2016

Catholic Junior College
H2 Economics / 9732

Preliminary Examination
Mark Scheme
Paper 1

Paper 1 – Case Study Questions

Question 1

Globalisation and the Economy

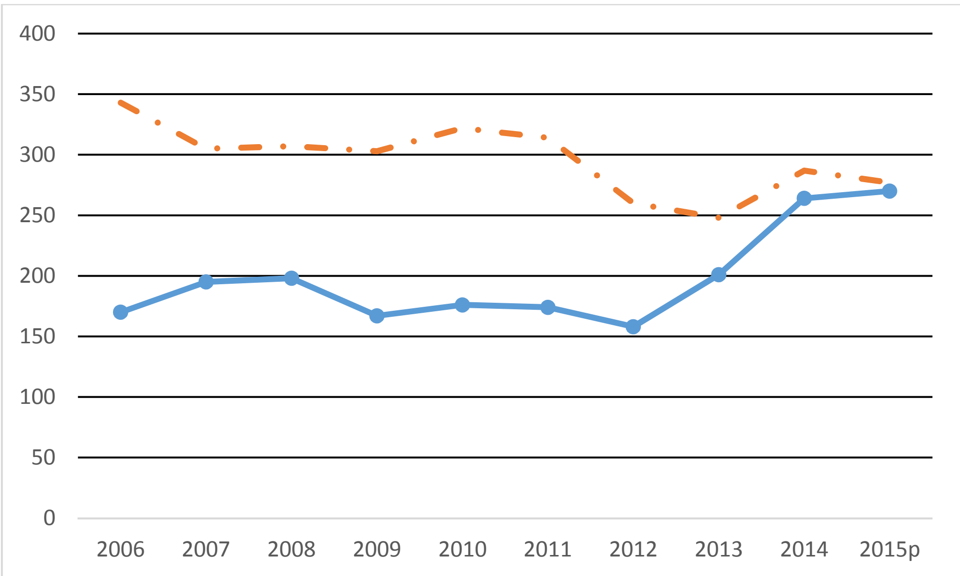
Extract 1: Too many immigrants, too quickly

The story of Brexit is a complex one, but one thread may be familiar to some developed countries today, including Singapore: too many immigrants, too quickly. As the European Union (EU) expanded in 2004 from 15 member states to include 10 more countries - mostly poorer ones from Eastern Europe - then Prime Minister Tony Blair opened Britain's doors to job seekers from these countries. Free to move to Britain to work, many from the new EU countries did, attracted by the prospect of better jobs or higher pay than back home. Some parts of Britain's working class felt the competition and the squeeze. Much of the fury of the 'Leave' campaigners focused around accusations that EU migrants were taking British jobs and depressing wages. Meanwhile, the big businesses and their consumers are gaining from this flow of cheap labour.

Perhaps Britain had not fully considered the evolving ramifications of EU membership and the allowing of sudden mass movement of populations to an island nation. One pressure from mass movement is how immigration is changing the identity of the country and putting pressure on services like the National Health Service. The undoubtable truth is that developed countries need to find better strategies to manage the impacts of migration and promote integration.

Source*: The Straits Times,* July 2016

Figure 1: Labour flow into the United Kingdom (UK), 2006 – 2015p (provisional)



Legend:
Labour Flows from Non-EU countries
Labour Flows from EU countries

Source: *Office for National Statistics*

Extract 2: Will globalisation make everyone better off?

Globalisation has made the planet more equal. As communication gets cheaper and transport gets faster, developing countries have closed the gap with their rich-world counterparts. Basic theory predicts that inequality falls when developing countries enter global markets, especially in the exchange of goods and services. With a larger proportion of their labour force being unskilled, this means that developing countries tend to produce goods that require labour-intensive processes. This increases their trade and thus, increases their wages. But the high inequality seen today in poor countries is prompting new theories. One emphasizes the recent pattern of outsourcing which deviates from the usual practice of creating low-value jobs overseas — rich countries are increasingly shifting parts of the high-value production process to poor countries, creating a larger demand for skilled labour as compared to unskilled labour in the developing countries.

Similarly, in developed countries the heavy costs to industries exposed to cheaper foreign imports offset most of the benefits to consumers and to firms in less vulnerable industries. Economists' assumption that workers would easily adjust to the upheaval of globalisation seems to have been misplaced. Manufacturing activity tends to be geographically concentrated. So the disruption caused by cheaper imports from developing countries was similarly concentrated, in certain hubs of the developed countries. The displaced workers were neither absorbed in the region due to a lack of growing industries, nor were they willing to look for jobs in other prosperous regions.

Immigration and jobs were hot-button issues in Singapore's general election in 2011. The public anger seen then was partly a response to the surge in foreign workers, due to a generous foreign worker policy in the boom years of 2004 to 2007. Deputy Prime Minister Tharman said: "The politics of the centre must stay connected to the challenges that ordinary people face - and address their need for jobs and security, and a balance in immigration that preserves a sense of identity." Tackling this without turning inward, and weakening jobs and society further, is the central challenge everywhere.

Sources: Adapted from *The Economist,* 2014 *and The Straits Times,* 2016

Extract 3: The economic impact of sharing economy platforms

The 'sharing economy' matches people who want to share assets online. Such convenience may come at cost for the traditional economy. Providers of traditional economy might see profits shrink due to the drop in demand and may even be driven out of the market. However the costs and benefits associated with sharing economy platforms depend on the business models in place.

One such 'sharing economy' platform is Uber which is one of the fastest growing start-ups worldwide. Taxi industries tend to be heavily regulated by the governments in order to ensure safety and quality standards. Uber, founded in the United States, used the sharing economy platform to circumvent these regulations by allowing private car owners to become ad-hoc taxi drivers. Furthermore, with countries becoming increasingly connected, Uber has found it easy to succeed commercially in many other countries as well, reducing the market share of the traditional taxi drivers. Uber's success can be attributed to the passengers who prefer diversity in payment options and for lowering their transportation cost. As a result, the incumbent taxi service providers are facing a crisis. Some taxi drivers in Canada complained losing business to the relatively cheap Uber services. Additionally, the government is concerned about drivers not declaring or paying taxes on their income.

In other businesses, homeowners internationally have earned extra cash by using another popular sharing service, Airbnb. Since the recession, more and more people have been looking for economical alternatives, increasing the demand for Airbnb. Likewise, the recession pushed significantly more segments of the American workforce into positions where they must string together part-time gigs and find alternative ways to bring in income. The leading businesses that are advancing the concept of the “sharing economy” are in many aspects no longer insurgents and newcomers.

The ‘sharing economy’ has managed to capture the market through great apps, social media marketing and aggressive links to the asset owners who are attracted by the minimal requirements to work for the likes of Uber and Airbnb. With the economic power of these technology-driven firms growing, there needs to be considerations as to whether regulation is needed.

Source: Adapted from *Time,* November 2014

Questions

(a) Describe the trend of labour flow from EU countries into the UK between 2006 and 2014. [2]

(b) (i) Explain why poor countries tend to specialise in and export goods that require large amounts of unskilled labour. [2]

(ii) Discuss if globalisation will always be beneficial for workers in different countries. [8]

c (i) What can you conclude about the income elasticity of demand for the services offered by Airbnb? [2]

(ii) Using economic analysis, explain the impact of the recession on the market for Airbnb. [4]

d) Explain one possible impact of globalisation on the level of competition in the market for transport. [2]

e) Discuss the factors that determine the need for regulation of the growing technology-driven firms in the ‘sharing economy’. [10]

[Total: 30]

Suggested Answers

a) **Describe the trend of labour flow into from EU countries to the UK between 2004 and 2014.** **[2]**

Answer

Labour flow from EU countries is generally increasing. (1m)
There was a dip between 2008 and 2009 from the EU countries. OR sharp increase from 2012-2014 (1m)

bi) **Explain why poor countries tend to specialize in and export goods that require large amounts of unskilled labour.** **[2]**

Answer

According to the theory of comparative advantage, countries should specialise and trade in goods and services in which they have lower opportunity cost of production. (1m)
Developing countries are usually well endowed with low skilled workers and have a lower opportunity cost in producing goods that require lower skills. As seen in extract 2, "*with a larger proportion of their labour force being unskilled, this means that developing countries tend to produce goods that require labour-intensive processes*" (1m)

ii) **Discuss if globalisation will always be beneficial for workers in different countries.** **[8]**

Answer

Introduction

Globalisation refers to the increasing integration and interdependence of the world's economies arising from increased trade and increased international mobility of factors of production such as labour, capital and enterprise. Traditionally, international movement of labour has always been moving from developing to developed countries and usually in the low skilled sector. However, with rapid pace of technology driven globalisation, movement of labour now does not necessary involve physical movements. Thus, the impact of globalisation on labour on different countries may be quite hard to gauge with all these dynamic factors at play. Countries will be categorised in terms of developed and developing countries in this essay.

Body

Thesis: globalisation may be beneficial for the labour in some countries

Labour in Developing countries may benefit.
With globalisation and increasing integration of the countries in terms of trade, demand for goods produced by developing countries is increasing as well. This is because previously the countries would only be producing for the domestic market as compared to a bigger world market now. This is seen in extract 2 which says "*Basic theory predicts that inequality falls when developing countries enter global markets, especially in the exchange of goods and services".* This evidence shows that there will be rise in production of goods and services in the developing countries, and as seen in extract 2 (and mentioned in b i), these countries tend to focus on production of goods that require low skilled workers, thus, demand for such low skilled workers would rise. This will lead to a rise in wage rates for the low skilled workers in the developing countries, thereby benefitting them.

Better job opportunities.
With the technology driven globalisation, as developed countries outsource part of their production processes to the developing countries as they offer lower cost of production, there will be creation of more and newer jobs in the developing countries. This is seen from the evidence in extract 2, "the recent pattern of outsourcing which deviates from the usual practice of creating low-value jobs overseas — rich countries are increasingly shifting parts of the high-value production process to poor countries"

In the developed countries, skilled labour may benefit from
By similar argument as the one for developing countries, developed countries will tend to specialise in goods and services requiring higher skilled workers. As a result, demand for such labour would rise and so will their wages.

Developed countries would also enjoy lower cost of production from outsourcing. As the developing countries have a bigger pool of labour, relocating parts of the production processes helps to reap advantage of this large resource base which lowers the cost of production for the developed countries. This helps them to sustain their growth by boosting their potential growth.

(Any other relevant advantages for developing or developed countries will be accepted. However, for the analysis of the developing countries it is advised that the students use the arguments they have evidence for).

<u>Anti-Thesis: globalisation may not be beneficial for the labour in some countries</u>
Although outsourcing has created job opportunities in developing countries, these opportunities often benefit only a privileged minority- those with relatively higher skills. This is because the developed countries specialise in high skilled production processes, thus they demand workers who can match up to those skills. This means that the wage rates of the highly skilled workers increase much faster than the expected increase for the unskilled workers, exacerbating the income gap in those countries. This is evidenced by, "*But the high inequality seen today in poor countries is prompting new theories. One emphasizes the recent pattern of outsourcing which deviates from the usual practice of creating low-value jobs overseas — rich countries are increasingly shifting parts of the high-value production process to poor countries, creating a larger demand for skilled labour as compared to unskilled labour in the developing countries." as seen in extract 2.*

The outsourcing of production to low cost developing countries as well as hiring cheap labour from developing countries has led to fall in demand for the local workers/labour in the developed countries. This has created the problem of resident unemployment of certain groups of workers in the developed countries. This problem is faced by developed countries like Singapore where job security has become a real issue for the local workers. This is seen from the evidence in extract 2, *"The politics of the centre must stay connected to the challenges that ordinary people face - and address their need for jobs and security..".* The increased competition for employment from the developing countries also leads to more job seekers competing for the same jobs, thereby depressing wage rates for the workers in the developed countries.

Moreover, with globalisation and increased trade, as the developed countries become more open to the cheaper imports from developing countries, many industries which are in direct competition with those goods and services tend to lose out in terms of cost advantages. These industries are notably low-skilled. As such industries start scaling down, many low skilled workers in those industries get displaced and suffer from rising unemployment and fall in income levels. Due to occupational and sometimes, geographical immobility (especially in the large economies) of these workers they cannot move to the industries where the demand for labour is still relatively high or increasing. As a result, they may lose skills over time.

Synthesis:
Whether globalisation benefits the workers depends on which sectors are workers are at and in which country are they based. Generally, the high skilled workers in both types of countries are likely to benefit based on the evidence available. However, it also depends on the govt. policies adopted to balance out the income levels for different types of workers and in different countries. For example, govt. in the developing countries may impose higher income taxes on the high skilled workers and transfer it to the low skilled workers in terms of social benefits. Similarly, govt. in the developed countries may focus on using supply side policies to improve job security of the local workers by enhancing the occupational mobility of the workers and improving their productivity.

L2: 4-6	Well-balanced answer that considers different types of labour in different types of countries. The answer analyses the impact of globalisation on labour (which also includes international trade and not just labour flow between countries). Must use extract evidence in order to access higher marks.
L1: 1-3	Answer is largely one-sided with some occasional flaws. The answer does not show different types of labour or different types of countries in the analysis.
E2-2	Makes a well justified stand
E1-1	Makes a stand.

c i) Explain the income elasticity of demand for the services offered by AirBnB. **[2]**

Answer
YED is negative or YED <0 (1m),
Extract 3: "since the recession, more and more people have been looking for economical alternatives, increasing the demand for AirBnB. This means that as incomes fall, demand rises indicating that they are inferior goods, consistent with a negative YED value. (1m)

No need to define YED. No need to state inferior goods to get the second mark

ii) Using economic analysis, explain the impact of the recession on the market for AirBnB. **[4]**

Answer
Recession has led to a rise in demand for services offered by AirBnB. This is because these are deemed to be inferior goods. As shown in extract, "*Since the recession, more and more people have been looking for economical*

alternatives, increasing the demand for Airbnb" , the options offered by AirBnb are considered to be more value for money as compared to normal hotels. This is shown by a rightward shift of the demand curve from D0 to D1. [1]

Recession has also led to a rise in supply due to an increase in number of suppliers of economical accommodation as more individuals are looking for part time options of earning income. This is seen from the extract which says, *"the recession pushed significantly more segments of the American workforce into positions where they must string together part-time gigs and find alternative ways to bring in income".* This leads to a rightward shift of the supply curve from S0 to S1. [1]
Diagram [1]

Impact on P and Q [1] P is indeterminate as a conclusion or a specific outcome based on the extent of shift of DD/SS as per explanation.

Alternative:
Up to 3m for both DDSS explanation, last mark to acknowledge that P is indeterminate OR to state which is the outcome based on the extent of shift.(no need to proof)

d) Explain one possible impact of globalisation on the level of competition in the market for transport. [2]

Answer
Globalisation → More firms enter(1m)
Increase competition and reduces market power of the traditional taxi drivers → Extract 3: Uber has reduces the market share of the traditional taxi drivers (1m)

e) Discuss the factors that determine the need for regulation for the growing technology-driven firms in the 'sharing economy'. [10]

Introduction

The sharing economy as the extract explains matches people who want to share assets online. Examples of which are Uber and Airbnb. Uber uses technology to help private car owners to use their car for taxi services and likewise Airbnb has allowed homeowners to rent out their private accommodation to travelers.

However the economic power of the above type of firms has raised the question of need for regulation. This essay will discuss several factors which would determine the need for regulation e.g. Efficiency (Allocative Efficiency), Equity, Safety and Consumer choice.

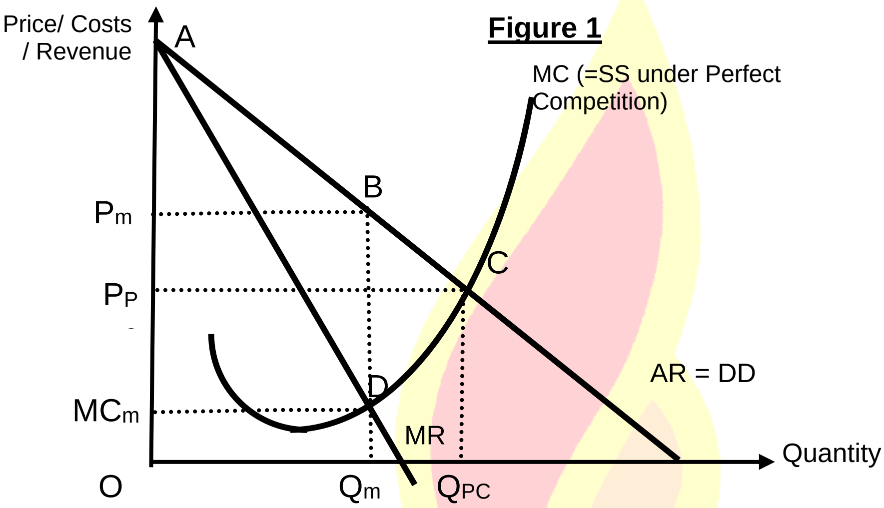
Body

Thesis: There are factors that justify the need for regulation of the sharing economy.

Paragraph 1(Possibility of inefficiencies)
As seen in extract 3, 'Uber has found it easy to succeed commercially in many other countries as well, reducing the market share of the traditional taxi drivers.' This point to the possibility of Uber gaining such a large market share over time that would make it the dominant firm as far as provision of taxi services are concerned. Monopoly power leads to the possibility of allocative

inefficiency.

A monopoly will have high degree of market power and is able to restrict output or raise prices to maximize their profits.



Equilibrium of the Industry under PC industry and Monopoly
(assuming same DD & cost conditions)

Assume similar demand and cost conditions in both market structures. For example, suppose some taxi firms initially operate under perfect competition, but subsequently the entrance of Uber drives out most firms and thus Uber acts as a monopoly supplier. Assuming the production costs would not have changed, given that it is the same taxi services as before.

As a monopolist, the profit maximising monopolist would produce at Q_m and P_m where MC cuts MR from below. Thus, the price charged is higher than the marginal cost of production (P_m>MC).

The monopolist produces at the level of output whereby price is greater than marginal cost (P>MC). This means that consumers' valuation of the goods is greater than marginal cost of production and that too few units of this good are produced. Hence there is a large under production of QmQpc, and consequently a large DWL as shown in the area BCD of figure. This leads to **allocative inefficiency.**

Hence price mechanism will fail to allocate scarce resources in the most efficient manner when there is market dominance. This factor of allocative inefficiency can justify the need for regulation of the growing technology-driven firm.

Paragraph 2(Possibility of inequity)
Equity deals with the notion of fairness in distribution of income and wealth. Even if current levels of production and consumption might be efficient, they might be regarded as unfair, if some people are rich while others are poor.

In the case of technology-driven firms in the 'sharing economy', firms may become dominant over time leading to the issue of inequity. When there are many firms, profits are shared among large number of small firms. Hence, distribution of income tends to be widely spread. However as seen in extract 3, due to the entrance of sharing economy firms, "Providers of traditional economy might see profits shrink due to the drop in demand and may even be driven out of the market." This will mean profits are likely to be enjoyed by a small group of shareholders of one firm at the expense of a large group of traditional firms, aggravating inequity.

*Paragraph 3 (*Other problems for the economy*)*
The other concerns that may lead to a need for regulation would be that the sharing economy asset holders are not paying taxes on their earnings. E.g in extract 3 "The government is concerned about drivers not declaring or paying taxes on their income." This will lead a loss in potential government revenue that could have been used for development of infrastructure or provision of merit goods such as education and healthcare.

Finally safety and quality standards may be severely compromised in the new sharing economy as they have managed to use technology to circumvent these regulations. In extract 3, "Taxi industries tend to be heavily regulated by the governments in order to ensure safety and quality standards. Uber, founded in the United States, used the sharing economy platform to circumvent these regulations by allowing private car owners to become ad-hoc taxi drivers."

Anti-Thesis: Certain factors may not lead to the need for regulation for the growing technology-driven firms in the 'sharing economy

Paragraph 4 (Lower Prices)
Despite the earlier disadvantages that may justify the need for regulation, technology-driven firms in the shared economy can have some advantages. This new business model allows for the industry to operate on low levels of costs as the assets are already available via the asset providers e.g. private cars and homes or apartments that asset providers live in. Furthermore the operating costs are also lower than the traditional firms as most of the business is run on technology e.g. apps and social media marketing.

The consumers would benefit if the lower costs are translated into cheaper goods. This seems to be the reality in the case of Uber as in extract 3 "Uber's success can be attributed to . . . .lowering their transportation costs."

Paragraph 5(Alternative Source of Income)
Such firms are giving more people alternative sources of incomes by providing a platform for them to rent out their apartments/homes via Airbnb and use their private cars to earn extra dollars in their spare time via Uber. This is especially beneficial in a time where many are affected by the recession.

Paragraph 6(Greater Consumer Choice)
Finally, such firms have improved consumer choice as they offer passengers diversity in payment options and alternatives to the traditional goods e.g. hotels to homestays and at cheaper rates too.

For the above reasons, it may be in the society's best interest not to regulate these sharing economy firms.

Synthesis

While technology-driven firms in the 'sharing economy' may have many advantages, the factors such as need for ensuring safety and quality standards and the issue of equity are more important considerations.

The growth of these new firms has had a destabilizing effect on traditional firms and can cause large disruptions to the firm owners and the workers as seen in the extract. As such regulation is needed to ensure that traditional firms have the chance and time to adapt to the new business model so as to minimize disruptions in the economy via massive and sudden shut downs of traditional firms and unequal distribution of profits to just one company. Furthermore regulation is needed to ensure safety and quality is not compromised in the provision of goods and services by the new firms in the ‘sharing economy’.

As such while there is no need to quash these new firms, however there is a need to regulate them to ensure safety, quality standards and to minimize disruptions.

L3: 7-8	Well balanced answer that considers the various factors and different economic agents, and hence, the need for regulation. Good use of extract evidence
L2:4-6	Two sided answer which considers various factors and at least ONE economic agent, to analyse the need for regulation Some attempts to use extract evidence
L1: 1-3	An one-sided answer that does not take into consideration the factors determining the need for regulation (i.e., the answer does not specify the factors of EFFICIENCY, EQUITY or any other indicators/aims that the economy needs to consider)
E2-2	Well justified stand with attempt to provide new perspective
E1-1	Stand without justification

Question 2

Oil and the Venezuelan Economy

Extract 4: Venezuela, a nation in a state

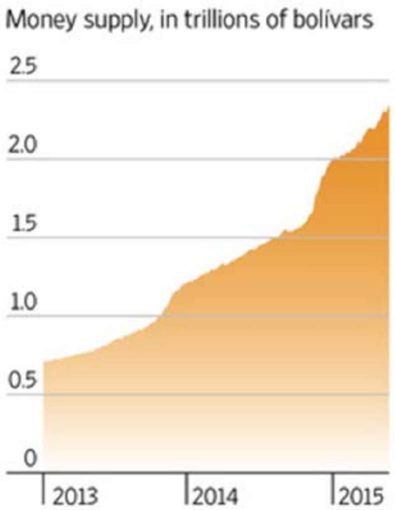
Under the watch of Venezuela's president, the nation has entered a steep decline. A global oil boom, which provided money to lavish on Venezuela's once neglected poor, is over. Venezuela sits on the world's largest proven oil reserves. Oil makes up 96% of the country's export earnings and 25% of its GDP. The government's income from oil in the year to November 2015 was two-thirds lower than during the same period the year before. The oil price has fallen further since then. With less money coming in and demand for imports still strong, the value of Venezuela's foreign-exchange reserves has dropped alarmingly.

The current oil slump would be painful, whoever was in power. The regime has greatly compounded the damage with policies that, though designed to favour the poor, end up impoverishing them and the state. Price controls have led to acute shortages of basic goods, forcing people to queue for hours to buy necessities. Although the official price of goods is correspondingly cheap, many are available only at inflated prices in the black market.

Inflation is officially running at 121.7% last year. Analysts believe the true figure is at least 200% a year; some predict hyperinflation in 2016 as the Central Bank continues to print money to finance the massive budget deficit.

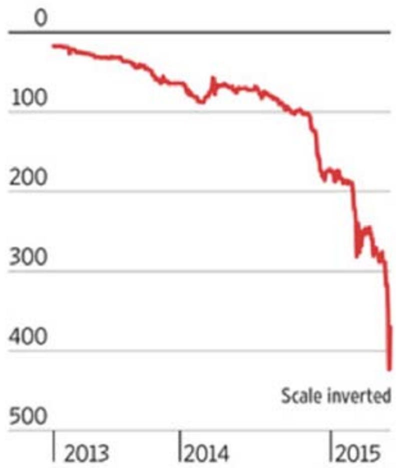
Source: Adapted from *Time*, December 2015 and *The Economist*, February 2016

Figure 2: Venezuelan money supply



Source: *Wall Street Journal*, May 2015

Figure 3: Venezuelan bolivar per US dollar



Source: *Wall Street Journal*, May 2015

Table 1: Venezuela: Selected economic indicators 2011 – 2015

Economic Indicators	2011	2012	2013	2014	2015
Gross Domestic Product (GDP) Growth (annual %)	4.2	5.6	1.3	-3.9	-5.7
Exports of goods and services (% of GDP)	29.9	26.2	24.8	-	-
Imports of goods and services (% of GDP)	19.7	24.2	29.5	-	-
Gross capital formation (% of GDP)	23.1	26.6	27.3	-	-
Inflation, consumer prices (annual %)	26.1	21.1	40.6	62.2	121.7
Unemployment, total (% of total labour force)	8.3	8.1	7.5	8.6	-

Source: *World Bank*, July 2016

Extract 5: Oil price plunge continues

The price of oil continued its precipitous fall on Friday, hitting five-and-a-half-year lows after the International Energy Agency (IEA) predicted demand next year would be lower than expected.

The oil price has plummeted in response to a massive build-up of shale-derived oil in the US, reduced fears of fighting in Iraq disrupting supplies, and slower growth in demand as the world economy falters. The IEA warned: “The resulting downward price pressure would raise the risk of social instability or financial difficulties if producers found it difficult to pay back debt.”

The Paris-based IEA singled out oil-producing countries such as Russia and Venezuela as potential flashpoints for trouble and the warning came as the rouble, which has lost 40% in value against the dollar so far this year, hit a fresh record low. One dollar now buys more than 57 roubles, compared with 35 in the summer.

But while the oil-producing countries face lost revenues and budget shortfalls, lower energy prices are expected to have a beneficial impact on the world economy.

Many countries, particularly in Asia, are desperately dependent on foreign oil and gas imports, so cheaper prices should cut inflation and give impetus to manufacturing output and consumer spending. Analysts at investment bank ING said: “The recent fall in oil prices may not be sustained but, in the meantime, it provides a very welcome boost to real incomes for most major economies.”

Lower energy prices will cause havoc in the UK North Sea, where companies such as BP and Shell are cutting jobs at a time when exploration levels have already dropped to very low levels.

But households will welcome the falling gas price cutting heating bills, while motorists will be glad of lower costs at the pump. High home and transport costs are a big influence on inflation and affect the production and distribution of food and other items.

There are strong signs in the US that lower energy prices are having a big effect on consumer spending with store and restaurant sales rising by 5% in November against the same month the previous year.

Tom Kloza, co-founder of the US-based Oil Price Information Service, has warned that the world could be heading for $45 per barrel oil, although he maintained that this kind of price was not sustainable long term.

Source: *The Guardian*, December 2014

Extract 6: The true cost of oil production

Every link in the chain of oil production, from exploration through consumption, generates profound damage to the local environment and communities. As the industry moves towards increasingly risky forms of fossil fuel production, the impacts become more pronounced.

A notable Harvard Medical School study identifies impacts from many aspects of oil production. Exploration for new oil and gas often brings seismic explosions and the clearing of huge swaths of forest; drilling produces toxic drilling muds and waste waters; oil extraction still often results in routine gas flaring at the point of extraction. Oil transport creates additional hazards, as oil spills from pipelines, tankers and tank farms are still routine, despite industry claims of safety measures.

Source: Adapted from *Oil Change International*, April 2014

Questions

(a) (i) Using Table 1, describe the trend of Venezuela's general price level between 2011 and 2015. [1]

(ii) Explain the statement: 'Although the official price of goods is correspondingly cheap, many are available only at inflated prices in the black market'. [3]

(b) Explain the inefficiency in resource allocation in the market for oil. [4]

(c) Explain how the change depicted in Figure 2 may have led to the outcome in Figure 3. [4]

(d) Given the challenges in the oil exporting market, discuss if Venezuela should respond by being less globalised. [8]

(e) Assess whether, on balance, lower oil prices can be beneficial. [10]

[Total: 30m]

Mark Scheme

a) i Using Table 1, describe the trend of Venezuela's general price level between 2011 and 2015. **[1]**

Between 2011 and 2015, Venezuela's general price level is increasing. [1]

ii Explain the statement: 'Although the official price of goods is correspondingly cheap, many are available only at inflated prices in the black market'. **[3]**

The reason why the 'official price of goods is correspondingly cheap' is due to the price ceiling implemented by the government, which is below the market equilibrium price [1] **OR** diagram depicting a price ceiling placed under the market equilibrium price [1]
This resulted in a shortage (Qs-Qd), which created an upward pressure on prices [1]
Since only Qs is available for sale, a black market may be created where prices charged are higher than the official price [1].

b) Explain the inefficiency in resource allocation in the market for oil. **[4]**

Oil production generates negative externalities + extract evidence [1]
this creates a divergence between MPC and MSC [1]
in the free market, Qf is produced as producers seek to maximize their net benefit at MPC=MPB. However, the socially efficient quantity is at Qs where MSC=MSB, leading to overproduction [1]
creating a deadweight loss to society [1]

Full credit is available for students who do not draw diagram

c) Explain how the change depicted in Figure 2 may have led to the outcome in Figure 3. **[4]**

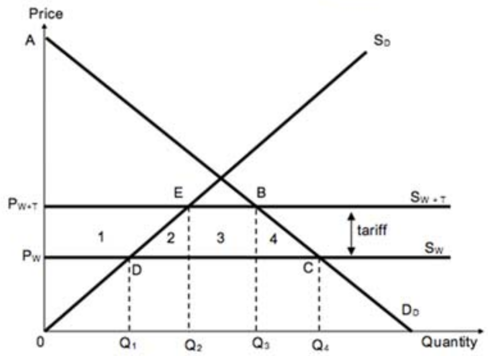
Figure 2 indicated that Venezuela's money supply has been increasing between 2013 and 2015 [1]
This increase in money supply would have caused interest rates to fall [1]
This may have led to an outflow of hot money [1]
Leading to an increase in supply of currency in the foreign exchange market, causing the exchange rate to fall as shown in Figure 3 [1]

d) Given the challenges in the oil exporting market, discuss if Venezuela should respond by being less globalised. **[8]**

Suggested Answer
Venezuela has been negatively affected by the challenges in the oil exporting market. Given the substantial fall in oil prices (Extract 2 Para 1), and coupled with the fact that the demand for oil is price inelastic due to it being a necessity in many production processes, export revenue (X) received by Venezuela has fallen (Extract 1 Para 2). This has led to a fall in AD, leading to a multiplied fall in national income, as evidenced by Table 1, where it shows that Venezuela is suffering from negative economic growth rates in recent years. Additionally, Venezuela is very reliant on oil exports for growth, which makes the fall in export revenue received from oil even more impactful (Extract 1: "Oil makes up 96% of the country's export earnings and 25% of its GDP").

Thesis: Venezuela should respond by being less globalized and engage in protectionism (e.g. import-substitution strategies)

Venezuela can impose tariffs on its imports (Extract 1 Para 2 and Table 1 shows Venezuela's reliance on imports) in order to encourage expenditure-switching behaviour.



An imposition of a tariff, T, will reduce world supply from Sw to Sw+T, and cause prices of imports to increase from Pw to Pw+T. As a result, imports fall from Q1Q4 to Q2Q3. Assuming that the PEDm>1, the imposition of a tariff will cause prices of imports to rise, and the quantity demanded of imports to fall more than proportionately, leading to a fall in import expenditure.

This fall in import expenditure can help to offset the fall in export revenue faced by Venezuela as an outcome of falling oil prices, allowing its net exports and national income to remain relatively unchanged.

Anti-Thesis 1: However, there are costs of engaging in protectionism. The imposition of protectionist measures such as tariffs may invite retaliation from Venezuela's trading partners, who may similarly slap tariffs on Venezuelan's exports. If this occurs, Venezuela may face a further reduction in export revenue, on top of the fall in export revenue due to falling oil prices.

Anti-Thesis 2: Additionally, by becoming less globalized Venezuela may lose out on benefits of globalization it could have reaped. According to the theory of comparative advantage, when countries export the goods they have comparative advantage in and import the goods they do not have comparative advantage in, there is a greater output produced. There is a more efficient allocation of resources because countries specialise in producing goods which they have a comparative advantage in and thus is able to produce at lower cost compared to other countries. This is further enhanced by the fact that with specialisation and large scale production, firms will be able to reap economies of scale thus reducing cost of production. Lower costs translate to lower world prices. However, by imposing an import tariff, Venezuela artificially causes the price of imports to be higher than what it is supposed to be. Consumers in Venezuela will suffer from the high prices and the reduction in consumer surplus.

Synthesis: Venezuela should not respond to the falling oil prices by becoming less globalized. From the above analysis, it is clear that the benefits gained from becoming less globalized is only temporary (short term) and will eventually be outweighed by the long-term costs. Therefore, becoming less globalized is a short-term solution to Venezuela's troubles. Venezuela should look towards diversifying its economy and reducing its reliance on oil exports for a more sustainable solution.

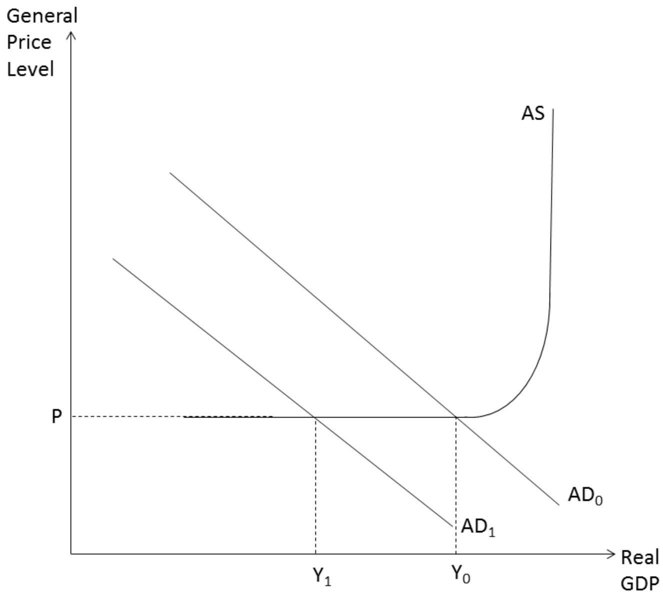
Level	Description	Marks

L2	A well-balanced response that looks at both the costs and benefits of becoming less globalized. Answer also includes extract evidence.	4-6
L1	One-sided response that looks at either the costs or the benefits of becoming less globalized. Response may not have included extract evidence as support.	1-3
E	Overall stand on the issue with/without justifications based on economic analysis.	1-2

e) **Assess whether, on balance, lower oil prices can be beneficial.** **[10]**

Thesis: There are costs incurred by major oil-producing countries from lower oil prices.

From Extract 5 Para 3: Oil producing countries face falling export revenue (X) because of falling oil prices, assuming that the demand for oil is price inelastic. With a fall in X-M, AD falls from AD0 to AD1 thus reducing national income by a multiplied amount via the negative multiplier effect (from Y0 to Y1). Unemployment rises as well, since the economy would be operating further away from full employment output. (Extract 5 Para 6: "Lower energy prices will cause havoc in the UK North Sea, where companies such as BP and Shell are cutting jobs at a time when exploration levels have already dropped to very low levels"). The evidence suggests that the fall in oil prices has resulted in unemployment of the oil exploration workers. This has the immediate effect of reducing the SOL of these workers. If these workers cannot re-train and move to another industries, they may face structural unemployment that will take a long time to address. If they are discouraged and move out of the labour force, they become hidden unemployment which will affect the productive capacity of the economy.

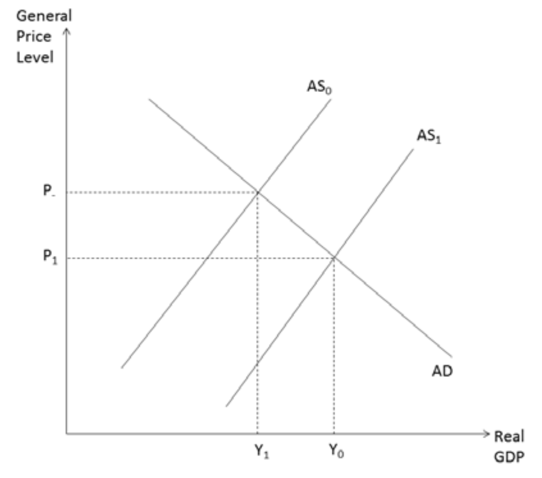


From the extract: "Rouble, which has lost 40% in value against the dollar so far this year, hit a fresh record low." Since there is a fall in expenditure on oil due to the falling oil prices, there will be a fall in demand for oil producing countries' currencies. This thus led to a currency depreciation for these countries, leading to external instability and possibly shakening investor confidence.

From Extract 5 Para 4: “Oil-producing countries face lost revenues and budget shortfalls”. When there is a fall in the revenue and profits of oil producing firms in the oil producing countries, the corporate tax revenue received by these governments will fall, which can lead to budget deficits and the inability for government to finance social (e.g. education and health) and infrastructural developments. Although the fall in tax revenues is a short term cost, there are long term implications for these economy as a fall in infrastructural and social development may result in a fall in AS as the productive capabilities and capacity of the economies may fall. This will result in future decline in NY and increase in GPL.

Antithesis: However, there could be benefits to lower oil prices as well, particularly to oil consumers.

As suggested in Extract 5, many countries, particularly in Asia, are dependent on foreign oil and gas imports, so cheaper prices should cut inflation, give impetus to manufacturing output, consumer spending and boost real incomes. The fall in costs of production as a result of falling oil prices will lead to an increase in AS (AS shifts downwards from AS0 to AS1), causing GPL to fall from P0 to P1 and increasing NY from Y0 to Y1, through an increase in consumption and investment (illustrated as a movement along AD). This is further justified by what is mentioned in Extract 5: “There are strong signs in the US that lower energy prices are having a big effect on consumer spending with store and restaurant sales rising by 5% in November against the same month the previous year”. Furthermore, Extract 5 also mentioned that “high home and transport costs are a big influence on inflation and affect the production and distribution of food and other items”, which suggested that this benefit is very significant as oil prices affect GPL very significantly and in a wide-ranging manner. Any fall in oil price will reduce transport costs thus increase AS drastically.



Counter-argument: However, Extract 5 indicated that “this kind of price was not sustainable long term” which implied that any benefits derived from the lower oil prices may not be sustained in the long term.

Mini-Synthesis: Therefore, while there are many benefits to lower oil prices, many of these benefits may not be long term as once the oil prices increase, these benefits will be reversed/eliminated.

Overall Synthesis: There are many benefits and costs associated with lower oil prices but it is clear that the ones who gain are the consumers but the ones who lose will be oil producers and oil exporting countries.

Alternative Synthesis: Although there are benefits and costs to lower oil prices to different countries and different groups of economic agents, given that the price is not expected to be sustainable in the long term, the long term benefits will be limited, even for those who may gain from the lower prices. On the other hand, the costs essentially will have longer term effects, thus on balance it is not so beneficial given that the benefits do not last.

<u>Note</u>
Students are not expected to include all points presented in this suggested answer.

Other possible costs – (i) fall in oil price leading to fall in price of petrol thus increasing consumption of petrol, which generates negative externalities.

Other possible benefits – (i) fall in oil exploration, which generates negative externalities, will help to reduce inefficient allocation of resources; (ii) fall in oil price may induce oil producing countries to re-structure and diversify to other industries that is more sustainable and less volatile in growth.

L3	A well-balanced response that looks at <u>both</u> the costs and benefits of lower oil prices to different parties in the economy (i.e. consumers and producers of oil, or oil-producing vs oil-consuming countries). Answer also includes extract evidence.	**7 - 8**
L2	One-sided response that looks at <u>either</u> the costs <u>or</u> the benefits of lower oil prices. Well elaborated response that includes extract evidence as support. OR Two-sided response that looks at the costs and the benefits of lower oil prices. May not have elaborated completely or no extract evidence as sipport.	**4 - 6**
L1	One-sided response that looks at <u>either</u> the costs <u>or</u> the benefits of lower oil prices. Response may not have considered the impact of lower oil prices on different parties within the economy. Response does not include extract evidence as support.	**1 - 3**
E	Overall stand on the issue with/without justifications based on economic analysis.	**1 - 2**