Economics
Standard level
Paper 1

Thursday 16 May 2019 (Afternoon)

1 hour 30 minutes

Instructions to candidates

- Do not open this examination paper until instructed to do so.
- You are not permitted access to any calculator for this paper.
- Section A: answer one question.
- Section B: answer one question.
- Use fully labelled diagrams and references to examples where appropriate.
- The maximum mark for this examination paper is **[50 marks]**.

Section A

Answer **one** question from this section.

Microeconomics

1. (a) Explain how the price mechanism reallocates resources when there is an increase in demand for a good or service. [10]

(b) To what extent is advertising the most effective way of increasing the consumption of merit goods? [15]

2. (a) Explain the concepts of consumer surplus and producer surplus in the market for air travel. [10]

(b) Discuss the view that a free market at competitive market equilibrium leads to the most efficient allocation of resources from society's point of view. [15]

Section B

Answer **one** question from this section.

Macroeconomics

3. (a) Explain why structural unemployment may occur in an economy. [10]

(b) Discuss the view that the best way to reduce unemployment is through education and training. [15]

4. (a) Explain the factors that cause demand-pull **and** cost-push inflation. [10]

(b) Discuss the view that deflation will always be bad for an economy. [15]

Jerry Jiang. Q1: 25 Q4: 22

47/50

85↑.

94↑.

Micro. Q1.

1. (a) ① Demand is the amount of good or services an individual or a business is willing to by at a variety of price, ceteris paribus.

② . Price mechanism is very important since it allocates the society's scarce resources to their best use.

1st YR: 85%

1Bachelor: 7(7.0)

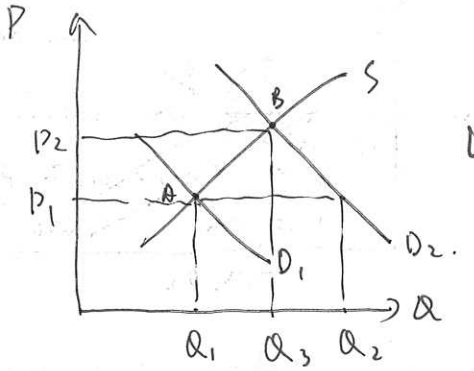


Diagram 1.

In diagram 1, you can find the case of Apple Watch.

- at first, the market for Apple Watch is at A, with quantity demanded at Q_1 and price at P_1.
- sinle this device has became more powerful and more popular, the demand of Apple Watch increase.
- This leads to the D_1 curve shifts out to D_2, leading to the demand at Q_2 and quantity supplied at Q_1.
- Since there's $Q_2 > Q_1$, there's excess demand. This is the signaling function for producers.
- since there's excess demand, Apple tends to raise price. And now the incentive function comes into play. Because the ~~total~~ ~~revenue~~ price is very high, the company want to earn ~~the~~ it. So they produce more.
- As a result the supply expand along S until it reaches B, and as the price rise, the demanded demand contracts along D_2 until it reaches B.
- Now the new equilibrium is formed at B, where the final quantity has rised from ~~Q_1~~ to ~~Q_3~~ and the price of apple Watch is rised to P_2.

10 good-

It's actually quite astonishing to know that the demand for Apple Watch has been increasing for around 5% in the past two years, and indeed, the Apple company has increased the price of it ~~into~~ according to the signaling, incentive function of the price mechanism.

(b). ① Merit good is the type of good which produces significant amount of positive externality when consumed.

② Subsidy is the government spending that decrease the cost of production of certain goods and services.

Please make diagram bigger.

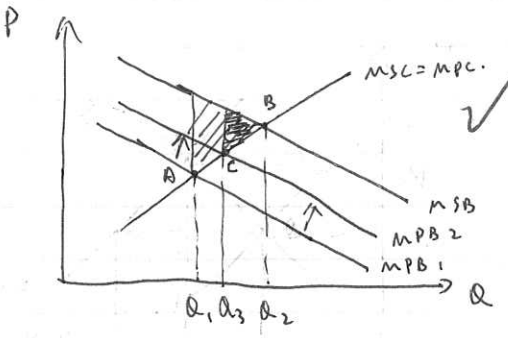


Diagram 2.

In diagram 2 above, you can find the case of vaccination in British Columbia.

- Vaccines are ~~a~~ merit goods. When people ~~take~~ take vaccines, they are prevented from the certain type of disease the vaccine is for.
- Also, when they take the vaccine, they won't have the potential of passing the disease to other compare to when they didn't take the vaccination.
- That's why the ~~social~~ marginal ~~private~~ social benefit is higher than the marginal prive benefit (MPB1) in the graph.

- When the government put advertisement on vaccination, they can ~~also~~ spread the information that vaccination is not only good for yourself, but also good for the people around you in the society.
- When people see the advertisement, they understand more on this type of merit good, so they're more willing to spend money for it.
- In diagram 2, MPB1 shifts out to MPB2 because of the advertisemant, moving the market from A to C.
- The quantity demanded for vaccines raise from Q1 to Q3. Since the optimal quantity ~~Q2~~ is at Q2, it's shows that advertising is somehow effective in increasing the demand for vaccine.

It's worth noting that at first, the welfare loss of this positive externality case is the whole big red triangle, but as the advertisment

becomes effective, the welfare loss decrease to the area of the small black triangle in Diagram 2.

However, it takes the government a lot of money to post enough advertisment in the society, and itself can't have perfect efficiency. why not? because people can't afford it.

Now let's look at another approach: subsidy:

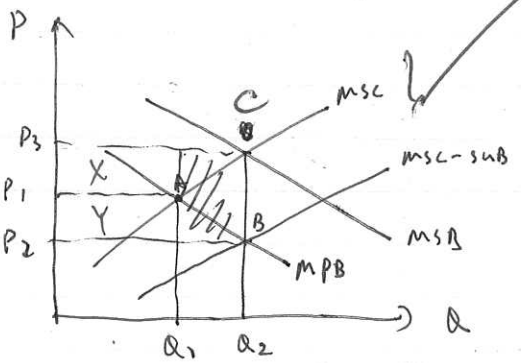


Diagram 3.

In diagram 3, you can find the ~~diagram~~ subsidy's influence to vaccine.

- At first, the market is at A, with quantity demanded at Q_1 and the optimal quantity at Q_2.
- The government impose a subsidy on vaccine, which lead to a shift-out of MSC (marginal social cost) curve.
- now the market is being brought to B, where the quantity demanded has been raised to Q_2, the optimal value.

15

Note that the ~~red~~ box is the amount of subsidy = P_3CBP_2 the government pays.

The vaccines producers will also be happy, since they can get a producer's share box Y;

outstanding

The vaccine consumers will also be happy, since the price of vaccine is only at P_1 and they get consumer's share of the box X.

After the subsidy, it's likely that a lot ~~of~~ more people will go and have the vaccine.

In fact, one policy don't work so well compared to the combined ones in the case of merit goods and postive externality. It's a good idea to combine advertisement of the merit good, subsidy, and also some other ~~possi~~ possible policies like government provision. After that, the case will be fixed to the largest extent.

Jerry Jiang.

Macro

Question 4.

(a). ① inflation is the sustain increase in the general price level.

② cost-push inflation is inflation caused by a supply shock, which lead to the shift-in of the country's SRAS curve.

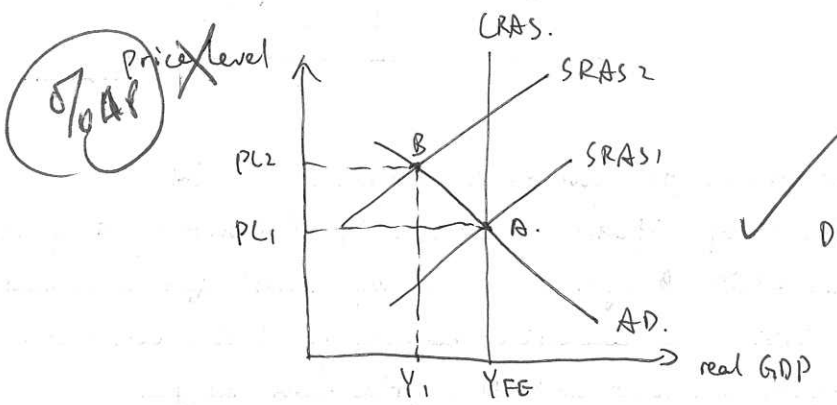


Diagram. 1.

In diagram 1, you can find the case of cost-push inflation in Pakistan.

- at the beginning, Pakistan's economy was at point A, where the output level is at Y_{FE} and price level at PL1.
- There's a sharp increase in price of oil import of Pakistan from the neighbouring country.
- since the cost of factor of production increase, the SRAS1 curve shifts into SRAS2.
- This shift brings Pakistan's economy from point A to point B.
- So now the price level rise from PL1 to PL2, which is a inflation.
- the output level decrease from Y_{FE} to Y_1, which opens a recessionary gap between Y_1 and Y_{FE}.
- As a result, there's both inflation and recession, so this terrible situation is called: stagflation.

When stagflation happens, businesses' output falls, so they tend to do these 2 things:

(1) they fire people, so that unemployment rate rises.

(2) they decrease the wages of the workers, which might lead to strikes, etc.

Now let's look into another type of inflation in Zimbabwe:

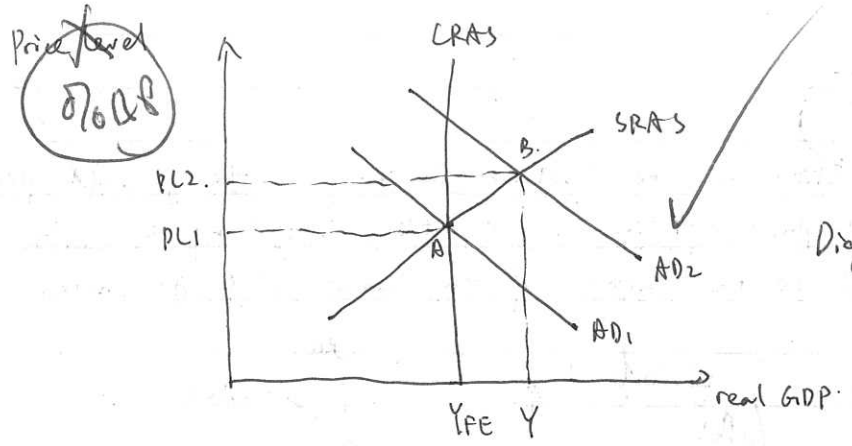


Diagram 2.

In diagram 2, you can find demand-pull inflation.
This kind of inflation is caused by the shifting out of the agregate demand curve, which might be caused by taxation or government spending changes.

- At first, the country's economy is at A, with the output at full employment level and the price floor at PL1.
- since the zimbawe government gets a huge amount of money from oil export, they decide to decrease taxation level and increase the government spending on education and health care.
- As a result, this decision rise the aggregate demand so it shifts out to AD2, moving the economy to point B.
- This cause the price level to rise from PL1 to PL2, which indicates an inflation;
- the output level rises from Y_{FE} to Y_1.

→ The reason why the AD curve shifts out is that:

① $C = Y - T - S$. when T↓, C↑.

② $AD = C\uparrow + G\uparrow + I + X - M$. we already know that C increase, but government spending also increase in Zimbabwe.

So that's the reason Zimbabwe has a demand-pull inflation.

(10) excellent!

4. (b) ① deflation happens when a country's general price level drops. sustained decrease in prices

② recession refer to a country's economy when its real GDP has been falling for at least 2 consecutive quarters.

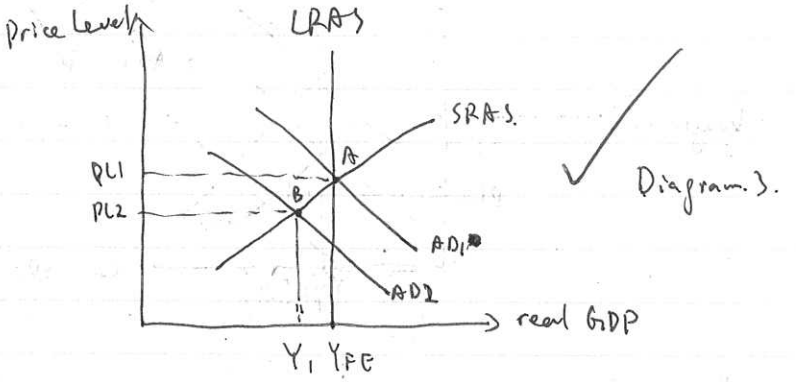


Diagram 3.

In diagram 3, you can find the case of deflation in Vietnam.

- at first, Vietam's economy is at point A where the output is at full employment level.
- The government decide to cut ~~gg~~ government ~~spent~~ spending and raise taxation level.
- As a result, the AD1 curve shifts into AD2, moving the economy from A to B.
- So this cause the price level to drop from PL1 to PL2, indicating deflation.
- ~~and~~ the output drops from Y_{FE} to Y_1, indicating recession.

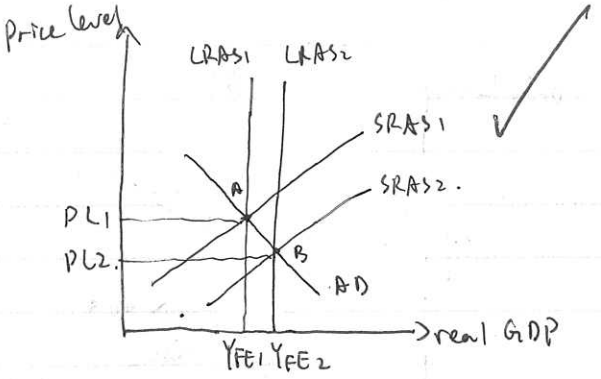
Add ①

- During deflation, the price level falls, which decrease the country's stability.
- When people borrow money before the deflation, they have to pay the same numeric amount of money back to the borrower. However since the price level has droped, that amount of money ~~has~~ has more value, so borrowers will be harmed by the deflation while the ~~borrowers~~ lenders, usually the bank, gets the benefit.
- However, for households with fixed income, their income remains mostly unchanged, since according to the theory of "sticky wages", businesses hesitates to drop wages. Since the price level falls, the household's real wage increase, which will actually benefit the people, especially the poor.

① But that's a reason the goverment do this. They don't want to cause too much deficit since there's a lot already. If they do, they have to borrow a lot of money to fill ~~th~~ the deficit, so the interest rate ~~de~~ increases. This largely discourages investment, so company will hesitate to invest. The crowding out of businesses will lead to a huge ~~dec~~ shift in of AD curve. That's why the Vietam government drops government expenditure.

However, the Zimbabwe case is not only ~~the~~ the case where a deflation might happen. Let's see the case in China where deflation leads to an expansion.

Diagram.4.



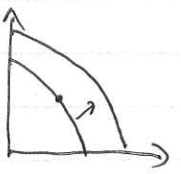


Diagram 5.

In Diagram 5, China is trying to use measures to shift the country's PPC ent so that a long-term growth is achieved.

① When Chinese government invest on education and health care, the quality and quantity of worker increase, Q/L↑, which leads to the increase in productivity.

② when Chinese government pays for the research and development, the technology renews and Q/K↑.

③ when Chinese government build sewage and water system, equity increase as well as the efficiency of labour.

These might lead to a shift out in SRAS1 curve to SRAS2, along with LRAS1 to LRAS2, YFE1 to YFE2, which indicates an expansion.

You can see in Diagram4, the Price level drops from PL1 to PL2, ~~but~~ ~~it's~~ indicating the deflation.

In conclusion, we know that deflation can be quite terrible since it's harmful to the economy's stability and harm the borrowers, in the case of Vietnam, but it also have some possitive effects when countries expand their output. It's not always that deflation is bad.

~~9/10~~ 12/15

You are on the right track.