

The BIG ideas!

Exchange Rates: summary

WEBNOTE 1492

I.b Syllabus 3.2: Macroeconomic Objectives: Exchange Rates

- **Syllabus 34 – 41 (39-41 = HL only)**
- **Webnotes 140 – 150**

Syllabus reference: items 34 - 41

MARKET FAILURE

Market fails to allocate resources efficiently to the the best benefit of society:

1. Externalities
2. Monopoly (HL)
3. Public/merit goods
4. Immobility of factors of production (poor resource allocation)

Syllabus reference: items 34 -41

See Webnote 143

4 externalities

Diagram 1: Negative Production Externality

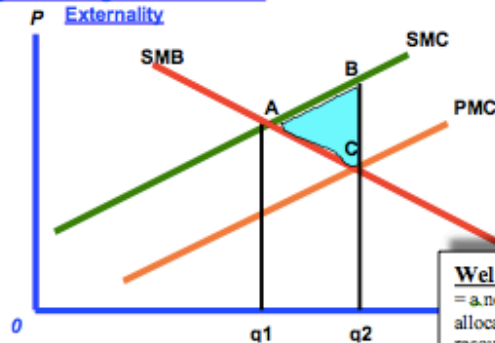
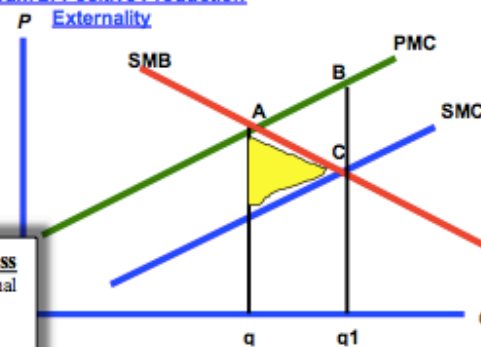


Diagram 2: Positive Production Externality



Welfare loss
= a non optimal allocation of resources.
MsB is not equal to **MsC**.

Diagram 4: Negative Consumption externalities

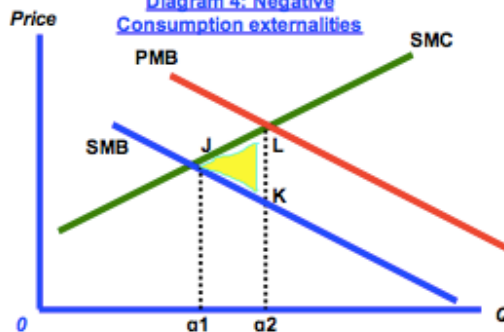
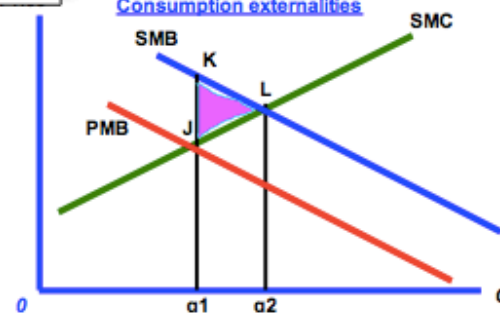


Diagram 3: Positive Consumption externalities



How to draw? Use 'blue box'

See Webnote 143

3 Steps to remember to draw the diagrams for market failure?

1. every time draw **MsB + MsC**. **Social optimum** is where these lines intersect. **See black** in diagrams 1+2.
2. decide whether the third line is a benefit or cost line i.e. is the story about consumption (PMB) or production (PMC) ?
See 3 below.
3. draw the third line using the following guidelines:
 - is it over or under production/consumption?
 - is it a merit or demerit good?
 - Does society want more or less of the consumption/production?
 - Is it over / under consumption or production
 - E.G. If government wants more consumption then the diagram should be diagram 2 below showing 'under-consumption' or positive externalities of consumption. Markets underconsume health care e.g. public health vaccine to protect public health
 - Which triangle for welfare loss do you shade? Angle between **SmB** and **SmC** = welfare loss e.g. **abc**, see web 252

Supply and Demand for a currency

See Webnote 144

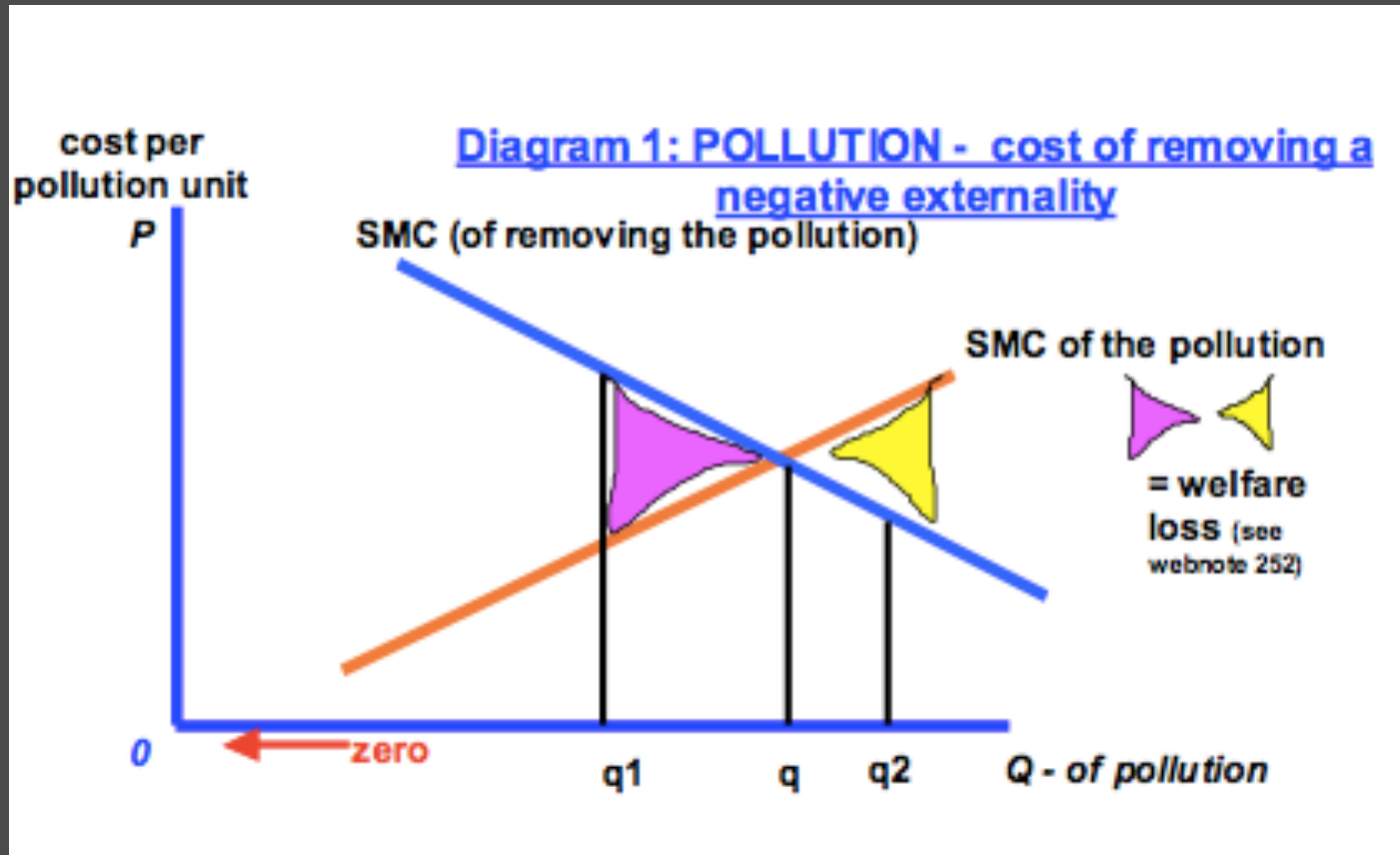
◎ Evaluate solutions

Some Solutions:

1. legislation
2. penalties
3. international agreement
4. taxation
5. ban
6. extend property rights
7. advertising
8. subsidy
9. tradeable permits

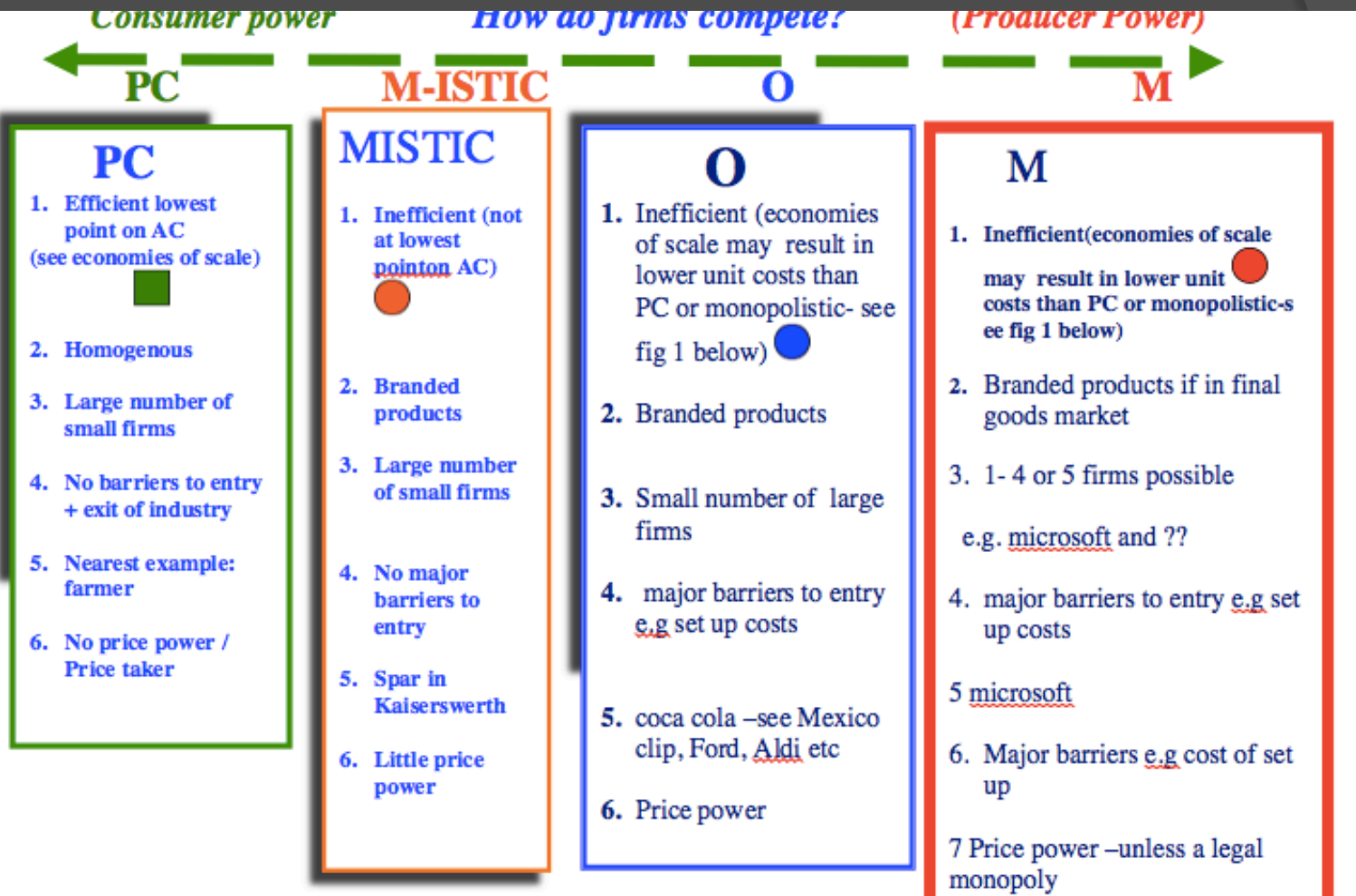
Zero pollution?

See Webnote 144



Monopoly Power...HL only

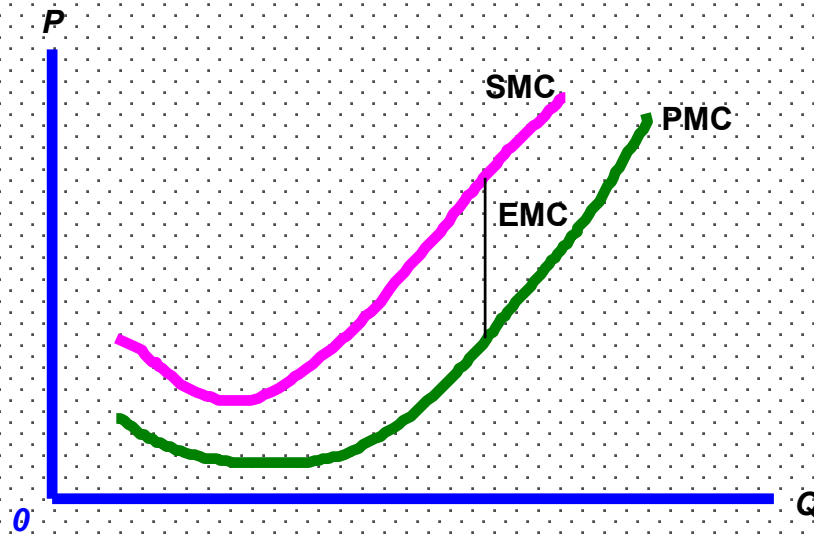
See Webnote 146



See Webnote 147

- Where $smc > pmc = emc$
Where e is external mc

Social Marginal Cost

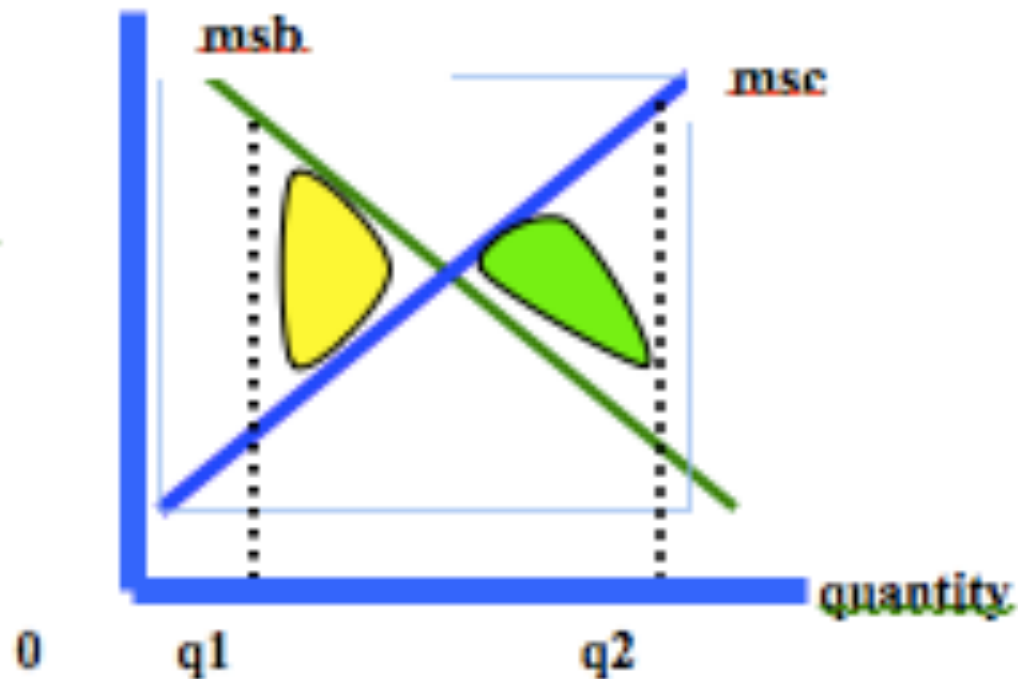


Welfare loss + gain

Diag 2: $msb + msc$ to show Welfare

Loss

Cost/
benefits

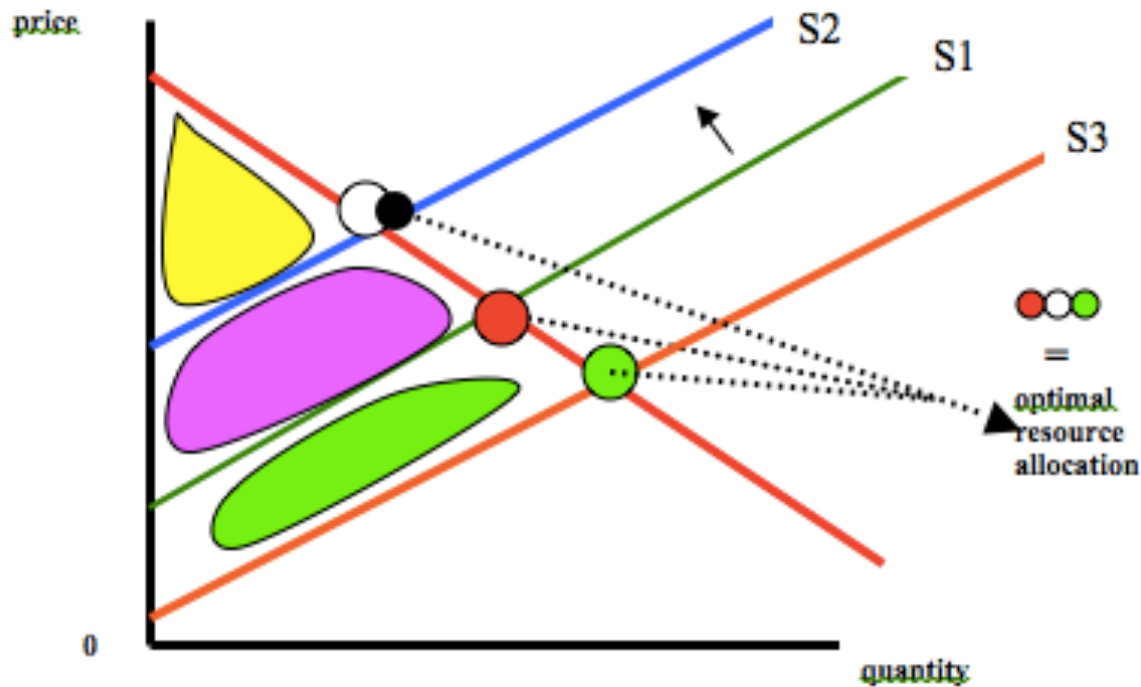


See Webnote 149

Long run...markets must grow

See Webnote 149

Diag 3: supply + demand to show consumer and producer surplus (society surplus \triangle = consumer+producer surplus)



The Exam question...

See Webnote 145

- May 2014 syllabus 1.2 HL
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- **1a) Analyse the private and external benefits associated with the consumption of university education. (10 marks)**
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- **1b) Evaluate the policies a government might use to increase the consumption of university education. (15 marks)**

Examples....you need to find some!

Solutions to market failure:	Do you have an example?
Government intervention	Indirect tax
Government intervention	Tradeable permit scheme. This one is notable because it is a market based solution. The firm has to buy the permit to pollute i.e. a quota or limit to the level of carbon emissions
Government intervention	Smoking ban, or a subsidy to alternative (clean) energy producers
Government intervention	International agreement e.g. Kyoto
Government intervention	Extending property rights e.g. restricting large scale fishing by large factory ships by setting 'no fishing zones

