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ADVANCED SUBSIDIARY (AS)
General Certificate of Education
January 2009

Economics

Assessment Unit AS 1

Markets and Prices

[AE111]

AE111

FRIDAY 16 JANUARY, MORNING

TIME

1 hour 30 minutes.

INSTRUCTIONS TO CANDIDATES

Write your Centre Number and Candidate Number on the Answer Booklet provided.
Answer **Question 1** and **one** question from **Questions 2**, **3 or 4**.

INFORMATION FOR CANDIDATES

The total mark for this paper is 80.
Quality of written communication will be assessed in all questions **except 1(a), 1(c)** and **1(e)**.
Figures in brackets printed down the right-hand side of pages indicate the marks awarded to each question or part question.

ADVICE TO CANDIDATES

You are advised to take account of the marks for each part question in allocating the available examination time.

Question 1: Data Response

The following passage is based on a BBC news extract from November 2007.

Study it carefully and answer the questions which follow.

Oil Prices, 1994–2007

Source: Wikipedia

Fig. 1

WHY IS THE PRICE OF OIL RISING?

The main reason for the oil price's continuing rise is the balance between demand and supply. Demand is at an all-time high because of the expansion of the Indian and Chinese economies. 1

Both countries have populations of over 1 billion. Both are enjoying rising incomes and living standards and growth rates of around 10%. Hence it is no surprise that manufacturers and consumers are using energy at an ever-increasing rate. China's demand for oil is growing at about 15% a year. 2

Analysts worry that global demand for oil is rising so quickly that supplies may not keep pace. The nature of oil exploration and development means that it is very difficult for oil producers to increase output in response to a rise in price. 3

Similarly, the essential nature of oil means that escalating prices do not appear to be reducing demand which the International Energy Agency (IEA) predicts will rise by an average of 2.2 million barrels a day next year, compared with the 1.5 million barrel rise seen in 2007. It says annual demand will rise by 2% per annum up to 2012. 4

CAN SUPPLY INCREASE?

Most of the world's oil is controlled by the Organisation of Petroleum Exporting Countries (OPEC) which acts as a cartel with the objective of controlling oil prices. It is under constant pressure to do something about the price bubble. 5

However most OPEC members are quite happy with the high oil price and show [illegible] to increase production. For example, in Venezuela oil revenue has allowed President [illegible] Chavez to fund extensive social programmes and to reject US criticism of his policies. 6

Indeed, even if they wished to, it is doubtful that many OPEC members have the reserves [illegible] to increase output. Recent research has cast doubt on the size of oil reserves claimed by some OPEC members. The BP Statistical Review of World Energy recently claimed that for every nine barrels of oil we consume, we are only discovering one. So both political and geological factors make it difficult to increase the supply of oil. **7**

IS THE SITUATION AS DIRE AS IT IS PAINTED?

In spite of doomsday headlines referring to record high oil prices, the situation is not so dire as it might appear. Taking inflation into account, prices are still below the levels seen in late 1980, when a barrel of oil – in today's prices – was worth more than $101. **8**

WHAT CAN BE DONE?

Very little would seem to be the answer. Governments can subsidise alternative energy sources and encourage firms and consumers to become more energy efficient but this is unlikely to have any significant impact on the demand for oil for many years to come. **9**

Some voices on the political left argue that the source of the problem is the excess profits earned by the big oil companies and that price controls should be imposed on oil and gas. However this proposal is unlikely to find favour with the UK government which means that motorists will just have to pay up or walk!! **10**

Adapted from BBC news November 1st 2007

(a) Using the information in **Fig. 1** describe what has happened to oil prices between 1994 and 2007. [4]

(b) With the assistance of a demand and supply diagram explain the increase in oil prices referred to in the passage. [9]

(c) Using the information in paragraphs **2** and **4**, explain what the passage tells us about:

(i) The price elasticity of demand for oil. [4]

(ii) The income elasticity of demand for oil. [4]

(d) Explain why it is possible that in the long term the demand for oil may become more price elastic. [6]

(e) Explain why oil prices would have to reach $101 per barrel in order to exceed the record high prices of the 1980s. [3]

(f) Evaluate the case for government-imposed maximum price controls on oil and gas. [10]

Essays:

Answer **one** from Questions 2, 3 **or** 4.

2 “Free markets are the best way to allocate scarce resources”

(a) Explain what is meant by resource allocation. [10]

(b) Analyse the means by which free markets allocate scarce resources. [15]

(c) Evaluate the view that, though free markets sometimes fail, they normally produce better outcomes than government control. [15]

3 “The benefits of education to society far outweigh its costs”

(a) Explain what economists mean by externalities. [10]

(b) Explain why merit goods are often under-consumed in a market economy. [15]

(c) Critically examine some of the policies which governments could implement in order to increase the consumption of merit goods. [15]

4 “The gap between the richest and poorest in society is growing”

(a) Explain what is meant by economic rent. [10]

(b) Explain why some groups of workers are able to earn much more economic rent than others. [15]

(c) Governments use a variety of policies in order to reduce extremes of economic inequality in society. Critically examine some of these policies. [15]

THIS IS THE END OF THE QUESTION PAPER
