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RECOGNISING ACHIEVEMENT

**ADVANCED SUBSIDIARY GCE**

# ECONOMICS

Markets in Action

# F581

Candidates answer on the question paper

**OCR supplied materials:**
None

**Other materials required:**
- Calculators may be used.

**Friday 20 May 2011**
**Morning**

**Duration:** 1 hour 30 minutes

| Candidate forename | | Candidate surname | |
|---|---|---|---|

| Centre number | | | | | | Candidate number | | | | |
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## INSTRUCTIONS TO CANDIDATES

- Write your name, centre number and candidate number in the boxes above. Please write clearly and in capital letters.
- Use black ink. Pencil may be used for graphs and diagrams only.
- Read each question carefully. Make sure you know what you have to do before starting your answer.
- Write your answer to each question in the space provided. If additional space is required, you should use the lined pages at the end of this booklet. The question number(s) must be clearly shown.
- Answer **all** the questions.
- Do **not** write in the bar codes.

## INFORMATION FOR CANDIDATES

- The number of marks is given in brackets **[ ]** at the end of each question or part question.
- The total number of marks for this paper is **60**.
- Your quality of written communication will be taken into account when marking your answer to the question labelled with an asterisk (*).
- This document consists of **16** pages. Any blank pages are indicated.

**A calculator may be used for this paper**

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## Tea market crash leaves a bitter taste

The Chinese are well known for their love of tea. A particularly popular type is pu'er, a pleasantly aromatic brew which is claimed to reduce cholesterol, aid weight loss and even cure hangovers. It is for these reasons that China's rich middle classes and tea drinkers worldwide have increased their demand for this wonder product. In summer 2007, top quality pu'er tea was selling for a massive US$150 a pound (lb) in weight.

So, why was the price so high? The main reason was on the supply side. For a good number of years the demand for top quality pu'er tea had increased at a slightly faster rate than supply. As a result, prices rose. Consequently, more and more farmers switched from growing rice and corn, their staple crop foods, to planting and producing pu'er tea. Other farmers dug up other types of tea bush and replaced them with pu'er. So, supply was increasing but not at quite as fast a rate as the increase in demand and price.

Also on the supply side of the market, irresponsible wholesalers hung onto their seemingly precious stocks of pu'er as they believed that prices could only increase further. After all, it is a simple principle of economics that if demand is increasing and supply is inelastic, prices should continue to rise. Fig. 1 below shows the results of research by economists at a local university.

**Fig. 1: Estimated annual change in the price and supply of pu'er tea**

| | % change in price | % change in supply |
|---|---|---|
| 2003 | 5 | 3 |
| 2004 | 20 | 15 |
| 2005 | 25 | 40 |
| 2006 | 30 | 60 |

At the beginning of 2009 the market crashed; wholesale merchants in the Menghai area of China, where most of this type of tea is grown, were grateful to get just US$40 per pound. So why did the market collapse? One reason was an increasing number of farmers adding to supply at a much faster rate than before 2004. The market situation was not helped either by stable demand, partly as a consequence of increasing doubts over the benefits of pu'er tea.

The fluctuations in the market continue to baffle farmers in Menghai. One farmer commented, 'Not long ago, everyone was wearing designer labels... a lot of people bought cars but now we cannot afford gas (petrol) so we just park them in front of our unfinished new houses'. In Menghai, hotels and restaurants are no longer packed with out-of-town tea buyers; once prosperous wholesalers have now had to resort to eating at cheap cafes and travelling by pedicab, a cheap form of motorised transport.

All is not lost. The Xishuangbanna provincial government has been encouraging pu'er tea farmers to destroy their bushes and revert to producing corn and rice. To encourage them to do this, generous subsidies have been made available for producing these crops. The objective of this policy has been to stabilise markets not only for pu'er tea but also for corn and rice, both of which remain central to the staple diet of the local population.

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Answer **all** questions.

**1** State **two** factors of production which are used to produce pu'er tea and give an example of each.

1 .....

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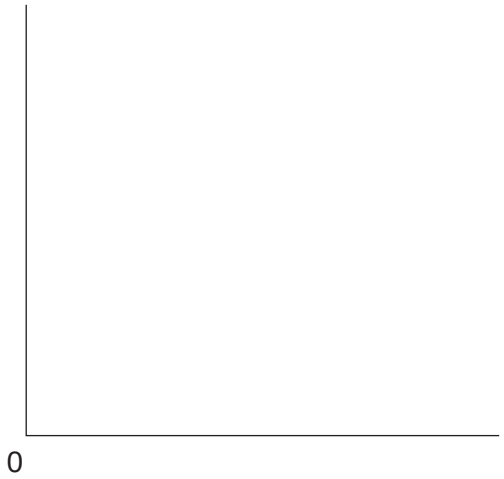
2 .....

.....**[4]**

**2** **(a)** Draw a production possibility diagram to show the effect of moving resources from the production of staple foods such as rice and corn to the production of pu'er tea.




**[4]**

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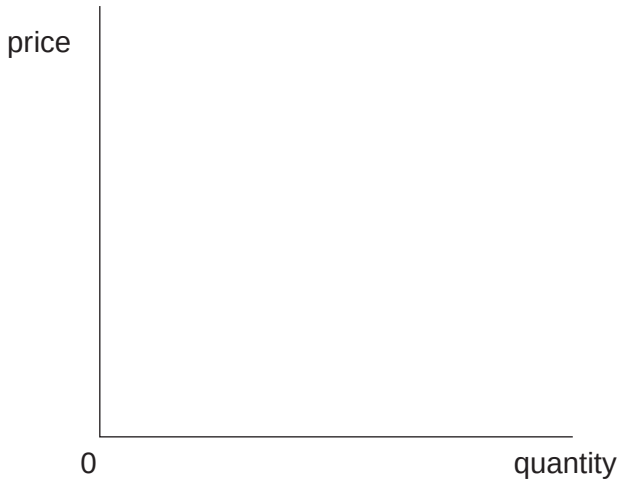
**(b)** 'It is a simple principle of economics that if demand is increasing and supply is inelastic, prices should continue to rise' (lines 13–15).

With the aid of a demand and supply diagram, comment on the extent to which an increase in demand will cause prices to rise.

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**3** **(a)** Define the term ‘allocative efficiency’.

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**(b)** Using the information in the case study, explain whether the market for pu’er tea is working efficiently.

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.....**[4]**

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**4** **(a)** Define the term ‘price elasticity of supply’.

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.....**[2]**

**(b)** Using the information in Fig. 1, comment on the business relevance for pu’er tea farmers of the changes in the price elasticity of supply between 2003 and 2006. (Your answer must include calculations of price elasticity of supply.)

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**5** **(a)** Define the term ‘producer surplus’.

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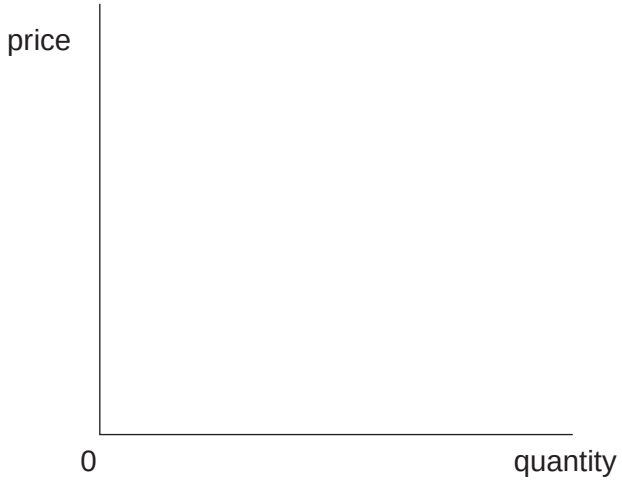
**(b)** Using a diagram, show how producer surplus changes with a fall in the price of pu’er tea.




**[4]**

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**6** **(a)** What is meant by the term ‘positive externality’?

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.....**[2]**

**(b)** Using an example from the case study, explain **one** positive externality arising from the increasing production of pu’er tea.

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.....**[3]**

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**7*** Discuss the extent to which a subsidy given to producers might encourage an increase in the consumption of a product such as pu'er tea which generates positive externalities. **[18]**

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Additional answer space. If you use these lined pages, you must write the question number next to your answer.

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