.
- Perfect competition / monopolistic competition – both market structures have many consumers/producers and can be regarded as non-concentrated. Stronger candidates may also include examples.

What is meant by "better" for the economy?

- Impact on consumers / supply chains / government fiscal position / macro indicators (i.e. growth, unemployment, inflation etc)

Reasons why concentrated markets may be better for the economy:

- Possibility of economies of scale leading to lower AC (more productively efficient) and possibility of lower prices (higher consumer surplus); could increase LRAS (more productive) and SRAS (lower costs), therefore leading to growth and lower inflation
- Large firms may be able to benefit from division of labour, causing higher productive potential
- Large employers (perhaps with good 'perks' e.g. transport subsidies, gym membership, childcare vouchers, pensions etc)
- Spending on R&D / dynamically efficient, which could lead to exports and long run growth
- Multipliers / trickle-down effects / external economies of scale as suppliers move to the area
- May be internationally competitive therefore boosting exports, and in turn AD/ growth / employment
- May have monopsony power in purchasing raw materials / factors of production, which can lower costs and in turn prices
- Theories of 'indivisibility' / natural monopoly argument
- Network economies e.g. benefit of Microsoft having the leading operating system which reduces the need for employees to learn new systems in different countries, thus increasing labour market flexibility

Reasons why non-concentrated markets may be better for the economy:

- Good for consumers: potentially more consumer choice, less risk of collusion therefore less exploitation of consumers, greater adaptation to local needs/wants; more competition may mean lower prices; can provide niche services/goods
- Potentially more allocatively and productively efficient (use of perfect competition diagrams / analysis), or lots of product differentiation and choice (monopolistic competition)
- Greater equality – perhaps greater ownership of business rather than being concentrated in the hands of the few

Further evaluative issues:

- Concentrated markets can be highly competitive e.g. price wars, heavy non-price competition
- Markets may be concentrated but barriers to entry may be low, encouraging incumbent firms to behave more competitively (limit pricing and contestability considerations)
- Impact of regulators
- Local / regional / national / international considerations e.g. a firm may be a local monopoly but competing internationally against many firms in the same industry
- Market classification (narrow v broad considerations) e.g. market for pizza restaurants may be quite concentrated but the market for restaurant meals is non-concentrated
- Markets are dynamic and continually change

n.b. this is a reversible answer.

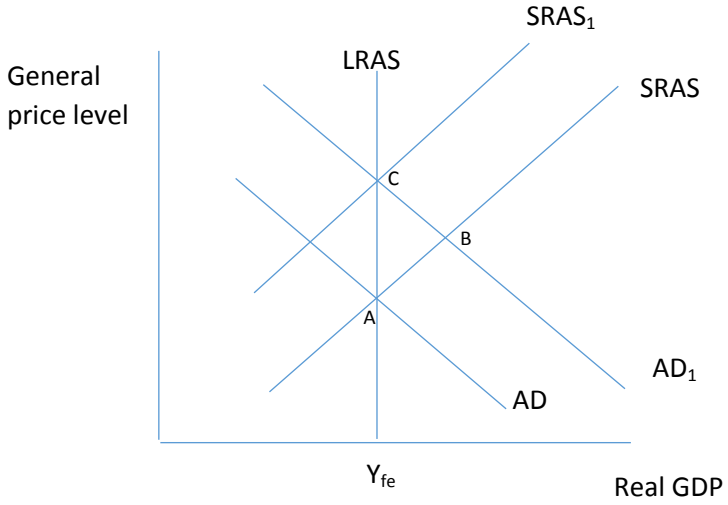
Q3 a	**Using an appropriate diagram, explain the process by which Neo-classical economists believe that the economy will always adjust to reach long-run equilibrium.** **[10]**	
Band	**AO1**	**AO3**
	6 marks	**4 marks**
3	**5 – 6 marks** Excellent understanding of Neoclassical economic assumptions and the theory of automatic adjustment. Accurate diagram showing the adjustment back to the full employment level of output from either a positive or negative output gap.	
2	**3 – 4 marks** Good understanding of Neoclassical economic assumptions and the theory of automatic adjustment. Candidates are likely to only consider adjustment back to full employment from either a positive or a negative output gap. The diagram is largely accurate with no significant errors or omissions	**3 – 4 marks** Accurate, clear chains of analysis explaining how the economy returns to full employment equilibrium from either a negative or positive output gap, with the very best candidates analysing the return to equilibrium from both of these starting points.
1	**1 – 2 marks** Limited understanding of what is meant by Neoclassical economics The diagram will have significant errors or omissions, or fail to properly show how the economy returns to full employment	**1 – 2 marks** Limited analysis of how the economy returns to full employment equilibrium; candidate is likely to make assertions rather than explanation
0	**0 marks** No valid diagram and no valid understanding	**0 marks** No valid analysis

Indicative content:

Assumptions of Neoclassical economists:

- Resources are allocated efficiently through the interaction of demand and supply
- Individuals are rational and aim to maximise their utility
- Markets always adjust, via the invisible hand, in order to reach equilibrium and do not require government intervention i.e. laissez-faire economics / believe in the power of the free market
- Individual demand and supply can be 'aggregated' for the full economy
- The economy always tends towards operating on the perfectly inelastic long-run aggregate supply at the full employment level of output

Likely diagram:



(Candidate may also draw a Neoclassical diagram showing a negative output gap, as opposed to the positive output gap shown in the diagram above, with subsequent downwards pressure on production costs shifting SRAS downwards – this is entirely acceptable).

Likely explanation of adjustment back to full employment output:

- The economy is initially in equilibrium at A; an economic shock or increase in government spending causes AD to rise to AD1 leading to a positive output gap at equilibrium B
- The economy is able to sustain a positive output gap for a short period of time by factors of production working overtime / beyond normal capacity
- As resources (e.g. raw materials, labour, capital etc) becomes more scarce, prices start to rise
- This increases the cost of production causing SRAS to shift upwards to SRAS1, restoring equilibrium at C at the full employment level of output (Y_{fe}) but at a higher price level

Q3 b	**Discuss the likely effectiveness of policies, other than the use of interest rates, to reduce the rate of inflation in an economy.** **[20]**		
Band	**AO1**	**AO3**	**AO4**
	6 marks	**6 marks**	**8 marks**
3	**5 – 6 marks** Excellent understanding of the need to reduce the rate of inflation. Excellent understanding of at least two policies that can be used to reduce the rate of inflation There is broad and deep coverage of the factors that are relevant with no significant omissions	**5 – 6 marks** An excellent, detailed analysis of how at least two policies can be used to reduce the rate of inflation in an economy. Diagrams, where used as part of the analysis, are well integrated and accurate. A well-developed argument is formed.	**6 – 8 marks** An excellent critical evaluation of at least two policies. Clear judgements are made with supporting statements to build an argument. Very top band responses will consider the effectiveness of policies in light of different economic contexts, causes of inflation, and from different perspectives.
2	**3 – 4 marks** Good understanding of at least two policies that can be used to reduce the rate of inflation. Answers in this band may omit significant content or the breadth of coverage is good but the depth of understanding is not sufficient to reach the highest band	**3 – 4 marks** A good analysis of how at least two policies can be used to reduce the rate of inflation in an economy. Answers in this band show developed chains of argument with a sensible grasp of how inflation can be reduced. Answers in this band may lack depth at times, and any diagrams that are used may not always be well-integrated or completely correct, or key points are missing	**3 – 5 marks** A good evaluation that includes most of the key issues At least 2 policies are evaluated in terms of their effectiveness in reducing inflation. Candidates in this band may superficially consider the effectiveness of the policies selected in light of different causes of inflation or in different economic contexts/countries.
1	**1 – 2 marks** Identification of, and some limited understanding, of one or more policies that can be used to reduce inflation Some limited understanding of inflation.	**1 – 2 marks** Limited analysis of one or more policies that can be used to reduce inflation. Answer tends to lack key economic concepts and avoid technical analysis.	**1 – 2 marks** Limited evaluation of one policy, or very superficial evaluation of more than one policy. A very one-sided answer.
0	**0 marks** No knowledge or understanding present	**0 marks** No relevant analysis	**0 marks** No relevant evaluation

Indicative content:

Key concepts:

- Inflation – a sustained increased in the general level of prices in an economy
- Candidates may possibly refer to the inflation target, or the fact that the use of interest rates (as part of monetary policy) has been the default policy in reducing inflation in many developed economies for some years
- Some candidates may briefly consider the harmful consequences of inflation and thus its need to be prevented, but this should not be over-rewarded

Alternative policies (as referred to in the specification) – candidates should consider at least two policies:

- Monetary policy options: reversing QE / reducing the money supply, reducing inflationary expectations / lowering the inflation target, active intervention in the Forex market to reduce the value of the currency
    - *But: reversing QE will impact on the fiscal balance; the inflation target is already quite low at 2%; intervention in the Forex market is unlikely*
- Fiscal policy options: any deflationary / contractionary policy such as reducing government spending and raising the rates of direct tax
    - *But: this runs counter to current UK fiscal policy with a relaxation of austerity measures*
- Supply side policies: any policies that increase LRAS / increase the productive capacity of the economy; candidates could consider interventionist approaches (e.g. tax credits) and/or free-market approaches (e.g. deregulation) **n.b. do not reward the use of lower interest rates to stimulate LRAS via investment**
    - *But: interventionists approaches may be costly; some SSP's work more quickly than others*
- Direct controls on wages and prices: use of pay freezes (e.g. public sector) and/or salary caps (e.g. banker bonus caps, limiting the pay of the highest paid in an organisation to a certain multiple of the lowest paid), maximum prices (e.g. on essential items such as food and fuel in some LEDCs), "prices and incomes policies"
    - *But: more likely to be used by a Labour/left wing government therefore unlikely at the moment; can lead to "stop go" cycles*

It is anticipated that many candidates will use a diagram in their answer to show either decreasing AD or increasing AS (short run or long run or both)

Key evaluative issues, in addition to policy-specific evalution

- Different policies may be needed depending on the cause of inflation e.g. inflation due to short run growth in AD may need demand-management policies, whereas inflation due to supply side constraints may need supply side policies
- Inflation may be caused by exogenous rather than endogenous shocks, thereby requiring different policy solutions
- The effectiveness of policies may depend on other macro policies currently being deployed or other issues in an economy that need addressing
- The effectiveness of policies may depend on the economic context e.g. no use suggesting a currency appreciation if the economy operates a freely floating exchange rate system

Q4 a	**Using an appropriate diagram, explain why Keynesian economists believe that government intervention is often essential for decreasing cyclical unemployment.** **[10]**	
Band	**AO1**	**AO3**
	6 marks	**4 marks**
3	**5 – 6 marks** Candidates draw an accurate diagram, with no significant errors or omissions. Some diagrams may indicate the operation of the multiplier process. Candidates demonstrate excellent knowledge and understanding of the Keynesian approach to managing the economy, cyclical unemployment, and why Keynesian economists believe that government intervention is essential, and use excellent appropriate terminology.	
2	**3 – 4 marks** Candidates draw an appropriate diagram to illustrate Keynesian demand management, with few significant errors or omissions. Candidates use appropriate terminology, and show good understanding of the Keynesian assumptions and approaches that result in demand management being required. Candidates show good understanding of cyclical unemployment.	**3 – 4 marks** A detailed and dynamic analysis of the use of interventionist policies / demand management to restore the economy to full employment, based on a sound explanation of the Keynesian approach to managing the economy
1	**1 – 2 marks** Candidates may attempt a diagram but with significant errors, inaccuracies or omissions. Candidates show a limited knowledge and understanding of the Keynesian approach to managing the economy. Candidates show a limited knowledge of cyclical unemployment.	**1 – 2 marks** Limited analysis of the reasons why demand management is considered important by Keynesians, and the process by which Keynesian tools can allow employment and GDP to increase
0	**0 marks** No valid diagram or understanding of Keynesian approaches to managing the economy.	**0 marks** No valid analysis of Keynesian economics

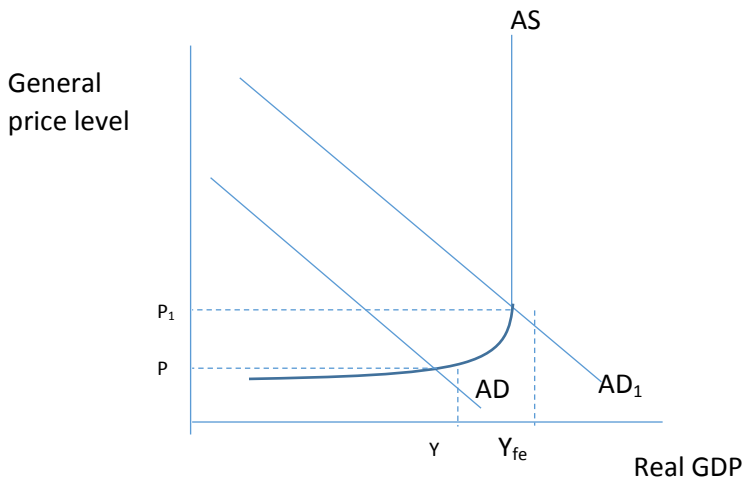
Indicative content:

Understanding of 'cyclical unemployment'

Keynesian assumptions / approaches / adjustments:

- Prices and wages may not automatically adjust to allow markets to clear e.g. downwards "sticky wages" (for example, due to the existence of trade unions, minimum wages, social norms). This means that SRAS does not automatically adjust to allow the economy to return to full employment, as it does in the Neoclassical model
- Consumption is determined by the current / actual level of income so if the economy is in recession / operating with a negative output gap then consumption will be low so AD will be low and remain low unless there is direct intervention by the government to stimulate AD (through government spending, or even through reducing interest rates or other interventionist policies)
- High unemployment can persist in a Keynesian model (in the Neoclassical approach, the only way in which high unemployment persists is due to overly high and inflexible real wages, perhaps due to trade union activity or minimum wages)
- Aggregate supply can be elastic when the economy is operating a negative output gap, and is inelastic at the full employment level of output
- Keynes argued that if wages were to fall in order for the economy to adjust back to full employment (as in the Neoclassical model) then this would be detrimental to consumer spending and so AD would actually fall, thus making a recession / depression even deeper
- Keynes advocated countercyclical fiscal policy i.e. running a budget surplus in times of boom and a budget deficit in times of recession – governments should try to solve economic problems in the short run rather than wait for markets to solve the problems in the long run because "in the long run we're all dead"
- The multiplier effect – an initial injection in government spending can result in a more than proportional increase in national income

Likely diagram:



Likely accompanying explanation:

- The economy is initially in equilibrium at PY, below the full employment level of output at Y_{fe} and there is cyclical unemployment
- The government operates a budget deficit i.e. increases spending and / or reduces revenue from tax in order to stimulate consumer spending and investment spending, which in turn increases AD to AD1
- Some candidates may explain that the initial increase in AD is smaller, but that the multiplier effect causes AD to continue rising so that equilibrium at the full employment level of output is reached at PY_{fe}
- Some candidates may explain that as the economy moves closer to full employment it becomes more difficult for rising AD to lead to rising real GDP as resources / factors of production become more scarce and their price is bid upwards

Q4 b	Assess the extent to which a fall in unemployment is always desirable. [20]		
Band	**AO1**	**AO3**	**AO4**
	6 marks	**6 marks**	**8 marks**
3	**5 – 6 marks** Excellent understanding of unemployment and the pros/cons of falling unemployment There is broad and deep coverage of the factors that are relevant with no significant omissions. If candidates choose to use diagrams, they are accurate and comprehensive. Answers at the top of this band are characterised by an excellent use of appropriate and accurate economic terminology.	**5 – 6 marks** An excellent analysis of why falling unemployment is or is not desirable for the economy. Answers at the top of this band are specific rather than overgeneralised.	**6 – 8 marks** An excellent critical evaluation with supporting statements to build an argument. Evaluation is specific rather than general. Very top band response will fully address the question and will reach a clear judgment on whether falling unemployment is *always* desirable
2	**3 – 4 marks** Good understanding of the impact of falling unemployment. The knowledge and understanding will be mostly specific, but at times may be over generalised. Candidates may draw mostly accurate diagrams. Answers in this band may omit significant content or the breadth of coverage is good but the depth of understanding is not sufficient to reach the highest band.	**3 – 4 marks** A good analysis of why falling unemployment is or is not desirable for the economy. Answers in this band show developed chains of argument with a sensible grasp of appropriate economic theory. Answers in this band may lack depth, diagrams may not always be well-integrated or completely correct, or key points are missing.	**3 – 5 marks** A good evaluation that includes a number of key evaluative points. In this band, at least 2 points are evaluated with a clear and supported judgement being reached as to the desirability of falling unemployment in an economy. The very best candidates will address the issue of it being *always* desirable.
1	**1 – 2 marks** Limited understanding of the impact of falling unemployment on the economy.	**1 – 2 marks** Limited analysis of why falling unemployment is or is not desirable for the economy. The analysis is likely to be in general terms, with no specific analysis of the impact of falling unemployment Answer tends to lack key economic concepts and avoids technical analysis.	**1 – 2 marks** Limited evaluation of the impact of falling unemployment on the economy. Answers in this band are likely to provide overly generalised or superficial evaluation.
0	**0 marks** No knowledge or understanding present of the impact of falling unemployment on the economy	**0 marks** No relevant analysis of the impact of falling unemployment on the economy.	**0 marks** No relevant evaluation of whether falling unemployment is desirable.

Indicative content:

Definition / explanation of unemployment: a situation in which people in the labour force are actively seeking work but cannot find work at the going wage rate
Some candidates may also provide an understanding of how unemployment is measured: Labour Force Survey (ILO measure) and the Claimant Count in order to provide context for their discussion.

Reasons why a fall in unemployment is desirable:

- Usually associated with an increase in real GDP (candidates may illustrate this using AD/AS diagrams)
- Increases living standards by increasing income
    - More goods and services can be afforded
    - Possibly more able to satisfy wants as well as needs
    - May increase the HDI
- Reduces the fiscal impact of unemployment i.e. less automatic spending by the government on unemployment benefits / welfare, and may lead to an increase in tax revenue as more income tax is paid; may in turn lead to a reduction in the national debt as well as a fall in the budget deficit / increase in budget surplus
- Reduces the social impact of unemployment e.g. stress, depression, possible crime
- May lead to the multiplier effect, in turn causing a further decrease in unemployment
- May reduce poverty – this could be a fall in absolute poverty especially in LEDCs
- Employed workers may be enrolled in pension schemes (reducing future government spending) or gain skills/training making the labour market more flexible

Reasons why a fall in unemployment may not be desirable:

- Trade off with inflation (some candidates may use a Phillips Curve – short run and/or long run – to discuss this issue)
- The fall in unemployment could be caused by ‘statistics’ i.e. disillusionment by some unemployed workers causing them to become economically inactive, ageing population shrinking the size of the labour force etc
- Previously unemployed workers becoming officially employed may not be better off than they were on benefits for a number of reasons e.g. low minimum wage, impact of high marginal tax rates, use of zero hours contracts, transport costs / externalities associated with commuting, childcare issues
- Consideration of under-employed workers i.e. a highly skilled unemployed worker having to accept a low skill job, or a job with fewer hours than desired

Other issues for consideration:

- Type of unemployment being reduced e.g. falling youth unemployment is probably highly beneficial for long term growth, whereas a fall in seasonal unemployment may be temporary
- Reasons for the fall in unemployment
- Depends on whether it is due to an increase in AD (likely to be beneficial) or a reduction in LRAS (less beneficial)

Q5 a	Explain the factors that may result in an improving terms of trade index. [10]	
Band	**AO1**	**AO3**
	6 marks	**4 marks**
3	**5 – 6 marks** A thorough understanding of the meaning of the Terms of Trade is demonstrated. Candidates demonstrate excellent knowledge of the likely causes of an improving Terms of Trade index. At the top of this band, candidates may illustrate their answers using appropriate examples and numerical examples. An excellent use of appropriate technical vocabulary.	
2	**3 – 4 marks** A good knowledge and understanding of the likely causes of an improving Terms of Trade with few significant errors or omissions; candidates will be able to link the ToT to changes in relative prices of X and M Candidates may include examples which are mostly correct.	**3 – 4 marks** A detailed analysis of a number of factors that may lead to an improving Terms of Trade index, possibly making good use of examples and numerical examples at the very top of the band. At the very top of this band, candidates will accurately and explicitly link the cause identified to its impact on the Terms of Trade index.
1	**1 – 2 marks** Limited knowledge and understanding of the Terms of Trade, and the causes of an improving Terms of Trade. Answers in this band are unlikely to link the ToT to relative prices. In this band there are unlikely to be any examples or numerical examples.	**1 – 2 marks** Limited analysis of the causes of an improving Terms of Trade, with errors and omissions. Candidates may cover many causes but very superficially, or a limited number of causes with limited depth. If examples are provided, then they may be inaccurate, or not fully developed and integrated into the analysis.
0	**0 marks** No valid knowledge or understanding of the Terms of Trade	**0 marks** No valid analysis of the causes of an improving Terms of Trade

Indicative content:

Understanding of the Terms of Trade index: (index of export prices) / (index of import prices) x 100.

Candidates may use an illustrative, numerical example to explain a rising terms of trade.

Understanding of an improving ToT index: the value of the ToT rising, which in turn means that more imports can be bought using the revenue earned from selling exports – this can be critical in an LEDC in particular because imports tend to be essential capital (which can be used for improving infrastructure and productivity) or essential items such as food and medicines.

The ToT may increase if *either* the index of export prices rises *and/or* the index of import prices falls - candidates could illustrate this using a simple numerical example.

Reasons for an improving ToT:

- Increasing demand for the economy's exports – in the case of many LEDCs this could be due to increase demand for essential commodities / raw materials (e.g. oil, minerals) which in turn could be due to growth in the global economy.
- Increasing interest in tourism, causing rising prices.
- Appreciation of the currency (which in turn could be due to higher interest rates attracting hot money, rising confidence in the government leading to inwards FDI, a better 'business environment' stimulating inwards FDI e.g. lower corporate tax rates etc).
- May reflect increased price-making power of firms in an economy (larger firms more likely if there is a reliable energy supply, decent communications, availability of workers / transport).
- Changing elasticity of exports and imports e.g. if the PED for a country's exports becomes more inelastic and there is a slight reduction in supply then the price may rise significantly.
- Impact of tariffs and other trade restrictions e.g. falling or removal of import tariffs can cause import prices to fall relative to export prices.

Q5 b	**Evaluate the view that running a current account surplus is always better than running a current account deficit for LEDCs.** **[20]**		
Band	**AO1**	**AO3**	**AO4**
	6 marks	**6 marks**	**8 marks**
3	**5 – 6 marks** Excellent understanding of the nature of the Balance of Payments / current account, and the economic impact of running a current account surplus/deficit. There is broad and deep coverage of the factors that are relevant with no significant omissions. Answers at the top of this band make specific reference to LEDCs and consider their nature. Excellent and appropriate economic vocabulary is used throughout the answer.	**5 – 6 marks** An excellent analysis of the impact of a current account surplus / deficit on LEDCs. A well-developed argument is made that integrates real-world or illustrative examples with the analysis. The answer is likely to contain appropriate diagrams that are accurate and comprehensive and relevant, and which are fully integrated into the written analysis.	**6 – 8 marks** An excellent critical evaluation of the view that a current account surplus is more desirable than a deficit. Answers will evaluate the impact on LEDCs Clear judgements are made with supporting statements to build an argument. A very top band response will consider a range of perspectives, and respond to the discriminator word “always”
2	**3 – 4 marks** Good understanding of the impact of a current account surplus / deficit on an economy. Answers in this band may omit significant content or the breadth of coverage is good but the depth of understanding is not sufficient to reach the highest band e.g. may lack specific focus on LEDCs Appropriate economic vocabulary is used throughout.	**3 – 4 marks** A good analysis of the impact of a current account surplus/deficit on LEDCs Answers in this band show developed chains of argument. Answers in this band may lack depth, diagrams may not always be well-integrated or completely correct, or key points are missing.	**3 – 5 marks** A good evaluation that includes most of the key issues, but which may focus more heavily on either evaluating a surplus or a deficit, and may only superficially consider the impact on LEDCs At least 2 points are fully evaluated.
1	**1 – 2 marks** Limited understanding of the impact of a current account surplus / deficit on an LEDC Some relevant consequences may be identified but no real understanding is shown. Limited use of appropriate economic vocabulary.	**1 – 2 marks** Limited analysis of the impact of a current account surplus/deficit on an LEDC In this band, answers are likely to only consider either the impact of a surplus or deficit, and are unlikely to consider the impact on LEDCs specifically Answer tends to lack key economic concepts and avoid technical analysis.	**1 – 2 marks** Limited evaluation of the impact of a current account surplus / deficit. Answer is one-sided, and evaluation is not developed and overly general. There is unlikely to be consideration of LEDCs
0	**0 marks** No knowledge or understanding of the impact of a current account surplus / deficit.	**0 marks** No relevant analysis of the impact of current account surpluses/deficits	**0 marks** No relevant evaluation of the relative desirability of current account surpluses / deficits

Indicative content:

Understanding of the difference between a current account surplus and a current account deficit.

Understanding of what is meant by LEDC and the characteristics of an LEDC e.g. low HDI value, possibly land-locked, possibly specialised in production of commodities or low-value manufactures, possibly characterised by political strife

Reasons why running a current account surplus is better than a current account deficit:

- Could be due to surplus on the balance of trade, therefore an injection into the circular flow of income / increase in AD due to positive net exports – this in turn leads to rising real GDP and falling unemployment. In an LEDC with lots of spare capacity this could be vitally important in raising development
- Could be due to inflow of remittances – especially true in an LEDC – causes higher GNI which in turn leads to a higher HDI
- Indicative of high demand for exports – internationally competitive, high quality, etc – less risky than relying solely on domestic demand to maintain GDP / employment, especially in an LEDC with low levels of domestic consumption
- Must mean that there is a corresponding outflow on the financial account – possible risk spreading by investing in other countries via portfolio investment, FDI etc e.g. China's investment into sub-Saharan Africa
- Can provide valuable hard currency / foreign reserves (e.g. China has large US $ foreign currency reserves) which can be used to buy other essential items and / or be used to help support the currency in a fixed / semi-fixed exchange rate system, or countries (like many LEDCs) with "soft" currency
- Could lead to an improving Terms of Trade index, so more units of imports can be bought for each unit of exports, raising living standards especially if imports are essential items such as food, capital or medicine

Reasons why running a current account surplus is not better than a current account deficit:

- High net exports can lead to export-led inflationary pressure (e.g. some Chinese manufacturing areas) if the economy is approaching full capacity
- Could be indicative of a short-lived boom in demand for a particular good e.g. commodities, tourism – this could encourage over-reliance on exports of a particular good or service, which in turn could lead to an appreciating exchange rate and the resource curse / Dutch disease
- There must be a corresponding outflow on the financial account, therefore outwards FDI rather than inwards FDI – this could be detrimental to business funding and long-run growth, perhaps meaning that inflationary pressure is more likely and could prevent sustainable economic growth
- Excess foreign currency reserves may be seen as potentially destabilising the international financial system and set in motion competitive currency devaluations
- Economic growth is dependent on continued growth in trading partners, which in turn may reduce the effectiveness of domestic macro policy
- Economic growth is dependent on openness to trade of trading partners – particularly pertinent in light of rising protectionism of large economies such as the US
- A current account deficit may mean that there is an inflow of FDI and therefore preferable to a surplus

Other issues for consideration:

- The reason for the existence of a current account surplus – better to be as a result of exports of capital and manufactures than commodities
- Whether the surplus is balanced by an outflow of hot money (short term capital outflow) or portfolio investment/FDI (long term capital outflow) – this is indicative of the sustainability of the current account surplus
- The current account surplus could be due to hefty trade restrictions on imports rather than being able to sell competitive exports – the former could be particularly detrimental to domestic living standards
- Is the current account surplus persistent or short-term, and large or small? Does it exist as a result of selling exports to a small number of trading partners (more risky) or a large number (less risky)?

Q6 a	Explain how and why a “resource curse” may develop in an economy. [10]	
Band	**AO1**	**AO3**
	6 marks	**4 marks**
3	**5 – 6 marks** An excellent understanding of the nature of a resource curse, and knowledge of possible causes At the very top of this band, candidates are likely to show knowledge and understanding of specific examples of the resource curse.	
2	**3 – 4 marks** Good understanding of the nature of and causes of a resource curse There are likely to be few examples.	**3 – 4 marks** Good, clear analysis showing depth of understanding of at least one cause of a resource curse
1	**1 – 2 marks** Some limited knowledge of the nature of and causes of a resource curse.	**1 – 2 marks** Limited analysis of the causes of a resource curse. Candidates are likely to only consider one cause, particularly rising demand for a given commodity.
0	**0 marks** No valid knowledge of a resource curse.	**0 marks** No valid analysis of the causes of a resource curse.

Indicative content:

Understanding of a “resource curse” or Dutch Disease (or the paradox of plenty):

- A situation in which demand for a country’s raw materials / commodities (e.g. coal, oil, minerals / rare earth metals) increases, causing an appreciation of their currency and an increase in domestic real wages, which in turn makes other export industries less competitive and unable to compete internationally.
- Furthermore, as the exchange rate appreciates, imports become cheaper and can damage domestic production which is undercut by cheaper imports.
- In many cases, this necessitates an increase in government spending to support domestic employment which can worsen government debt and raise interest rates.
- Overall, this combination of events increases dependence on exports of the raw material / commodity, which can be risky if demand falls in the future or if other countries also attempt to ‘cash in’ on the resource boom.
- Furthermore, when the commodities run out, there is little industry left to replace it.
- Possible examples include: Senegal’s ground nut industry in the 1980s, the Netherlands and the gas boom in the late 1950s and 1960s, Nauru and phosphate (an ingredient for fertiliser), Venezuelan oil during the 2000s

Possible causes:

- An increase in global demand for commodities e.g. growth in China – due to rising global incomes, economic development in large countries – causing an appreciation of the currency (candidates may illustrate this appreciation using an appropriate exchange rate diagram)
- Government policy that allows all income generated by sales of commodities to enter the economy rather than be “managed” by, say, a sovereign wealth fund as in Norway
- Lack of government support for other industries in an economy i.e. lack of support for diversification
- Similarly, lack of comparative advantages / transferable skills to allow other industries to thrive
- Lack of monetary policy to counterbalance the appreciation of the exchange rate e.g. lower interest rates, active intervention by, for example, buying foreign currency reserves

Q6 b	**Discuss the extent to which governments of all LEDCs should encourage inward foreign direct investment (FDI).** **[20]**		
Band	**AO1**	**AO3**	**AO4**
	6 marks	**6 marks**	**8 marks**
3	**5 – 6 marks** Excellent understanding of the meaning and nature of inwards FDI and development, and excellent understanding of the main reasons why LEDC governments might want to encourage inwards FDI. Answers in this band may include a number of relevant examples of a broad range of FDI types	**5 – 6 marks** An excellent analysis of the reasons why governments of LEDCs should encourage inwards FDI A well-developed argument is made that supports (or negates) the view in the question. At the top of this band, it is likely that candidates will fully analyse 3 or 4 reasons why governments of LEDCs should encourage inwards FDI.	**6 – 8 marks** An excellent critical evaluation of the reasons why governments of LEDCs may want to encourage FDI Clear judgements are made with supporting statements to build an argument. Very top band responses will likely refer to specific examples to support/refute key points, and consider the discriminator word *all* LEDCs, and consider FDI as a whole rather than simply MNC activity.
2	**3 – 4 marks** Good understanding of the meaning and nature of inwards FDI and development, and good understanding of the main reasons why LEDC governments might want to encourage inwards FDI Answers in this band may omit significant content or the breadth of coverage is good but the depth of understanding is not sufficient to reach the highest band. For example, answers may focus mainly on MNC activity. Answers in this band are likely to include a small number of relevant examples.	**3 – 4 marks** A good analysis of the reasons why governments in LEDCs might want to increase inwards FDI. Answers in this band show developed chains of argument with a sensible grasp of the issues facing LEDCs. Answers in this band may lack depth, diagrams may not always be well-integrated or completely correct, or key points are missing.	**3 – 5 marks** A good evaluation that includes most of the key issues, including an awareness that each LEDC is different and therefore that the impact of FDI may be different, and that FDI can take different forms. At least 2 points are evaluated with a clear discussion.
1	**1 – 2 marks** Limited understanding of the meaning and nature of inwards FDI and development, and limited understanding of the main reasons why LEDC governments might want to encourage inwards FDI Minimal use of relevant economic vocabulary.	**1 – 2 marks** Limited analysis of the reasons why governments in LEDCs may want to encourage inwards FDI. Answer tends to lack key economic concepts and avoid technical analysis.	**1 – 2 marks** Limited evaluation
0	**0 marks** No knowledge or understanding present of the nature of inwards FDI and its link with development.	**0 marks** No relevant analysis of why governments of LEDCs may want to encourage inwards FDI	**0 marks** No relevant evaluation of whether governments of LEDCs may want to encourage inwards FDI

Indicative content:

Understanding of the nature of an LEDC, what is meant by inwards FDI, and improvements in the level of development (i.e. an increase in living standards)

Reasons why inwards FDI should be encouraged as a means of improving development:

- FDI can increase / improve infrastructure (e.g. transport, communications, finance) which can increase productivity and lead to an increase in LRAS, thereby leading to more sustainable growth and an increase in employment
- Can stimulate a multiplier effect / trickle-down effect
- Knowledge transfer and capital transfer – may allow "leapfrogging" in terms of technology e.g. bypassing landlines for mobile phone infrastructure
- External economies of scale / network effects
- Some MNCs may bring their own workers / managers and require better quality healthcare, leading to improvements for locals too
- FDI can plug the savings gap in LEDCs, leading to further investment (some candidates may consider, for example, the Harrod-Domar model of economic development)
- There may be an increase in exports, causing a rise in AD
- The government of the LEDC may be able to earn essential tax revenue that it cannot otherwise generate from its own low-paid citizens

Reasons why inwards FDI should not be encouraged:

- FDI may have been attracted by lax labour and environmental standards in the LEDC, which helps to keep production costs down for MNCs – this can lead to exploitation of labour and the environment, perhaps using commodities too quickly, generating negative externalities and so on. Similarly, property rights may be transgressed.
- Profits may be repatriated and provide little in the way of tax revenue for the government or help fill the savings gap
- Local labour may not be employed – production could be capital intensive, or firms may bring their own labour
- Locals may be unable to afford the products being made, leading to social unrest etc
- May be a resource curse effect / exchange rate appreciation

Other issues for consideration:

- The nature of the FDI – is there an impact on infrastructure / LRAS, or just AD, or whether local labour is used
- Depends on whether it is portfolio investment (purchase of shares of LEDC companies – which may improve corporate oversight but could lead to short-termism) or actual physical investment
- The relationship between the corporations investing and the host country government i.e. degree of transparency
- The economic context in the LEDC – whether FDI is into one industry, or many, or the extent to which the trickle-down effect is likely to occur (which depends on factors such as labour market flexibility/education levels, transport infrastructure etc)
- Inwards FDI means an inflow on the financial account of the BoP, and therefore needs to be balanced by an outflow elsewhere i.e. a current account deficit