1 (a) Explain the functions of an economic system. [8]

(b) Discuss possible reasons why mixed economic systems have replaced most of the former planned economic systems. [12]

(a) Any country's economic system can be defined as decision making process through which it allocates its scare resources towards production of unlimited wants in such a manner that citizens' living standards are maximized. There are three different types of economic systems among which countries can choose from namely free markets, mixed economy and planned economy. Over time economists have extensively studied these 3 types of economic systems and have identified potential pros and cons of each.

What to produce? How to produce? For whom to produce? These are the three basic questions that any economic system needs to answer to determine its resource allocation pattern.

What type of goods/services should be produced is the most basic question that needs to be answered by an economic system. Since economies cannot produce all needed and /or wanted goods/services they need to decide which products should be produced in preference to other possible alternatives.

Moreover the question concerning how to produce refers to selection of production technique that will cause economy to incur minimum possible costs. Since productive efficiency is only way to maximize country's total output; its presence is necessary to ensure achievement of highest possible living standards.

Lastly, for whom to produce helps economies decide upon distribution of produced goods / services. Should only people who are able to afford consume the produced goods /

services or there should be more equitable distribution of economy's output ensuring more equal distribution of total output.

(b) Planned economic system is the one where central decision making bodies decided upon allocation of resources and distribution of produced goods/services. Such economic systems try to ensure availability of basic necessities for all citizens. Though this might sound appealing because such economic systems unlike mixed and free markets do not result in massive income and wealth disparity among economy's nationals but they might

not provide sufficient incentives for market participants to work hard. Limited economic incentives discourage individuals to work harder because government being the owner of most of economy's factors of production is the biggest contributor to economic activity leaving very limited economic opportunities (if any) for the citizens. Hence leaving citizens / private businesses with any incentives to make the best possible use of their resources /faculties. Moreover inadequate incentives for public sector firms that dominate the economic activity in planned economies limit countries' economic growth. Lower national incomes result in lower living standards for country's citizens. Limited knowledge and slow decision making process (bureaucratic process) in public sector firms limit their ability to make the best possible use of economic resources. Government failure that results in economic inefficiency makes case for mixed economies.

Mixed economies on the other hand have presence of both public and private sector. Public sector is mainly responsible for providing public goods/services and establishes rules / regulations to monitor / control operations of private sector businesses. Apart from this all private goods / services are provided by the private firms. Existence of competition and profit incentives for private businesses encourage firms to satisfy consumers' wants / needs in the best possible manner (maximizing efficiency).

Free markets on the other hand though promote growth because of presence of relevant economic incentives but very limited or absence of government regulation might result in market failure like monopolies, externalities, over-production of demerit goods and under-production of merit goods. This market failure which is basically absence of economic efficiency is not a desirable situation for any economy.

Therefore mixed economy mixes positive aspects of both the other two economic systems like economic incentives of free markets and presence of government watch dog bodies to prevent presence of market failure hence making it is the most appropriate economic system for any economy.

2 (a) Explain how the effects of a devaluation on the level of economic activity differ from those of a deflation. [8]

(b) Discuss whether inflation can be both the cause and the result of fluctuations in an economy's exchange rate. [12]

Qasim 3

(a) Devaluation of exchange rate refers to weakening of an economy's exchange rate meaning each unit of local currency being able to buy less units of foreign currency and vice versa. Devaluation refers to deliberate weakening of economy's exchange rate by the government (central bank) to enhance the country's performance on international trade. Deflation on the other hand refers to constant fall in economy's general price level. The two can have quite different effects both positive and negative on the economy depending upon its exact circumstances.

Given price elasticity of demand is more elastic for an economy's exports and imports, devaluation is expected to boost an economy's net exports (exports minus imports) because lower prices of domestic goods in terms of foreign currencies will significantly increase their demand and similarly, compared to before, higher prices of foreign goods in terms of local currency will significantly decrease their demand resulting in substantial fall in country's imports. This prediction is supported by Marshal Lerner condition that claims that if sum of economy's export and import elasticity is greater than one then there will be an overall increase in country's net exports following depreciation of its exchange rate. However, in case, country relies on foreign economies for import of crucial goods like fuel etc then its weaker exchange rate can result in cost-push inflation due to price hike of raw materials.

Deflation on the other hand is not considered desirable by economists for it eliminates economic incentives for investors to undertake higher levels of investment. Falling price levels during deflation periods result in falling profit margins, given other factors are constant, which results in lower investment. Reduced investment lowers economic activity due to lower aggregate demand which causes economy's national income (GDP) to fall. Deflation is generally the result of investors' and consumers' pessimistic expectations about the future. This in itself can be harmful for the economy.

Though devaluation might not always be beneficial in terms of economy's improved performance on international trade but it is definitely less harmful compared to deflation which can result in long periods of low economic activity. For instance Japan suffered from persistent low levels of economic activity due to constant low investment and consumption levels.

(b) Yes, inflation can be both cause and result of fluctuations in economy's exchange rates. Weaker exchange rate can cause an economy's imports of necessary raw materials to increase in value resulting in higher import expenditure. This will be because of rising prices of imported goods in local currency. This cost-push inflation, or imported inflation as sometimes referred as, will increase domestic cost of production especially when local substitutes are not available for the goods imported. Higher production costs will result in higher general price level (inflation). On the other hand weaker exchange rates might be beneficial if an economy's import price elasticity of demand is more elastic resulting in lower import expenditure.

Similarly domestic causes of inflation can cause fluctuations in economy's exchange rate. If country's rate of inflation is relatively low compared to other economies then comparatively cheaper products will boost demand for country's exports. This will result in increased demand for country's currency which is expected to result in exchange rate appreciation. On the contrary if relative rate of inflation in an economy is high then reduced demand for country's products will result in lower demand for its currency which will cause economy's exchange rate to depreciate.

However the strength of relationship between these two variables will depend upon changes and significance of other variables affecting rate of inflation and exchange rate changes. If price is not the only consideration determining economy's exports then perhaps even during times of high inflation rates economy's net exports might not be very adversely affected. Similarly if an economy does not heavily rely on imported capital goods and raw materials then even during times of significant depreciation of its exchange rate economy's inflation rate might not that substantially be affected.

3 Explain how the different international transactions of a country are recorded in its balance of payments account. [8]

(a) Economies' Balance of Payments (BOP) is an official document that records all of an economy's international transactions that take place during a certain time period. BOP comprises of three accounts namely Current Account, Capital Account and Financial Account. BOP is made following the accounting double entry rule therefore each

transaction has two aspects namely debit and credit entries. Hence balance of payments like balance sheet of any business should always balance. However in some cases due to missing information it might not be the case and therefore the difference would be recorded in Errors and Omission section of Balance of Payments.

Current account has four sections namely Trade in Goods, Trade in Services, Income and Current Transfers. As the names suggests, Trade in Goods record economy's exports and imports of tangible goods during certain time period. Each export results in cash inflow and is recorded as credit entry and imports as debit entry. Similarly Trade in Services only records economy's exports and imports of services during certain time period (usually one year). Income section includes income earned by foreign nationals on locally owned assets and by economy's nationals on foreign held assets. Where income earned by country's nationals on foreign held assets is money inflow, income earned by foreigners on local held assets represent money outflow and therefore is recorded as debit entry. Lastly, in Current Transfers economies' transactions with foreign governments and international organizations are recorded. For instance if during certain time period Pakistan receives loan/grant from World Bank then it will be recorded as credit entry. On the other hand if our country provides aid to some other country then that will be recorded as debit entry for that represents money outflow.

In capital account economies' sale and purchase of assets is being recorded. Any foreigner buying asset in Pakistan is recorded as credit entry and any Pakistani buying asset in foreign country is recorded as debit entry.

Financial account records international transactions related to real and portfolio investment. For instance if any Pakistani invests in US stock exchange then that will be recorded as debit entry in our BOP and credit entry in US BOP.

4 (a) Using economic analysis, explain the possible causes of the increase in the sales of electronic goods, such as mp3 players, in recent years. [8]

(b) Suggest two possible reasons why a government might increase the indirect tax on such goods and discuss, in light of these reasons, the likely effectiveness of such a policy. [12]

(a) Over time when consumers' income increase their demand for luxury goods / services increase more than proportionately than any change in their income levels (meaning the income elasticity of demand for such luxury goods is more elastic). Higher incomes allow consumers to afford goods / services that they were previously not able to afford. High income elasticity of luxurious consumer goods including MP3 players make consumers generally demand more of these products during times of higher income levels.

Moreover persuasive advertisement of such products often makes consumers engage in impulse buying of these goods. Furthermore bandwagon affect might be present which causes consumers' demand for such products to be positively correlated with recent fashion trends.

Convenience, durability and improved product features which have made latest technology a must have thing can also be significant factors in increasing demand for products like MP3 players and other gadgets.

Lastly decrease in such products prices due to increased competition has resulted in higher demand due to their high price elasticity of demand.

(b) Generally indirect taxes are imposed on goods with negative externality or demerit goods. For the goods with negative externalities the imposition of indirect taxes makes consumers / producers involved in the consumption / production process to internalize the external costs that would otherwise have been borne by the third party. For instance by imposition of indirect taxes on smoking the external cost in the form of passive smoking is paid by the smokers rather than other people facing the cost in terms of increased pollution.

Similarly indirect taxes make producers causing pollution in the production process to pay for the external cost of pollution. Increased production costs after application of indirect taxes discourages consumption of such goods bringing the production to more socially desirable level.

For instance imposition of indirect taxes on electronic consumer goods has no economic justification unless their production involves negative externalities. This might be due to pollution caused from production of such products and unless producers and consumers of these products are not made to compensate the individuals who are adversely affected from their trade, society's welfare will be low. Similarly there might be negative

externality involved with consumption of such products. This might be because of their usage during driving that might cause safety hazard for other people on roads. If this is the case then imposition of indirect tax will be justified.

Depending upon elasticity of demand of the product the demand for inelastic products might not significantly fall preventing indirect taxes to be very effective tool for discouraging the consumption of these products. For instance discouraging the use of smoking through imposition of indirect taxes would not be very effective since it being addictive products have quite inelastic demand which means that consumers do not mind paying higher prices for these products but will not cut upon their consumption by a large extent.

5 (a) Explain why the successful operation of the division of labor depends upon the use of money. [8]

(b) Discuss whether it is the behavior of producers, consumers or governments that is most likely to cause inflation. [12]

(a) Division of labor refers to individuals' specialization in production of certain goods and services. Economists advocate for specialization because it is claimed that labor specialization results in higher economic output (due to improved productivity). Hence specialization will help economy achieve economic efficiency that is necessary to maximize citizens' living standards. Unlike self-sufficiency that was common among ancient civilizations, contemporary economic systems heavily rely on labor specialization where individuals instead of producing all goods that they need just focus on production / provision of certain goods and services and trade the surplus to consume other goods / services that they are unable to produce themselves.

Initially trade that is natural consequence of specialization was facilitated through barter system. In barter economies individuals used to exchange goods / services for other products. Though barter system did allow a way to trade surplus arising from labor specialization but the exchange system was not very efficient due to various reasons. This is because goods / services do not possess characteristics that are generally considered to be important for an object to be used as money. Lack of durability, non-divisibility and

presence of double coincidence of wants present some problems for barter system to be effectively used as a medium of exchange.

Hence to get around the operational inefficiencies present in usage of barter system economies came up with the idea of currency notes that are portable, divisible, and durable and therefore help money to execute its intended function of being used as medium of exchange. Hence now with invention of paper currency trade can be undertaken in much more efficient and convenient manner and therefore it has facilitated economies' pursuit of increased labor specialization.

(b) Depending upon the actual causes of inflation different market participants can be blamed for inflation taking place in an economy.

Demand pull inflation often results from consumers' increased consumption and investment. This might be because of increased economic incentives encouraging higher consumption and investment levels. Lower interest rates reducing incentives to save and encouraging consumers to borrow more might be reason behind citizens' increased consumption. Similarly lower cost of borrowing will encourage producers to undertake more investment because of higher profit margins. Moreover fiscal policy might also be significant determinant of economy's aggregate consumption and investment levels. Lower tax rates will boost consumption and investment due to citizens' higher disposable incomes.

Furthermore government spending itself directly affects economy's aggregate spending levels. Higher government spending will increase aggregate demand and can cause inflation. Hence government's deliberate change of its fiscal and monetary policy to affect economy's aggregate spending level can cause inflation and obviously government should be held responsible for such inflationary pressures.

Moreover excess money printing might be the reason behind economy's higher inflation rates. Money printing is used by governments to finance their budget deficits. However this often results in rise in economy's general price level. To avoid creation of inflationary pressures due to excessive money printing governments should rely on internal and external sources of finance for their budget deficits.

Cost push inflation is another type of inflation that causes prices for goods / services to increase due to increased production costs. This might be due to increased bargaining

power of economy's trade unions negotiating higher wage levels. Moreover rising fuel prices might be the reason behind economy's higher inflation levels. To keep profit margins constant, producers often raise their products' prices in line with increase in costs which cause general price level to rise. Producers might be blamed for this type of inflation.

6 (a) Explain how resources are allocated in a free market economy. [8] (b) Discuss how the market system might be influenced by government intervention to provide appropriate quantities of goods and services. [12]

(a) Unlike command / planned economies where central decision making bodies solely determine allocation of economies' resources, in free markets its market forces of supply and demand that determine allocation of economy's resources. Market demand being representative of consumers' preferences and market supply being representative of producers ability to produce collectively determine equilibrium price and equilibrium quantity traded. Increased demand for any good / service for given level of supply result in higher prices and vice versa. On the contrary increased supply for given level of demand results in lower prices and vice versa.

Changes in relative prices (which are determinant of changes in relative profits assuming ceteris paribus) allow prices to effectively undertake resource allocation mechanism. Hence increased demand for certain goods / services will result in greater quantity of resources being allocated towards their production and vice versa.

(b) Government intervention in operations of free market is justified because of presence of market failure. Market failure is defined as inefficient use and allocation of economy's resources that actually prevent economies to achieve economic efficiency and therefore limits their ability to maximize consumers' well-being.

Market failure can result because of many different reasons including over-production of demerit goods, under-production of merit goods, no provision of public goods, lack of information etc.

To correct market failure related to merit and demerit goods governments often use subsidies and indirect taxes to increase and decrease the quantity consumed of merit and

demerit goods respectively. By reducing the cost of production subsidies will cause supply curve of merit goods to shift rightwards and by increasing cost of production supply curve will shift leftwards for goods on which indirect taxes are imposed. Moreover since it is not profitable for private sector to provide public goods hence minimal presence of public sector is necessary to ensure provision of public goods to economy's citizens.

Moreover presence of positive and negative externalities is also common reason behind market failure. Under and over consumption of positive and negative externality goods results in resource misallocation which is obviously a cause of concern for governments. Provision of subsidies and imposition of indirect taxes are common policy instruments to correct market failure related to positive and negative externalities respectively.

Being facilitator for private sector, governments ensure efficient use of economies' resources to maximize citizens' living standards.

7 (a) Explain how and why the price elasticity of supply of agricultural goods differs from that of manufactured goods. [8]

(b) Discuss whether the payment of government subsidies to farmers is a beneficial policy. [12]

(a) Price elasticity of supply refers to responsiveness of quantity supplied with regards to changes in product's price. More elastic supply is refers to changes in prices resulting in more than proportionate change in quantity supplied. On the other hand less elastic supply refers to less than proportionate changes in quantity supplied following certain changes in products' prices.

Due to reasons including agricultural goods having longer production lag than manufactured goods and weather requirements not allowing cultivation of any crop throughout the year result in agricultural goods having exceptionally low price elasticity of supply. This is not the case for manufactured goods that can be produced round the clock depending upon businesses' excess capacity.

Moreover it is comparatively much easier to stock manufactured goods than primary products that are perishable and therefore cannot be preserved for long periods of time.

Comparatively longer expiry periods of manufactured goods make them easier to store and therefore they have relatively higher price elasticity of supply.

Furthermore availability of raw material also affects products' price elasticity of supply. Countries where comparatively more of agricultural land is available are expected to have higher price elasticity of supply for agricultural products and vice versa. Moreover economies where greater proportion of total land is allocated for industrial purposes are expected to have comparatively higher price elasticity of supply for manufactured goods.

Level of competition based upon number of firms operating in any economy will also affect products' price elasticity of supply. Limited number of firms producing certain products results in lower price elasticity of supply.

(b) Financial payments to producers of certain products are known as subsidies. Subsidies are intended to increase products' supply by contributing towards suppliers' cost of production. Rightwards shift in products' supply, due to provision of subsidy, results in greater consumption which positively affect both consumers' and producers' surplus.

Reduced cost of production due to governments' financial assistance in terms of subsidies will help producers earn higher profits. At each price level producers will be willing to produce and sell larger quantities of products for which government is providing them financial assistance for. Higher consumer surplus will also ensure higher well-being of consumers that arises from lower prices compared to before provision of subsidy. Similarly higher prices received by producers will make them enjoy higher surplus.

However overall economy might not become better off and instead there will be government failure arising because of deadweight. Often government expenditure to finance subsidies exceeds combined increase in consumer and producer surplus. This basically means that people contributing to national taxation will become more worse off than combined welfare gain of consumers and producers in terms of their higher surplus.

8 (a) Explain the limitations of the theory of comparative advantage in accounting for a country's pattern of trade. [8]

(b) Discuss whether the introduction of trade barriers against imports can always be justified. [12]

Qasim 12

(a) Comparative advantage model predicts that economies will / should specialize in production of goods / services for which their opportunity cost in terms of other goods / services is lower. Meaning countries should produce / specialize in products for which they do not have to give-up too much of other goods / services. Economies generally have comparative advantage in products that require resources that are in abundant supply in those countries. For instance Pakistan has comparative advantage in production of agricultural goods because being a larger economy it has relative abundance of land and semi / un-skilled labor. This is quite opposite for developed economies that have relatively abundance of capital and enterprise and therefore their comparative advantage lies in production of technologically-sophisticated goods and services.

Though economies' specialization based upon their comparative advantage is expected to result in overall higher world output levels but there are other factors that might also impact countries specialization patterns; absolute advantage is one of them. Absolute advantage predicts that international trade will be based upon economies ability to produce goods / services at the lowest possible costs. Cheaper goods / services will result in higher demand for economy's products and therefore absolute advantage should be the basis for economies' specialization patterns for international trade.

This being said there might be other factors explaining patterns of international trade. Distance between economies, cost of transportation, political and diplomatic ties between countries might also explain volume of trade between different economies.

(b) Trade barriers or protectionist tools as they are generally known refer to use of financial instruments that artificially make imported goods less competitive. Use of tariffs, quotas, exchange control and export subsidies are all different possible ways of making foreign products less competitive as compared to exports.

Economies use trade barriers for protection of their local industries and employment. Lesser proportion of foreign products in economies' aggregate consumption will result in comparatively higher domestic employment and national income levels. Moreover for protection of infant industries also known as sunrise industries trade barriers might be imposed. Developing economies are often in the process of inception of new industries and therefore to ensure their smooth growth it is important to protect them

against foreign competition. Developing economies justify use of these protectionist tools to argue that developed economies have used similar strategies during their initial development phases.

Moreover to control dumping that is an illicit competition practice economies often resort to protectionist policies. Dumping is defined as export of products below their cost of production to destroy local competition and to create monopoly in foreign economies. This reason unlike many others is supported by economic theory and is a justified reason for any economy to impose protectionist tools against any country's imports. However since economies nowadays are more interdependent upon each other for promotion of free international trade to help themselves achieve higher living standards therefore use of protectionist policies might not be a very economically useful tool except for few reasons which are supported by economic theory.

9 (a) Explain, using elasticity of demand, the possible reasons why in some countries there has been an increased use of private transport instead of public transport. [8] (b) Discuss the economic reasons for subsidizing public transport and taxing private transport. [12]

(a) Elasticity of demand refers to responsiveness of quantity demanded with regards to changes in product price. More elastic demand refers to more than proportionate change in quantity demanded following any change in price level. Less the proportionate change in quantity demanded following a price change is known as less elastic demand.

In this case, private transport is expected to have more elastic demand in relation to demand for public transport. Private transport being comparatively expensive and presence of cheaper alternatives makes its consumers more sensitive to changes in its price levels. However greater convenience of private transport might make its demand inelastic. Moreover countries where public transport is not considered as equally good substitute for private transport especially developing economies including Pakistan, there is expected to be higher demand and lower price elasticity of demand for private transport.

Since, over time, cars manufacturing has become cheaper and especially with the invention of more fuel efficient cars private transport has become comparatively cheaper than before. This might be the reason behind higher demand for private transport since any given fall in usage of private transport is expected to increase its quantity demanded by significant percentage. Moreover since private transport is also expected to have higher income elasticity of demand because it being more of a luxury than necessity therefore over time increases in consumers' income level might have significantly contributed towards increased consumption of private transport.

(b) Firstly presence of negative externality with usage of private transport can be the justification for imposition of indirect taxation. Economy's greater fuel consumption results in higher emission levels of harmful gases including carbon mono-oxide which adversely affect environment and therefore lower consumers' well-being. This market failure associated with over-consumption of negative externality can be dealt with imposition of indirect taxes. On the other hand lower air pollution arising from use of public transport in relation to private transport makes it a merit good. Hence government promotion of public transport through provision of subsidies can be supported in light of economic theory.

Apart from increased air pollution, private transport is also expected to increase road congestion which makes valid justification for the product to be imposed indirect tax upon. Furthermore greater chances of road accidents arising from increased road congestion call for market regulation through government strategies to discourage increased usage of private transport. Moreover due to increased road congestion government might need to allocate greater proportion of its total resources towards infrastructural development which obviously has huge opportunity cost (especially for developing economies where government revenue is quite low due to lower national income levels).

Because public transport often do not create societal problems related to air pollution, road congestion, road safety hazards etc it is justified for governments to provide subsidies on public transport. Moreover because public transport is generally used by less-wealthy people who cannot otherwise afford their private transport; their well-being will be higher because of their increased mobility. Provision of subsidies on public

transport satisfies governments' economic objective of achieving more equitable income distribution.

10 a) Use economic analysis to explain the benefits of international trade. [8]
(b) Discuss whether restrictions on international trade can ever be justified.
[12]

(a) Majority of economists advocate for promotion of free international trade. Proponents of free international trade believe that global output levels will be higher given economies specialize in production of certain goods/services based upon their absolute and comparative advantages instead of countries aiming for self-sufficiency.

Economic theory fully supports free international trade based upon its acclaimed benefits. Since all economies have unique factor endowments and if they specialize in production of goods/services that require factor inputs that are in abundance supply in any economy then greater surplus produced can be exchanged for cheaper foreign products. This economically efficient exchange is expected to increase economies' well-being.

Moreover increased international trade is expected to improve economies' supply-side conditions. Transfer of technology and capital goods and raw material and labor mobility are expected to positively affect economies' production potential. Furthermore higher economic well-being of consumers due to availability of cheaper foreign goods is another potential benefit of international trade.

(b) Protectionism of infant industries is generally considered to be valid reason behind economies' use of protectionist policies. It takes time for newly established industries to prosper and to adequately undergo product and innovation progress to be able to effectively compete with well-established foreign producers.

Moreover use of protectionist policies might be justified to avoid dumping. Dumping is defined as export of goods/services below their cost of production. Often well-established large firms are accused of dumping their products in economies where certain industries are in their inception periods. The idea is to destroy local competition and try establishing monopoly in the long run. Hence economies feeling threatened from illicit competition practices of large monopolies might be justified in protecting their booming industries from dumping practices.

Apart from these above mentioned reasons some economies also justify use of protectionist policies on the basis of protection of their national income and local employment. Countries' too much reliance on imports is expected to adversely affect the demand for their locally manufactured goods. This is seen as valid reason by some for justifying application of protectionist policies. However it needs to be remembered that restriction for free international trade will adversely affect consumers' well-being due to lesser availability of cheaper goods. Hence excessive protection of local industries indicates that higher national income and employment is coming at the expense of reduced consumers' well-being.

11 (a) Explain whether the factors of production are always of equal economic importance within and between economies. [8]

(b) Discuss whether planned economies should always be replaced by free market economies. [12]

(a) No, different types of factor inputs are not always equally important in different economies. Higher population levels of developing economies make their human resource more abundant resource (relative to other factors of production) and therefore their comparative advantage often lies in production of goods/services that involve labor intensive production techniques. On the other hand developed economies often have capital as their abundant resource and therefore their comparative advantage lies in production of capital intensive goods/services. Similarly large countries have land as their abundant resource and hence their comparative advantage is expected to lie in production of agricultural / primary goods for which land is the most important factor input. Moreover over times economies generally experience changes in relative supply of different factors of production.

For instance, Pakistan's increased investment in capital goods will increase stock of capital goods with regards to economy's population levels. Hence then economy's comparative advantage might switch from primary goods to low value-added manufactured goods. China and India can be appropriate examples of economies that deliberately underwent such changes in their factor inputs to better benefit from global trade.

(b) Planned economies are where central decision making bodies are generally in-charge of making economic decisions including allocation of resources and distribution of produced goods / services. In free markets, demand and supply forces determine products' prices and their distribution between various market participants.

In free markets unlike planned economies prices undertake two very important functions including allocative mechanism and rationing mechanism. Allocative mechanism refers to resource allocation among various types of goods/services. Rising prices of certain goods/services attract increased investments from various producers and as the result supply of these goods increase and vice versa. Moreover prices also determine distribution of goods/services among economy's citizens. Only people who are able to afford these goods/services are expected to consume them.

Economic theory supports prices efficient execution of allocative and rationing mechanism especially given that wealth / income distribution is not very unequal. Moreover rate of growth for planned economies is generally low due to lesser incentives for market participants to maximize their profits/income. This presents serious constraint for command economies to experience high national income levels. Moreover limited private ownership of factors of production limits economies' entrepreneurship spirit which restraints their ability to effectively compete with international competitors due to their limited product and process innovation.

12 (a) Explain how income elasticity of demand and cross elasticity of demand can be used to classify different types of goods. [8]

(b) Discuss the effectiveness of government use of maximum and minimum prices to help consumers and producers. [12]

(a) Income elasticity of demand is a quantitative measure that estimates products' responsiveness of quantity demanded following changes in their income levels. More elastic income demand refers to more than proportionate change in consumers' demand for certain products following any change in their income levels. On the opposite less elastic income demand of products is when their quantity demanded is not significantly affected following any change in consumers' income levels. Moreover economists believe that some products might even have negative income elasticity of demand. This

means that increase in consumers' income makes them consume lesser quantities of those goods and vice versa (during times of falling income larger quantities are consumed). Products having positive income elasticity of demand are known as normal goods for increased consumer demand results in larger quantity being demanded for these goods and vice versa. On the other hand products with negative income elasticity are defined as inferior goods.

Cross elasticity of demand is quantitative measure of relationship between quantities demanded of one product with regards to changes in others' prices. Either the value can be positive or negative. Positive values show direct relationship between one good quantity demanded and other good price. This means higher prices of one good will result in higher quantity demanded of other good. This is for substitutes. Similarly negative values represent complementary goods because increase in price of one will result in lesser quantity demanded for the other good.

(b) Maximum prices refer to government legislation to impose prices lower than market's equilibrium prices. On the other hand minimum prices are when through legislation and government intervention in market operations certain products' prices are set above their prevailing price level.

Minimum and maximum prices are set to increase producers and consumers' well-being respectively. When governments want to ensure higher income levels of producers and they expect current price levels to result in inadequate revenue for product producers then they might make use of minimum prices. Above equilibrium prices increase producers' revenue for each unit sold and excess production that results from having these minimum prices in place is being purchased by government for either exports or maintaining buffer stocks to be released during periods of low production in any future time period. On the other hand when governments want to ensure higher consumer well-being by making them pay lower prices, often maximum prices are considered useful. If governments fear lack of affordability of certain product at their prevailing price level then maximum prices can be an effective way to dealing with such problem. Product shortage that arises from imposition of maximum prices is dealt with through use of buffer stocks or import of foreign products.

Strong institutional framework and effective government intervention in market operations is needed to ensure smooth implementation of maximum and minimum prices.

13(a) How does aggregate demand and aggregate supply analysis explain the existence of inflation in the short run? [8]

(b) Discuss whether a period of inflation or a period of deflation is more economically desirable. [12]

(a) Aggregate demand and aggregate supply analysis is needed to determine an economy's macroeconomic equilibrium. Aggregate demand being total spending on economy's goods/services along with aggregate supply being total production of goods/services in an economy is expected to determine economy's equilibrium. Just like individual markets equilibrium is where market demand and market supply interact, for economies as a whole aggregate demand and aggregate supply collectively determine macroeconomic equilibrium. Increased aggregate demand for given level of economy's aggregate supply will result in higher general price levels.

Aggregate demand being made of economy's total consumption, investment, government spending and net exports is expected to react to changes in variables that affect any of these components of aggregate demand.

Presence of spare capacity, in short run, allows economies to accommodate additional aggregate demand without experiencing very high inflation rates. This is because of economies' upward sloping short run aggregate supply curves. Higher general price levels encourage producers to undertake more production due to higher expected profits. Hence elastic short run aggregate supply makes economies' quantity supplied responsive to changes in countries' general price levels.

In long run, economies are expected to experience higher inflation rates following a given change in their aggregate demand levels due to their operation at maximum production levels. Classical believe that economies' long run aggregate supply curves are vertical lines with regards to their general price levels. This is based upon their idea that economies' long run aggregate supply curves are depiction of their maximum production potential. Hence any change in economies' aggregate demand levels are not expected to

affect their national income levels but will only build inflationary pressure resulting in higher inflation rates.

(b) Economists have consensus that low and stable inflation rates help economies achieve their growth objectives. A steady and low rate of increase in economy's general price level helps investors to earn higher profits because increase in cost of production especially wages is not directly in line with increase in products' prices. However unanticipated and high inflation rates cause distortionary effects by preventing prices to effectively execute their allocative and rationing mechanism. Relative changes in prices might be difficult to estimate during high inflation periods which are expected to result in resource misallocation. Moreover consumers might also allocate their expenditure incorrectly due to difficulty in comparing prices of various goods/services. For instance even if prices for certain goods have relatively become cheaper due to smaller increase in their prices they might still not experience increased demand.

Deflation on the other hand is not considered desirable for economy's well-being for low investment levels adversely affect economy's growth rates.

14 (a) Explain why the free market is ineffective in arriving at the correct price for merit goods and demerit goods. [8]

(b) Discuss the policies a government might adopt to ensure the correct price for merit and demerit goods is charged in the market. [12]

(a) Merit goods are defined as goods whose benefits are under-estimated by their consumers. Similarly demerit goods are those goods whose harmful effects are under-estimated by their consumers. Education, health care can be appropriate examples of merit goods. Similarly smoking, pollution etc can be cited as examples of demerit goods.

Under-estimation of benefits of merit goods causes consumers to under demand them. Hence left to market forces, consumers' demand of merit goods is at a lower level compared to what socially desirable level of consumption would have been. This results in market equilibrium where lesser quantity of merit goods is being traded. For demerit goods it is opposite and consumers demand for such goods is higher than what is

considered to be socially desirable. This results in market equilibrium where larger quantity of demerit goods is being traded.

To bring consumers' demand of merit and demerit goods at socially desirable level government make use of subsidies and indirect taxes.

(b) Use of subsidies and imposition of indirect taxes can help governments achieve more desirable prices for merit and demerit goods respectively. As mentioned in earlier part, greater demand for demerit goods compared to socially desirable level and lesser demand for merit goods compared to socially desirable level results in higher quantity consumed for demerit goods and lesser quantity of merit goods being consumed by economy's citizens. To correct this market failure governments can use indirect taxes on consumption of demerit goods. This causes demerit goods' supply to shift leftwards and hence will result in higher prices. Higher prices will shrink consumers demand and will result in lower quantity demanded eventually. On the other hand provision of subsidies on merit goods will cause their supply curve to shift rightwards which will cause their prices to fall. Lower price level will in turn result in expansion of consumers' demand resulting in higher quantity consumed.

15 (a) Explain how unemployment and inflation are measured. [8]

(b) With the help of diagrams, analyze the factors that will lead to an increase in aggregate demand in an economy, and discuss whether this increase is more likely to have an impact on inflation or unemployment in that economy. [12]

(a) Unemployed individuals are those who are able and willing to work but are unable to find paid employment. Inflation is defined as persistent increase in economy's general price level. All economies wish to achieve low unemployment and low inflation rates. These macroeconomic objectives are achieved through governments various policy instruments including fiscal and monetary policy.

Unemployment is generally calculated using Claimant Count and Labor Force Surveys. As the names suggest, claimant counts refers to government estimation of economy's level of unemployment through people who are registered with various social security governmental departments as unemployed and hence are receiving unemployment

benefits. On the other hand, labor force surveys are regularly conducted in various economies to help them estimate their level and rate of unemployment. These surveys are designed in accordance with International Labor Organization (ILO) standards. Unlike claimant count that is easier and more effective way of estimating unemployment; labor force surveys are difficult and time consuming process to gather required data and is often subject to sampling error problems that disrupts economy's unemployment statistics. However it is not hard to imagine why at times claimant count might also not be very accurate way of predicting country's unemployment levels because certain voluntarily unemployed might be registered and benefiting from state's unemployment compensation payments.

Inflation on the other hand is calculated through various price indices that record changes in prices of certain goods/services over time. Percentage changes in index values of these price indices are used as estimate for economies' rate of inflation. Consumer price index is one of the most popular price index that captures rate of inflation in an economy from the perspective of economy's consumers.

(b) Any economy aggregate demand is made up of consumption, investment, government spending and net exports. Changes in any of these components will cause economy's aggregate demand to change. Increased consumption due to lower direct tax rates, lower interest rates or consumers being optimistic about future will cause aggregate demand to increase. Similarly increase in economy's investment due to lower corporate tax rates and interest rates which are expected to positively affect economies' profit levels will result in higher aggregate demand levels. Similarly increased government spending due to political or economic objective and higher net exports due to increased price competitiveness of local goods, improved quality and durability of locally manufactured all will result in higher aggregate demand levels. Moreover reduced proportion of imports in economy's aggregate consumption will also result in higher aggregate demand levels. This can be due to governments' deliberate use of strategies to discourage citizens from consuming imported goods.

Economies higher aggregate demand levels for given level of aggregate supply will result in higher inflationary pressures. These inflationary pressures will be comparatively less severe during short run because of presence of economies' excess production capacity.

However when in long run economies are operating close to their maximum production potential increase in their aggregate demand will result in higher inflationary pressures as compared to short run. In general closer an economy output with regards to its maximum production potential higher will be inflationary pressures following an increase in economies general price levels.

16 (a) In a two country world one country is more efficient at producing one product and the other country is more efficient at producing another product. Explain why specialization and trade usually benefit both countries. [8]
(b) Suppose one country were more efficient at producing both products. Discuss whether it is the case that specialization and trade will always benefit both countries. [12]

(a) Economic theory supports economies specialization in certain goods/services based upon their absolute and comparative advantages. Absolute advantage is when economies are able to produce certain good/services at the lowest possible costs. Comparative advantage refers to the idea that economies should specialize in production of products that they can produce at lower opportunity cost.

Economic theory supports promotion of free international trade based upon the idea that world output levels will be higher when economies will specialize in goods/services that they have cost competitiveness in and export their surplus. This also allows economies to benefit from consumption from cheaper foreign goods. Economists also claim that import of higher quality cheaper products result in transfer of technology from more to less developed economies. This helps them develop their stock of capital goods that will help them better exploit their unique factor endowments' potential.

Moreover economies exporting certain goods/services are expected to benefit from exploitation of economies of scale.

Furthermore increased international competition arising from free international trade is expected to exert constant pressure on developing economies producers improve their products quality and lower their prices.

(b) Though it is possible for one economy to have absolute advantage in production of both goods/services but one economy can never have comparative advantage in production of

both goods/services. Hence in cases when due to absolute advantage limitations economies cannot decide upon their specialization pattern comparative advantage allows economies to predict their beneficial specialization patterns.

Hence according to comparative advantage, economies instead of achieving self sufficiency should only specialize towards production of products that they can produce relatively more cost efficiently meaning with lower opportunity cost. This allows economies to make most efficient use of global resources. And because other economies are able to produce certain products at lower costs they can provide cheaper good/services to any economy that does not specialize in those products.

17 In a free market price rations scarce goods.

(a) Explain this statement and, with the help of a diagram, show how price rations scarce goods when there is an increase in the costs of production. [8]

(b) Discuss whether preventing the price mechanism from working freely by using government price controls can ever be effective. [12]

(a) Rationing mechanism refers to distribution of goods/services among economy's citizens. Unlike command economies where central decision making body decides upon distribution of economies' output, in free markets prices decide upon distribution of goods/services. Only individuals who are able to afford certain goods/services are able to consume them in free markets and need based distribution does not exist as in planned economic systems.

Increased costs of production causes products' market supply curves to shift leftwards due to lower profits levels for each price level that discourages producers to undertake higher investment levels. Leftward shift in products' supply curves cause their market equilibrium prices to rise which limits certain consumers to afford this now more expensive product. This shrinkage in product's demand is due to consumers' lower affordability of expensive goods/service. This automatic reduction in citizens' demand for expensive products that are now available in lesser quantities is known as prices rationing mechanism. Unlike this relatively more efficient rationing mechanism

command economies rely on central decision making bodies distribution of goods /

services.

Hence free markets are often preferred over command economies based upon the idea that prices undertake rationing and allocative mechanism more efficiently than central decision making bodies that often due to lack of information are unable to make best possible decisions.

(b) Governments can impose maximum and minimum prices to facilitate consumers and producers respectively. Lower the equilibrium price is known as maximum price and prices higher than minimum price is known as minimum price. Maximum prices are imposed when government thinks that the prevailing equilibrium price is higher for consumers to afford the product. Similarly minimum prices are imposed when government want to contribute towards producers' income through higher prices.

Governments are expected to buy the excess surplus produced due to minimum price to ensure that prices stay at this higher level and for the maximum prices governments need to make up for the shortage in the market through import or using buffer stock. In either case it is an expensive government intervention. Moreover the increase in consumer surplus in case of maximum price is lower than the combined loss of producer surplus and the cost that government spends on importing the shortage. Similarly in the case of minimum price the gain in producer surplus is less than the combined loss of consumers in terms of lower consumer surplus and the cost that government spends on buying the excess production.

Therefore apart from maximum prices benefiting the consumer and minimum prices benefiting the producers are not much beneficial from the overall society's gain perspective.

18 (a) Define the components of aggregate demand and, with the help of a diagram, explain how an increase in spending in an economy might result in inflation. [8] (b) If an economy is experiencing inflation, discuss the view that its government should be more concerned about the external effects than its effects within the domestic economy. [12]

(a) Economy's aggregate demand is made up of aggregate consumption, investment, government spending and net exports. Consumption is made up of total spending of economy's citizens on consumer goods. Investment is defined firms' total spending on purchase of capital goods. Government spending refers to government expenditure that is undertaken on different goods/services for various developmental, infrastructure projects etc. Net exports refer to difference between economies export revenue and import expenditure.

Any change in any of these components will result in change in economies' level of aggregate demand. For instance increased government spending will result in rightward shift of economies aggregate demand which will cause increase in country's general price level. Demand pull inflation often results from economies' higher aggregate demand levels. In short run when economies have excess production capacity increase in their aggregate demand levels is not expected to result in significant increase in their inflation rates. But in long run economies are expected to experience larger increase in their general price levels for in long run countries are expected to be working close to their maximum production potential and therefore increases in aggregate demand cannot be easily be met by economy's increased supply.

(b) High inflation rates adversely affect economies' ability to achieve their different macroeconomic objectives and therefore low and stable inflation rates are often considered desirable. Inflation affects economies internal and external operations including increased cost of living for countries' citizens, reduced international demand for locally manufactured goods and unfavorable position on Balance of Payments and exchange rate (due to reduced exports).

Often domestic and external effects of inflation are equally damaging for an economy and therefore government should be concerned about both of these. Where higher cost of living due to inflation adversely affecting citizens' living standards is concern for government; reduced international demand for locally manufactured goods should also attract policymakers' attention. Persistent decrease in citizens' real wages might call for increased income support schemes for marginalized segments of the society. Minimum prices and provision of subsidies on necessities are potential government policies for financial assistance of less advantaged segments. Such income redistribution schemes are expensive to operate and can also result in government failure due to limited information which causes deadweight loss.

Relative inflation rates are significant determinant of economies' volume of exports. If an economy's inflation rates are lower than that of its competitors then its products will be price competitive otherwise higher relative inflation rates can substantially reduce demand for economy's exports. Lower export revenue results in depreciation of country's exchange rate. This can in turn further accelerate domestic inflation rates by causing cost push inflation arising from expensive import of foreign goods. Persistent balance of payments deficits can cause serious international debt problems. To avoid such problems economies should ensure maintenance of favorable position on their balance of payments. For this use of supply-side policies is often beneficial and provides effective long term solution to problems related to weak international trade performance.

19 (a) Explain the meaning of the term 'protection' in the context of international trade and describe two methods of protection used by governments. [8]

(b) Discuss, with examples, how international trade protection may affect consumers and producers in an economy and whether on balance protection can be justified. [12]

(a) Protectionism refers to use of financial instruments to discourage use of cheaper foreign products. Economies that face threat from increased supply of better quality foreign goods use protectionist tools to limit availability of these products in their countries. Though economic theory mainly does provide much justification for use of protectionist tools but there are certain reasons why it might be legit for countries to use protectionist tools to protect themselves against use of illicit competition practices.

Tariffs, quotas, exchange control are certain protectionist tools from which economies can choose from. Tariff is an indirect tax imposed on imported goods. This artificially increases foreign products prices which makes them relatively less price competitive and therefore makes them lose to local alternatives. Quotas are restriction on physical quantities imported in an economy. Instead of tariffs that increase foreign goods' prices, quotas limit the quantity of goods imported. Quotas limit proportion of local market that can be captured by foreign producers. Unlike tariffs that contribute to tax revenue, quotas do not provide any revenue stream to economies using these protectionist tools.

(b) Protectionism is justified in certain cases but often these unfair competition practices have adverse effects on economies' citizens including producers and consumers. Lesser availability of cheaper foreign goods due to presence of protectionist tools will adversely affect consumers' well-being. Similarly retaliation from foreign economies following local economy's discrimination against their products will result in lower export revenue for closed economies. Limited opportunities to exploit production potential and to benefit from economies of scale will result in lower national income for closed economies.

Limited choice for consumers due to restricted supply of foreign goods will adversely affect consumers' well-being. Presence of quotas will restrict physical quantities of imported goods and will limit choices for economy's citizens. Moreover government use of tariffs will make imported goods expensive and consumers will be discouraged to purchase more of imported goods. Especially if local goods are not up to the standard of foreign products then imports restriction will severely affect citizens' well-being. Producers are also expected to suffer in terms of reduced exports. However, overall, closed economies' producers are expected to experience higher well-being because of increased demand from local consumers. However lower competition from international players might slow economies' innovation process. Hence open economies are more prone to technological changes and they as result undergo rapid process and product innovation than closed economies.

20 (a) With the help of a diagram, explain how a production possibility curve can illustrate the concepts of opportunity cost and economic growth. [8]

(b) Discuss whether free market economies or centrally planned economies are more likely to make choices that will maximize the benefit for consumers. [12]

(a) Economies production possibility curves (PPC) is graphical depiction of their maximum production potential. PPC shows different combinations of two products that can be produced by any economy's given factor endowments.

Economies that are operating within their PPC are not producing at their maximum production potential. Economies are unable to produce any combination that lies beyond their frontier. These combinations of goods will only become achievable from economy's engagement in international trade or due to its improved production potential arising from improvement in factor endowments.

Opportunity cost is benefit of next best alternative forgone from economy/individual's choice. With regards to PPC greater production of one good result in increasing opportunity cost in terms of production of other good forgone (given PPC of any economy takes a concave shape). For linear shaped PPC opportunity cost of producing more of one good in terms of other good is constant. Unless economies do not engage in international trade they will try producing a more balanced combination of two goods. But specialization is preferred when economies engage in international trade.

Economic growth refers to increase in economy's output levels. Percentage changes in economies GDP figures is generally the statistic used to gauge countries' economic growth. When economies move from certain point within their PPC towards the frontier at which more of both goods are being produced then that is defined as economic growth. However for economies those are already operating at their maximum capacity and therefore are producing a combination of goods/services that lies at their frontier then such countries do not have any growth potential left to be exploited. But outward shifts in economies' PPC due to improvement in their factor endowments will allow them to have higher future growth rates.

(b) Unlike command economies where central decision making bodies make most of economic decisions concerning allocation of economy's resources and distribution of produced goods/services; for free markets these decisions are undertaken by market prices. In free markets prices undertake allocative and rationing mechanism.

Changes in products' prices signal profit levels which help producers adjust their expenditure among production of various goods/services accordingly. Similarly consumers' consumption in free markets is based upon their affordability (purchasing power). Though social security is often not absolutely not existent in free markets but unlike command economies where distribution of goods is generally based upon citizens' perceived need as decided by central decision making bodies, free markets rely on prices for rationing mechanism.

Though generally there is greater choice in free markets due to producers allocating their resources based upon consumers' preferences but less wealthy consumers might not be able to enjoy as high of living standards as their wealthy counterparts. But then economic incentives are often limited in command economies due to state ownership of most factors of production. These limited incentives pose constraint for increased productivity of economies' human and enterprise resources. Most individuals are employed in government organizations where due to inefficient processes and lack of incentives employees' professional and personal development is limited.

21 Explain on which goods and services the government should impose indirect taxes to ensure that the incidence of the tax falls mainly on consumers, and discuss the extent to which consumer surplus would be affected. [12]

(a) Indirect tax is tax imposed on citizens' consumption. Goods and services are subject to national taxation to help government achieve its revenue targets. Since it is comparatively easier for individuals to evade direct taxation, governments at times need to rely on indirect taxes to ensure achievement of their revenue targets. Higher prices paid by consumers and lower revenue per unit received by producers are the consequence of any indirect taxation. But how much of this indirect tax burden is borne by consumers is what will depend upon their price elasticity of demand. Less elastic demand as compared to price elasticity of supply will make producers transfer a larger proportion of tax burden on consumers and vice versa. More inelastic demand with regards to price elasticity of supply; higher tax burden will be borne by consumers and vice versa. This is why when necessary goods/services are subject to indirect taxes higher burden falls on consumers for they cannot reduce demand for necessities by large extent.

In case government wants consumers to bear greater incidence of tax then goods/services with lower price elasticity of demand should be imposed this tax upon. However, as stated earlier, but in case supply for that good is also very inelastic then producers will end up bearing comparatively larger proportion of tax burden. Agricultural goods can be good example of such goods for which demand and supply are both inelastic.

22 The best way to reduce a deficit on the current account of the balance of payments is to change the value of the deficit country's exchange rate.

(a) Explain how a change in a country's exchange rate might reduce a deficit on the current account of its balance of payments. [8]

(b) Discuss whether changing the exchange rate or imposing tariffs is the better way of reducing a deficit on the current account of the balance of payments. [12]

(a) An economy's current account is made of trade in goods, trade in services, income and current transfers. Countries' exchange rate directly influences their current account transactions.

Weaker exchange rates are expected to positively affect economies' export revenue. Greater purchasing power of foreigners for local currency makes domestic produced goods cheaper which positively affect countries' exports. Similarly opposite will also be true when stronger exchange rates are expected to adversely affect economies' exports and increase their import expenditure.

Since trade in goods and trade in services have largest balances on economies' current accounts therefore changes in economies' exports and imports volume are expected to significantly affect their overall current account balances. But income and current transfers can also significantly affect countries current account balances. Increased loans / aids / grants from foreign economies/international organizations will increase their current account balances. Moreover increased income earned by economy's nationals on foreign held assets will positively affect their income balance within their current accounts. However changes in economies' exchange rates are not expected to have significant effect on their income and current transfers. Stronger exchange rates will reduce burden of international loans through greater purchasing power of local currency in terms of foreign currency and vice versa. Moreover weaker exchange rates might encourage higher investments in local economy through greater purchasing power of foreign currencies in terms of local currency which will in turn result in more income generation for foreign nationals that is expected to adversely affect economies' income balances.

(b) Though use of expenditure dampening and expenditure switching policies are often useful in controlling short term temporary deficits on economies current accounts but supply side policies are the only effective long term solution for economies persistent current account deficits.

Reducing aggregate demand, through expenditure dampening policies, result in reduced expenditure on imports that is expected to improve economies' trade balance resulting in overall improvement in economies' current account balances. Deflationary fiscal and monetary policies are helpful in achieving such expenditure dampening policies. Moreover use of protectionist tools will result in reduced demand for foreign products which is expected to improve economies' current account balances. These strategies unlike supply side policies do not affect economies' production potential.

Exchange rate fluctuations are expected to have comparatively long lasting and greater effect on economies' current account balances. This is because maintaining low exchange rates are comparatively less problematic in terms of cost faced by economies. Use of protectionist tools makes other economies retaliate against locally manufactured goods by imposing similar protectionist tools against their exports. Such consequences of protectionist policies severely limit their ability to improve economies' current account balance. However governments' deliberate maintenance of weaker exchange rates can also be cause of concern for international stakeholders (other economies).

If economies have export potential and more elastic demand for exports and imports then according to Marshal Lerner condition economies' current account balances are expected to improve following their exchange rate depreciations. However both of these strategies are expected to bring temporary improvements in economies' current account balances.

23 Explain whether you would expect the price elasticity of supply of an agricultural product, such as rice, in a market to be elastic or inelastic. [8]

(a) Price elasticity of supply refers to responsiveness of quantity supplied with regards to changes in products' prices. More elastic supply refers to more than proportionate changes in product's quantity supplied following certain change in product's prices. On the other hand products for which quantity supplied varies less than proportionately than changes in their prices are referred to as having inelastic supply.

There are a lot of factor that significantly affect products' price elasticity of supply. Production lag needed to alter upon product's quantity produced. For manufactured goods this is generally shorter. Goods with shorter production lags have more elastic supply and vice versa.

Availability of raw material also affects price elasticity of supply. Goods for which raw materials needed to produce/manufacture them are more readily available in an economy will have more elastic supply and vice versa.

Number of producers producing a product can be expected to affect products' price elasticity of supply. Greater the number of producers producing any product higher will be its price elasticity of supply and vice versa.

Agricultural goods' supply is hard to alter following changes in their price levels. Since certain agricultural goods can only be produced under certain conditions including special weather conditions and agricultural land requirements. Higher prices for rice might not help significantly increase their production except for using buffer stocks or relying on imports.

24 (a) Explain the difference between private goods and public goods, and why it is possible for a business to make a profit in the supply of private goods but not in the supply of a public good. [8]

(b) Discuss the view that a market economy is always preferable to a planned economy because of the existence of the price mechanism. [12]

(a) Private goods unlike public goods are excludable and rivalry. Owners of private goods can choose to exclude certain individuals from consumption of their possessions. Similarly when consumption of certain good by one individual reduces/restricts others from its consumption is known as rivalry. Public goods like defense, street lighting, police etc are non-rivalry and non-excludable. Utility from consumption of an individual does not depend upon number of people who are already using the product. Similarly no one can exclude someone else from consumption of public good.

Since public goods are both non-excludable and non-rivalry; it is nearly impossible for private sector to make profit through provision of public goods. Just imagine how private infrastructure developer will charge people for usage of a newly constructed road? Since road being a public good is non-excludable and non-rivalry hence unlike prices of private goods that is in relation to consumption of particular product; public goods can be charged a flat rate (at most). Often this is also not possible because of inability of producers to identify all people using a particular product. For instance how can producers charge citizens for use of defense services?

Therefore public sector that does not strive to maximize profits is needed for provision of public goods. This is why government use major chunk of national taxation to ensure provision of public goods to their citizens which otherwise will not be available.

(b) Prices undertake allocative and rationing mechanism in free markets. Unlike command economies where central decision making body decide upon allocation of resources and distribution of resources, prices undertake both of these tasks in free markets. Greater choice arising because of more competition, comparatively more economic incentives, and constant improvement in factor endowments are potential advantages of free markets that hardly exist in command economies.

Lack of choice, presence of limited economic incentives, and inefficient government intervention in market operations are some potential disadvantages of command economies. However since planned economies have generally more welfare oriented approach hence there is expected to be more equitable distribution of income and economic opportunities. Similarly unlike market economies where citizens' ability to afford mainly determines their consumption of certain goods/services; in planned economies products are mainly distributed based upon citizens' need.

Moreover, as stated earlier, limited incentives to innovate and improve locally manufactured goods/services in planned economies results in lower growth and development of planned economies in comparison with market economies. These limited economic incentives often arise from the fact that majority of resources are state owned and since governments often maintain low disparity in citizens' living standards they try maintaining minimum possible wage differentials.

25 Explain what is meant by the term 'money' and outline its characteristics in a modern twenty-first century economy. [8]

(a) Money is defined as object that is used as medium of exchange. With latest invention in banking sector, economies are seen using electronic money apart from using usual currency notes/coins. Previously economic systems used to rely on barter system for which goods//services were exchanged for other goods/services. This exchange system apart from being inconvenient due to existence of double co-incidence of wants was also inefficient because goods/services do not possess right set of characteristics to be used as money. Divisibility, durability and portability are important characteristics that make any commodity to effectively serve as money.

Divisibility refers to ability of commodity/product to be broken down in smaller denominations. Durability refers to ability of commodity to endure for longer periods of time and one that does not perish easily. Lastly, portability refers to characteristics of commodity to be easily moved as and when needed.

Since these characteristics are generally not possessed by many normal products and therefore their usage as money is not often possible. Presence of these characteristics allow commodity that is used as money to effectively execute its intended functions including medium of exchange, store of value, means of deferred payments and store of value.

26 (a) Explain the meaning of the term 'equilibrium price and quantity' in the market for a good or service and show how a new equilibrium is established when there is an increase in demand. [8]

(b) Discuss the view that attempts to help poorer consumers through the imposition of a maximum price for food items will always fail. [12]

(a) Market equilibrium is defined as situation where market demand is equal to market supply. This is the only point for given level of demand and supply where there is no tendency for market prices to change. However any change in product's demand and/or

supply will result in establishment of new equilibrium that will change equilibrium quantity traded and equilibrium price.

The point where market demand is equal to market supply will determine market's certain equilibrium point. At that point the quantity of the product that consumers and producers are willing to trade is known as equilibrium quantity. Similarly the prices that consumers are willing to purchase each unit for and what producers are willing to accept as compensation for their products at equilibrium point is known as equilibrium price.

Following an increase in demand for any product its equilibrium price and equilibrium quantity traded is expected to increase. Following an increase in certain product's demand which causes its price to increase product's supply is expected to expand (also known as increase in quantity supplied) and as the result higher quantity is being traded.

(b) Government regulation to fix any product's price below its equilibrium price is known as maximum price. Such policy instrument is expected to help increase consumers' affordability of these products by reducing their prices. Since equilibrium prices for given level of demand and supply is only price level at which quantity demanded is equal to quantity supplied hence government restriction on price level results in shortage. This is because at lower than equilibrium price level quantity demanded exceeds quantity supplied. Hence governments need to decide upon ways to eliminate market shortage for effective implementation of maximum prices.

Buffer stocks or imports can be two possible ways for governments to make-up for shortage that exists. However since some consumers will be willing to consume these products at higher prices, especially if necessities are involved, hence such policy creates threat of establishment of informal markets.

27 (a) Distinguish between income elasticity of demand and cross elasticity of demand and explain how each is used to identify different types of product. [8]

(b) Discuss which of these two types of elasticity would be more useful when predicting how a firm's revenues would change as demand factors change in a market economy. [12]

(a) Income elasticity of demand refers to responsiveness of quantity demanded following changes in consumers' income levels. More income elastic demand refers to situation

when demand for goods/services change more than proportionately following any change in consumers' incomes. Less elastic income demand, on the other hand, refers to situation when products' quantity demanded fluctuates less than proportionately following given change in consumers' income levels. Positive values of income elasticity refer to normal goods for increase in consumers' income will cause them to demand larger quantity of that good/service. On the other hand, negative income elasticity refers to inferior goods which are demanded less following increase in consumers' income. This is because when consumers' income increases they have better substitutes available to replace lower quality inferior goods.

Cross elasticity of demand refers to measure of responsiveness of changes in quantity demanded for one products following change in another product's price. Positive values of cross elasticity of demand indicate substitute goods. This is because increase in price of one good will cause quantity of the other to increase and vice versa. Similarly negative values of this measure refer to complementary goods. This is because increase in price of one good will cause quantity demanded of the other good to fall and vice versa.

(b) Depending upon the nature of change in product's demand, researchers can use either one or both of these quantitative measures to estimate changes in firm's revenue. Increased consumers' income will cause revenue for normal goods to increase. Higher the income elasticity of normal good, higher will be increase in product's revenue. Similarly if price of product's complementary or substitute changes then cross elasticity of demand value will be analyzed to predict changes in firm's total revenue. If price of complementary good decreases then due to increased demand for firm's product its revenue will increase and vice versa. On the other hand, if price of substitute good increases then demand for firm's product will increase and that will positively affect firm's revenue and vice versa. Higher the value of cross elasticity of demand, higher will be change in firm's products' quantity demanded following a change in its complementary and/or substitute goods/services.

28 Distinguish between the domestic and external consequences of inflation and discuss which is most damaging to an economy. [12]

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(a) Demand pull inflation, rising cost of production due to internal factors and increased money supply due to excessive printing of currency notes are possible causes of domestic inflation. On the other hand any factor that causes inflation that is not intrinsic to any economy can be classified as external inflation causes. These include depreciation of economy's exchange rate that results in expensive import of necessary goods/services including capital goods, raw materials etc.

Effective supply side policies targeted at enhancing economies' production potential are long term sustainable solution for controlling economies' demand pull inflation. Similarly excessive money printing should be avoided at all costs and instead governments should try relying on foreign and domestic sources of finance for financing its additional expenditures. Moreover improved factor endowments can help economies avoid cost-push inflation. To consistently enhance countries' production potential will require their adequate investment in supply side policies like investment in human capital through education and training.

Similarly to control foreign cost push inflation due to persistent depreciation of economy's exchange rate economies will need to utilize their foreign currency reserves to artificially stabilize their currency's demand. This might be problematic given poor economies have limited amounts of foreign currency reserves and they are insufficient to maintain decent position of economy's exchange rate.