



IGCSE 0455 Economics Resources

Prepared by the Aitchison College Academic Portal

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Paper Pattern



Assessment overview

All candidates take two papers. Candidates will be eligible for grades A* to G.

All candidates take:

Paper 1

Multiple Choice

40 marks

Candidates answer 40 multiple-choice questions.

Externally assessed

1 hour

30%

and:

Paper 2

Structured Questions

80 marks

Candidates answer one compulsory question with six parts in Section A and three questions from a choice of four in Section B.

Externally assessed

2 hours

70%

Assessment objectives

The assessment objectives (AOs) are:

AO1 Knowledge and understanding

- Demonstrate knowledge and understanding of economic definitions, formulas, concepts and theories.
- Use economic terminology.

AO2 Analysis

- Select, organise and interpret economics data and information.
- Apply economic analysis to written, numerical, diagrammatic and graphical data.
- Analyse economic issues, identifying and developing links and relationships.

AO3 Evaluation

- Evaluate economic information, data and arguments, and recognise that economic decisions have uncertain outcomes.

Weighting for assessment objectives

The approximate weightings allocated to each of the assessment objectives (AOs) are summarised below.

Assessment objectives as a percentage of the qualification

Assessment objective	Weighting in IGCSE %
AO1 Knowledge and understanding	43
AO2 Analysis	47
AO3 Evaluation	10
Total	100

Assessment objectives as a percentage of each component

Assessment objective	Weighting in components %	
	Paper 1	Paper 2
AO1 Knowledge and understanding	50	40
AO2 Analysis	50	45
AO3 Evaluation	0	15
Total	100	100



Chapter 1: The basic economic problem

1 The basic economic problem

The first section of the syllabus introduces the fundamental ideas and concepts that underpin the study of economics including the basic economic problem, factors of production, opportunity cost and production possibility curves.

1.1 The nature of the economic problem

Topic

1.1.1 finite resources and unlimited wants

1.1.2 economic and free goods

Guidance

Definition and examples of the economic problem in the contexts of: consumers; workers; producers; and governments.

The difference between economic goods and free goods.

The fundamental problem that faces all economies (individuals, firms, and governments) is **Scarcity**.

• **Scarcity is caused by the conflict between:**

1. **Unlimited Wants:** The desire for goods and services is endless and constantly increasing. As one want is satisfied, new wants emerge.
2. **Finite (Limited) Resources:** The inputs required for the production of goods and services are limited in supply at any given time.

Free goods vs. Economic goods

Free goods are those which exist outside of the basic economic problem because they are not scarce, they do not use factors of production. e.g. sunlight.

Economic goods are the products and services that form the basis of the entire economy. Their existence is defined by the basic economic problem: **scarcity**.

PAST-PAPER QUESTIONS

Q: Explain the economic problem and why it is always likely to exist. [4]

Mark Scheme:

- **The economic problem is:** finite / limited resources (1) **AND** infinite / unlimited wants / wants exceed resources (1).
- **Why it always exists:** because resources (factors of production) will always be limited (scarce) (1) in relation to the ever-growing/unlimited wants of the people/society (1).
- *Alternatively, allow Scarcity (1) as a definition for the economic problem.*

Q: Define a free good. [2]

Mark Scheme:

- A good that has no opportunity cost (1).
- A good that takes no resources/factors of production to produce / naturally abundant in supply / does not use scarce resources (1).

Multiple Choice Questions (MCQs)

Q1: Which combination of terms gives the general definition of the economic problem?

- A) bigger families, less food, starvation
- B) falling supply, rising demand, shortage
- C) higher population, fewer jobs, unemployment
- D) limited resources, unlimited wants, scarcity

ANS-D

1.2 The factors of production**Topic**

1.2.1 definitions of the factors of production and their rewards

1.2.2 mobility of the factors of production

1.2.3 quantity and quality of the factors of production

Guidance

Definitions and examples of land, labour, capital and enterprise. Examples of the nature of each factor of production.

The influences on the mobility of the various factors.

The causes of changes in the quantity and quality of the various factors.

The **Factors of Production** are the resources used to produce goods and services. Production requires a combination of all four factors.

Land

Non-man-made natural resources available for production.

Examples: Oil, wood, fish, water, minerals

Reward: Rent

Labour

The human effort (mental or physical) input into the production process.

Examples: Factory workers, teachers, bus drivers, sales people.

Reward: Wages/Salaries

Capital

Any man-made resource that is used to produce other goods and services (capital goods).

Examples: Tools, buildings, machines, computers, tractors, engines.

Reward: Interest.

Enterprise

The risk-taking and key decision-making function in a business, involving organizing the other factors.

Examples: An entrepreneur who sets up or runs a firm.

Reward: Profit

Mobility of Factors of Production

Mobility refers to how easily factors can switch between different uses (occupational) or move from one geographical area to another (geographical).

Land

Generally geographically immobile (cannot be physically moved).

Generally occupationally mobile (can be used for a new purpose, e.g., farmland to housing).

Labour

Can be geographically immobile. Barriers include family ties, cost of living, lack of information, and difficulty securing/affording accommodation.

Can be occupationally immobile. Difficulties arise if skills are not transferable between different occupations (e.g., structural unemployment).

Capital

Varies. Some is geographically mobile (e.g., desks, computers). Some is immobile (e.g., a coal mine, a specific machine in a factory).

Varies. Some is occupationally mobile (e.g., a pen, a general-purpose truck). Some is immobile (e.g., specialised machinery, docks).

Enterprise

Generally geographically mobile (an entrepreneur can relocate).

Generally occupationally mobile (entrepreneurial skills are transferable between industries).

Changes in the Quantity and Quality

An increase in the quantity or quality of the factors of production leads to an **outward shift** of the potential output of an economy (a Production Possibility Curve shift).

Land

Influences on Quantity: Discovery of new natural resources (e.g., new oil fields). New government regulations that increase usable land/resources (e.g., deregulation of fracking).

Influences on Quality: Soil type and fertility. Weather and climate conditions.

Labour

Influences on Quantity: Demographic changes (positive net birth rate, migration). Retirement age, school leaving age, and the attitude of women towards work.

Influences on Quality: Education and training, which lead to better skills and higher productivity. Experience.

Capital

Influences on Quantity: Investment by firms (e.g., building a new factory). Total savings by individuals in a country.

Influences on Quality: Technological advances, which improve the efficiency of machinery. Process innovation and moving towards automated production.

Enterprise

Influences on Quantity: Education that fosters entrepreneurial skills (risk-taking, innovation). Low corporate taxes and favourable business regulations.

Influences on Quality: Education and skills, including knowledge of how to organise resources.

Theory/Structured Questions

Q. State two ways in which the quality of a country's labour force can be improved.

- **Increased spending on education** . This improves the knowledge, skills, and qualifications of workers, making them more productive.
- **Provision of training schemes**. This helps to equip workers with the necessary skills to operate new technology or switch occupations.

Q. Explain why a large, purpose-built shipping dock would be considered a geographically immobile factor of production, but an occupationally mobile one.

- **Geographically Immobile:** The dock is fixed to a specific location and cannot be moved from one geographical area to another.

- **Occupationally Mobile:** The dock *can* be used for a new purpose. For example, a dock originally used for importing oil could be converted to a dock for exporting finished manufactured goods, or for leisure activities like docking cruise ships.

Q. Define the factor of production 'Enterprise' and state its reward.

- **Definition:** Enterprise is the factor of production that involves taking risks, organizing the other factors (Land, Labour, and Capital), and making key decisions in a business with the aim of generating profit.
- **Reward:** The reward for Enterprise is **Profit**.

Multiple Choice Questions (MCQs)

1. Which combination of a factor of production and its factor income is not correct?

- A. Capital → Interest
- B. Enterprise → Profit
- C. Labour → Dividends
- D. Land → Rent

Answer and Explanation:

- **C** is the correct answer. The factor income for Labour is **Wages**. Dividends are payments to shareholders, a reward for investing capital (finance).

2. Which statement about factors of production is incorrect?

- A. Capital is the amount of money borrowed from a bank.
- B. Land includes commercially grown rice crops.
- C. Profit is the reward for enterprise.
- D. Labour is the output made by an employee.

Answer and Explanation:

C is the correct answer. Profit is the financial reward for enterprise (the risk-bearing and decision-making function).

A is incorrect: Capital is *man-made resources* (e.g., machinery), not money itself.

B is incorrect: Commercially grown crops are the *output* of production or part of working capital/raw materials, not the primary factor **Land** (which refers to the natural resources)

D is incorrect: Labour is the human **input/effort** into the production process.

3. What is most likely to increase the occupational mobility of labour?

- A. Building more houses.
- B. Increased spending on re-training schemes.
- C. Increased total government spending.
- D. Increasing the information on job availability.

Answer and Explanation:

B is the correct answer. Occupational mobility is the ability of a worker to change occupations. Retraining schemes would improve a worker's skills, making their skill base more transferable and thus increasing their occupational mobility.

A and D primarily affect **geographical mobility**.

1.3 Opportunity cost

Topic	Guidance
1.3.1 definition of opportunity cost	Definition and examples of opportunity cost in different contexts.
1.3.2 the influence of opportunity cost on decision making	Decisions made by consumers, workers, producers and governments when allocating their resources.

Opportunity cost is defined as the **next best alternative forgone** when an economic decision is made.

- It's the value of the choice that you did **not** pick, which was the second-best option.
- Opportunity cost is not necessarily a monetary amount; it is the **benefit** that could have been gained from the next-best use of the resources (time, money, land, etc.).

Decision Made: A student attends a concert.

Next Best Alternative Forgone (Opportunity Cost) : The knowledge and preparation that could have been gained from

Consumers (Households) allocate their **limited income** to satisfy their **unlimited wants and needs**.

Decision : What to buy?

Allocation of Resources: Allocating income between different goods and services to maximize utility (satisfaction).

Opportunity Cost : Choosing to buy a new smartphone means forgoing the opportunity to save that money or buy a laptop.

Producers (Firms) allocate the **Factors of Production** (land, labour, capital, and enterprise) to produce specific goods and services. Their primary goal is typically **profit maximisation**.

Decision:What to produce?

Allocation of Resources: Allocating capital and land to produce the goods most demanded by consumers (guided by the price mechanism).

Opportunity Cost : A farmer choosing to grow corn instead of wheat means forgoing the potential profit from selling wheat.

Governments allocate **national resources** (funded by taxes and borrowing) to provide public goods and services for the entire society. Their goal is to **maximise social welfare**.

Decision: What to spend on?

Allocation of resources : Allocating the national budget between different sectors (e.g., healthcare, education, defence, infrastructure).

Opportunity Cost : Increasing spending on building a new highway means forgoing the opportunity to build a new hospital or provide a larger education subsidy.

Past-paper Questions

Structured Questions

Q.Define and explain the term opportunity cost.(2)

ANS- **Opportunity cost** is defined as the **next best alternative foregone** (or sacrificed). This concept arises because **scarcity** forces choices to be made.

Multiple choice questions

1-Which statement best defines opportunity cost?

- A. The total cost of making a choice
- B. The financial expense of a product
- C. The **next best alternative foregone**
- D. The difference between costs and revenue

2-For a student deciding between studying for an exam or watching a movie, what is the opportunity cost of watching the movie?

- A. The cost of the movie ticket
- B. The enjoyment gained from the movie
- C. The higher exam grade that could have been achieved

D. The time spent watching the movie.

3-Why does opportunity cost exist for all economic agents ?

- A. Because they always aim to maximise profit
- B. Because resources are scarce in relation to unlimited wants
- C. Because prices of goods and services constantly change
- D. Because they make rational decisions

ANS-

- 1. C
- 2. C
- 3. B

1.4 Production possibility curve (PPC) diagrams

Topic	Guidance
1.4.1 definition of PPC	Definition, drawing and interpretation of appropriate diagrams.
1.4.2 points under, on and beyond a PPC	The significance of the location of production points.
1.4.3 movements along a PPC	Movements along a PPC and opportunity cost.
1.4.4 shifts in a PPC	The causes and consequences of shifts in a PPC in terms of an economy's growth.

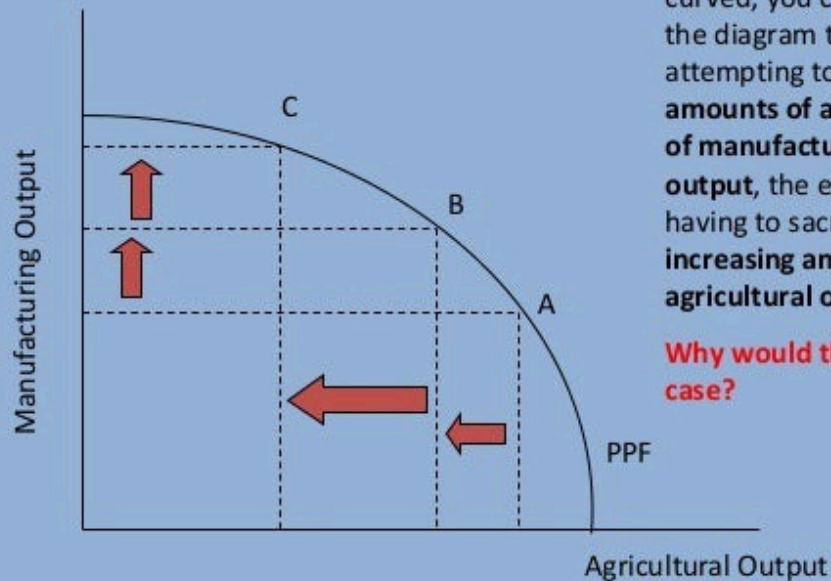
Production Possibility Curve (PPC), also known as the Production Possibility Frontier (PPF), is an economic model that illustrates the maximum potential output combinations of two goods or services that an economy can produce, assuming all its resources (factors of production) are fully and efficiently employed with a fixed state of technology.

-It is graphical representation of opportunity cost

The **Production Possibility Curve** is a curve showing the various combinations of two goods (e.g., consumer goods and capital goods) that can be produced in an economy when all resources are fully and efficiently utilized.

- **Drawing:** Typically, the PPC is drawn as a curve that is **concave** (bowed outwards) to the origin. This shape reflects the law of **increasing opportunity cost**.
- One good is plotted on the x-axis (e.g., Capital Goods) and the other on the y-axis (e.g., Consumer Goods).

Curved PPCs



When the PPC is curved, you can see from the diagram that in attempting to gain **equal amounts of addition units of manufacturing output**, the economy is having to sacrifice **increasing amounts of agricultural output**.

Why would this be the case?

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The location of a production point relative to the PPC has significant meaning:

Location : **On the PPC**

Significance : Productive Efficiency

Interpretation : All resources are being used fully and efficiently to produce the maximum possible output. These points represent the productive potential of the economy.

Location : **Under the PPC (Inside the curve)**

Significance : Productive Inefficiency

Interpretation : The economy is not using all of its available resources, or is using them inefficiently (e.g., due to unemployment, underutilization of factory capacity). More of both goods could be produced without giving up any of the other.

Location : **Beyond the PPC (Outside the curve)**

Significance : Unattainable

Interpretation : This combination of output cannot be achieved with the economy's current resources and technology. It represents a production level that is currently impossible.

MOVEMENTS ALONG THE PPC

A **movement along the PPC** involves changing the production mix from one point on the curve to another.

- **Opportunity Cost:** Such a movement illustrates **opportunity cost**, which is the value of the next best alternative forgone.

- **Trade-off:** When an economy moves along the PPC to produce more of one good (e.g., capital goods), it **must** give up some production of the other good (e.g., consumer goods), because resources are finite (scarcity). The amount of the second good forgone is the **opportunity cost** of the additional production of the first good.

- **Increasing Opportunity Cost:** The typically **concave shape** of the PPC shows **increasing opportunity cost**. As production of a good increases, greater quantities of the other good must be sacrificed for each additional unit. This occurs because resources are not perfectly adaptable to the production of both goods (e.g., a farmer specializing in wheat might not be as efficient when switched to car production).

SHIFTS IN A PPC

A **shift in the entire PPC** indicates a change in the **productive potential** of the economy, meaning the maximum possible output of both goods has changed.

Outward Shift (PPC shifts to the right)

- **Cause:** An increase in the **quantity** or **quality** of the economy's factors of production.
- **Quantity:** e.g., discovery of new resources, increase in the labor force (population growth, higher immigration), increase in capital stock (new factories/machinery).
- **Quality:** e.g., improvements in technology (leading to higher productivity), better education and training for the workforce (improving human capital).
- **Consequence (Economic Growth):** An outward shift represents **economic growth**. It means the economy can now produce more of *both* goods, leading to a higher potential standard of living.

Inward Shift (PPC shifts to the left)

- **Cause:** A decrease in the **quantity** or **quality** of the economy's factors of production.
- **Quantity:** e.g., natural disasters, wars, reduction in the labor force (emigration, decline in working-age population), depletion of natural resources.
- **Quality:** e.g., depletion of natural resources, lack of investment in education/technology.
- **Consequence (Economic Decline):** An inward shift represents a reduction in the economy's **economic contraction** or a decrease in the standard of living.

PAST-PAPER QUESTIONS

Structured Questions (unsolved)

- 1- **Define** what is meant by a **Production Possibility Curve (PPC)**. [2]
- 2- **Explain** the **significance** of a production point **inside** a PPC and a production point **on** its PPC. [4]
- 3- **Draw** and fully **label** a PPC diagram showing the production of two goods, **capital goods** and **consumer goods**. [4]
- 4- **Analyse** how an increase in a country's **labour productivity** can be shown using a PPC diagram and what this implies for **economic growth**. [6]
- 5- A government decides to increase spending on **healthcare** at the expense of **education**. Using the concept of a PPC, **discuss** the implications of this decision. [8]

Multiple Choice Questions (MCQ)

- 1- If an economy is producing at a point **inside** its PPC, what does this indicate?

- A. Resources are being used efficiently.
- B. Economic growth has occurred.
- C. The economy is experiencing unemployment or under-utilisation of resources.
- D. The combination of goods produced is unattainable.

2-Which of the following events would most likely cause an **outward shift** of the entire PPC?

- A. A successful campaign to reduce unemployment.
- B. A decrease in a country's average retirement age.
- C. The discovery of new, large mineral deposits.
- D. A switch in production from capital goods to consumer goods.

ANS-

1-C

2-C

2 The allocation of resources

The fundamental principles of resource allocation are considered through the price mechanism in a market economy. The market forces of demand and supply, market equilibrium and disequilibrium, and elasticity form the core of this section.

2 The allocation of resources

2.1 Microeconomics and macroeconomics

Topic	Guidance
2.1.1 microeconomics	The difference between microeconomics and macroeconomics and the decision makers involved in each.
2.1.2 macroeconomics	

MICROECONOMICS VS MACROECONOMICS

Microeconomics is the branch of economics that studies the **behavior and decisions of individual economic units** such as consumers (households), firms, and resource owners. It focuses on how these individual units allocate scarce resources and how their interactions determine **prices and quantities in specific markets**.

Macroeconomics is the branch of economics that studies the **economy as a whole** (the aggregate). It focuses on **economy-wide phenomena** and major policy goals, examining issues that affect an entire nation or the global economy.

Economic Agents

The economic agents making decisions at each level are:

Microeconomic Decision Makers

These agents make choices that impact their individual welfare, profit, or market outcome.

Decision Maker : Households / Consumers

Typical Microeconomic Decisions: What to buy (consumption), how much to save, where to work (labour supply).

Decision Maker : Firms

Typical Microeconomic Decisions: What to produce, how much to produce (output), what price to charge, how many workers to hire, how to minimise costs.

Decision Maker : Government

Typical Microeconomic Decisions: Intervening in a specific market (e.g., setting a tax on cigarettes or a maximum price for rent) market outcome.

Macroeconomic Decision Makers

These agents make choices that impact the entire economy.

Organisations like the World Bank or IMF that make decisions affecting multiple

Decision Maker : Government /Treasury

Typical Macroeconomic Decisions : Implementing Fiscal Policy (decisions on overall taxation levels and government spending) to influence national demand and growth.

Decision Maker : Central Bank

Typical Macroeconomic Decisions : Implementing Monetary Policy (setting interest rates and controlling the money supply) to manage inflation and stimulate/dampen economic activity.

Decision Maker : International Bodies

Typical Macroeconomic Decisions : Organisations like the World Bank or IMF that make decisions affecting multiple national economies.

PAST-PAPER QUESTIONS

Q.1- Define the terms **microeconomics** and **macroeconomics**. [4]

ANS- **Microeconomics** is the study of **individual economic units** or markets (e.g., a single firm, a household, or the market for one good). It focuses on **small-scale** decisions and how resources are allocated in specific areas. **Macroeconomics** is the study of the **whole economy** (the national or global economy)

Q.2- Identify the key **decision makers** (economic agents) involved in microeconomics and describe one decision each makes. [4]

ANS-

-Households/Consumers: They decide **what to buy** (consumption) and **how much to save or borrow**.

-Firms: They decide **what to produce**, **how much to produce** (output), and **what price to charge** for a specific good.

-Government (Micro-intervention): They decide to intervene in a **specific market**, e.g., by setting a **tax on a particular product** (like cigarettes) or a **minimum wage** in a specific industry.

MCQ

Q. In 2020, to prevent the spread of a pandemic, many governments temporarily closed restaurants and cafés. What would be a macroeconomic impact of such a policy?

- A. Demand for food to be consumed at home would rise
- B. Gross Domestic Product (GDP) would fall.
- C. The profits from restaurants and cafés would fall.
- D. Staff working in restaurants and cafés would lose income

ANS- B

2.2 The role of markets in allocating resources

Topic	Guidance
2.2.1 the market system	How a market system works; including buyers, sellers, allocation of scarce resources, market equilibrium, and market disequilibrium.
2.2.2 key resources allocation decisions	Establishing that the economic problem creates three key questions about determining resource allocation – what to produce, how, and for whom.
2.2.3 introduction to the price mechanism	How the price mechanism provides answers to these key allocation questions.

Resource allocation: the way in which economies decide what goods and services to provide, how to produce them and who to produce them for.

These questions- **what to produce, how to produce, and for whom to produce** – are termed **‘the basic economic questions’**. In short, resource allocation is the way in which economies solve the three basic economics questions.

The Three Basic Economic Questions

The problem of **scarcity** (unlimited wants vs. limited resources) forces all economies to make fundamental choices about how to allocate their scarce resources. These choices are:

1. **What to produce?** Which goods and services will be made (e.g., more consumer goods or more capital goods)?
2. **How to produce?** Which combination of resources/methods will be used (e.g., labour-intensive or capital-intensive production)?
3. **For whom to produce?** Who gets to consume the goods and services produced (how the output is distributed)?

In a pure **market economic system**, resources are allocated by the forces of **demand and supply** through the **price mechanism**.

Market is any set of arrangement that brings together all the producers and consumers of a good or service, so they may engage in exchange. Example: a market for soft drinks. Goods and services are bought and sold in a market at an equilibrium price where demand and supply are equal. This is called the price mechanism. It helps answer the three basic economic questions. Producers will produce the good that consumers demand the most, it will be produced in a way that is cost-efficient, and will be produced for those who are willing and able to buy the product.

PAST-PAPER Questions

Q. Explain the three fundamental economic questions that an economy must answer, and briefly describe how the price mechanism answers each one. (6 marks)

ANS-

- **What to produce?** - Answered by **consumer demand** and the pursuit of **profit** by firms. Rising prices (due to high demand) signal to producers to allocate resources to those goods.
- **How to produce?** - Answered by **cost minimization**. Firms choose the most cost-efficient production methods (e.g., labour-intensive vs. capital-intensive) based on the relative prices of the factors of production.
- **For whom to produce?** - Answered by **purchasing power/ability to pay**. Goods are allocated to those consumers who are willing and able to pay the market price.

MCQs

Q.1. What is the primary function of the price mechanism in a free market economy?

- A. To set a minimum price for all essential goods.
- B. To ensure equal distribution of income among all citizens.
- C. To provide signals and incentives to consumers and producers to allocate scarce resources.
- D. To allow the government to have complete control over what is produced.

ANS: C. To provide signals and incentives to consumers and producers to allocate scarce resources.

2.3 Demand

Topic	Guidance
2.3.1 definition of demand	Definition, drawing and interpretation of appropriate diagrams.
2.3.2 price, demand and quantity	A demand curve to be drawn and used to illustrate movements along a demand curve with appropriate terminology, for example extensions and contractions in demand.
2.3.3 individual and market demand	The link between individual and market demand in terms of aggregation.
2.3.4 conditions of demand	The causes of shifts in a demand curve with appropriate terminology, for example increase and decrease in demand.

- **Demand:** The **want and willingness** of consumers to buy a good or service at a given price.
- **Effective Demand:** Demand where the willingness to buy is backed by the **ability to pay** (i.e., having the money).
- **Example:** Wanting a laptop is 'demand'; having the money to buy it is '**effective demand**'.
- **Quantity Demanded:** The term for the effective demand for a specific good or service.
- **Individual Demand:** The demand from a single consumer.
- **Market Demand (Aggregate Demand):** The **total** demand for a product, which is the sum of all individual demands from consumers.

The Law of Demand

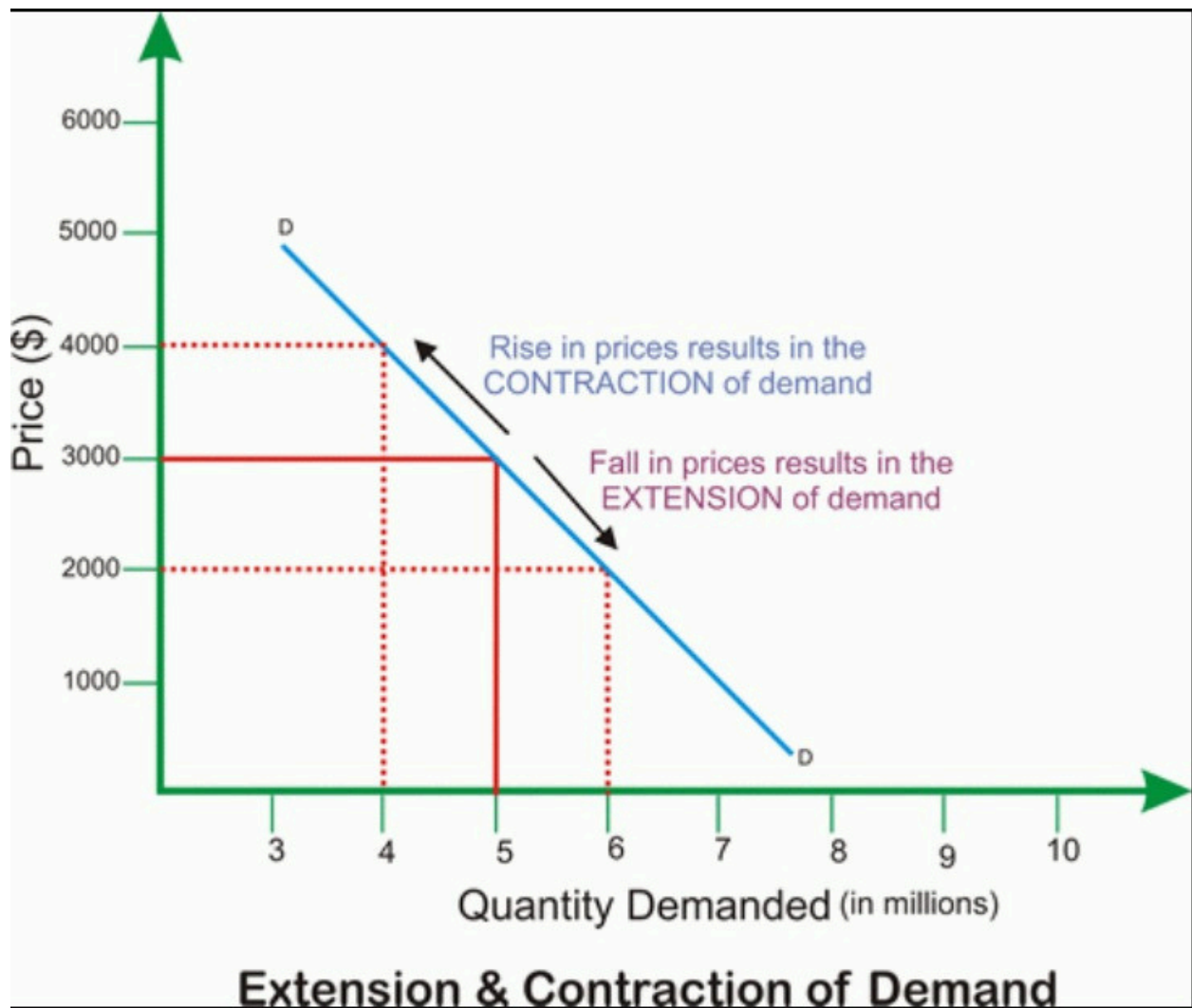
• **Statement:** The law of demand states that there is an **inverse relationship** between price and quantity demanded (ceteris paribus - all other factors remain constant). • An increase in price leads to a **decrease in demand** (or quantity demanded). • A decrease in price leads to an **increase in demand** (or quantity demanded). • **Note on Causality:** The law is established with respect to changes in **price** affecting **quantity demanded**. Changes in demand (a shift of the curve) affect price, not the other way around in this context.

Changes in Quantity Demanded (Movement Along the Curve)

Changes in quantity demanded are caused **only** by a change in the **price of the good itself**. This results in a movement along the existing demand curve.

Extension in Demand : an increase in quantity demanded due to decrease in price - it is shown as a movement down the demand curve

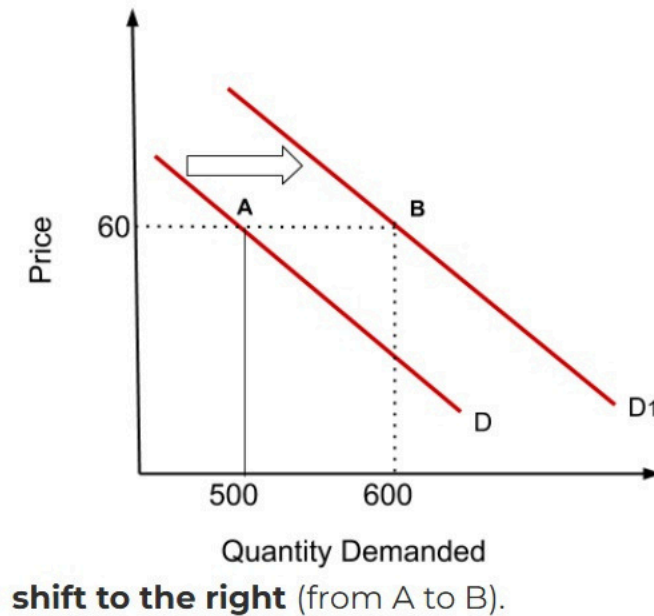
Contraction in Demand : a decrease in quantity demanded due to an increase in price - it is shown as a movement up the demand curve



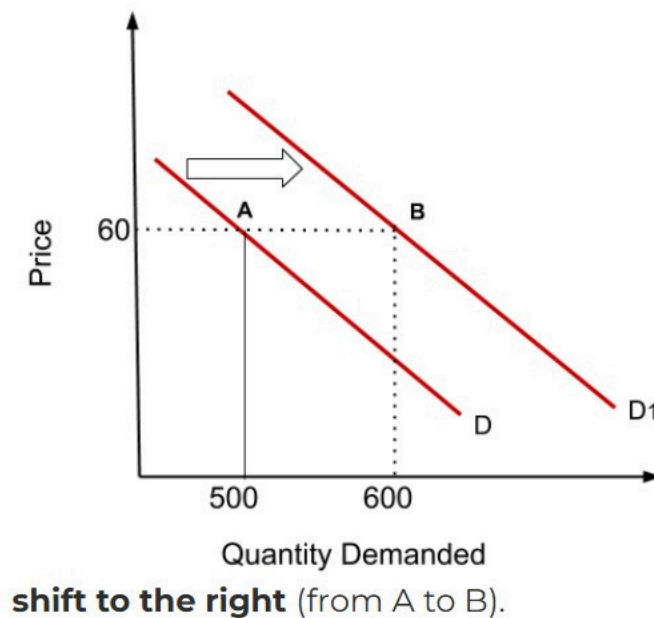
Changes in Demand (Shifts of the Curve)

A change in demand is caused by a change in any factor **other than the price of the good itself**. This results in a shift of the entire demand curve.

other than the price of the good



In this example, there is a rise in the demand of Coca-Cola from 500 to 600, without any change in price. **A rise in the demand for a product due to the changes in other factors (excluding price) causes the demand curve to**



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Rise in Demand : Demand increases at every price

Fall in Demand : Demand decreases at every price

Factors that cause shifts in a demand curve:

- **Consumer incomes:** a rise in consumers' incomes increases demand, causing a shift to the right. Similarly, a fall in incomes will shift the demand curve to the left.
- **Taxes on incomes:** a rise in tax on incomes means less demand, causing a shift to the left; and vice versa.
- **Price of substitutes** **Substitutes** are goods that can be used instead of a particular product. Example: tea and coffee are substitutes (they are used for similar purposes). A rise in the price of a substitute causes a rise in the demand for the product, causing the demand curve to shift to the right; and vice versa.
- **Price of complements** **Complements** are goods that are used along with another product. For example, printers and ink cartridges are complements. A rise in the price of a complementary good will reduce the demand for the particular product, causing the demand curve to shift to the left; and vice versa.
- **Changes in consumer tastes and fashion:** for example, the demand for DVDs has fallen since the advent of streaming services like Netflix, which has caused the demand curve for DVDs to shift to the left.
- **Degree of Advertising:** when a good is very effectively advertised (Coke and Pepsi are good examples), its demand rises, causing a shift to the right. Lower advertising shifts the demand curve to the left.
- **Change in population:** A rise in the population will raise demand, and vice versa.
- **Other factors,** such as weather, natural disasters, laws, interest rates etc. can also shift the demand curve.

2.4 Supply

Topic	Guidance
2.4.1 definition of supply	Definition, drawing and interpretation of appropriate diagrams.
2.4.2 price, supply and quantity	A supply curve to be drawn and used to illustrate movements along a supply curve with appropriate terminology, for example extensions and contractions in supply.
2.4.3 individual and market supply	The link between individual and market supply in terms of aggregation.
2.4.4 conditions of supply	The causes of shifts in a supply curve with appropriate terminology, for example increase and decrease in supply.

Definition of Supply

- **Supply:** The **want and willingness** of producers to **supply** a good or service at a given price.
- **Quantity Supplied:** The specific amount of goods or services producers are willing to make and supply.
- **Market Supply:** The **total** amount of goods and services all producers of that product are willing to supply, or the sum of all individual supplies.

The Law of Supply

- **Statement:** The law of supply states that there is a **positive** (or direct) relationship between price and quantity supplied (*ceteris paribus*).
- An increase in price leads to an **increase in supply** (or quantity supplied).
- A decrease in price leads to a **decrease in supply** (or quantity supplied).
- **Rationale:** Producers are motivated by profit. A higher price increases profitability, encouraging firms to produce and supply more.

Changes in Quantity Supplied (Movement Along the Curve)

Changes in quantity supplied are caused **only** by a change in the **price of the good itself**. This results in a movement along the existing supply curve.

Extension in Supply : An increase in quantity supplied due to an increase in price.

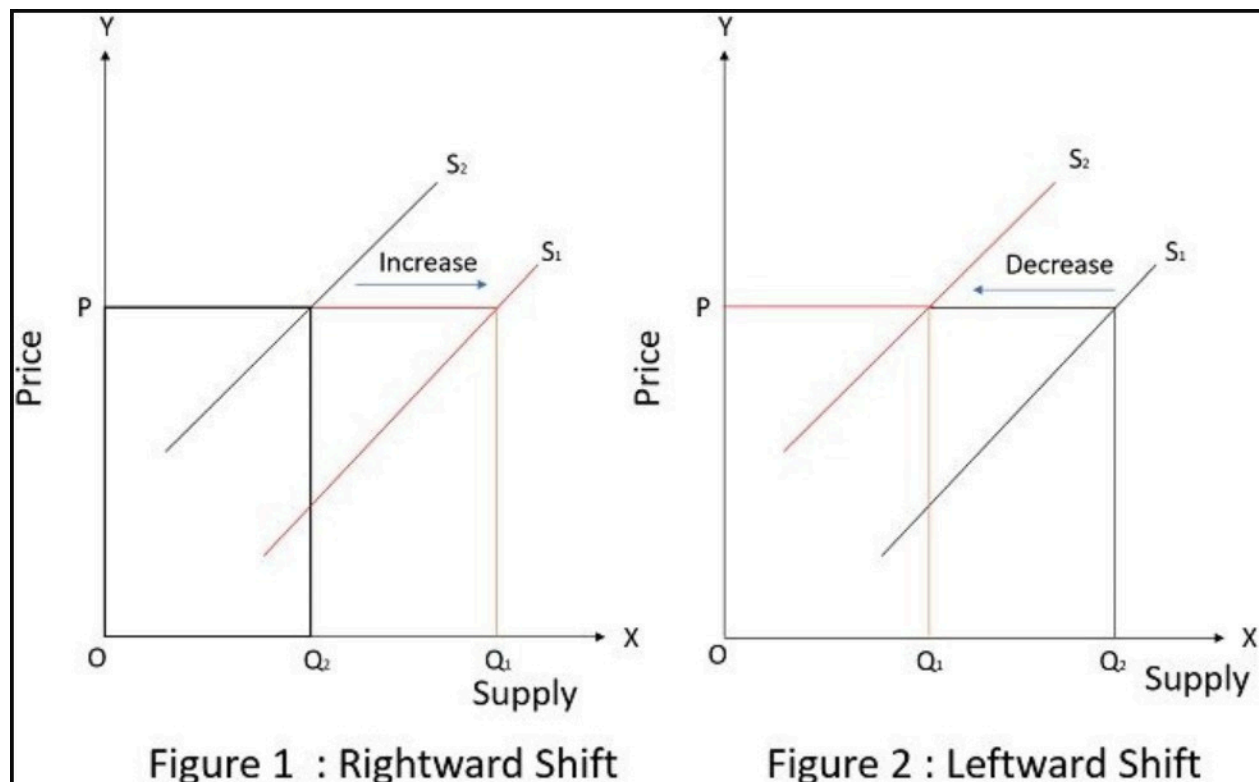
Contraction in Supply : A decrease in quantity supplied due to a decrease in price.

Changes in Supply (Shifts of the Curve)

A change in supply is caused by a change in any factor other than the price of the good itself. This results in a shift of the entire supply curve

Rise in Supply : Supply decreases at every price

Fall in Supply : Supply increases at every price.



Factors that cause shifts in supply curve:

- **Changes in cost of production:** when the cost of factors to produce the good falls, producers can produce and supply more products cheaply, causing a shift in the supply curve to the right. A subsidy*, which lowers the cost of production also shifts the supply curve right. When cost of production rises, supply falls, causing the supply curve to shift to the left.
- **Changes in the quantity of resources available:** when the amount of resources available

risers, the supply rises; and vice versa.

- **Technological changes:** an introduction of new technology will increase the ability to produce more products, causing a shift to the right in the supply curve.

- **The profitability of other products:** if a certain product is seen to be more profitable than the one currently being produced, producers might shift to producing the more profitable product, reducing supply of the initial product (causing a shift to the left).

- Other factors: weather, natural disasters, wars etc. can shift the supply curve left.

2.5 Price determination

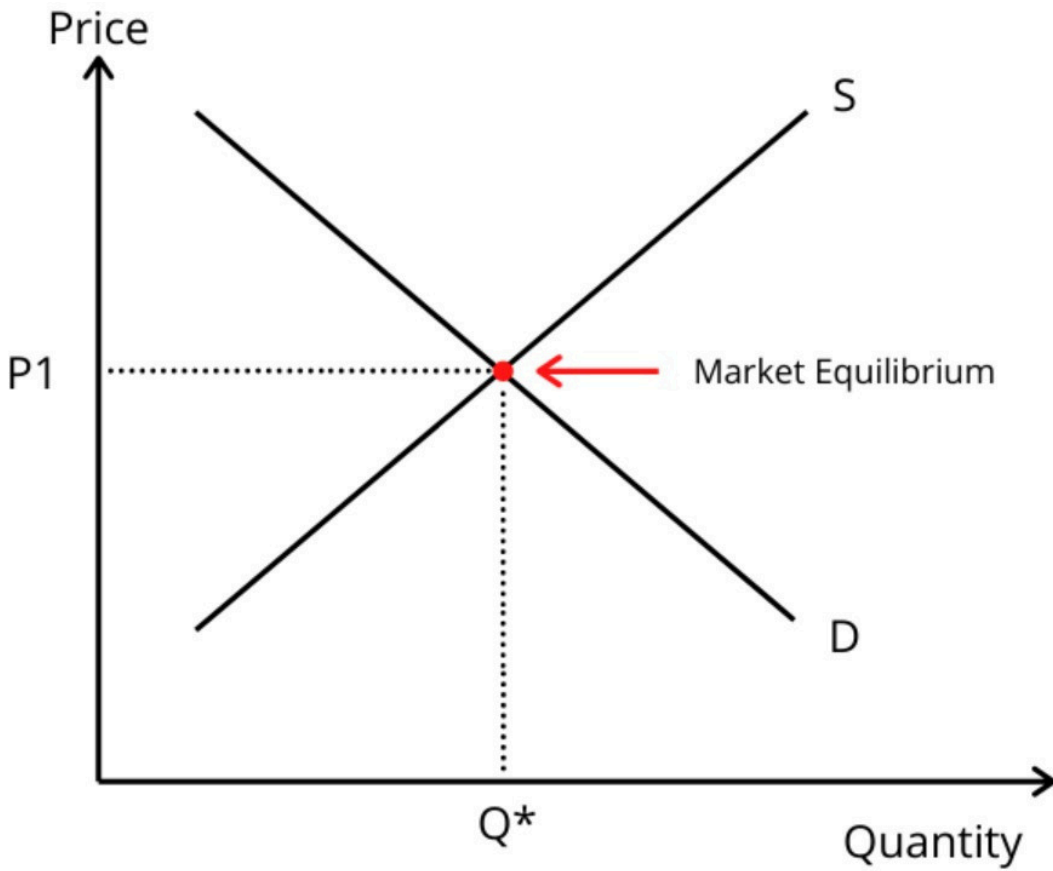
Topic	Guidance
2.5.1 market equilibrium	Definition, drawing and interpretation of demand and supply schedules and curves used to establish equilibrium price and sales in a market.
2.5.2 market disequilibrium	Definition, drawing and interpretation of demand and supply schedules and curves used to identify disequilibrium prices and shortages (demand exceeding supply) and surpluses (supply exceeding demand).

2.6 Price changes

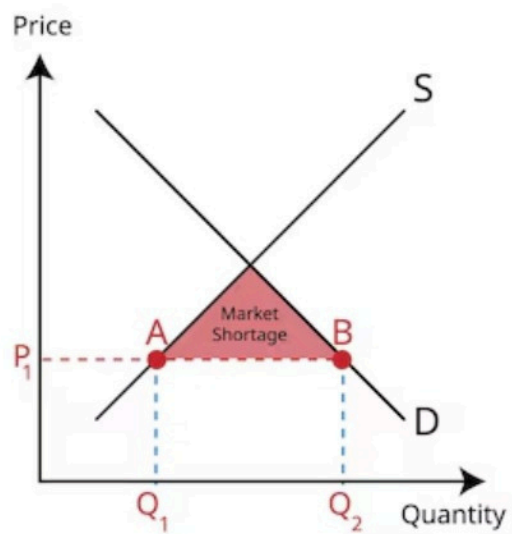
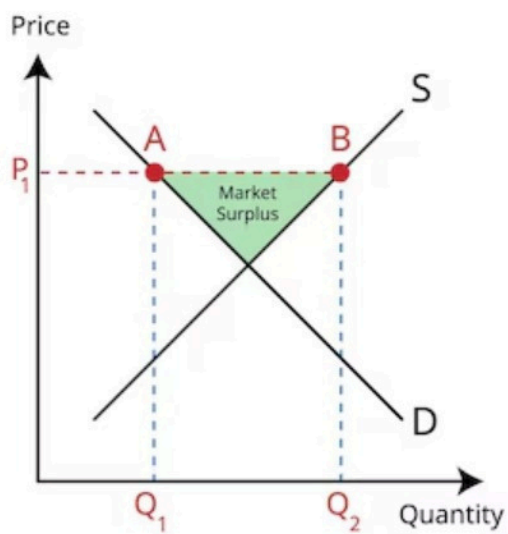
Topic	Guidance
2.6.1 causes of price changes	Changing market conditions as causes of price changes.
2.6.2 consequences of price changes	Demand and supply diagrams to be used to illustrate these changes in market conditions and their consequences for equilibrium price and sales.

The market **equilibrium price** is the price at which the demand and supply curves in a given market meet.

Disequilibrium price is the price at which market demand and supply curves do not meet.



Market Disequilibrium



**PAST-PAPER QUESTIONS
OF
(DEMAND,SUPPLY,PRICE DETERMINATION,
&PRICE CHANGES)**

Q. There was a global surplus of steel in 2017. In mid-2017, the US government considered imposing tariffs on steel imports to protect its declining steel industry. Cheap imports from other countries were reducing employment in the US steel industry. The pattern of US employment was also being affected by improvements in education.

Explain how market forces will eliminate a surplus and a shortage.

[4]

MARKING SCHEME-

A surplus will be eliminated by a fall in price (1) demand will rise / supply will fall (1).

A shortage will be eliminated by a rise in price (1) demand will fall / supply will rise (1).

2 marks could be awarded for an accurately drawn demand and supply diagram showing changes in price.

Q. The price elasticity of demand (PED) for sugar in most countries is less than 1. In 2017, the price of sugar fell. However, the price of specialised, higher quality sugar grown in countries such as Mauritius fell by less than the average global price. Efficient producers, such as some farmers in Brazil that have a low fixed cost of production, were also less affected by the fall in price.

MARKING SCHEME-

Explain two reasons why the price of sugar may fall.

[4]

Mark Scheme

- demand may fall (1)
- supply may increase (1)
- a fall in income will lower demand (1) because of less purchasing power (1)
- a fall in population will lower demand (1) as there will be fewer consumers (1)
- a change in tastes will lower demand (1) as people may find sugar less appealing (1)
- concern about health will lower demand (1) as consumers will switch to other foods (1)
- a rise in the price of a complement (1) e.g. tea (1)
- a fall in the price of a substitute (1) e.g. sweeteners (1)
- reduction in costs of production will increase supply (1) as it is likely to lead to higher profits (1)
- subsidies will increase supply (1) as they will give an incentive to firms to produce more (1)
- a cut in indirect tax will increase supply (1) as it lowers costs (1)
- good weather conditions will increase supply (1) as less of the crop will be lost (1)
- more firms in the market (1) increasing competition in the market (1)

Q.In 2019, France produced inside its production possibility curve (PPC). France exports a wide range of its products. It is the world's top exporter of luxury perfume and the 7th largest exporter of soap. Changes in technology affect the products people produce and buy. The French government plans to upgrade its infrastructure for all households to have internet access.

MARKING SCHEME-

Analyse, using a demand and supply diagram, how an increase in income will affect the market for a luxury brand of perfume.

[6]

Mark Scheme

Coherent analysis which might include: Up to 4 marks for the diagram:

D and S diagram:

Axes correctly labelled - price and quantity or p and q (1).

Original demand and supply curves correctly labelled (1).

New demand curve shifted to the right (1).

Equilibriums - shown by lines or equilibrium points (1).

Up to 2 marks for written analysis which might include:

Luxury perfume will be more affordable / greater purchasing power / luxury perfume will take a smaller proportion of income / more will be demanded at the same price (1) price will rise / quantity traded will increase (1).

Q.In May 2017, the price of olive oil rose by more than 10%. This was caused by a drought in Greece, Italy, Spain and Tunisia, the major producing countries. Global supply was forecast to fall by 14% in

2017. Demand for olive oil fell in Europe, but rose in a number of other countries including Australia, Brazil and China. Some basic food items, including bread and rice, are taxed in some countries but are subsidised in other countries.

Analyse why the demand for a product may be higher in one country than in another country. [6]

Marking Scheme-

Incomes may be higher (1) allowing people to buy more of the product (1).

There may be a larger population (1) more potential buyers (1).

The product may be more to the taste of people in that country (1) example e.g. falafel is popular in the middle east (1).

The product may be more heavily advertised (1) which may increase the attractiveness of the product (1).

Price may be lower (1) due to lower costs of production / government subsidy / lower (indirect) taxes (1).

Price of substitutes may be higher (1) example (1).

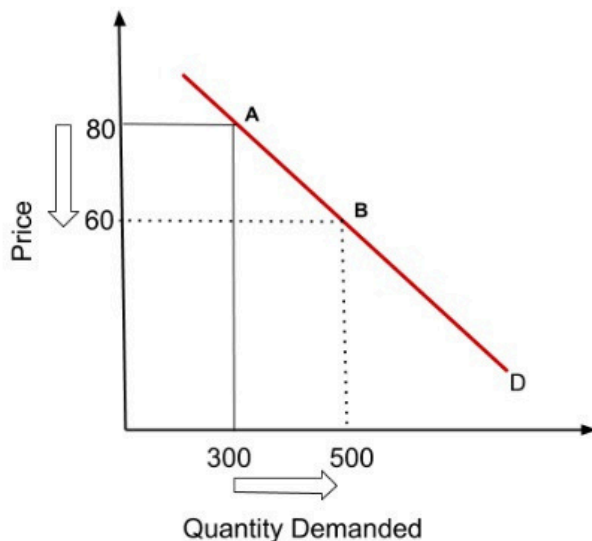
Credit may be more available / interest rate lower (1)

2.7 Price elasticity of demand (PED)

Topic	Guidance
2.7.1 definition of PED	
2.7.2 calculation of PED	Calculation of PED using the formula and interpreting the significance of the result.
	Drawing and interpretation of demand curve diagrams to show different PED.
2.7.3 determinants of PED	The key influences on whether demand is elastic or inelastic.
2.7.4 PED and total spending on a product/ revenue	The relationship between PED and total spending on a product/revenue, both in a diagram and as a calculation.
2.7.5 significance of PED	The implications for decision making by consumers, producers and government.

Price Elasticity of Demand (PED) The PED of a product refers to **the responsiveness of the quantity demanded to changes in its price.**

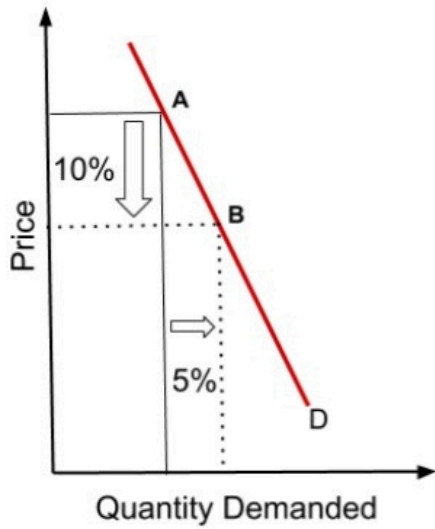
PED (of a product) = % change in quantity demanded / % change in price



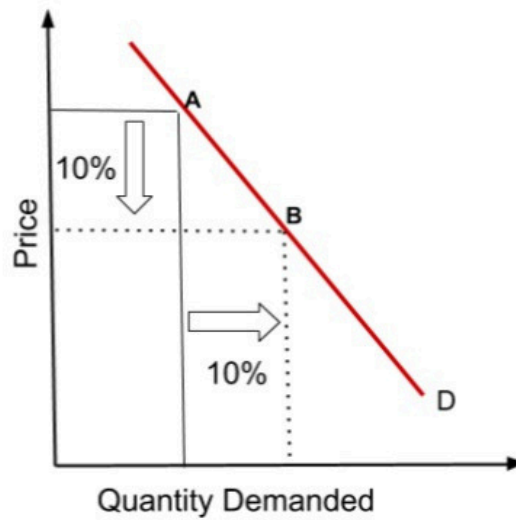
For example, calculate the price elasticity of demand of Coca-Cola from this diagram.

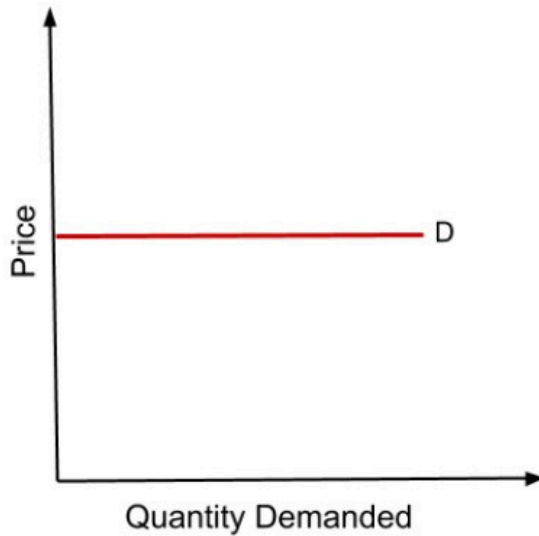
$$\begin{aligned} \text{PED} &= [(500 - 300) / 300] * 100 / [(80 - 60) / 80] * 100 \\ &= 66.67 / 25 = 2.67 \end{aligned}$$

In this example, the PED is 2.67, that is, the % change in quantity demanded was higher than the % change in the price. This means, **a change in price makes a higher change in quantity demanded.** These products have a **price elastic demand.** Their values are always above 1.

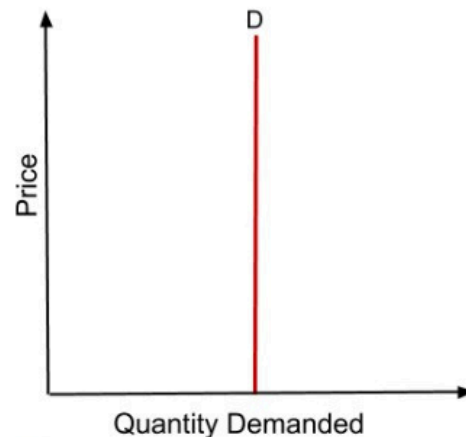


When the % change in quantity demanded is lesser than the % change in price, it is said to have a price **inelastic demand**. Their values are always below 1. **A change in price makes a smaller change in demand.**





When the quantity demanded changes without any changes in price itself, it is said to have an **infinitely price elastic demand**. Their values are infinite.



When the price changes have no effect on demand whatsoever, it is said to have a **perfect price inelastic demand**. Their elasticity is 0.

What affects PED?

- **No. of substitutes:** if a product has many substitute products it will have an elastic demand. For example, Coca-Cola has many substitutes such as Pepsi and Mountain Dew. Thus a change in price will have a greater effect on its demand (If price rises, consumers will quickly move to the substitutes and if price lowers, more consumers will buy Coca-Cola).
- **Time period:** demand for a product is more likely to be elastic in the long run. For example, if the price rises, consumers will search for cheaper substitutes. The longer they have, the more likely they are to find one.
- **Proportion of income spent on commodities:** goods such as rice, water (necessities) will have an inelastic demand as a change in price won't have any significant effect on its demand, as it will only take up a very small proportion of their income. Luxury goods such as cars on the other hand, will have a high price elastic demand as it takes up a huge proportion of consumers' incomes.

Relationship between PED and revenue and how it is helpful to producers:

Producers can calculate the PED of their product and take a suitable action to make the product more profitable.

Revenue is the amount of money a producer/firm generates from sales, i.e., the total number of units sold multiplied by the price per unit. So, as the price or the quantity sold changes, those changes have a direct effect on revenue.

If the product is found to **have an elastic demand, the producer can lower prices to increase revenue**. The law of demand states that a price fall increases the demand. And since it is an elastic product (change in demand is higher than change in price), the demand of the product will increase highly. The producers get more revenue.

If the product is found to **have an inelastic demand, the producer can raise prices to increase revenue**. Since quantity demanded wouldn't fall much as it is inelastic, the high prices will make way for higher revenue and thus higher profits.

PAST-PAPER QUESTIONS

Q. The demand for flat screen televisions has increased enormously in many countries and this has had an effect on the market.

- (a) Explain what is meant by price elasticity of demand. [4]
- (b) Discuss the potential usefulness of price elasticity of demand to a manufacturer of flat screen televisions. [6]

Mark Scheme-

(a) Up to 2 marks for definition:

PED is the percentage change in the quantity demanded of a product (1) divided by the percentage change in its price (1)

Or

PED is the responsiveness of demand (1) to a change in price (1).

Up to 2 marks for expansion:

Its value can range from perfectly inelastic (1) to perfectly elastic (1) inelastic demand has a value of less than 1 (1) elastic demand has a value of more than 1 (1) and it is usually a minus figure (1) varies along the demand curve (1).

Note: maximum of 4 marks.

(b)

It will give guidance to the firm if it is thinking about changing the price (1)

- if PED is elastic, a price reduction will increase revenue (1) additional mark for development of this point e.g. as demand will rise by more than price (1)
- if PED is inelastic, a price rise will increase revenue (1) additional mark for development of this point e.g. as demand will fall by less than price (1)

Limitations:

- may be difficult for the manufacturer to calculate accurately (1)

- may be constantly changing (1) There are likely to be a number of competitors in the industry/the produce might be considered to be a luxury (1) and, therefore, the PED is likely to be elastic (1) unless the manufacturer can build up a strong sense of brand loyalty (1) in which case the PED will be less elastic (1). Answers which fail to refer to the television manufacturing industry can gain no more than 4 marks. A maximum of 5 marks for a one-sided approach. Note: maximum of 6 marks. [6]

2.8 Price elasticity of supply (PES)

Topic	Guidance
2.8.1 definition of PES	
2.8.2 calculation of PES	Calculation of PES using the formula and interpreting the significance of the result. Drawing and interpretation of supply curve diagrams to show different PES.
2.8.3 determinants of PES	The key influences on whether supply is elastic or inelastic.
2.8.4 significance of PES	The implications for decision making by consumers, producers and government.

Price Elasticity of Supply (PES)

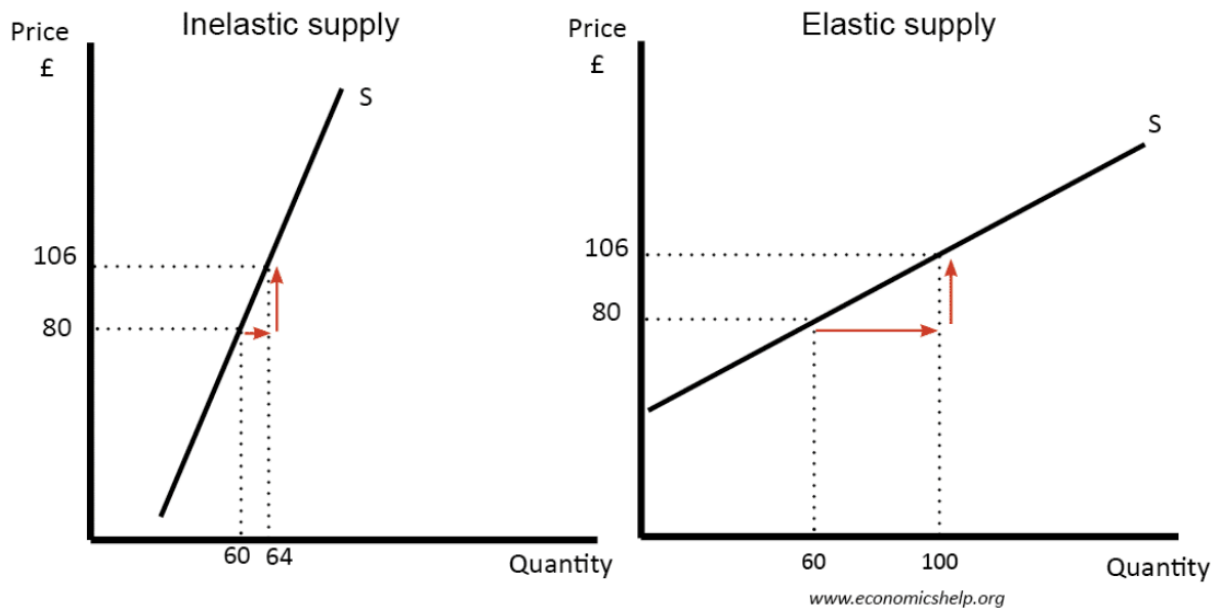
The PES of a product refers to **the responsiveness of its quantity supplied to changes in its price.**

PES of a product = %change in quantity supplied / %change in price

Similar to PED, PES too can be categorized into price elastic supply, price inelastic supply, perfectly price inelastic supply, infinitely price elastic supply and unitary price elastic supply.

The price elasticity of supply (PES) is measured by % change in Q.S divided by % change in price.

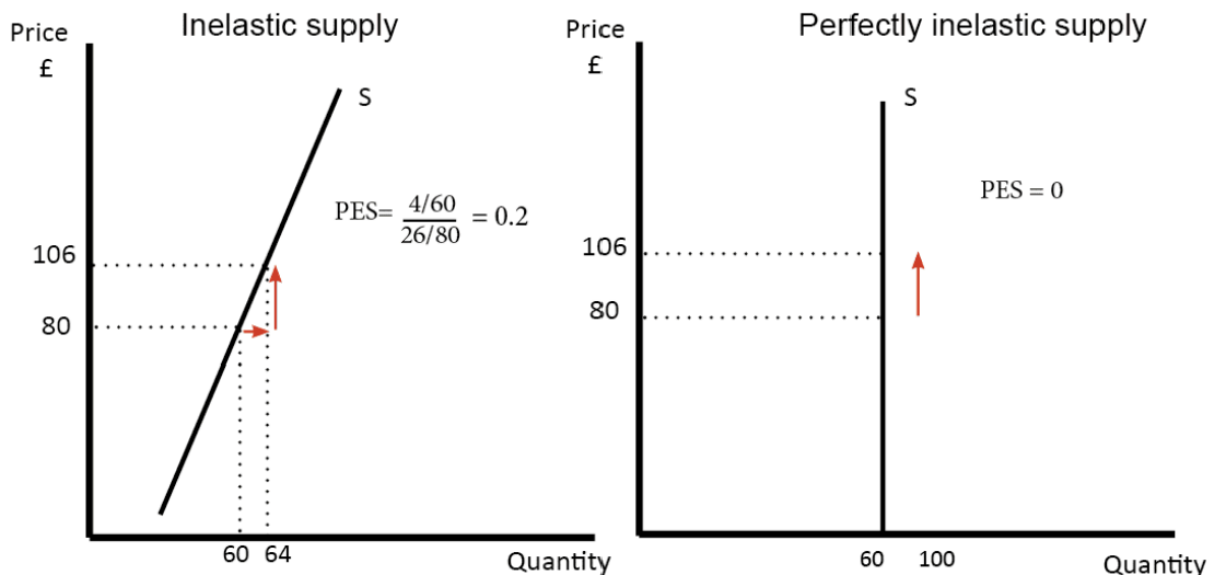
- If the price of a cappuccino increases by 10%, and the supply increases by 20%. We say the PES is 2.0.
- If the price of bananas falls 12% and the quantity supplied falls 2%. We say the PES = $2/12 = 0.16$



- Inelastic supply – a change in price causes a smaller proportional change in quantity supply
- Elastic supply – a change in price causes a bigger proportional change in supply

Inelastic supply

This means that an increase in price leads to a smaller % change in supply. Therefore $PES < 1$



Supply could be inelastic for the following reasons Firms operating close to full capacity.

- Firms have low levels of stocks, therefore there are no surplus goods to sell.
- In the short term, capital is fixed in the short run e.g. firms do not have time to build a bigger

factory.

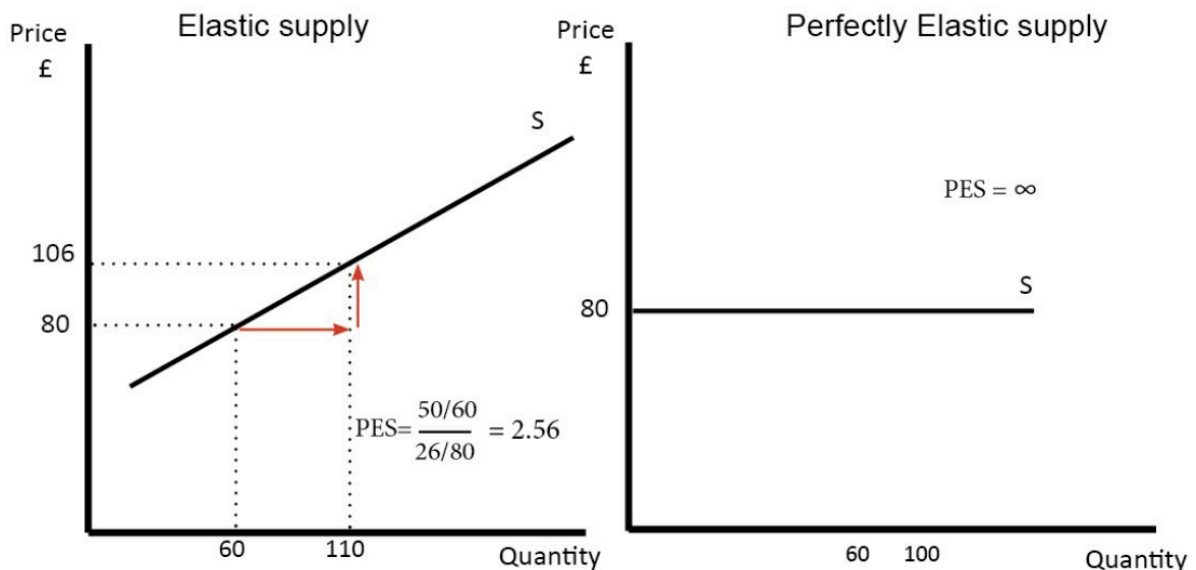
- If it is difficult to employ factors of production, e.g. if highly skilled labour is needed
- With agricultural products, supply is inelastic in the short run, because it takes at least six months to grow new crops. In September the farmer cannot suddenly produce more potatoes if the price goes up.

Examples of goods with inelastic supply
Nuclear reactors – It takes considerable time and expertise to build a new reactor. If there is high demand, few firms would be able to increase output in quick time

- Grapes – Harvest is once a year, so in short-term, supply would be very inelastic.
- Flood defences – If there is heavy rainfall and flooding, there would be high demand for flood defences. But, to supply barriers against the floods cannot occur overnight. It will take many months of construction to build.

Elastic supply

This occurs when an increase in price leads to a bigger % increase in supply, therefore $PES > 1$



What affects PES?

- **Time of production** : If the product can be quickly produced, it will have a price elastic supply as the product can be quickly supplied at any price. For example, juice at a restaurant. But products which take a longer time to produce, such as cars, will have a price inelastic supply as it will take a longer time for supply to adjust to price.
- **Availability of resources**: More resource (land, labour, capital) will make way for an elastic

supply. If there are not enough resources, producers will find it difficult to adjust to the price changes, and supply will become price inelastic.

PAST-PAPER QUESTIONS

Q. The costs of production in the motorcycle industry have risen significantly in recent years.

(a) Explain the concept of price elasticity of supply. [4]

(b) Discuss to what extent time is the main influence on the price elasticity of supply. [6]

Mark Scheme

(a) Up to 2 marks for definition:

- the responsiveness of supply to a change in price/the percentage change in quantity supplied of a product divided by the percentage change in price (2)
- how price affects supply/change in supply divided by change in price (1)

Up to 2 marks for further development:

elastic supply has value greater than 1 (1) inelastic supply has a value less than 1 (1) PES varies from perfectly elastic to perfectly inelastic (1) PES varies along the length of the supply curve (1)

always positive (1)

(b) Up to 4 marks for why it might be the main influence:

- at a particular moment in time, it may be very difficult (or impossible) to increase supply (1)
 - supply may be relatively inelastic (1)
 - the longer the period of time, the more responsive supply is likely to be to a price change (1)
- relatively elastic (1)

Up to 4 marks for discussion of other possible influences:

- the ease with which a product can be stored (1) the easier it is to store the product, the more elastic the supply will be (1)
- the availability of factors of production (1), e.g. supply may be inelastic in periods of full employment (1)

2.9 Market economic system

Topic

Guidance

2.9.1 definition of market economic system

2.9.2 advantages and disadvantages of the market economic system

Including examples of how it works in a variety of different countries.

Market Economic System

Definition : An economic system where resources are mainly owned and controlled by private individuals and firms (the private sector).

Resource Allocation : Resource allocation is determined by the price mechanism (the forces of demand and supply).

Government's Role : Government intervention is minimal or non-existent.

Key Aim Firms aim to maximize profit, while consumers aim to maximize satisfaction (utility)

Features:

- All resources are owned and allocated by private individuals.
- Government refrains from regulating markets. It instead tries to create very business-friendly environments and any intervention is mostly limited to protecting private property. The demand and supply fixes the price of products. This is called **price mechanism**.
- What to produce is solved by **producing the most-demanded goods** for which people spend a lot, as their only motive is to generate a high profit.
- How to produce is solved by **using the cheapest yet efficient combination of resources** – capital or labour – in order to maximise profits.
- For whom to produce is solved by **producing for people who are willing and able to pay for goods** at a high price.

Advantages:

- A **wide variety of quality goods and services** will be produced as different firms will compete to satisfy consumer wants and make profits. Quality is ensured to make sure that consumers buy from them. There is consumer sovereignty.
- Firms will **respond quickly to consumer changes in demand**. When there is a change in demand, they will quickly allocate resources to satisfying that demand, so as to maintain profits.
- **High efficiency** will exist. Since producers want to maximise profits, they will use resources very efficiently (producing more with less resources).
- Since there is hardly any government intervention (in the form of regulations, extra fees and fines etc. for example), firms will find it easy and inexpensive to start and run businesses.

Disadvantages:

- Only profitable goods and services are produced. **Public goods*** and some **merit goods*** for which there is no demand **may not be produced**, which is a drawback and affects the

economic development. • Firms will **only produce for consumers who can pay for them**. Poor people who cannot spend much won't be produced for, as it would be non-profitable. • **Only profitable resources will be employed**. Some resources will be left unused. In a market economy, capital-intensive production is favoured over labour-intensive production (because it's more cost-efficient). This can lead to unemployment. • Harmful (**demerit**) **goods may be produced** if it is profitable to do so. • Negative impacts on society (**externalities**) may be ignored by producers, as their sole motive is to keep consumers satisfied and generate a high profit. • A firm that is able to dominate or control the market supply of a product is called a **monopoly**. They may use their power to restrict supply from other producers, and even charge consumers a high price since they are the only producer of the product and consumers have no choice but to buy from them. • Due to high competition between firms, **duplication of products** may take place, which is a waste of resources.

***Public goods**: goods that can be used by the general public, from which they will benefit. Their consumption can't be measured, and thus cannot be charged a price for (this is why a market economy doesn't produce them). Examples are street lights and roads.

***Merit goods**: goods which create a positive effect on the community and ought to be consumed more. Examples are schools, hospitals, food. The opposite is called demerit goods which includes alcohol and cigarettes

***Subsidies**: financial grants made to firms to lower their cost of production in order to lower prices for their products.

2.10 Market failure

Topic	Guidance
2.10.1 definition of market failure	The key terms associated with market failure: public good, merit good, demerit good, social benefits, external benefits, private benefits, social costs, external costs, private costs.
2.10.2 causes of market failure	With respect to public goods, merit and demerit goods, external costs and external benefits, abuse of monopoly power and factor immobility. Examples of market failure with respect to these areas only.
2.10.3 consequences of market failure	The implications of misallocation of resources in respect of the over consumption of demerit goods and goods with external costs, and the under consumption of merit goods and goods with external benefits. Note: demand and supply diagrams relating to market failure are not required.

Market Failure:

A situation where the **free market** (price mechanism) leads to an **inefficient or less than optimum** allocation of scarce resources from the point of view of **society**.

Private Cost:

The cost paid by the **individual producer or consumer** in an economic transaction (e.g., cost of raw materials for a firm, or the price paid for a cigarette by a consumer).

External Cost (Negative Externality):

The **harm or damage** imposed on a **third party** (society) not involved in the transaction, which is **not factored into the market price**.

Social Cost:

The **total cost** to society, which includes both the private cost and the external cost.

$$\text{Social Cost} = \text{Private Cost} + \text{External Cost}.$$

Private Benefit:

The benefit gained by the **individual producer or consumer** (e.g., profit for a firm, or satisfaction/utility for a consumer).

External Benefit (Positive Externality):

The **benefit** received by a **third party** (society) not involved in the transaction, which is **not**

factored into the market price (e.g., a beef farm's bees pollinating nearby orchards).

Social Benefit:

The **total benefit** to society, which includes both the private benefit and the external benefit.

$$\text{Social Benefit} = \text{Private Benefit} + \text{External Benefit}.$$

Market Failure

Market failure occurs when the price mechanism fails to allocate resources effectively. This is the most disadvantageous aspect to the market economy. Causes of market failure are:

Cause of Market Failure	Explanation	Consequence (Misallocation)
1. Public Goods	Goods that are non - excludable (non - payers cannot be prevented from using the good) and non-rivalrous (one person's consumption does not reduce another's ability to consume it).	Complete Market Failure: The market provides none of the goods due to the "Free-Rider Problem" (individuals benefit without paying), making it unprofitable for private firms.
2. Merit Goods	Goods that are beneficial to society, but consumers under-consume them because they don't fully recognise the private or external benefits (Information Failure).	Under-provision/Under-consumption: Resources are under-allocated to these goods (e.g., education, healthcare). Social Benefit (SB) > Private Benefit (PB).
3. Demerit Goods	Goods that have harmful impacts on consumers and society, often over-consumed because consumers fail to fully recognise the true negative costs (Information Failure and often addictive nature).	Over-provision/Over-consumption: Resources are over-allocated to these goods (e.g., cigarettes, alcohol). Social Cost (SC) > Private Cost (PC).
4. Externalities	The existence of external costs or benefits. Negative Externalities (e.g., pollution) mean the producer/consumer does not pay the full social cost.	Negative Externalities → Over-production/Over-consumption. Positive Externalities → Under-production/Under-consumption.

5. Abuse of Monopoly Power	When a single firm dominates a market, it may restrict output and charge higher prices due to a lack of competition.	Under-provision/High Prices: Goods are under-provided to limit supply and raise profits, reducing consumer choice and welfare.
6. Factor Mobility	Difficulty for factors of production (especially Labour) to move between uses or locations (occupational/geographical immobility).	Inefficient Allocation: Resources are stuck in unproductive uses or locations, leading to under-provision of goods/services in high-demand areas.

PAST-PAST QUESTIONS

Q. Define external costs. [2]

Mark Scheme-

Harmful effects (1) on third parties (1).

Social costs - private costs (1).

Q. There is an area of rubbish, three times the size of France, floating in the Pacific Ocean called the Great Pacific Garbage Patch. It is made up of rubbish including old fishing nets but most is plastic waste. It is forecast that, by 2050, there will be more plastic in the Pacific Ocean than fish. A number of islands in the Pacific Ocean specialise in fishing. Greater pollution will increase the social cost of the fishing industry.

(a) Identify the two types of costs that make up social cost. [2]

(b) Analyse how cleaning up pollution could benefit an economy. [6]

Mark Scheme-

(a)

Private costs (1)

External costs (1)

(b) Coherent analysis which might include:

- Will reduce external costs (1) improve health / less sickness (1) raise quality of life / standard

of living (1).

- Less (government) spending on healthcare (1) more can be spent on other priorities e.g., education (1).
- Cleaning up pollution may create jobs / employment (1) reduce unemployment (1) may attract MNCs (1) increase in incomes (1) reduction in poverty (1).
- Recycling of some of the material collected (1) could increase the country's output (1) less use of non-renewable resources (1).
- Better working conditions (1) productivity of labour could increase (1) reduce costs of production (1) increase output (1) reduce unemployment (1) reduce inflation (1).
- Improve the environment (1) Increase tourism (1) increase exports of services (1) improve the Reduction in ocean pollution (1) will improve fish stock (1) improve quality of fish (1) greater current account position (1).
Catches of fish (1) leading to rise in incomes / revenue / GDP (1).

Mixed Economic System

In a mixed economic system, **both the market and government intervention co-exist**. Examples include almost all countries in the world (India, UK, Brazil etc.). This is because it overrides all the disadvantages of both the market and planned (govt. only) economies. It identifies the importance of the price mechanism in operating an efficient resource allocation and also the role of the government in correcting (any) market failures.

Features:

- both the public and the private sector exists
- planning and final decisions are made by the govt. while the market system can determine allocation of resources owned by it, along with the public organizations.

Advantages:

- The govt. can provide public goods, necessities and merit goods. The private businesses can provide profitable and most-demanded goods (luxury goods, superior goods). Thus, everyone is provided for.
- The govt. will keep externalities, monopolies, harmful goods etc. in control.
- The govt. can provide jobs in the public sector (so there is better job security).
- The govt. can also provide financial help to collapsing private organizations, so jobs are kept secure.

Disadvantages:

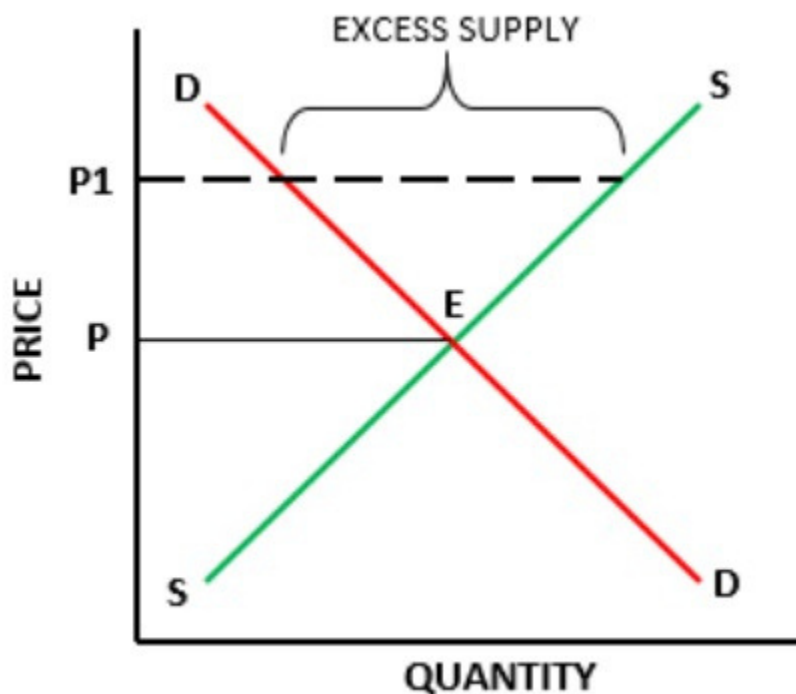
- Taxes will be imposed, which will raise prices and also reduce work incentive.

- Laws and regulations can increase production costs and reduce production in the economy.
- Public sector organizations will still be inefficient and will produce low quality goods and services.

The specific ways in which the government, in a mixed economic system, can **correct market failures** of the market:

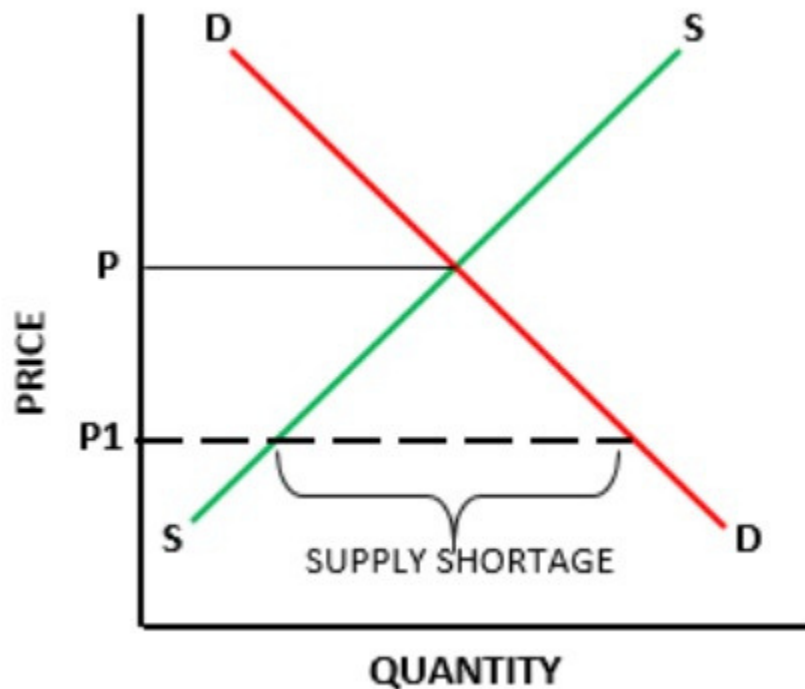
Legislation and regulation – the government can make laws that regulate market activity, for example, prohibit smoking in public (which would cause a negative externality). One important kind of legislation the govt. can undertake price **controls** – setting a minimum price or maximum price on goods.

Minimum price or **price floor** is set to control a decreasing tendency of price. The minimum wage laws in many countries are an example of minimum price. The government sets the minimum wage above the existing market equilibrium wage, to ensure that all workers get a basic minimum wage to sustain them. But even as low-income workers now get better wages, the higher wage will cause the demand for labour to contract, as shown in the diagram to the left. There will also be a higher supply of labour (workers who want work) because of higher wages. A reduced demand and increased supply will cause excess supply of labour i.e., unemployment.

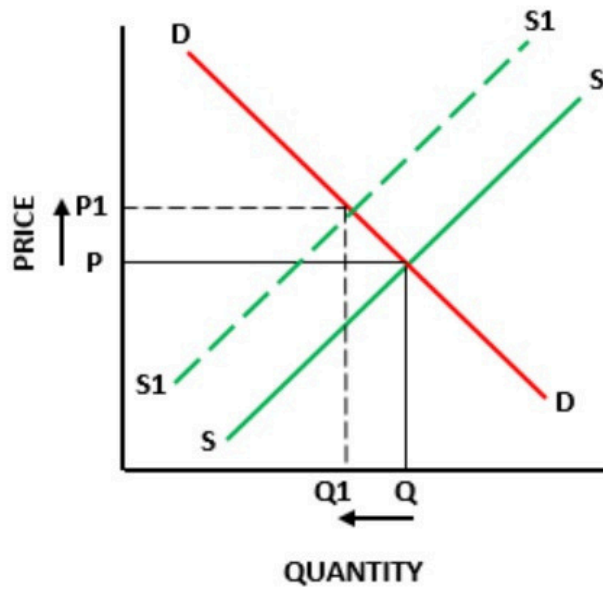


Maximum price or **price ceiling** is set to control an increasing tendency of price. It is usually set on rent (this is called rent control), to ensure that low-income tenants can afford to rent homes. But as a result of the lower rent, landlord will stop renting more homes, causing supply to contract, as shown in the diagram to the left. At the same time, lower rent will increase the

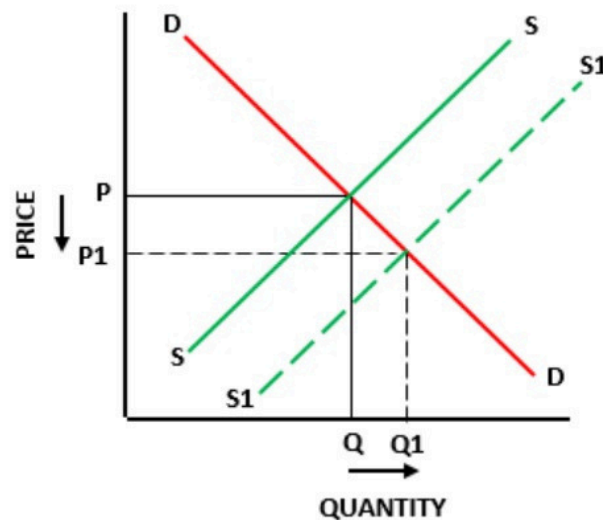
demand for homes. A reduced supply of homes and higher demand for them will cause a shortage of supply in relation to demand.



- **Direct provision of merit and public goods** – since there is little incentive for the price mechanism to supply these goods, governments usually provide them. For example, free education, free healthcare, public parks. One way the govt. can do this is by **nationalising** certain products it considers essential to be provided by a governing authority, rather than the market. For example, in India, the government operates the only railway network because only it can provide cheap services to its millions of poor, daily passengers.
- **Taxation** on products – imposing a tax on products (indirect taxes) with negative externalities can discourage its production and consumption. For example, a tax on tobacco will make it expensive to produce and consume. In the diagram below, a tax has been imposed on a product, causing its supply to shift from S to S_1 . The price rises from P to P_1 because of the additional tax amount, and the quantity traded in the market falls from Q to Q_1 .



Subsidies – a subsidy is a grant (financial aid) on products that have a positive externality. Subsidising, for example, cooking gas for the poor, will increase the living standard of the population. In the diagram below, a subsidy has been imposed on a good, causing its supply to shift from S to $S1$. It results in a fall in price from P to $P1$ and subsequently, an increase in the quantity traded in the market from Q to $Q1$.



- **Tradable permits** – firms will have to buy permits from the government to do something, for example, pollute at a certain level, and these can be traded among firms. Since permits require money, firms will be encouraged to pollute less.
- **Extension of property rights** – one of the main reasons for pollution in public spaces is that it is public – it does not harm a specific private individual – the resource is the government's who cannot charge compensations easily. So the government can extend property rights (right to own property) of public places to private individuals. This will effectively **privatise** resources,

create a market for these spaces and then individuals can be fined for polluting

- **International cooperation** among governments – governments work together on issues that affect the future of the environment.

- **Political incentives:** this occurs when there is a clash between political and economics (because a government is a political entity with political incentives). For example, even though mining companies cause a lot of environmental damage, the government may encourage and promote their activities to garner political and financial support from them.

- **Lack of incentives:** in the free market, individuals have a profit incentive to innovate and cut costs, but in the public sector, such an incentive is absent since the government will pay them salaries regardless of their performance. So, even as the government provides certain public and merit goods directly to the people at low costs, they tend to be very inefficient.

- **Time lags, information failure:** these are some of the government failure arising because of a lack of incentive. Government offices and employees don't have an incentive to provide timely services or give accurate information and this leads to very inefficient systems.

- **Welfare effects of policies:** government policies such as taxation and welfare payments distort the market. This means that such policies will influence demand and supply in the economy and cause markets to move away from the efficient points produced by a market system. For example, high corporate taxes will deter companies from expanding their operations and making more profits or deter new enterprises from entering the market. Unemployment benefits given out by the government may cause people to stay unemployed and receive free benefits instead of working.

PAST-PAPER QUESTIONS

Q.A market system, such as in Spain, has a number of advantages but, despite these benefits, it can also be said to fail in certain circumstances. This is why governments are sometimes required to intervene.

- Discuss whether government intervention is always successful in correcting market failure.
[8]

Mark Scheme

(b) Advantages of government intervention:

- indirect taxes to discourage consumption of demerit goods (don't need to use that term)
- subsidies to encourage consumption of merit goods (don't need to use that term)
- taxation to finance expenditure on public goods (don't need to use that term)
- regulations to control private producers, e.g. on pollution and monopolies having market dominance.

Limitations of government intervention:

- consumption of demerit goods (don't need to use that term) might be discouraged, but unlikely to end completely given inelastic demand, e.g. for cigarettes and alcohol
- consumption of merit goods (don't need to use that term) might be encouraged, but still a limit to extent of increase in consumption
- available finance to provide public goods (don't need to use that term) might be

limited/restricted, especially if a large budget deficit
•regulations may not be adequately policed/ enforced.

3.1 Money and Banking

This section covers the nature of money, its functions, and the roles of central banks, commercial banks, and the stock exchange in an economy.

3.1 Money and banking

Topic

3.1.1 money

3.1.2 banking

Guidance

The forms, functions and characteristics of money.

The role and importance of central banks and commercial banks for government, producers and consumers.

Definitions

- **Money:** Any item or verifiable record that is generally accepted as payment for goods and services and repayment of debts in a particular country or socio-economic context.
- **Barter:** The direct exchange of goods and services for other goods and services without using money.
- **Functions of Money:** The four key roles money plays in an economy: a medium of exchange, a measure of value, a store of value, and a standard for deferred payment.
- **Commercial Bank:** A financial institution that provides services such as accepting deposits, making business loans, and offering basic investment products to the general public and companies.
- **Central Bank:** The institution responsible for managing a nation's currency, money supply, and interest rates. It oversees the commercial banking system.

- **Stock Exchange:** A marketplace where securities (like company stocks and shares) are bought and sold.

Notes

The Evolution and Functions of Money

Before money, economies relied on **barter**. This system was inefficient because it required a **double coincidence of wants** – you had to find someone who had what you wanted and also wanted what you had.

Money was developed to solve this problem. To be effective, money must have these characteristics:

- **Acceptability:** Everyone must be willing to accept it as payment.
- **Durability:** It must be able to withstand being used repeatedly.
- **Portability:** It must be easy to carry around.

- **Divisibility:** It must be easily divided into smaller denominations.
- **Scarcity:** Its supply must be limited to ensure it holds its value.
- **Uniformity:** All units of the same denomination must be identical.

The four **functions of money** are crucial:

1. **Medium of Exchange:** Facilitates the buying and selling of goods and services.
2. **Measure of Value (Unit of Account):** Provides a common measure of the value of goods and services, allowing for comparison.
3. **Store of Value:** It can be held over time and used for future purchases. Its value should remain relatively stable.
4. **Standard for Deferred Payment:** Allows for contracts for future payments (i.e., loans and debts) to be made.

The Role of Banks

1. Commercial Banks: These are high-street banks that individuals and firms use daily. Their main functions are:

- **Accepting Deposits:** Providing safe accounts (current, savings) for people and firms to store their money.
- **Making Loans:** Lending money to individuals (e.g., mortgages, personal loans) and firms (e.g., business loans) to finance expenditure and investment. This is their main source of profit, earned through **interest rate** differentials.
- **Providing Financial Services:** Offering services like credit/debit

cards, foreign currency exchange, and financial advice.

2. Central Banks: The central bank is the apex financial institution in a country. Its key functions include:

- **Sole Issuer of Banknotes and Coins:** It is the only body with the legal authority to print and mint the national currency.
- **Banker to the Government:** It manages the government's finances, processes payments, and issues public debt (government bonds).
- **Banker to Commercial Banks:** Commercial banks hold accounts at the central bank, which they use to settle debts with each other.
- **Lender of Last Resort:** If a commercial bank faces a liquidity crisis, the central bank can provide an emergency loan to prevent it from collapsing and protect the financial system.
- **Managing the National Debt:** It handles the issuance and repayment of government debt.
- **Implementing Monetary Policy:** It uses tools like interest rates and quantitative easing to manage the money supply, control inflation, and influence economic activity.

The Stock Exchange

The stock exchange is a vital component of the financial system. Its main roles are:

- **Raising Capital for Firms:** It allows public limited companies (PLCs) to raise finance by issuing new shares (**primary market**).
- **Facilitating Market for Second-hand Shares:** It allows

existing shares to be bought and sold between investors (**secondary market**), providing liquidity for shareholders.

- **Indicating Economic Performance:** The general trend of

share prices (e.g., on indices like the FTSE 100 or Dow Jones) is often seen as an indicator of business confidence and the health of the economy.

Unsolved Past Paper Questions

1. Multiple Choice (Paper 1)

What is the most important function of a central bank?

- A. controlling the money supply
- B. issuing bank notes and coins
- C. lending to commercial banks
- D. lending to the public

2. Structured Question (Paper 2)

- (a) Define 'barter'. [2]
- (b) Explain two characteristics an item needs to have to be successful as money. [4]
- (c) Analyse how commercial banks can make a profit. [6]
- (d) Discuss whether or not the services provided by a central bank are more important than those provided by commercial banks. [8]

Solved Answers (Note Form)

1. Multiple Choice

- **Answer:** A. controlling the money supply
- **Note:** While B and C are functions, controlling the money supply is the central bank's most crucial macroeconomic role as it is key to managing inflation and overall economic stability. D is incorrect as central banks do not lend to the general public.

2. Structured Question

- (a) **Definition of Barter**
 - **Note:**
 - The direct exchange of goods/services for other goods/services. [1]
 - Without the use of money. [1]
 - Requires a double coincidence of wants.
- (b) **CharacteristicsofMoney**
 - **Note:** (Choose any two)
 - **Acceptability:** Must be widely accepted by people as payment for goods and services. Without this, it cannot function as a medium of exchange.
 - **Durability:** Must be strong enough to be used many times without deteriorating. Coins and polymer notes are very durable.
 - **Portability:** Must be easy to carry around. Modern money (notes, coins, digital) is very portable compared to bartering with, for example, livestock.
 - **Divisibility:** Can be broken down into smaller units of value to pay for items of different prices.
- (c) **Analysis ofCommercialBankProfits**
 - **Note:**
 - **Primary Source:** Profit is mainly from the **interest rate spread**.
 - **Process:** They take deposits from savers and pay them a certain rate of interest.
 - They then lend this money out to borrowers (e.g., mortgages, business loans) at a **higher** rate of interest.
 - The difference (spread) between the lending rate and the saving rate is their gross profit.
 - **Other Sources:** They also earn revenue from **fees and commissions** on services like international money transfers, financial advice, and account administration.
- (d) **DiscussionoftheImportanceofCentralvs.CommercialBanks**
 - **Note:** (A good answer requires looking at both sides before concluding).
 - **Argumentsthat a Central Bank is more important:**
 - **Macroeconomic Stability:** Manages the entire country's monetary policy, controlling inflation and influencing unemployment/growth. This impacts everyone.
 - **Systemic Stability:** Acts as the 'lender of last resort', preventing the collapse of commercial banks which could trigger a financial crisis.
 - **Government Banker:** Manages the government's finances and the national debt, which is crucial for the running of the country.
 - **Issues Currency:** It is the sole issuer of legal tender, which is the foundation of the entire monetary system.
 - **Arguments that Commercial Banks are more important:**
 - **Direct Public Interaction:** They are the main point of contact for individuals and firms for day-to-day financial transactions (deposits, payments, credit).

- **Engine of Credit:** They provide the loans (credit) that enable investment by firms and large purchases by households (e.g., houses). This is vital for economic growth.
- **Financial Intermediation:** They channel funds from savers to borrowers, a critical function for a modern economy. Without them, investment would be very difficult.
- **Conclusion/Evaluation:** While commercial banks are vital for the daily functioning of the economy and for individuals, the central bank is arguably more important. Its role in maintaining the stability of the entire financial system and managing the macroeconomy provides the secure foundation upon which commercial banks can operate. A central bank failure would have catastrophic consequences for the entire economy.

3.2 Households

This section examines the factors that influence household decisions on spending, saving, and borrowing, and how these patterns differ across income levels.

3.2 Households

Topic

3.2.1 the influences on spending, saving and borrowing

Guidance

Including income, the rate of interest and confidence – between different households and over time.

Definitions

- **Disposable Income:** The income that is available to a household for spending and saving after direct taxes (like income tax) have been deducted. **Real Income:** Income adjusted for inflation. It measures the amount of goods and services that can be bought with a given income. **Spending (or**
- **Consumption):** The total expenditure by households on goods and services.

- **Saving:** The portion of disposable income that is not spent.
- **Borrowing:** Taking out money from a financial institution with the intention of paying it back over a period of time with interest.
- **Wealth:** The total value of all assets owned by a household (e.g., property, shares, savings) minus their liabilities (e.g., debts, mortgages).

Notes

Influences on Household Spending, Saving, and Borrowing

A household's decision to spend, save, or borrow is influenced by several factors:

1. Disposable Income:

- This is the single most important factor.
- As disposable income rises, households generally **spend** more.
- However, the **proportion** of income spent tends to fall as income rises (**Average Propensity to Consume** falls).
- Higher-income households are able to **save** a larger proportion of their income.

2. Interest Rates:

- **Saving:** Higher interest rates **increase the reward for saving**, encouraging households to save more and spend less. Lower rates have the opposite effect.
- **Borrowing:** Higher interest rates **increase the cost of borrowing**, discouraging households and firms from taking out loans for major purchases (e.g., cars, houses). Lower rates make borrowing cheaper and encourage spending.

3. Confidence in the Future:

- If households are confident about future job security and economic growth, they are more likely to spend and borrow.
- If they are pessimistic (e.g., fear of unemployment, recession), they are more

likely to increase their **precautionary savings** and reduce spending.

4. Age:

- Spending and saving patterns typically follow a life-cycle. **Young Adults:**
- Tend to be net borrowers (e.g., student loans, mortgages) and save little.
- **Middle-Aged:** Incomes are typically at their peak. They save more for retirement and spend it on their families. **Elderly/Retired:** They "dis-save," meaning they spend their accumulated savings and pensions to fund their retirement.

5. Wealth:

- A household with more wealth may feel more financially secure and therefore spend a higher proportion of its current income (the **wealth effect**).

Differences in Expenditure Patterns

Spending patterns vary significantly, particularly between high-income and low-income households.

• Low-Income Households:

- Spend a **higher proportion** of their income.
- A large percentage of their expenditure is on **necessities** like food, housing, and fuel. This is explained by **Engel's Law**, which states that as income

- | | |
|--|---|
| <p>risers, the proportion of income spent on food falls.</p> <ul style="list-style-type: none"> ○ Have a low capacity to save. ● High-Income Households: <ul style="list-style-type: none"> ○ Spend a lower proportion of their income (they save more). ○ While they spend more in absolute terms on | <p>necessities, it represents a smaller percentage of their total income.</p> <ul style="list-style-type: none"> ○ Spend a much higher proportion of their income on luxury goods and services (e.g., holidays, entertainment, high-end cars). |
|--|---|

Unsolved Past Paper Questions

1. Multiple Choice (Paper 1)

What is most likely to cause a person to save a larger proportion of their income?

- A. a rise in the rate of inflation
- B. a rise in the rate of interest
- C. a rise in their income
- D. a rise in the range of products available

2. Structured Question (Paper 2)

- (a) Define 'disposable income'. [2]
- (b) Explain two reasons why a person's spending may increase. [4]
- (c) Analyse why people with high incomes are likely to save a higher proportion of their income than people with low incomes. [6]
- (d) Discuss whether or not an increase in taxation on spending is likely to be the most effective way to increase saving. [8]

Solved Answers

1. Multiple Choice

- **Answer: B. a rise in the rate of interest**

- **Note:** A higher interest rate increases the reward for saving and increases the opportunity cost of spending, providing a direct incentive to save more. A rise in income (C) will increase the amount saved, but not necessarily the *proportion*.

2. Structured Question

- **(a) Definition of Disposable Income**

- **Note:**

- The income a person or household has left to spend or save. [1]
 - After direct taxes (e.g., income tax) have been deducted. [1]

- **(b) Reasons for Increased Spending**

- **Note:** (Choose any two)

- **Increase in Disposable Income:** If income rises, households have more money available to spend on goods and services, leading to higher consumption.
 - **Fall in Interest Rates:** The cost of borrowing becomes cheaper, encouraging spending on expensive items (e.g., cars) using credit. The reward for saving also falls, making spending relatively more attractive.
 - **Increased Confidence:** If people are optimistic about their future job security and the economy, they are more willing to spend and less likely to save for precautionary reasons.

- **(c) Analysis of Saving Proportions by Income**

- **Note:**

- **Low-income earners:** Must spend a very high proportion of their income on **necessities** (food, housing, energy). There is little money left over after these essential costs are covered. Their **marginal propensity to consume** is very high.
 - **High-income earners:** Can afford all necessities easily. These necessities make up a small proportion of their total income. They have a large amount of discretionary income left over.
 - This means they have a much greater **ability/capacity to save**. They can save for luxuries, retirement, or investment without sacrificing their standard of living. Their **marginal propensity to save** is high.

- **(d) Discussion of Increased Spending Taxes to Increase Saving**

- **Note:** (A good answer requires looking at both sides). An increase in taxation on spending refers to higher indirect taxes like VAT or sales tax.

- **Arguments that it is an effective way to increase saving:**

- **Makes Spending More Expensive:** Higher taxes on goods and services directly increase prices, which should discourage consumption.
 - **Saving becomes relatively more attractive:** If spending is less appealing, saving becomes the default alternative for disposable income.
 - **Can Target Luxury Goods:** Taxes can be placed on luxury goods, which are more likely to be bought by high-income earners, encouraging them to save instead.

- **Arguments that it is NOT an effective way / Other methods are better:**

- **Regressive Nature:** Indirect taxes are regressive; they take a larger proportion of income from low-income earners who have little choice but to buy necessities. They have no ability to save more, it just reduces their living standards.
- **Inflationary:** Raising indirect taxes can lead to cost-push inflation.
- **Alternative Policies are better: Increasing interest rates** is a more direct and arguably more effective policy. It directly increases the reward for saving for everyone, without the regressive side-effects.
- **Government Savings Schemes:** Policies like tax-free savings accounts directly incentivise saving.
- **Conclusion/Evaluation:** While increasing taxes on spending might discourage some discretionary consumption, it is likely not the *most effective* way. It is a blunt instrument that harms low-income earners disproportionately. A policy of increasing interest rates is more direct and targeted at the act of saving itself and is likely to be more effective across different income groups.

3.3 Workers

This section covers the labour market, including the demand for and supply of labour, wage determination, and reasons for wage differentials.

3.3 Workers	
Topic	Guidance
3.3.1 factors affecting an individual's choice of occupation	Wage and non-wage factors.
3.3.2 wage determination	The influences of demand and supply, relative bargaining power and government policy, including minimum wage.
3.3.3 reasons for differences in earnings	How changes in demand and supply, relative bargaining strengths, discrimination and government policy can all influence differences in earnings between workers whether they are: skilled/unskilled; primary/secondary/tertiary; male/female; private sector/public sector. Definition, drawing and interpretation of diagrams that illustrate the effects of changes in demand and supply in the labour market.
3.3.4 division of labour/specialisation	Advantages and disadvantages for workers, firms and the economy.

Definitions

Labour: Human effort, both physical and mental, used in the production of goods and services.

Demand for Labour: The number of workers that firms are willing and able to hire at a given wage rate. It is a **derived demand**, meaning it depends on the demand for the final good or service the labour produces.

Supply of Labour: The number of workers willing and able to work at a given wage rate.

Wage Rate: The price of labour, typically expressed as pay per hour, day, or year.

Wage Factor: The financial compensation from work, such as basic pay, overtime pay, bonuses, and commission.

Non-Wage Factor: The non-financial rewards from work, such as job satisfaction, job security, working conditions, holidays, training opportunities, and fringe benefits (e.g., company car).

Net Advantages: The sum of all wage and non-wage factors for a job. Workers will choose the job with the highest net advantages.

Geographical Mobility: The ease with which workers can move between different areas or countries to find work.

Occupational Mobility: The ease with which workers can change between different occupations or jobs, usually determined by skills and training.

Specialisation is when an individual, firm, or country concentrates on producing a limited range of goods or services they are best at.

The **Division of Labour** is a form of specialisation where the production process of a good is broken down into a sequence of separate, specific tasks, and each worker is assigned one of these tasks

Demand and Supply of Labour

Demand for Labour (DL)

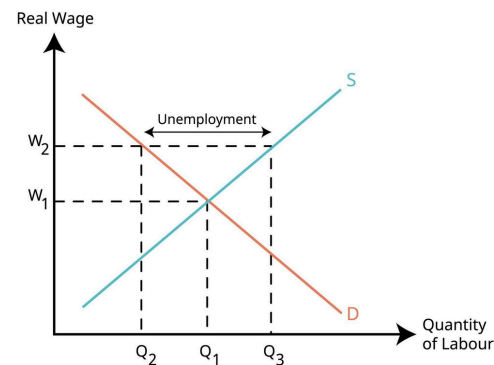
- **Relationship with Wage:** Inversely related. As the wage rate falls, the quantity of labour demanded rises because it is cheaper to hire more workers.
- **Shifts in the Demand Curve:**
 - **Increase in Demand for the Final Product:** If consumers buy more of the product, firms need more labour to produce it. DL increases (shifts right).
 - **Increase in Labour Productivity:** If workers become more efficient (produce more output per hour), firms may demand more of that productive labour. DL increases (shifts right).
 - **Change in Price of Capital:** If machinery (capital) becomes more expensive, firms may substitute it with relatively cheaper labour. DL increases (shifts right).

Supply of Labour (SL)

- **Relationship with Wage:** Directly related. As the wage rate rises, the quantity of labour supplied rises because more people are encouraged to enter the market or choose that specific occupation.
- **Shifts in the Supply Curve:**
 - **Improvements in Non-Wage Factors:** If working conditions, job security, or holidays improve, the job becomes more attractive. SL increases (shifts right).
 - **Increase in Size of Working Population:** Due to natural population growth or net immigration. SL increases (shifts right).
 - **Reduction in Training/Qualifications Required:** If an occupation requires less time or cost for training, the pool of suitable workers increases. SL increases (shifts right).

Wage Determination

- The **equilibrium wage rate** and level of employment are determined where the **demand for labour (DL)** equals the **supply of labour (SL)** in a free market.



Reasons for Wage Differentials

Differences in wages exist between different occupations and individuals.

- **Skills, Training, and Qualifications:** Jobs requiring high skills, long training, or scarce qualifications have a **lower supply of labour** (SL shifts left), leading to higher wages.
- **Non-Wage Factors:** Jobs with unattractive non-wage factors (e.g., dangerous, dirty, irregular hours, low job security) must offer **higher wages** to compensate workers (compensating differentials).
- **Labour Mobility:** Occupations or regions with **low occupational or geographical mobility** restrict the supply of labour, leading to higher wages compared to occupations where labour is highly mobile.
- **Productivity:** Workers who are more productive (generate more revenue for the firm) can command **higher wages**.
- **Trade Union Strength:** Workers belonging to a strong trade union can use collective bargaining to

negotiate a wage above the market equilibrium.

- **Public vs. Private Sector:** Wages can differ due to different funding, objectives, and employment policies. The public sector may offer better non-wage factors (e.g., pensions, security) in exchange for potentially lower wages.
- **Discrimination:** Unfair treatment based on characteristics like gender, race, or age can restrict opportunities or lower the wage paid to a discriminated group, despite equal productivity.

Advantages of Specialisation/Division of Labour

- **Increased Productivity:** Workers become highly skilled and proficient at their specific task due to **repetition** ("practice makes perfect"), increasing output per worker.
- **Time Saving:** Less time is wasted by workers switching between different tasks and tools.
- **Reduced Training Time:** Workers only need to be trained for one specific, simple task, reducing the cost and time of training.

- **Facilitates Machinery Use:** It allows for the use of specialised, capital-intensive machinery for each specific task, further increasing efficiency.
- **Leads to Economic Growth:** Higher productivity across firms leads to a greater total output of goods and services for the economy.

Disadvantages of Specialisation/Division of Labour

- **Monotony and Boredom:** Repetitive tasks can become boring and unsatisfying (alienation), potentially leading to low motivation, absenteeism, and poor quality work.
- **Lack of Mobility:** Workers acquire a very **narrow skill set**, which reduces their **occupational mobility** and makes them vulnerable to structural unemployment if the demand for their specific task declines.
- **Interdependence:** The production process becomes highly dependent on every stage. If one specialised worker or stage fails (e.g., due to illness or breakdown), the **entire production line can halt**.

Due to Unit 3.4 (Trade Unions) being closely linked to topic 3.3 (Workers), the solved questions sections have been merged together under the notes of Unit 3.4

3.4 Trade Unions

This section covers the role, functions, and impact of trade unions.

3.4 Trade unions

Topic	Guidance
3.4.1 definition of a trade union	Including engaging in collective bargaining on wages, working hours and working conditions; protecting employment; and influencing government policy. Factors influencing the strength of trade unions. From the viewpoint of workers, firms and the government.
3.4.2 the role of trade unions in the economy	
3.4.3 the advantages and disadvantages of trade union activity	

Definitions

Trade Union (Labour Union): An organised association of workers in a trade or profession formed to **protect and further their rights and interests**, especially concerning pay and working conditions.

Collective Bargaining: The process of **negotiation** over wages and working conditions between **trade union representatives** and the **employer** (or employers' association).

Industrial Action: Various disruptive measures taken by a trade union to put pressure on an employer during a dispute.

Strike: A form of industrial action where workers **refuse to work** and often picket the workplace, halting production.

Go-Slow (Work-to-Rule): Industrial action where workers deliberately **work at a slower pace** (go-slow) or adhere strictly to every rule, thus reducing productivity.

Roles and Functions of Trade Unions

The primary goal is to promote and protect the interests of their members.

- **Negotiate Pay and Benefits:** Use collective bargaining to secure a **higher wage rate** and better non-wage benefits (e.g., better pensions, longer holidays).
- **Improve Working Conditions:** Campaign for better health and safety, more reasonable working hours, and fair treatment.
- **Legal Protection and Representation:** Defend employees against unfair dismissal, discrimination, and exploitation in the workplace.
- **Training and Education:** Push for or provide training schemes to improve members' skills and job prospects.
- **Provide Benefits:** Offer support to members such as legal aid, or strike pay during industrial action.

Factors Influencing Trade Union Strength

The bargaining power of a trade union determines its ability to achieve its goals.

- **Economic Activity/Unemployment:** The union is stronger when **unemployment is low** (the firm finds it hard to replace striking workers) and demand for the firm's product is high.
- **Membership Density:** A **high percentage of workers** in the industry or firm are union members. This makes a strike more effective.
- **Skill Level of Members:** Unions representing **highly skilled** or specialist workers are stronger, as these workers are difficult and costly to replace.
- **Proportion of Labour Cost:** If the cost of labour is a **small proportion** of the firm's total costs, the firm is more likely to grant a wage rise than risk a strike.
- **Essential Industry:** Unions in industries that provide **essential services** (e.g., energy, transport) have great power because a strike causes maximum disruption to the economy.

Impact of Trade Union Activity

Impact on Workers (Pros and Cons)

- **Pros:** Higher wages and improved non-wage benefits. Greater job security and protection against exploitation. Improved skills through union-backed training.
- **Cons:** Membership fees must be paid. Workers may lose pay if forced

to go on strike. Higher labour costs could cause the firm to reduce employment or even close down.

Impact on Firms (Pros and Cons)

- **Pros:** Collective bargaining can **save time** by negotiating with one body rather than many individuals. A good relationship with the union can lead to improved cooperation and productivity.
- **Cons:** **Higher wage costs** reduce profit margins. **Loss of output and revenue** during industrial action. Decisions may be delayed due to lengthy negotiation processes.

Impact on the Economy (Pros and Cons)

- **Pros:** Can help to achieve **greater equity** and income equality. May boost **consumption** through higher wages, which stimulates economic growth. May improve national **labour productivity** through better training.
- **Cons:** Higher wages can cause **cost-push inflation** if the cost increase is passed on to consumers. Industrial action can lead to a significant **loss of national output** (GDP). Higher production costs can make a country's **exports less competitive** internationally.

Unsolved Past Paper Questions

Question 1 (4 Marks)

Explain **two** reasons why the demand for labour in an industry might increase.

Question 2 (6 Marks)

Analyse the role of non-wage factors in influencing a worker's choice of occupation.

Question 3 (8 Marks)

Discuss the impact of a strong trade union on a country's economy, considering the viewpoints of workers, firms, and the government.

Solved Answers (Note Form)

Q1: Reasons for Increased Labour Demand (4 Marks)

- **Reason 1: Increased Demand for Product**
 - **K:** Demand for labour is derived from the demand for the final good or service.
 - **A:** If consumer demand for the firm's product increases, the firm needs to produce more.
 - **A:** This requires the firm to hire more workers, shifting the demand for labour curve to the right.
- **Reason 2: Increase in Labour Productivity**
 - **K:** Labour productivity is output per worker hour.
 - **A:** If productivity rises (e.g., due to new technology or training), labour becomes more effective at generating revenue.
 - **A:** Firms will be encouraged to hire more of this more productive labour, shifting the demand for labour curve to the right.

Q2: Role of Non-Wage Factors in Choice of Occupation (6 Marks)

- **K:** Non-wage factors are the non-financial benefits of a job, such as job satisfaction, job security, and working environment.
- **A:** Workers aim to maximise the **net advantages** of an occupation, which is the total of wage and non-wage factors.
- **An:** Jobs with **high non-wage factors** (e.g., high satisfaction, flexible hours) can afford to pay a **lower wage** and still attract sufficient workers, as the overall net advantage is high.
- **An:** Conversely, jobs with **poor non-wage factors** (e.g., dangerous, low security) must offer a **higher wage** (a compensating differential) to attract labour and offset the poor conditions, thereby influencing worker choice.

- **E:** The importance of non-wage factors varies between individuals; a young worker might prioritise training (non-wage), while a worker with a family might prioritise high pay (wage).

Q3: Impact of a Strong Trade Union on the Economy (8 Marks)

- **Point 1: Workers and Equity**
 - **K:** A strong union uses collective bargaining power to push the wage rate above the market equilibrium.
 - **An:** This is beneficial for workers, as it increases their real incomes, helping to reduce income inequality and potentially boosting consumption and aggregate demand in the economy.
- **Point 2: Firms and Costs**
 - **K:** The higher wages and improved benefits forced by a strong union increase a firm's costs of production.
 - **An:** This is a disadvantage for firms, as it reduces their profitability and may force them to raise prices (contributing to cost-push inflation) or reduce investment.
- **Point 3: Government and National Output**
 - **K:** If the union uses industrial action like a strike, it halts production in that industry.
 - **An:** This reduces the nation's output (GDP) and can damage the economy's international competitiveness if the higher costs make exports more expensive.
- **Evaluation:**
 - The overall impact **depends on the increase in productivity**. If the union's actions encourage better training and the wage rise is matched by an increase in worker productivity, the economic effect is largely positive (lower average costs and higher output).
 - If the wage rise is *not* matched by productivity, the negative effects of inflation and unemployment will dominate, making the impact detrimental to the economy.

3.5 Firms

This section covers the objectives of firms, different forms of business organisation, and firm growth.

3.5 Firms

Topic

3.5.1 classification of firms

3.5.2 small firms

3.5.3 causes and forms of the growth of firms

3.5.4 mergers

3.5.5 economies and diseconomies of scale

Guidance

In terms of primary/secondary/tertiary sectors and private/public sector, and the relative size of firms.

Note: detailed knowledge of different types of structure of a firm is not required.

The advantages and disadvantages of small firms, the challenges facing small firms and reasons for their existence.

Internal growth, for example increased market share. External growth, for example mergers.

Examples, advantages and disadvantages of different types of mergers: horizontal, vertical, and conglomerate.

How internal and external economies and diseconomies of scale can affect a firm/industry as the scale of production changes.

Definitions

Firm(Producer): An organisation that employs factors of production to produce goods and services.

Profit: Total Revenue minus Total Costs (TR - TC). The reward to the entrepreneur for taking risks.

Revenue (Total Revenue): The income a firm receives from selling its goods and services (Price * times Quantity).

Cost (Total Cost): All the expenses incurred by a firm in producing its goods and services.

Sole Trader (Sole Proprietor): A business owned and controlled by one person, who takes all the profit but bears **unlimited liability**.

Partnership: A business owned and controlled by two or more people, who share the profits but also bear **unlimited liability**.

Private Limited Company (Ltd): A business owned by shareholders whose shares are not traded publicly. Owners have **limited liability**.

Public Limited Company (Plc): A large business where shares are bought and sold publicly on a stock exchange. Owners have **limited liability**.

Unlimited Liability: The legal status where the personal assets of the business owner(s) can be taken to pay off the firm's debts.

Limited Liability: The legal status where the personal assets of the shareholders are protected from the firm's debts; the most they can lose is the value of their shares.

Notes: Objectives of Firms

- **Profit Maximisation:** The traditional and primary objective. Firms aim to produce at the level of output where

the difference between Total Revenue and Total Cost (TR-TC) is greatest.

- **Survival:** Often the objective of new or struggling firms. Focus is on covering costs to stay in business.
 - **Growth:** Increasing the size of the firm, usually measured by revenue, market share, or number of employees. Growth can lead to **economies of scale** and greater market power.
 - **Increase Market Share:** Aiming to increase the firm's proportion of the total sales in an industry. This can give the firm greater influence over pricing.
 - **Social/Environmental Objectives:** Firms may pursue non-financial goals such as reducing pollution or supporting the local community (Corporate Social Responsibility).
-

Notes: Forms of Business Organisation

Sole Trader and Partnership

- **Advantages:** Simple to set up; owner keeps all the profit (sole trader); quick decision-making; direct contact with customers.
- **Disadvantages: Unlimited liability** (a major risk); difficulty raising capital; owner bears full responsibility; business ends if the owner dies or retires.

Private Limited Company (Ltd)

- **Advantages: Limited liability** attracts investment; easier to raise capital than a sole trader/partnership; greater continuity.

- **Disadvantages:** More complex legal formalities to set up; cannot raise capital from the public; accounts must be published (less privacy).

Public Limited Company (Plc)

- **Advantages: Limited liability** ; ability to raise very large amounts of capital by selling shares to the public; easier to obtain loans.
 - **Disadvantages:** Very complex legal formalities; high cost of setting up; accounts are fully public (competitor risk); pressure from public shareholders for short-term profit.
-

Notes: Firm Growth (Integration and Economies of Scale)

Types of Firm Growth

- **Internal (Organic) Growth:** A firm expands by reinvesting profits, increasing output, and expanding its own operations (e.g., building a new factory).
- **External Growth (Integration/Merger):** Two or more separate firms join together.
 - **Horizontal Integration:** Firms at the **same stage of production** and in the **same industry** merge (e.g., two car manufacturers).
 - **Vertical Integration:** Firms at **different stages of production** in the **same industry** merge.
 - **Backward Vertical:** A firm merges with its **supplier** (e.g., a car manufacturer buys a tyre company).

- **Forward Vertical:** A firm merges with its **distributor/retailer** (e.g., a car manufacturer buys a car showroom chain).
- **Conglomerate Integration:** Firms in **unrelated industries** merge (e.g., a car manufacturer buys a food processing company).

Reasons for Firm Growth

- **Achieve Economies of Scale:** To reduce long-run average costs (see 3.6).
- **Increased Market Share/Power:** To gain greater control over the market, which can enable higher prices or deter new competitors.
- **Increase Profits:** Growth often leads to higher sales and lower costs, resulting in greater profits.
- **Diversification (Conglomerate):** Spreading risk across different markets so if one sector performs poorly, the others might still do well.

3.6 Firms and Production

This section covers the concepts of production, productivity, and economies and diseconomies of scale.

3.6 Firms and production

Topic	Guidance
3.6.1 demand for factors of production	Influences to include demand for the product, the price of different factors of production, their availability and their productivity.
3.6.2 labour-intensive and capital-intensive production	The reasons for adopting the different forms of production and their advantages and disadvantages.
3.6.3 production and productivity	The difference between, and influences on, production and productivity.

Definitions

Production: The process of combining the four factors of production (Land, Labour, Capital, Enterprise) to create output (goods and services).

Productivity: A measure of the efficiency of production, typically measured as **output per unit of input** (e.g., output per worker hour).

Capital-Intensive: Production methods that rely heavily on **capital** (machinery and

equipment) relative to labour (e.g., robotic car assembly).

Labour-Intensive: Production methods that rely heavily on **labour** (workers) relative to capital (e.g., hair dressing, tailor-made clothing).

Economies of Scale (EoS): The **fall in long-run average costs** of production as the scale of output increases.

Diseconomies of Scale (DoS): The **rise in long-run average costs** of production as the scale of output increases.

Notes: Production and Productivity

Factors Affecting Productivity

- **Quality of Labour:** The skills, education, and training of the workforce. Higher quality labour is generally more productive.
- **Quality of Capital:** The age and technological sophistication of the machinery and equipment used. Modern capital is typically more efficient.
- **Management Efficiency:** How well the firm's resources are organised and managed, including motivation and communication methods.
- **Division of Labour/Specialisation:** Breaking down tasks into specific roles allows workers to become highly skilled and faster (see 3.3.4 notes).

Importance of High Productivity

- **For the Firm:** Lower average costs, which increases profits and makes the firm more competitive.
 - **For Workers:** Higher productivity can lead to higher wages, as the worker is generating more revenue for the firm.
 - **For the Economy:** Increased national output (GDP) and higher international competitiveness due to lower prices.
-

Notes: Economies and Diseconomies of Scale

Internal Economies of Scale (Advantages from within the firm)

- **Financial EoS:** Large firms can often borrow money more cheaply (lower interest rates) and raise large sums by selling shares.
- **Marketing EoS:** Large firms can spread the cost of advertising and marketing over a much larger volume of output (e.g., a national advertising campaign is cheaper per unit for a large company).
- **Technical EoS:** Large-scale production allows firms to use highly specialised, large-capacity machinery (e.g., a massive oil tanker) and use the **Division of Labour** effectively.
- **Managerial EoS:** Large firms can afford to employ specialist managers (e.g., HR, Finance) who are highly skilled in their area, improving efficiency.
- **Risk-bearing EoS:** Large firms can spread their risks by diversifying their production across different

markets (conglomerates) or countries.

Internal Diseconomies of Scale (Disadvantages from within the firm)

- **Poor Communication:** As the firm grows, the chain of command becomes longer, slowing down communication between different departments or layers of management.
- **Lack of Control:** Managers find it harder to monitor the performance

and efficiency of every employee or department in a very large organisation, leading to potential slack.

- **Poor Industrial Relations (Demotivation):** Workers can feel like small parts of a huge machine, leading to low morale, demotivation, reduced productivity, and potential conflicts or strikes.

Unsolved Past Paper Questions

Question 1 (4 Marks)

Explain **two** reasons why a sole trader might decide to change their business into a Private Limited Company (Ltd).

Question 2 (6 Marks)

Analyse the benefits of a firm achieving internal **economies of scale**.

Question 3 (8 Marks)

Discuss whether **profit maximisation** is always the most important objective for all firms.

Solved Answers (Note Form)

Q1:ReasonstoChangetoaLtd(4Marks)

- **Reason 1: To Gain Limited Liability**
 - **K:** Sole traders have unlimited liability, meaning personal wealth is at risk from business debts.
 - **A:** Changing to a Ltd gives the owner and investors **limited liability**, protecting their personal assets.
 - **A:** This reduces the financial risk to the owner and makes the business more secure.
- **Reason 2: To Raise Capital More Easily**
 - **K:** A sole trader relies only on personal savings and bank loans.
 - **A:** A Ltd can raise capital by **sellingshares** privately to friends or family.

- **A:** This influx of new capital can be used to fund investment, growth, or expansion.

Q2: Benefits of Internal Economies of Scale (6 Marks)

- **K:** Internal Economies of Scale (EoS) are the fall in a firm's average costs as its scale of output increases.
- **A:** Technical EoS allow the firm to use large, specialist machinery or production lines, which lowers the cost per unit.
- **An:** This reduction in average costs directly leads to an increase in the firm's **profit margin** if the price remains constant.
- **An:** The firm can use the lower costs to either reinvest for future growth or **reduce the selling price** of its product.
- **E:** By lowering prices, the firm becomes **more competitive** against rivals, allowing it to increase its market share both domestically and internationally.

Q3: Discussion of Profit Maximisation as the Objective (8 Marks)

- **P1: Arguments for Profit Maximisation**
 - **K:** Profit is the primary reward for entrepreneurship and risk-taking.
 - **An:** Without sufficient profit, a firm cannot survive in the long run, nor can it attract necessary investment (capital) for expansion and innovation. Profit is therefore essential for sustainability.
- **P2: Arguments against Profit Maximisation (Alternative Objectives)**
 - **K:** For **newfirms** and those in competitive markets, **survival** may be the primary short-term goal.
 - **An: Growth** (increasing market share) may be the focus, even if it requires temporarily accepting lower profits (e.g., lowering prices to gain customers) to achieve long-run economies of scale.
 - **An:** Owners of large public companies (Plc) may focus on non-financial objectives such as **social responsibility** or maintaining a good public image, especially if they are not the day-to-day managers.
- **EVALUATION**
 - While other objectives exist, **profit maximisation remains the dominant long-run goal** for most commercial firms, as it underpins all others. A firm must be profitable to survive, grow, and pursue social goals. Alternative objectives are often pursued only as a means to achieve greater profit in the future.

3.7 Firms' costs, revenue and objectives

3.7 Firms' costs, revenue and objectives

Topic

3.7.1 definition of costs of production

3.7.2 calculation of costs of production

3.7.3 definition of revenue

3.7.4 calculation of revenue

3.7.5 objectives of firms

Guidance

Total cost (TC), average total cost (ATC), fixed cost (FC), variable cost (VC), average fixed cost (AFC), average variable cost (AVC).

Note: marginal cost is not required.

Calculation of TC, ATC, FC, VC, AFC and AVC.

Definition, drawing and interpretation of diagrams that show how changes in output affect costs of production.

Total revenue (TR) and average revenue (AR).

Note: marginal revenue is not required.

Calculation of TR and AR.

The influence of sales on revenue.

Survival, social welfare, profit maximisation and growth.

3.7.1 Definition of Costs of Production

Total Cost (TC): The entire expenditure incurred by a firm in producing a given level of output.

Fixed Cost (FC): Costs that **do not change with the level of output** in the short run. They must be paid even if output is zero.

Examples: rent, insurance, interest on loans.

Variable Cost (VC): Costs that **change directly with the level of output**. They are zero if output is zero. *Examples: raw materials, piece-rate wages, electricity for machinery.*

Average Total Cost (ATC): The total cost per unit of output produced.

$ATC = \text{Total Cost} / \text{Quantity Output}$

Average Fixed Cost (AFC): The fixed cost per unit of output. This value always falls as output increases.

$AFC = \text{Fixed Cost} / \text{Quantity Output}$

Average Variable Cost (AVC): The variable cost per unit of output.

$AVC = \text{Variable Cost} / \text{Quantity Output}$

Note: Marginal cost is not required for this section.

3.7.2 Calculation of Costs of Production

The following relationships and calculations are essential:

- $\{TC\} = \{FC\} + \{VC\}$
- $\{ATC\} = \{AFC\} + \{AVC\}$

Interpretation of Cost Diagrams (Changes in Output):

- In the short run, the cost curves (ATC, AVC, FC, VC, AFC) show how costs are affected by changing the amount of variable factors (like labour) while at least one factor (like capital) remains fixed.

- **Total Fixed Cost** is a horizontal line because it remains constant as output changes.
- **Average Fixed Cost** continuously slopes downward because the fixed cost is spread over a larger number of units.
- The **Average Total Cost (ATC)** curve is typically U-shaped: it falls initially due to rising efficiency and falling AFC, but eventually rises due to the **Law of Diminishing Returns**.

3.7.3 Definition of Revenue

Total Revenue (TR): The total income generated by a firm from selling its output.

$TR = \text{Price} * \text{Quantity sold}$ Average

Revenue (AR): The revenue generated per unit of output sold, which is equal to the price charged for the product.

$AR = \text{Total Revenue} / \text{Quantity Sold}$

Note: Marginal revenue is not required for this section.

3.7.4 Calculation of Revenue and Influence of Sales

- **TR Calculation:** The basic calculation is simply the price the firm sells its product for multiplied by the number of units sold.
- **AR Calculation:** Total Revenue divided by the quantity sold.
- **Influence of Sales on Revenue:**
 - If demand is **inelastic**, a firm can raise its price, and the reduction in quantity sold will

be small, causing Total Revenue to **increase**.

- If demand is **elastic**, a firm must lower its price to increase sales, but the quantity demanded will rise by a larger percentage, causing Total Revenue to **increase**.
- For a firm in a highly competitive market, sales volume is the only way to significantly increase revenue since the firm cannot control price.

3.7.5 Objectives of Firms

- **Profit Maximisation:** The traditional and most common goal. Firms aim to produce the level of output where the difference between Total Revenue and Total Cost ($\{TR\} - \{TC\}$) is greatest. This is the financial reward for enterprise.
- **Survival:** A priority for **new or struggling firms**. The objective is to cover costs and remain operational in the short term, often until market conditions improve.
- **Growth:** Firms aim to increase their size, measured by revenue, market share, or number of employees. Growth often leads to lower long-run average costs through **economies of scale**.
- **Social Welfare/Corporate Social Responsibility (CSR):** Objectives that consider the impact on society and the environment, such as reducing pollution or supporting the local community. These goals are

often pursued alongside profit,
particularly by large, visible firms.

3.8 Market structure

3.8 Market structure

Topic

3.8.1 competitive markets

3.8.2 monopoly markets

Guidance

The effect of having a high number of firms on price, quality, choice, profit.

Note: the theory of perfect and imperfect competition and diagrams are not required.

Characteristics, advantages and disadvantages of monopoly.

Note: diagrams are not required.

3.8.1 Competitive Markets

This topic covers the effect of having a high number of firms on price, quality, choice, and profit.

- **Effect on Price:** High competition means firms are **price takers** or have very little control over price. Prices are generally **lower** as firms compete to attract customers.
- **Effect on Quality:** Competition encourages firms to **improve quality** and service to differentiate their product and retain customers.
- **Effect on Choice:** A high number of firms leads to a **wide variety** of products and services, giving consumers a large **choice**.
- **Effect on Profit:** Intense competition generally leads to **lower profit margins** for firms, especially in the long run, as the high number of rivals drives prices down towards average cost.

Note: The theory and diagrams of perfect and imperfect competition are not required.

3.8.2 Monopoly Markets

This topic covers the characteristics, advantages, and disadvantages of a monopoly.

Characteristics of a Monopoly

- **Single Seller/Dominant Firm:** A market where one firm supplies all or a very high percentage of the market output (e.g., typically defined as over 25% or 50% market share).
- **High Barriers to Entry:** Significant obstacles prevent new firms from entering the market, such as very high start-up costs, legal barriers (patents), or control over essential resources.
- **Price Maker:** The firm has the ability to **influence the price** by controlling the quantity of output it supplies.

- **Unique Product:** The product or service has no close substitutes.

Advantages of Monopoly

- **Economies of Scale:** Monopolies are often large and can fully exploit **technical economies of scale**, leading to low average costs and potentially lower prices for consumers than if multiple small firms existed.

Research and Development

(R&D): The high profits earned can be reinvested into **R&D** to develop new products or more efficient production methods, which benefits society in the long run.

Disadvantages of Monopoly

- **Higher Prices:** Since there is no competition, the monopolist can restrict output and charge a **higher price** than a competitive firm, reducing consumer surplus and welfare.
- **Lower Output:** The monopolist supplies less output than a competitive market, leading to an **inefficient allocation of resources** for society.
- **Reduced Choice:** Consumers have a **limited choice** because only one firm supplies the product.
- **Incentive to be Inefficient:** Without competitive pressure, the monopolist may become complacent, leading to **poor quality products** or a **lack of innovation**.

Note: Diagrams are not required for this section.

Unsolved Past Paper Questions

Question 1 (4 Marks)

Explain **two** types of **fixed costs** a manufacturing firm is likely to incur.

Question 2 (6 Marks)

Analyse the reasons why **profit maximisation** might not be the main objective for a newly established firm.

Question 3 (8 Marks)

Discuss the advantages and disadvantages for consumers of a product being sold in a **monopoly market** compared to a competitive market.

Solved Answers (Note Form)

Q1: Two Types of Fixed Costs (4 Marks)

- **Fixed Cost 1: Rent or Lease Payments**

- **K:** These costs relate to the fixed factor of production (Land or Capital) and are independent of output.
- **A:** The firm must pay the rent for its factory building or premises, whether it produces 1 unit or 100,000 units.
- **Fixed Cost 2: Insurance Premiums**
 - **K:** Costs paid to protect the business assets (capital) against risks like fire or theft.
 - **A:** The annual insurance premium is set regardless of the volume of production in the factory during that year.

Q2: Reasons Against Profit Maximisation for a New Firm (6 Marks)

- **K:** Profit maximisation is achieved when $\{TR\} - \{TC\}$ is greatest. A new firm may face high initial costs and low demand.
- **A:** The primary objective for a new firm is **Survival**. It must ensure $TR \geq TC$ (at least break-even) to remain operational in its early stages.
- **An:** The firm may choose to set a **low price** initially to attract customers and build a market presence, even if this means accepting a lower profit margin or temporary loss.
- **An:** The firm may prioritise **Growth** (increasing market share) to gain recognition and secure future customers, which is more important than short-term maximum profit.
- **E:** Once the firm has survived the initial period and established a customer base, it is likely to switch its objective to profit maximisation.

Q3: Monopoly vs. Competitive Market for Consumers (8 Marks)

- **P1: Advantage of Monopoly for Consumers (Price/Quality)**
 - **K:** Monopolies often achieve significant **economies of scale** due to their size.
 - **An:** This can lead to **lower production costs** than a host of small competitive firms. The monopolist *may* pass these cost savings on as **lower prices** to the consumer.
 - **An:** Furthermore, high monopoly profits can fund extensive **Research and Development (R&D)**, resulting in genuinely new or high-quality products over time.
- **P2: Disadvantage of Monopoly for Consumers (Price/Choice)**
 - **K:** Due to high **barriers to entry**, monopolists face no competitive pressure.
 - **An:** The monopolist is likely to **restrict output and charge a higher price** than the competitive equilibrium, forcing consumers to pay more and reducing their purchasing power.
 - **An:** Consumers face **reduced choice** as there are no close substitutes, and the lack of competition may lead to **complacency** and poor quality or customer service.
- **EVALUATION**
 - Overall, competitive markets are **generally better for consumers** in the short run due to low prices and high choice. Monopoly is only beneficial if the firm is a **natural monopoly** where economies of scale are so great that the single firm's low-cost price is lower than any price competitive firms could offer.

4.1 The Role of Government

This section covers the reasons for government intervention and the roles the government plays at different levels in a mixed economy.

4.1 The role of government

Topic

4.1.1 the role of government

Guidance

Locally, nationally and internationally.

Effective Definitions

Mixed Economy: An economic system that combines elements of both a **market economy** (private ownership and the price mechanism) and a **planned economy** (government intervention and public ownership).

Government Intervention: Actions taken by a government to influence, regulate, or change economic activity.

Public Goods: Goods that are **non-excludable** (non-payers cannot be prevented from using them) and **non-rivalrous** (one person's consumption does not reduce supply for others). They are usually provided by the government. *Examples: national defence, street lighting.*

Merit Goods: Goods that the government believes people **under-consume** relative to the benefit they bring to society, and are therefore often subsidised or provided directly by the government. *Examples: education, healthcare.*

Notes: Reasons for Government Intervention

- **To Correct Market Failure:**

Intervening to overcome the free market's failure to efficiently provide certain goods. This includes stepping in to provide **public goods** (due to the **free-rider problem**) and **merit goods** which would be under-consumed. **To Control**

- **Externalities:** Implementing policies like taxes or regulations to reduce negative impacts, such as pollution, and encourage activities with positive impacts (positive externalities).

- **To Redistribute Income:** Using **progressive taxes** (taxing the rich at higher rates) and **welfare benefits/transfers** to reduce the wide gap in income and wealth, promoting greater **equity** (fairness).

- **To Manage the Macroeconomy:** Using policy tools (fiscal, monetary, supply-side) to achieve key national aims like ensuring economic growth, low unemployment, and low inflation.

- **To Provide Legal Framework:** Establishing laws (e.g., contract law, property rights) that are essential for markets to function fairly, securely, and efficiently.
-

Notes: Roles of Government at Different Levels

- **Local Level:** Responsible for providing essential services within a specific geographic area.
 - *Examples:* Local roads maintenance, rubbish collection, running local schools, and fire services.
- **National Level:** Responsible for managing the entire national economy and providing national public services.

- *Examples:* Setting national tax and spending plans, controlling the money supply, providing national defence, and implementing economic policy.

- **International Level:** Responsible for managing economic relationships with the rest of the world.
 - *Examples:* Negotiating **trade agreements**, imposing measures like **tariffs** or **quotas**, and representing the country in global economic organisations.
-

Unsolved Past Paper Questions

Question 1.1 (4 Marks)

Explain **two** reasons why the provision of **public goods** is usually the responsibility of the government.

Question 1.2 (6 Marks)

Analyse the role of a government at the **international level** in promoting the country's economic welfare.

Question 1.3 (8 Marks)

Discuss whether governments should always intervene in markets to provide

merit goods like

healthcare and education free of charge.

Solved Answers (Note Form)

Q1.1: Provision of Public Goods (4 Marks)

- Reason 1: Non-Excludability:
 - K: Public goods are non-excludable, meaning non-payers cannot be prevented from consuming them (the **free-rider problem**).
 - A: Private firms won't produce them since they cannot charge a price, leading to zero provision and market failure.
- Reason 2: Non-Rivalry:
 - K: One person consuming the good doesn't reduce its availability for others.
 - A: It is efficient for the government to provide the good to everyone, as the marginal cost of serving an extra user is zero.

Q1.2: Role at International Level (6 Marks)

- K: International intervention involves managing economic relations with other countries, primarily through trade and finance.
- A: Governments negotiate **trade agreements** to reduce tariffs and quotas, which helps domestic firms export more and increases national output (GDP).
- An: They can use **protectionist measures** (e.g., imposing tariffs) to shield vital domestic infant industries from intense foreign competition, allowing them time to grow.
- An: Governments manage the **exchange rate** (sometimes intervening in foreign exchange markets) to influence the price of imports and exports, affecting the Balance of Payments.
- E: This role is critical as international trade is a major source of economic growth and stability for most modern economies.

Q1.3: Provision of Merit Goods (8 Marks)

- P1: Arguments For Free Provision
 - K: Merit goods (e.g., education) generate significant **positive externalities** (e.g., a healthier, more productive workforce).
 - An: Free provision ensures **equity** and access for the poor, overcoming the problem of under-consumption that would occur if they were sold at market prices.
 - An: Universal access to education boosts the **human capital** of the nation, directly increasing the economy's long-run productive capacity (AS).
- P2: Arguments Against Free Provision
 - K: Free provision is very expensive, requiring higher **taxation** or increased **government borrowing**, which diverts resources from the private sector.
 - An: State-provided services may suffer from **inefficiency** or low quality due to a lack of competitive pressure and a reduced incentive to innovate.
 - An: Providing goods for free may lead to **over-consumption** and waste (e.g., longer waiting lists for treatments that aren't critical).
- EVALUATION:

- Intervention is essential to prevent under-consumption and promote equity. However, charging a **small fee** or allowing a mix of public and private providers might improve efficiency while retaining broad access, offering a balance between equity and efficiency.

4.2 The Macroeconomic Aims of Government

This section covers the key objectives a government pursues to manage the entire national economy and the potential conflicts between these aims.

4.2 The macroeconomic aims of government

Topic	Guidance
4.2.1 the macroeconomic aims of government	Economic growth, full employment/low unemployment, stable prices/low inflation, balance of payments stability, redistribution of income. Reasons behind the choice of aims and the criteria that governments set for each aim.
4.2.2 possible conflicts between macroeconomic aims	Possible conflicts between aims: full employment versus stable prices; economic growth versus balance of payments stability; and full employment versus balance of payments stability.

Effective Definitions

Economic Growth: An increase in the **real Gross Domestic Product (GDP)**—the total volume of goods and services produced—of an economy over time.

Full Employment: A situation where all people who are **willing and able to work** are employed, with unemployment only being frictional (short-term job searching).

Price Stability (Low Inflation): Maintaining a **low and stable rate** of increase in the general price level, which ensures the purchasing power of money is largely maintained.

Balance of Payments Stability

(Equilibrium): Ensuring the total flow of money from abroad (mainly exports) roughly balances the total flow of money sent abroad (mainly imports).

Redistribution of Income: The deliberate reduction of income and wealth inequality across the population through government measures.

Environmental Sustainability: Ensuring that current economic development and resource use can be maintained over the long term without causing irreversible damage to the environment.

Notes: The Six Key Macroeconomic Aims

- **1. Economic Growth:** The goal is a high and sustainable rate of increase in **Real GDP** (e.g., 2%–3% annually).
 - **2. Full Employment:** The goal is to achieve a **low unemployment rate** (e.g., around 4%–5%), which represents the natural rate where the labour market is efficiently functioning.
 - **3. Price Stability:** The goal is to maintain a **low and stable inflation rate** (e.g., 1%–3%) as measured by the **Consumer Price Index (CPI)**.
 - **4. Balance of Payments Stability:** The goal is to **avoid a large or persistent current account deficit**, which would require the country to borrow heavily from abroad.
 - **5. Redistribution of Income:** The goal is to increase **equity** by using taxes and benefits to reduce poverty and narrow the gap between the highest and lowest earners.
 - **6. Environmental Sustainability:** The goal is to ensure economic activity does not cause long-term environmental damage, for instance, by reducing pollution and conserving resources.
-

Notes: Conflicts Between Macroeconomic Aims (Trade-offs)

- **Low Unemployment vs. Low Inflation (The Phillips Curve):**
 - **Conflict:** Policies to boost employment (e.g., spending more) raise **Aggregate Demand (AD)**. If the economy is close to maximum capacity, this drives up prices, leading to **demand-pull inflation**.
- **Economic Growth vs. Balance of Payments Stability:**
 - **Conflict:** When incomes rise rapidly due to economic growth, consumers buy more goods, including a higher volume of **imports**. This causes the value of imports to rise faster than exports, potentially creating or worsening a trade **deficit**.
- **Economic Growth vs. Environmental Sustainability:**
 - **Conflict:** Increased output and consumption require more energy and raw materials, leading to higher levels of pollution, waste generation, and resource depletion, which clashes with the goal of long-term sustainability.

Unsolved Past Paper Questions

Question 2.1 (4 Marks)

Explain what is meant by **price stability** and how it is measured.

Question 2.2 (6 Marks)

Analyse the conflicting nature of the macroeconomic aims of **economic growth** and a stable **Balance of Payments**.

Question 2.3 (8 Marks)

Discuss whether the aim of **environmental sustainability** should take priority over the aim of achieving low unemployment.

Solved Answers (Note Form)

Q2.1: Price Stability and Measurement (4 Marks)

- K: Price stability is the macroeconomic aim of maintaining a **low and stable rate of increase** in the general price level (low inflation).
- A: It is measured using the **Consumer Price Index (CPI)**, which tracks the average change in the price of a fixed 'basket' of goods and services typically purchased by households.
- A: The goal is to keep inflation within a narrow target band (e.g., 2%–3%) to ensure the value of money is largely predictable.

Q2.2: Conflict between Growth and BOP Stability (6 Marks)

- K: Growth aims for increased Real GDP; BOP stability aims to balance the inflow and outflow of funds internationally.
- A: Rapid economic growth leads to rising **national income** and consumer affluence.
- An: Consumers use this higher income to buy more goods, particularly a greater volume of **imports** from abroad.
- An: Since imports rise faster than exports, the country experiences a widening **Current Account Deficit** (BOP instability).
- E: This forces the government to often use policies that slow growth (e.g., higher interest rates) to correct the deficit, illustrating the trade-off.

Q2.3: Sustainability vs. Low Unemployment Priority (8 Marks)

- P1: Arguments for Sustainability Priority
 - K: Environmental damage (e.g., climate change) is an existential, long-term threat that affects all future generations.

- An: If the environment is not sustained, the economic base itself will eventually collapse, making long-term unemployment irrelevant.
- An: Environmental policies (e.g., investing in green energy) can create new jobs in the long run, transitioning the economy towards sustainability.
- P2: Arguments for Low Unemployment Priority
 - K: High unemployment causes immediate and severe costs, including lost output, poverty, social unrest, and high government debt from welfare payments.
 - An: Governments are judged in the short run; people facing job loss will prioritise immediate income over abstract future environmental benefits.
 - An: Some argue that only wealthy countries with low unemployment can afford to invest heavily in expensive environmental clean-up and R&D.
- EVALUATION:
 - The priority depends on the **time horizon**. In the short term (e.g., during a recession), unemployment is the immediate crisis. However, in the long term, **sustainability must take priority** because it protects the resource base necessary for all future economic activity and employment.

4.3 Fiscal Policy

4.3 Fiscal policy

Topic	Guidance
4.3.1 definition of the government budget	
4.3.2 reasons for government spending	The main areas of government spending and the reasons for and effects of spending in these areas.
4.3.3 reasons for taxation	Taxation as the main source of government revenue and the reasons for levying taxation.
4.3.4 classification of taxes	Examples of the different classifications of tax; progressive, regressive, proportional; and direct, indirect.
4.3.5 principles of taxation	The qualities of a good tax.
4.3.6 impact of taxation	The impact of taxation on consumers, producers, government and economy as a whole.

Continued

4.3 Fiscal policy continued

Topic

4.3.7 definition of fiscal policy

4.3.8 fiscal policy measures

4.3.9 effects of fiscal policy on government macroeconomic aims

Guidance

The tax and spending changes, in the form of fiscal policy, that cause budget balance or imbalance. Including calculations of the size of a budget deficit or surplus.

How fiscal policy measures may enable the government to achieve its macroeconomic aims.

Note: aggregate demand and aggregate supply are not required.

Effective Definitions

Fiscal Policy: The use of **government spending** and **taxation** to influence the level of economic activity and achieve macroeconomic aims.

Budget: The government's plan for its revenue (mainly taxation) and expenditure (spending) over a financial year.

Budget Deficit: Occurs when **Government Expenditure (G) is greater than Government Revenue (T)** ($G > T$). The government must borrow to finance the difference.

Budget Surplus: Occurs when **Government Revenue (T) is greater than Government Expenditure (G)** ($T > G$). The government pays off debt.

Notes: Reasons for Government Spending

- **To Provide Public and Merit Goods:** Funding essential services like national defence, police, roads, schools, and hospitals.
- **To Redistribute Income:** Providing welfare benefits, pensions, and

unemployment pay to reduce inequality.

- **To Manage the Economy:** Using spending as a tool to influence aggregate demand (e.g., funding infrastructure projects to boost economic growth).
- **To Support Key Industries:** Providing subsidies or grants to essential industries like agriculture or renewable energy.

Notes: Reasons for Taxation

- **To Raise Revenue:** The primary purpose: funding government expenditure on public and merit goods.
- **To Redistribute Income:** Implementing **progressive taxes** (higher rates for the rich) to reduce income inequality.
- **To Discourage Harmful Activities:** Imposing taxes on demerit goods (e.g., tobacco, alcohol) or negative externalities (e.g., carbon tax) to reduce their consumption/production.
- **To Manage the Economy:** Using tax changes to influence **Aggregate Demand (AD)** (e.g., raising taxes to fight inflation).

Unsolved Past Paper Questions

Question 3.1 (4 Marks)

Explain **two** reasons why a government imposes taxation.

Question 3.2 (6 Marks)

Analyse how a significant increase in **Government Spending (G)** might be used to reduce unemployment.

Question 3.3 (8 Marks)

Discuss the potential economic consequences of a country running a **budget deficit**.

large and persistent

Solved Answers (Note Form)

Q3.1: Reasons for Taxation (4 Marks)

- Reason 1: To Raise Revenue:
 - K: The primary reason is to finance massive public sector expenditure on **public and merit goods** (e.g., healthcare, education, defence) and welfare benefits.
- Reason 2: To Influence Behaviour:
 - K: Governments use taxes to discourage the consumption of **demerit goods** (e.g., high tax on tobacco) or activities that cause **negative externalities** (e.g., carbon taxes).

Q3.2: G Used to Reduce Unemployment (6 Marks)

- K: Increasing G is an **expansionary fiscal policy** aimed at boosting Aggregate Demand (AD).
- A: Spending on **infrastructure projects** (e.g., road building) immediately creates jobs for construction workers and related industries.
- An: This increase in employment and wages leads to further consumption through the **multiplier effect**, raising AD across the economy.
- An: Firms across the economy respond to higher AD by increasing their own output and hiring more labour, reducing **cyclical unemployment**.
- E: This method is highly targeted and can quickly stimulate job creation during a recession.

Q3.3: Consequences of Persistent Budget Deficit (8 Marks)

- P1: Negative Financial/Macro Consequences
 - K: A persistent deficit means the government must borrow heavily, increasing the **national debt**.
 - An: Increased borrowing can put upward pressure on **interest rates** (as the government competes for funds), potentially **crowding out** private investment and consumption.
 - An: Servicing (paying interest on) the debt becomes a large and growing mandatory expenditure item, diverting tax money away from productive public services like education and healthcare.
- P2: Potential Positive/Demand-Side Consequences
 - K: If the deficit is caused by funding significant infrastructure or education projects, it can boost **Aggregate Supply (AS)**.
 - An: A deficit is often necessary during a **deep recession** to stimulate AD and prevent the economy from collapsing into prolonged unemployment.
- EVALUATION:
 - A deficit caused by necessary counter-cyclical spending is acceptable in the short term. However, a **persistent, structural deficit** (even in a boom) is dangerous, as it leads to unsustainable debt levels and higher future taxes, reducing long-term growth prospects.

4.4 Monetary Policy

4.4 Monetary policy	
Topic	Guidance
4.4.1 definition of money supply and monetary policy	
4.4.2 monetary policy measures	Changes in interest rates, money supply and foreign exchange rates.
4.4.3 effects of monetary policy on government macroeconomic aims	How monetary policy measures may enable the government to achieve its macroeconomic aims.

Effective Definitions

Monetary Policy: Actions taken by the **Central Bank** to influence the **supply of money** and **rate of interest** in an economy.

Interest Rate: The price of borrowing money, or the reward for saving money, usually expressed as a percentage per year.

Central Bank: The main financial institution responsible for implementing monetary

policy, controlling the money supply, and regulating the commercial banking sector.

Notes: How Monetary Policy Works

- **Instrument:** The main tool of monetary policy is adjusting the **Interest Rate** (the cost of borrowing).
- **Impact of Raising Interest Rates (Contractionary Policy):**
 - **Borrowing Cost:** Rises, discouraging consumers and firms from taking out loans.
 - **Saving Reward:** Rises, encouraging consumers to save more and spend less.
 - **Effect on AD:** Overall, **Aggregate Demand (AD)**

falls (less Consumption and Investment). This is used to fight **inflation**.

- **Impact of Lowering Interest Rates (Expansionary Policy):**
 - **Borrowing Cost:** Falls, encouraging greater spending and investment.
 - **Saving Reward:** Falls, encouraging consumers to spend rather than save.
 - **Effect on AD:** Overall, **Aggregate Demand (AD)** **rises** (more Consumption and Investment). This is used to fight **recession/unemployment**.
-

Unsolved Past Paper Questions

Question 4.1 (4 Marks)

Explain the term **Monetary Policy** and identify the institution responsible for its implementation.

Question 4.2 (6 Marks)

Analyse the effects of a decision by the Central Bank to significantly **lower interest rates** on Aggregate Demand (AD) and investment.

Question 4.3 (8 Marks)

Discuss the potential limitations of using **interest rate changes** as the main tool for managing the macroeconomy.

Solved Answers (Note Form)

Q4.1: Monetary Policy Definition (4 Marks)

- K: Monetary policy refers to actions taken by a country's **Central Bank** to influence the **supply of money** and the general **rate of interest** in the economy.
- A: The institution responsible is the **Central Bank** (e.g., the Bank of England), which typically sets the benchmark or base interest rate.

Q4.2: Lowering Interest Rates (6 Marks)

- K: Lowering interest rates is an **expansionary monetary policy** aimed at increasing Aggregate Demand (AD).
- A: The cost of borrowing for firms and consumers falls, encouraging them to take out more loans for investment (I) and consumption (C).
- An: The reward for saving falls, encouraging consumers to reduce their savings and **increase spending (C)** instead.
- An: The combined effect is a rise in **Aggregate Demand (AD)**, leading to higher output and lower unemployment in the short run.
- E: Firms will also increase Investment (I) as borrowing is cheaper and the expected return on projects is higher.

Q4.3: Limitations of Interest Rate Changes (8 Marks)

- P1: Lack of Effectiveness in Deep Recession
 - K: When an economy is in a deep recession, business and consumer **confidence** may be extremely low.
 - An: Even if interest rates are lowered significantly, firms and consumers may **refuse to borrow or spend** (liquidity trap), rendering the policy ineffective.
- P2: Time Lags and Imprecision
 - K: There is a significant and variable **time lag** (e.g., 12 to 18 months) between changing the interest rate and seeing the full effect on inflation or growth.
 - An: This makes the policy difficult to time precisely, potentially causing a policy to have an effect only after the economic problem has already corrected itself.
- P3: Impact on Exchange Rate and Debt
 - K: Changing interest rates also affects the **exchange rate** and the position of borrowers/savers.
 - An: Raising rates to fight inflation may attract foreign capital, causing the exchange rate to **appreciate**, harming the export industry.
- EVALUATION:
 - Monetary policy is highly effective at controlling **demand-pull inflation** during a boom because raising rates immediately impacts borrowing costs. However, it is a weak tool for fighting a recession unless supported by fiscal or supply-side policies.

4.5 Supply-Side Policy

4.5 Supply-side policy

Topic

4.5.1 definition of supply-side policy

4.5.2 supply-side policy measures

4.5.3 effects of supply-side policy measures on government macroeconomic aims

Guidance

Possible supply-side policy measures include education and training, labour market reforms, lower direct taxes, deregulation, improving incentives to work and invest, and privatisation.

How supply-side policy measures may enable the government to achieve its macroeconomic aims.

Effective Definitions

Supply-Side Policies: Government measures aimed at increasing the **productive capacity** and efficiency of the economy (increasing Aggregate Supply, AS).

Productive Capacity: The maximum output an economy can produce when all resources are fully and efficiently employed.

Notes: Examples and Effects of Supply-Side Policy

Supply-side policies focus on improving the quality and quantity of the factors of production.

- **Education and Training:**

Action: Increased government spending on schools, colleges, and vocational training.

- **Effect:** Improves the **quality of labour**, leading to higher productivity and lower long-run average costs for firms.

- **Lower Direct Taxes (Income Tax):**

- **Action:** Reducing income tax rates.
- **Effect:** Increases the incentive to **work and save**, shifting the labour supply curve to the right and increasing the quantity of labour supplied.

- **Deregulation and Privatisation:**

- **Action:** Removing unnecessary rules/laws (deregulation) or selling state-owned firms to the private sector (privatisation).
- **Effect:** Increases **competition** and efficiency, forcing firms to lower costs and innovate, leading to a rise in AS.

- **Infrastructure Investment:**

- **Action:** Building better roads, rail, and telecommunications.
 - **Effect:** Reduces firms' costs of transport and improves efficiency, leading to higher AS.
-

Unsolved Past Paper Questions

Question 5.1 (4 Marks)

Explain **two** ways in which **supply-side policies** can promote long-term economic growth.

Question 5.2 (6 Marks)

Analyse why the use of **supply-side policies** is often preferred to fiscal policy for reducing inflation.

Question 5.3 (8 Marks)

Discuss the potential drawbacks and limitations of using **supply-side policies** to improve the performance of an economy.

Solved Answers (Note Form)

Q5.1: Supply-Side and Long-Term Growth (4 Marks)

- Way 1: Investment in Education and Training:
 - K: Investing in education increases the skills and qualifications of the labour force (human capital).
 - A: This raises the overall **productivity** of labour, allowing the economy to produce more output with the same amount of resources, shifting **Aggregate Supply (AS)** outwards.
- Way 2: Infrastructure Spending:
 - K: Spending on roads, rail, and communication networks improves the country's capital stock.
 - A: This lowers the costs of transport and improves efficiency for all firms, leading to an increase in the long-run productive capacity (AS).

Q5.2: Supply-Side vs. Fiscal for Inflation (6 Marks)

- K: Inflation can be reduced by reducing AD (fiscal policy) or increasing AS (supply-side policy).
- A: Supply-side policies (e.g., deregulation) work by increasing competition and efficiency, leading to lower production costs for firms.
- An: This directly addresses the cost problem and reduces **cost-push inflation** without sacrificing output or employment.

- An: Contractionary fiscal policy (reducing G or raising T) reduces inflation by lowering AD, but this simultaneously raises **unemployment** and slows growth (the Phillips Curve trade-off).
- E: Supply-side policies are preferred because they can achieve **lower inflation and higher output** simultaneously, avoiding the negative trade-off of fiscal contraction.

Q5.3: Drawbacks of Supply-Side Policies (8 Marks)

- P1: Time Lags and High Cost
 - K: Supply-side policies (e.g., building a new airport or reforming education) typically take **many years** to have their full effect on AS.
 - An: They are often very **expensive** for the government to implement, potentially requiring high borrowing or large cuts in spending elsewhere.
- P2: Negative Equity Consequences
 - K: Policies like cutting income tax or deregulation may disproportionately benefit the wealthy and large firms.
 - An: This can lead to increased **income inequality** and potential social unrest, conflicting with the government's aim of income redistribution.
- P3: Political Resistance
 - K: Policies such as privatisation or reducing trade union power often face strong resistance from vested interests and workers.
 - An: This political opposition can delay or halt implementation, making the policy unreliable.
- EVALUATION:
 - While supply-side policies are essential for long-term growth and efficiency, they are unsuitable for correcting **immediate macroeconomic problems** (like a sudden recession or inflation spike) due to their long time lags and initial cost.

4.6 Economic Growth

4.6 Economic growth

Topic	Guidance
4.6.1 definition of economic growth	
4.6.2 measurement of economic growth	Real Gross Domestic Product (GDP) and how it can be used to measure economic growth. GDP per head (capita).
4.6.3 causes and consequences of recession	Meaning of recession and how a recession moves the economy within its PPC.
4.6.4 causes of economic growth	How changes in total demand may increase the utilisation of resources and GDP – resulting in a movement from inside toward the PPC. How economic growth shifts the economy's PPC to the right and is caused by changes in investment, technology, and the quantity and quality of the factors of production.
4.6.5 consequences of economic growth	The costs and benefits of economic growth in the context of different economies.
4.6.6 policies to promote economic growth	The range of policies available to promote economic growth and how effective they might be.

Effective Definitions

Gross Domestic Product (GDP): The total value of all final goods and services produced within a country's borders in a given time period.

Real GDP: GDP adjusted for inflation (measured at constant prices). This is the key measure of economic growth.

Nominal GDP: GDP measured at current prices (not adjusted for inflation).

Recession: A period of **at least two consecutive quarters** (six months) of negative economic growth (falling real GDP).

Notes: Causes and Consequences of Economic Growth

Causes of Growth

- **Increase in Aggregate Demand (Short-run growth):** Lower interest rates, lower taxes, higher consumer confidence, or increased government spending.
- **Increase in Aggregate Supply (Long-run growth):** Improvements in technology, increased quantity/quality of capital (investment), increased quantity/quality of labour (migration/training), or discovery of new natural resources.

Consequences of Growth

- **Benefits:**
 - **Higher Living Standards:** Consumers have higher incomes and access to more goods and services.
 - **Lower Unemployment:** Firms demand more labour to increase output.
 - **Higher Tax Revenue:** Government revenue rises,

- allowing more spending on public services.
 - **Costs:**
 - **Inflation:** If AD rises faster than AS, prices may be pushed up.
 - **Income Inequality:** Benefits may be concentrated among the rich (e.g., shareholders, skilled workers).
 - **Environmental Damage:** Increased production and consumption lead to higher pollution and resource depletion.
-

Unsolved Past Paper Questions

Question 6.1 (4 Marks)

Explain the difference between **Nominal Gross Domestic Product (GDP)** and **Real GDP**.

Question 6.2 (6 Marks)

Analyse the benefits to a government of achieving a stable and sustainable rate of economic growth.

Question 6.3 (8 Marks)

Discuss whether the benefits of economic growth are evenly distributed across the population of a country.

Solved Answers (Note Form)

Q6.1: Nominal vs. Real GDP (4 Marks)

- K: **Nominal GDP** measures the value of an economy's output using **current market prices**.
- A: **Real GDP** measures the value of an economy's output using **constant prices** from a base year.
- A: Real GDP is the true measure of **economic growth** because it adjusts (deflates) nominal GDP for the effects of inflation, showing whether the actual volume of goods and services produced has increased.

Q6.2: Benefits of Stable Growth to Government (6 Marks)

- K: Stable growth means a reliable, sustained increase in national output and income.

- A: Growth leads to **higher employment** and higher incomes across the economy.
- An: This results in a massive increase in **tax revenue** (from income tax and sales tax) for the government.
- An: Simultaneously, government expenditure on unemployment benefits falls, which significantly improves the **budget position** (lower deficit or higher surplus).
- E: This stronger fiscal position allows the government to increase spending on public services (e.g., healthcare, infrastructure) without raising taxes or debt, benefiting the entire electorate.

Q6.3: Distribution of Growth Benefits (8 Marks)

- P1: Arguments For Uneven Distribution
 - K: Growth often primarily benefits owners of capital and skilled labour.
 - An: Profits and returns on assets rise quickly, leading to higher dividends and wealth for the **rich**. Unskilled wages may remain stagnant.
 - An: This causes an increase in **income inequality**, meaning the benefits of growth are not shared, potentially leading to social problems.
- P2: Arguments For Widespread Distribution
 - K: Growth creates more jobs, reducing **unemployment** across all sectors.
 - An: Increased tax revenue allows the government to increase **welfare spending** and improve public services (e.g., better schools/hospitals).
 - An: Even if incomes rise unequally, **absolute poverty** generally falls, as even the lowest incomes rise due to job availability.
- EVALUATION:
 - The distribution is highly dependent on **government policy**. If the government uses **progressive taxation** and strong **welfare systems**, it can significantly mitigate the market tendency for growth to benefit the rich, making the distribution more equitable.

4.7 Employment and Unemployment

4.7 Employment and unemployment

Topic	Guidance
4.7.1 definition of employment, unemployment and full employment	
4.7.2 changing patterns and level of employment	The nature and causes of changes in the pattern of employment, for example increase in proportion of workers employed in the tertiary sector and formal economy as an economy develops; a greater proportion of women in the labour force due to changes in social attitudes; decline in the proportion employed in the public sector as a country moves towards a market economy.
4.7.3 measurement of unemployment	How unemployment is measured – claimant count and labour force survey – and the formula for the unemployment rate.
4.7.4 causes/types of unemployment	Frictional, structural and cyclical unemployment.
4.7.5 consequences of unemployment	The consequences of unemployment for the individual, firms and the economy as a whole.
4.7.6 policies to reduce unemployment	The range of policies available to reduce unemployment and how effective they might be.

Effective Definitions

Employment: The number of people working and contributing to the production of goods and services.

Unemployment: The number of people who are **willing and able to work** but are currently **without a job**.

Unemployment Rate: The percentage of the total labour force that is unemployed.

long-term changes in the economy (e.g., decline of a traditional industry like coal mining).

- **Cyclical (Demand-Deficient) Unemployment:** Caused by a **fall in Aggregate Demand (AD)** during an economic recession or downturn. As demand falls, firms reduce output and lay off workers.
- **Seasonal Unemployment:** Occurs at specific times of the year due to variations in demand (e.g., tourism, agricultural harvesting).

Notes: Types of Unemployment

- **Frictional Unemployment:** Short-term unemployment that occurs when people are between jobs (e.g., graduating, switching careers). It is temporary and always exists.
- **Structural Unemployment:** Caused by a **mismatch between workers' skills and the jobs available** due to

Notes: Consequences of Unemployment

- **Cost to the Individual:** Loss of income, reduced living standards, stress, and loss of self-esteem.
- **Costs to the Government:** **Lower tax revenue** (fewer people earning income/paying sales tax) and **higher**

spending on unemployment benefits, leading to a budget deficit.

- **Costs to the Economy:** A loss of potential output (the economy is operating inside its Production Possibility Curve, PPC) and reduced

Aggregate Demand (AD) due to lower consumer spending.

Unsolved Past Paper Questions

Question 7.1 (4 Marks)

Explain the difference between

Question 7.2 (6 Marks) **cyclical unemployment** and **structural unemployment**.

Analyse the main economic consequences of a high rate of national economy.

Question 7.3 (8 Marks)

cyclical unemployment for a

Discuss whether **cyclical unemployment** **unemployment**.

is easier for a government to reduce than **structural**

Solved Answers (Note Form)

Q7.1: Cyclical vs. Structural Unemployment (4 Marks)

- Cyclical Unemployment:
 - K: Caused by a **fall in Aggregate Demand (AD)** during an economic recession or downturn.
 - A: It is a temporary lack of demand for labour across the economy.
- Structural Unemployment:
 - K: Caused by a fundamental **mismatch of skills** between workers and the jobs available (e.g., decline of a traditional industry).
 - A: It is a long-term problem requiring workers to be retrained or relocate.

Q7.2: Consequences of Cyclical Unemployment (6 Marks)

- K: Cyclical unemployment signifies a severe lack of demand, leading to underutilisation of resources.
- A: The primary consequence is a large **loss of potential output (GDP)**, as the economy operates inside its Production Possibility Curve (PPC).

- An: The government's **budget position worsens** significantly due to lower tax revenue (fewer people earning income) and higher expenditure on unemployment benefits.
- An: This unemployment is widespread, causing a reduction in overall consumer spending, which further discourages business investment and prolongs the recession via the **negative multiplier effect**.
- E: It is a clear indicator of inefficient resource allocation and lost national wealth.

Q7.3: Reducing Cyclical vs. Structural Unemployment (8 Marks)

- P1: Cyclical Unemployment is Easier to Reduce
 - K: It is a demand problem that can be solved with **demand-side policies**.
 - An: Governments can use **expansionary fiscal policy** (e.g., increased G, tax cuts) or **monetary policy** (lower interest rates) to increase AD.
 - An: These policies are relatively fast-acting and can restore demand, quickly reducing unemployment as firms re-hire laid-off workers.
- P2: Structural Unemployment is Harder to Reduce
 - K: It is a long-term supply problem requiring fundamental economic change.
 - An: The solution requires expensive and slow-acting **supply-side policies** like education, training, and geographical subsidies to relocate workers.
 - An: There is a high chance of **political and social resistance** from workers unwilling to retrain or move away from their communities.
- EVALUATION:
 - **Cyclical unemployment is definitely easier** because the necessary skills still exist in the workforce; the workers just need demand to return. Structural unemployment requires fundamental changes in human capital, which involves significant time, cost, and political will.

4.8 Inflation and Deflation

4.8 Inflation and deflation

Topic	Guidance
4.8.1 definition of inflation and deflation	
4.8.2 measurement of inflation and deflation	Measurement of inflation and deflation using the Consumer Prices Index (CPI).
4.8.3 causes of inflation and deflation	Causes of inflation: demand-pull and cost-push. Causes of deflation: demand-side and supply-side.
4.8.4 consequences of inflation and deflation	The consequences of inflation and deflation for consumers, workers, savers, lenders, firms and the economy as a whole.
4.8.5 policies to control inflation and deflation	The range of policies available to control inflation and deflation and how effective they might be.

Effective Definitions

Inflation: A **sustained increase** in the **general price level** in an economy over a period of time, leading to a fall in the purchasing power of money.

Deflation: A **sustained decrease** in the **general price level** in an economy.

Consumer Price Index (CPI): The main measure of inflation, calculated by tracking the change in price of a '**basket**' of typical consumer goods and services over time.

Notes: Causes of Inflation

- **Demand-Pull Inflation:** Caused by an **increase in Aggregate Demand (AD)** that outstrips the economy's ability to supply the goods and services. Too much money chasing too few goods.
 - *Causes:* Lower interest rates, increased consumer confidence, higher government spending.
- **Cost-Push Inflation:** Caused by an **increase in firms' costs of production**, which are then passed on to consumers as higher prices.
 - *Causes:* Rising wage rates, higher price of imported raw materials (e.g., oil), higher indirect taxes.

Unsolved Past Paper Questions

Question 8.1 (4 Marks)

Explain the term **cost-push inflation** and give a cause of it.

Question 8.2 (6 Marks)

Analyse the main negative consequences of a high rate of **inflation** for an economy.

Notes: Consequences of Inflation and Deflation

Consequences of High Inflation

- **Fall in Real Income:** The purchasing power of people's money falls, harming those on fixed incomes (e.g., pensioners).
- **Uncertainty:** Firms and consumers find it difficult to plan for the future, which discourages investment.
- **Trade:** Exports become relatively more expensive and imports become relatively cheaper, worsening the **Balance of Payments**.

Consequences of Deflation

- **Reduced Consumption:** Consumers postpone spending, expecting prices to fall further in the future.
- **Falling Profit:** Firms' revenues fall, forcing them to cut production and lay off workers, increasing **unemployment**.
- **Increased Debt Burden:** The real value of debt rises, increasing the burden on borrowers.

Question 8.3 (8 Marks)

Discuss the possible causes and consequences of a period of **deflation** for a country's economy.

Solved Answers (Note Form)

Q8.1: Cost-Push Inflation (4 Marks)

- K: Cost-push inflation is caused by a **rise in the costs of production** for firms across the economy, leading to a fall in Aggregate Supply (AS).
- A: Firms pass these higher costs on to consumers in the form of higher prices to protect their profit margins.
- Cause: A sharp increase in the price of a key imported raw material, such as **oil** or natural gas, or a large, negotiated increase in **wage rates**.

Q8.2: Negative Consequences of High Inflation (6 Marks)

- K: High inflation is a rapid and sustained increase in prices, eroding the value of money.
- A: It causes **uncertainty**, making it difficult for firms to forecast future costs and profits, which discourages long-term **investment**.
- An: It results in a loss of **purchasing power** for people on fixed incomes (e.g., pensioners), worsening income inequality and potentially causing hardship.
- An: The country's **exports become more expensive** for foreigners, while imports become relatively cheaper, worsening the **Balance of Payments** current account deficit.
- E: High inflation often leads to policy confusion and can spiral out of control, damaging the overall confidence in the economy.

Q8.3: Causes and Consequences of Deflation (8 Marks)

- P1: Causes of Deflation
 - K: Deflation is a sustained fall in the general price level.
 - An: **Bad Deflation** is caused by a large and persistent fall in **Aggregate Demand (AD)** (e.g., a recession causing mass saving and low confidence).
 - An: **Good Deflation** is caused by a large increase in **Aggregate Supply (AS)** due to technological improvements and lower production costs.
- P2: Consequences of Deflation (Focusing on Bad Deflation)
 - K: Falling prices cause firms' revenues and profits to drop, leading to cuts in **production** and mass layoffs, which raises **unemployment**.
 - An: Consumers **postpone spending** and investment, expecting prices to fall further, which further reduces AD and deepens the recessionary spiral.

- An: The real burden of **debt rises** as money owed is worth more in real terms than when it was borrowed, making loan repayments difficult for households and firms.
- EVALUATION:
 - Deflation caused by falling demand is severely damaging to an economy and is extremely difficult to reverse. However, deflation caused by technological advancements (AS-led) is beneficial, as it means higher output and lower prices simultaneously.

5.1 Economic Growth

Definition & Explanation

- Economic growth is the increase in total output of goods and services in an economy over time, measured by real GDP.
- It reflects improved living standards and employment opportunities.

Causes of Economic Growth

- Investment in capital goods and infrastructure.
- Technological progress improving productivity.
- Growth in labour supply and human capital.
- Political stability and favourable business environment.

Benefits of Economic Growth

- Higher employment and income levels.
- Increased tax revenue and improved public services.
- Greater business confidence and FDI inflows.

Costs / Limitations

- Inflationary pressures if demand outpaces supply.
- Environmental damage and income inequality.

Key Terms

- GDP, Real GDP, Investment, Productivity, Living standards.

5.2 Employment & Unemployment

Definition & Explanation

- Employment refers to people of working age engaged in productive work for payment.
- Unemployment occurs when individuals who are able and willing to work cannot find a job.

Types of Unemployment

- Frictional – temporary between jobs.
- Structural – mismatch of skills due to industrial change.
- Cyclical – caused by a fall in aggregate demand.
- Seasonal – occurs in industries with seasonal demand (e.g., agriculture, tourism).

Policies to Reduce Unemployment

- Fiscal policy – increase government spending or reduce taxes.
- Monetary policy – lower interest rates to encourage investment.
- Supply-side policies – education, training, and labour market reforms.

Key Terms

- Labourforce, Unemployment rate, Frictional, Structural, Cyclical, Seasonal.

5.3 Inflation & Deflation

Definition & Explanation

- Inflation is a sustained increase in the general price level of goods and services.
- Deflation is a persistent fall in the general price level.

Causes of Inflation

- Demand-pullinflation – excess demand in the economy.
- Cost-push inflation – rising production costs increase prices.

Policies to Control Inflation

- Monetarypolicy–raisinginterest rates to reduce borrowing and demand.
- Fiscal policy – reducing public spending or increasing taxes.
- Supply-side policies – improving efficiency to reduce production costs.

Key Terms

- Inflationrate, Deflation, CPI, Demand-pull, Cost-push.

5.4 Balance of Payments

Definition & Explanation

- The Balance of Payments(BoP) records all economic transactions between residents of a country and the rest of the world.
- The current account includes trade in goods, services, income, and transfers.

Causes of Deficits / Surpluses

- Highimportspendingorlow exports may cause a deficit.
- Export growth, devaluation, and competitiveness may create a surplus.

Policies for Stability

- Exchange rateadjustment, promoting exports, reducing non-essential imports.
- Fiscal and monetary policy to influence demand.

Key Terms

- Currentaccount, Trade balance, Deficit, Surplus, Devaluation.

5.5 Macroeconomic Policies

Definition & Explanation

- Fiscal, monetary and supply-side policies are used to achieve economic aims.

Fiscal Policy

- Involves changes in government spending and taxation to influence economic activity.
- Used to manage demand, reduce unemployment, and control inflation.

Monetary Policy

- Conducted by the central bank using interest rates and money supply.
- Lower interest rates boost demand; higher rates control inflation.

Supply-Side Policy

- Improves productive capacity and efficiency of the economy.
- Includes education, deregulation, investment incentives.

Key Terms

- Fiscal, Monetary, Supply-side, Interest rate, Government budget.

Summary Table

Topic	Key Concepts	Significance
Economic Growth	GDP, investment, productivity	Improves living standards, creates jobs in Pakistan
Employment	Unemployment rate, labour market	Reduces poverty and boosts income
Inflation	CPI, cost-push, demand-pull	Affects cost of living and competitiveness Determines external stability
Balance of Payments	Trade, current account	Used to achieve macro goals
Policies	Fiscal, monetary, supply-side	

Examination & Revision Notes

- Define all key terms accurately.
- Practise AD/AS and unemployment diagrams.
- Link explanations to Pakistan's context (GDP growth, inflation, unemployment).
- Provide balanced arguments in 8-mark 'Discuss' questions.

Unsolved Past Paper Questions

- Explain two causes of unemployment. [4]
- Analyse how inflation can affect producers. [6]
- Analyse how fiscal policy could be used to control inflation. [6]
- Discuss whether economic growth always benefits consumers. [8]
- Discuss whether monetary policy is effective in reducing unemployment in developing countries like Pakistan. [8]

Solved Past Paper Questions

Question: Explain two causes of inflation. [4]

- One cause is demand-pull inflation, which occurs when aggregate demand increases faster than supply. In Pakistan, strong consumer demand or higher government spending can raise prices.
- Another cause is cost-push inflation, where rising wages or imported oil prices increase firms' production costs, leading to higher prices.

Question: Analyse how fiscal policy could be used to reduce unemployment. [6]

- Expansionary fiscal policy involves increasing government spending or cutting taxes to stimulate demand.
- In Pakistan, higher public spending on infrastructure projects creates direct jobs and encourages growth in private sectors like cement and transport.
- Reducing income tax increases disposable income, boosting consumer spending, while lower corporate taxes encourage firms to expand and hire more workers.
- However, excessive spending may cause inflation if the economy is near full capacity.

Question: Discuss whether economic growth always leads to improved living standards. [8]

- Economic growth refers to an increase in real GDP and often improves living standards through higher incomes and employment.
- In Pakistan, growth in manufacturing and services has created jobs and increased government revenue, allowing more spending on education and health.
- However, not all groups benefit equally — income inequality may rise, and pollution or inflation can reduce real welfare.
- Therefore, growth generally improves living standards but depends on equitable income distribution and sustainable policies.

Section 6

6 International trade and globalisation

The importance of trade between countries and the growth of globalisation is explored. Principles such as specialisation, the role of free trade, the role of multinational companies, foreign exchange rates and balance of payments stability are considered.

6.1 International Specialisation & Trade

6.1 International specialisation

Topic	Guidance
6.1.1 specialisation at a national level	The basis for specialisation at national level in broad terms of: superior resource allocation and/or cheaper production methods.
6.1.2 advantages and disadvantages of specialisation at a national level	For consumers, firms and the economy.

Definition & explanation

- *Specialisation* occurs when a country, firm or individual focuses on producing a limited range of goods or services in which they have an advantage.

- A country or firm will specialise when it can produce a good or service at lower opportunity cost than others.
- By specialising, output can increase, costs may fall, efficiency may rise and trade becomes beneficial.

Benefits of specialisation

- Higher productivity, economies of scale, improved skills and use of technology.
- Increased variety of goods for consumers through trade.
- Gains from trade: countries can consume beyond their production possibility frontier (PPF).

Risks/limitations of specialisation

- Over-dependence on a narrow range of goods or sectors.
- Vulnerability to external shocks (demand fall, commodity price drop).
- Structural unemployment if certain industries decline.

International trade

- Trade allows countries to export what they specialise in and import what they do not produce.
- Terms of trade: ratio of export prices to import prices.
- Trade enables consumption possibilities to expand compared to domestic production alone.

Key terms

- *Opportunity cost, comparative advantage, absolute advantage, terms of trade.*
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6.2 Globalisation, Free Trade & Protection

6.2 Globalisation, free trade and protection

Topic	Guidance
6.2.1 definition of globalisation	
6.2.2 role of multinational companies (MNCs)	MNCs and the costs and benefits to their host and home countries.
6.2.3 the benefits of free trade	The benefits for consumers, producers and the economy in a variety of countries.
6.2.4 methods of protection	Tariffs, import quotas, subsidies and embargoes.
6.2.5 reasons for protection	Including infant industry, declining industry, strategic industry and avoidance of dumping.
6.2.6 consequences of protection	Effectiveness of protection and its impact on the home country and its trading partners.

Globalisation

- Process by which economies become more interdependent through increased trade, investment, migration, technology and culture.
- Features: growth of multinational corporations (MNCs), global supply chains, reduction in trade barriers, improved transport and communication.

Advantages of globalisation

- Access to larger markets, greater competition, innovation, lower costs, transfer of technology and skills.
- Consumers benefit from a greater variety of goods and lower prices.

Disadvantages of globalisation

- Domestic industries may struggle to compete; job losses in some sectors.
- Environmental concerns, cultural homogenisation, inequality between and within countries.
- Profits may be repatriated by MNCs rather than retained locally.

Free trade

- Trade between countries without tariffs, quotas, subsidies or other trade-barriers.
- Promotes specialisation and efficiency; leads to higher overall welfare.

Protectionism

- Use of trade barriers to protect domestic producers from foreign competition.
- Common methods: **tariffs** (taxes on imports), **import quotas**, **subsidies** (to domestic firms), **embargoes** (ban on trade) and **voluntary export restraints**.

Reasons for protection

- Protecting infant industries.
- Protecting strategic industries (defence, food security).
- Preventing dumping (selling abroad below cost).
- Safeguarding employment and reducing trade deficits.

Consequences of protection

- Higher prices for consumers, resources diverted to inefficient industries, risk of retaliation from trading partners, loss of welfare gains.

6.3 Foreign Exchange Rates

6.3 Foreign exchange rates

Topic	Guidance
6.3.1 definition of foreign exchange rate	Floating and fixed systems.
6.3.2 determination of foreign exchange rate in foreign exchange market	The demand for and supply of a currency in the foreign exchange market and the determination of the equilibrium foreign exchange rate.
6.3.3 causes of foreign exchange rate fluctuations	Including changes in demand for exports and imports, changes in the rate of interest, speculation, and the entry or departure of MNCs.
6.3.4 consequences of foreign exchange rate fluctuations	The effects of foreign exchange rate fluctuations on export and import prices and spending on imports and exports via the PED.
6.3.5 floating and fixed foreign exchange rates	The difference between, and the advantages and disadvantages of, a floating foreign exchange rate and a fixed foreign exchange rate system.

Definition

- The foreign exchange rate is the price of one country's currency in terms of another currency.

Determination of exchange rates

- In a floating system: determined by demand and supply of the currency in foreign exchange markets.
 - Demand arises from exports, inward investment, speculation.
 - Supply arises from imports, outward investment, exchange controls.
- In a fixed system: the rate is set by the government or central bank and maintained via interventions (buying/selling currency).

Floating vs fixed exchange rates

- **Floating:** flexible to market conditions, but may be volatile.
- **Fixed:** more stable exchange rate, but requires large reserves and may not reflect market fundamentals.

Causes of fluctuations

- Changes in interest rates, inflation rates, speculator activity, political and economic stability, changes in exports/imports.

Effects of exchange rate changes

- If domestic currency **appreciates**: exports become more expensive abroad, imports become cheaper at home — may worsen trade balance.
- If domestic currency **depreciates**: exports cheaper abroad, imports costlier — may improve trade balance, but risk inflation.

Significance for Pakistan context

- Fluctuations in PKR exchange rate affect cost of imports (fuel, machinery), export competitiveness (textiles, agriculture), foreign debt servicing and remittances.

6.4 Current Account of the Balance of Payments

6.4 Current account of balance of payments

Topic	Guidance
6.4.1 structure	The components of the current account of the balance of payments – trade in goods, trade in services, primary income and secondary income. Calculation of deficits and surpluses on the current account of the balance of payments and its component sections.
6.4.2 causes of current account deficit and surplus	Reasons for deficits and surpluses.
6.4.3 consequences of current account deficit and surplus	Impact on GDP, employment, inflation and foreign exchange rate.
6.4.4 policies to achieve balance of payments stability	The range of policies available to achieve balance of payments stability and how effective they might be.

Structure of the current account

- Components:
 - **Trade in goods** (exports and imports of physical goods).
 - **Trade in services** (tourism, transport, insurance, financial services).
 - **Primary income** (investment income, earnings from abroad).
 - **Secondary income** (current transfers: remittances, foreign aid).

Deficit and surplus

- A **surplus**: $\text{export of goods/services/income/transfers} > \text{imports}$ — net inflow of foreign exchange.
- A **deficit**: $\text{imports} > \text{exports}$ — net outflow of foreign exchange.

Causes of deficits/surpluses

- Strong export growth, devaluation, high commodity prices → possible surplus.
- High imports, weak exports, over-valued currency, domestic boom → possible deficit.

Consequences

- Persistent deficit: may lead to depletion of foreign reserves, currency devaluation, inflation, increased borrowing.
- Surplus: may strengthen currency, reduce inflation risk, improve reserves — but may also indicate weak domestic consumer demand or high savings.

Policies to achieve balance of payments stability

- Exchange rate adjustment (devaluation/realignment).
 - Trade policy (promote exports, restrict non-essential imports).
 - Supply-side improvements (increase competitiveness, productivity).
 - Fiscal and monetary policy to influence demand and inflation.
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Summary Table

Topic	Key Concepts	Significance
Specialisation & Trade	Comparative advantage, terms of trade, gains from trade	Helps countries like Pakistan maximise production, trade efficiently
Globalisation & Trade Policy	MNCs, free trade, protection, tariffs, quotas	Impacts local industries, employment, trade relationships

Exchange Rates	Floating vs fixed, determinants, appreciation/depreciation	Affects Pakistan's export competitiveness, import costs, inflation
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Balance of Payments – Current Account	Goods & services trade, income flows, transfers, deficits/surpluses	Key indicator of country's external economic health
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Examination & Revision Notes

Command word	What it means
Analyse	examine in detail to show meaning, identify elements and the relationship between them
Calculate	work out from given facts, figures or information
Define	give precise meaning
Describe	state the points of a topic / give characteristics and main features
Discuss	write about issue(s) or topic(s) in depth in a structured way
Explain	set out purposes or reasons / make the relationships between things clear / say why and/or how and support with relevant evidence
Give	produce an answer from a given source or recall/memory
Identify	name/select/recognise
State	express in clear terms

- **Definitions:** Ensure you can accurately define each key term.
 - **Diagrams:** Be able to illustrate trade, exchange rate movements, balance of payments flows where required.
 - **Examples:** Use specific examples (e.g., textile exports, remittances, PKR depreciation) to illustrate points.
 - **Analysis & evaluation:** In longer questions, discuss advantages & disadvantages, short and long-run effects, stakeholder perspectives.
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Sample Past Paper Questions

0455/21/O/N/20

South east Asian countries have reduced tariffs between themselves through the ASEAN Free Trade Agreement. ASEAN member countries are also removing non-tariff methods of protection. The intention is to raise economic growth through more international trade. This should enable small and medium-sized firms in ASEAN countries to grow and increase their exports.

d) Discuss whether or not increased international trade can promote economic growth. [8]

0455/23/M/J/18

In the 1990s Cambodia became a mixed economy. One of the results of this was specialisation in the clothing industry. In 2005, import quotas for clothing in the key markets of the USA and the EU were removed. Clothing now accounts for 80% of Cambodia's exports. The increased role of the private sector has resulted in a rise in malnutrition in Cambodia.

b) Explain two advantages to a country of specialisation. [4]

0455/22/F/M/24

New Zealand is a high-income country with a low unemployment rate and a surplus of imports over exports. Recently, its government has made some important economic decisions. In 2022, it banned everyone born after 2008 from buying cigarettes. A year before, it gave permission for firms to explore for oil in the country.

d) Discuss whether or not the discovery of oil in a country will benefit its economy. [8]

0455/22/O/N/23

Botswana uses both capital goods and labour in its diamond mining industry. The country had an average economic growth rate of 3.8% between 2015 and 2019 compared to a global average of 2.8%. Over this period, the country experienced a low inflation rate and a move away from protectionism and towards free international trade.

d) Discuss whether or not a country will benefit from diamond mining. [8]

0455/21/O/N/23

Malaysia once specialised in the production and export of natural rubber. The production of natural rubber was very labour-intensive. However, despite still being in the top 5 of natural rubber exporters in the world, Malaysia has moved towards producing manufactured goods that use natural rubber instead of just producing and exporting this primary product.

a) Identify, other than natural rubber, two primary-sector products. [2]

b) Explain two reasons why a country may change its specialisation. [4]

c) Analyse the economic benefits for a country in producing manufactured goods instead of primary-sector products. [6]