

YISHUN JUNIOR COLLEGE

PRELIMINARY EXAMINATION 2008

H2 ECONOMICS

9732/1

PAPER 1

19 AUGUST 2008

TIME: 2 HR 15 MIN



READ THESE INSTRUCTIONS FIRST

Write your name and CTG on all the work you hand in.
Write in dark blue or black pen on both sides of the paper.
You may use a soft pencil for any diagrams, graphs or rough working.
Do not use highlighters or correction fluid.

Answer **all** questions.

At the end of the examinations, fasten all your work securely together.
The number of marks is given in brackets [] at the end of each question or part question.

Question 1 Oil and Petrol

Extract 1: Rising demand fuelling global energy crisis

With oil prices approaching US\$100 (S\$144) a barrel, the world is headed towards its third energy shock in a generation. But today's surge is different from previous oil crises, with broad and longer-lasting global implications.

Just as in the energy crises of the 1970s and 1980s, today's high prices are causing anxiety and pain for consumers and igniting wider fears about the impact on the economy. But unlike past oil shocks, which were caused by sudden interruptions in exports from the Middle East, this time prices have been steadily increasing as demand for petrol grows in developed countries, as hundreds of millions of Chinese and Indian climb out of poverty and as other developing economies grow at a sizzling pace.

For oil companies, high prices have sparked a frenzied search for new sources around the world. The trouble is that these big new developments take a long time, and companies have been hobbled by higher costs. The cost of drilling rigs, for example, has doubled in recent years. Supplies have also been hampered by political tension in the Persian Gulf, the war in Iraq, devastating hurricanes in the oil producing Gulf of Mexico and violence in Nigeria's oil rich province.

Source: *The Sunday Times*, 11 November 2007

Extract 2: Tax rise fuels petrol price fears

Petrol prices could surge to near record highs following a 2 pence rise in fuel duty. The Petrol Retailers Association said the rise would put an undue "strain on motorists and petrol retailers alike". It has criticised the government's move, highlighting that petrol prices have risen steeply in line with the oil price.

However, Stephen Joseph, executive director of the Campaign for Better Transport, said the rise was welcome, provided the extra money raised was used to improve public transport and "other measures that will give people real travel choices". A Treasury spokesman said the tax rise sent "the right environmental signals in our fight against climate change".

Source: *BBC News*, 01 October 2007

Extract 3: US airline catastrophe looms under record oil prices

THE United States airline industry is set to crash as record oil prices threaten to push several carriers into bankruptcy, an industry study said.

According to a study issued by Airline Forecasts and the Business Travel Coalition, at current oil prices, several large and small US airlines will default on their obligations to creditors, beginning at end-2008 and early 2009. The grim industry snapshot comes as US airlines cut fleets, jobs and capacity and add fees as they struggle with spiralling jet fuel costs and a weak domestic economy.

The study shows that oil at US\$130 will increase yearly airline costs by US\$30 billion, while airlines will be able to generate only US\$4 billion in fare increases and incremental fees. Recently introduced bag-checking charges and other fees would only yield US\$1 billion to US\$1.5 billion at the industry level.

'Stabilising this ailing industry must become a national policy priority,' the study said, calling on the White House, Congress, federal regulators and state officials to take action. 'Absent direct policy intervention, the likelihood is several airlines will fail. The consequences will be devastating to US jobs, families, businesses, communities and our American way of life.'

Source: *www.straitstimes.com*, 14 June, 2008

Extract 4: Indonesia inflation set to surge after fuel price hike

Inflation in Indonesia is set to soar in response to a government plan to hike the price of subsidised fuel, imperilling growth in Southeast Asia's biggest economy, experts said.

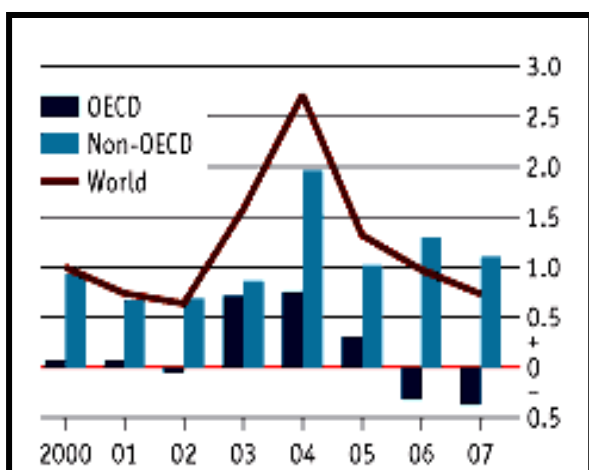
The country's government announced recently that it planned to raise the fuel price due to record-high global oil prices, which are causing the cost of the multi-billion-dollar subsidy scheme to balloon. The increase comes on top of the fallout from high global food prices.

Budget committee chairman Haris Azhar Azis said the fuel price hike was necessary to prevent even greater damage to the economy in future. Fuel subsidies have become increasingly expensive as the price of oil has surged, and are projected to nearly triple this year to 126.8 trillion rupiah (S\$19 billion dollars), amounting to about 12 per cent of the state budget.

However, there are fears that a fuel price rise could trigger unrest in Indonesia. Small protests have already started over the latest plan. Police and students clashed in two cities, while peaceful rallies have cropped up around the sprawling archipelago.

Source: www.straitstimes.com, 8 May 2008

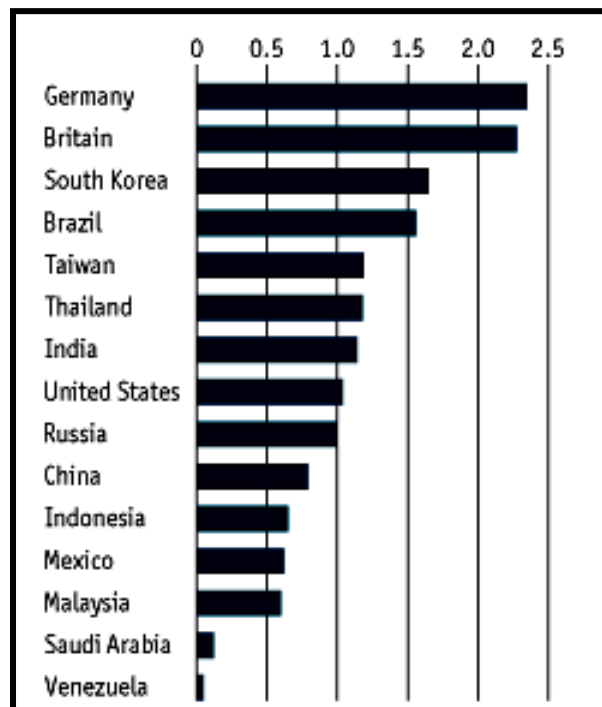
Chart 1:
Annual Change in World Oil Consumption
(million barrels per day)



Source: *The Economist*, 29 May 2008

*OECD - Organisation of Economic Co-operation and Development. Member countries include Britain, the US, Germany etc. Non-OECD are countries such as Indonesia and Mexico.

Chart 2:
Retail Petrol Prices, US\$ per litre
(latest prices)



Source: *The Economist*, 29 May 2008

Questions:

- (a) (i) Compare the trend in oil consumption levels of OECD countries with non-OECD countries between 2004 and 2007 in Chart 1. [2]
- (ii) Account for this trend in the consumption of oil for OECD and non-OECD countries. [3]
- (b) (i) Explain what is meant by allocative efficiency. [1]
- (ii) Using the data and your economic knowledge, discuss whether the imposition of a 2 pence fuel duty in Britain will lead to an efficient allocation of resources. [6]
- (c) Based on Extract 3, analyse the possible impacts of an oil hike on the airline industry in the US and its economy. [8]
- (d) In the light of the data provided, if you were an economic advisor to the Indonesian government, would you recommend the government to go ahead with the fuel hike in view of rising inflation? [10]

Question 2 Economic Development of Vietnam

Extract 5: Vietnam's Economic Outlook

The Vietnamese economy maintained robust growth of 8.5% in 2007. Accession to the World Trade Organisation in January 2007 and a surge in Foreign Direct Investment inflows highlighted an impressive course of economic reforms as the economy continues its transition to a market-based economy.

These reforms have led to strong economic performance - an average of 7.5% annual growth over the past decade, one of the fastest rates in Asia. Consumption, boosted by wage increases and remittances inflows, also continued to grow strongly. Strong growth spurred a surge in imports, resulting in a sharp widening of trade and current account deficits in 2007.

Source: Asia Development Outlook, Vietnam

Extract 6 : Less haste, more quality investment

VIETNAM'S rapid growth has been marked more by massive rather than efficient investment. For many developing countries, just managing to accomplish the targets set in their five-year development plans is a matter of satisfaction. Not for Vietnam.

A country in haste, Vietnam aims to achieve middle-income country status by 2010 and cut its poverty level to under 10 per cent. These are ambitious targets for a country whose serious economic development took effect, in a real sense, only in the 1990s.

In 1993, nearly three out of five Vietnamese were living below the poverty line and nearly all of the country's infrastructure was heavily damaged. Today, poverty rate has dropped from 58 to 15 per cent.

Vietnam's nominally socialist economy has acknowledged and encouraged the rise of the private sector. That sector has been creating new jobs for more than 90 per cent of the 1.6 million entrants to the labour market each year.

Another key reason for its success is the country's determined emphasis on a high level of investment, especially in physical infrastructure. During its fifth five-year plan (2001-2005), Vietnam's total investment stood at 37.5 per cent of its GDP. It aims to raise this ratio to 40 per cent during the ongoing sixth five-year plan (2006-2010). The only country in the region with a higher investment rate is China.

But despite all the positive developments, Vietnam's challenges in the coming years are going to be many and complex.

Continuing to rely on increased investment for higher growth will have a limit. Merely increasing investment quantity may not deliver the expected result for several reasons:

Vietnam has performed well in terms of investment quantity but less so in terms of quality. A 2004 World Bank study covering 23 countries placed Vietnam in third position in terms of investment rate but 17th in terms of investment quality.

In addition, future FDI commitments may be contingent upon Vietnam's ability to undertake more reforms and provide efficient infrastructural support and competitive skilled human resources.

In view of these factors, it is only prudent that focus be given to not just raising the quantity of investment but, more importantly, to enhancing its efficiency and productivity. It is time for Vietnam to shift from input-driven growth to efficiency-led growth.

Source: The Straits Time, 28 February 2008

Chart 3: Rate of inflation and credit growth

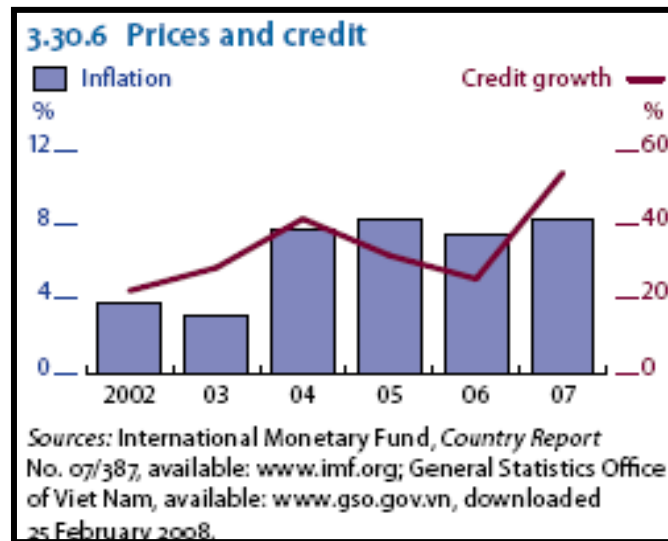


Chart 4: Vietnam's trade and current account balances

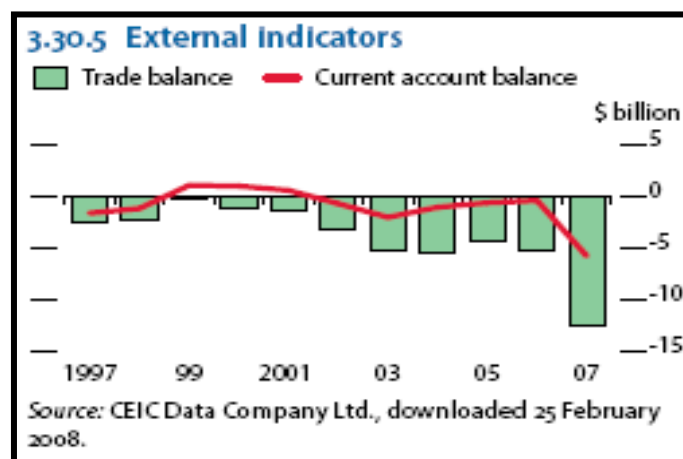
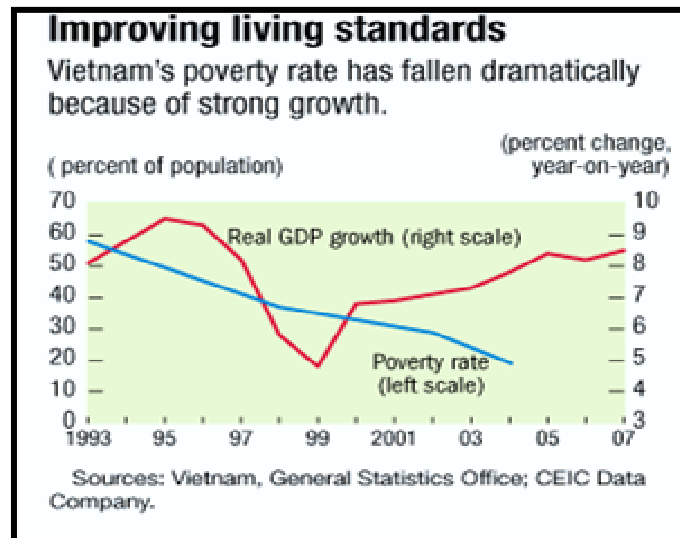


Chart 5: Vietnam's GDP growth and poverty rate



Questions:

- (ai) Explain the meaning of inflation. [2]
- (ii) Explain the relationship between credit growth and inflation rate as shown in Chart 3. [4]
- (bi) Compare the trend in the trade balance with current account balance of Vietnam from 1997 to 2007. [2]
- (ii) Account for the trend observed in the trade and current account balances. [4]
- (c) Based on the extracts given, assess the advantages and disadvantages of Vietnam's transition towards a market-based economy. [8]
- (d) Discuss the measures which the Vietnamese government could adopt to ensure a sustained economic growth for the economy. [10]

Suggested Answers for Case Study Q1

(a) (i) Compare the trend in oil consumption levels of OECD countries with non-OECD countries between 2004 and 2007 in Chart 1. [2]

Oil consumption by the OECD countries was decreasing over the period of time (1m) whereas oil consumption by non-OECD countries was increasing but at a slower rate over the time period (1m)

(ii) Account for the trend in the consumption of oil for OECD and non-OECD countries. [3]

OECD countries' consumption of oil fell over the period due to higher retail prices of oil as the govt in these countries may have imposed higher fuel taxes. On the other hand, the non-OECD countries consumed more oil because the retail prices of oil were lower (Chart 2) possibly due to high subsidies given by the governments of these countries. Changes in consumption levels could also be due to other factors – such as higher consumption caused by higher growth leading to higher demand for oil.

1m for an answer which relates oil consumption levels to differences in relative prices of oil.

1m for an answer which relates the price differences to taxes and subsidies imposed.

1m for other non-price factor such as economic growth

(b) (i) Explain what is meant by allocative efficiency. [1]

Allocative efficiency is achieved when an economy uses resources to produce **the right amount** of goods which maximise the society's welfare. (SMC=SMB)

(b) (ii) Using the data and your economic knowledge, discuss whether the imposition of a 2 pence fuel duty in Britain will lead to a better allocation of resources. [6]

Thesis

▪

Use of petrol fuel generates negative externalities (pollution and negative impact on environment)
→ costs to society more than costs to private motorists (SMC > PMC)

Motorists do not take into account such side effects when using petrol

→ So, may over consume it. ($Q_e > Q_s$)

→ Inefficient allocation of resources as cost to society is more than benefit. (SMC > SMB)

→ Welfare loss results

Increase in fuel tax will get more motorists to internalise the negative externalities → reduce usage of petrol to socially optimal level & thus maximise welfare => hence a more efficient allocation of resources.

- Tax is effective → it is easy to implement and the amount is only 2 pence (seems relatively small)
- Can also use the tax revenue to improve the public transport system to encourage to drive less in the long term. (maxi 4m)

Anti-thesis:

- To set an optimal tax rate, it should be equal to MEC.
However, difficult to impose the optimal level of tax because MEC is difficult to estimate (certain negative effects do not have a monetary value attached to it. Hence, may not be able to achieve allocative efficiency.

Able to explain how fuel tax results in internalisation of EC => reduction in usage of petrol (max 4m)

Able to explain one limitation of fuel tax (max 2m)

(c) Based on extract 3, analyse the possible impacts of oil hike on the airline industry in the US and its economy. [8]

- In the SR, a hike in fuel prices will have significant impact on the airline industry as fuel cost is a major component of total cost. Fuel costs increased by US\$30b but airlines are unable to pass on the full costs to consumers resulting in a rise in revenue of only US\$4b (Extract 3). Thus, many airlines may be faced with rising losses.
- In the LR, if more airlines reduce capacity or exit the industry, it would lead to other impact on the airline industry as well as the US economy:
 - Airline workers lose jobs, unemployment rises & income falls in airline sector
 - Domestic travelling becomes more costly as businessmen find alternative ways to travel across the country. This raises the costs of certain business and may reduce profits.
 - The fall in income in the industry also induce further fall in consumption and other sectors (such as retail and hotels) will suffer a fall in business and may be forced to cut costs by cutting jobs. Employment falls further.
- → This reduces national income by multiple times and actual growth will decline. There may be a recession.
 - Unemployment in the economy will also rise.
 - SOL falls (i.e. American way of life)
- However, the fall in income may reduce import expenditure, which may improve the trade balance and current account although the fallout in the economy may lead to outflows of short term financial capital may worsen the capital account balance. Overall the impact on the balance of payment in the short run is not certain.
- In the long term, investments may decline as pessimism sets in.
 - This reduces the capital stock and productive capacity of the country falls.
 - AS may fall in the long run and potential growth is negatively affected.

L1	Able to give a brief answer on the impact on the airline industry	1-2
L2	Able to analyse the impact of rising fuel prices on the industry as well as the economy	3-6
L3	Able to give a thorough analysis of short and long term impact on both the airline industry and the economy with good reference to the data given	7-8

(d) In the light of the data provided, if you were an economic advisor to the Indonesian government, would you recommend the government to go ahead with the fuel hike in view of rising inflation? [10]

As an economic advisor, the concern currently should be with the rising inflation which affects the purchasing power of the people (a fall in the internal value of money as GPL rises). A fuel hike will cause the price of fuel to rise which will worsen inflation in Indonesia.

Thesis: Give reasons why it should go ahead

Rising cost of oil → cannot keep on giving subsidies → strain on government budget

Fuel subsidies involve opportunity costs → less expenditure on other more important areas (such as infrastructure and education etc)

Fuel hike may reduce consumption of petrol and improve efficiency in allocation of resources as prices of fuel move closer to eqm prices impact on efficiency and other macroeconomic goals (e.g. potential growth in LR)

Fuel hike also helps to reduce the usage of cars and reduce negative externalities and improve in allocation of resources.

Anti-thesis: Give reasons why it should not go ahead

Food prices are rising. If raise fuel prices now → inflation rate will rise further → Explain problems of rising inflation → rising rate of inflation has negative impact on investment, export competitiveness and SOL of the Indonesians.

Fuel hike will cause political fallout which may dampen investors' confidence and slow down Indonesia's growth in the SR → impact on NY and employment.

Synthesis

Fuel hike is a necessary action as subsidies on fuel put a strain on the govt's budget. In addition, subsidies also lead to a distortion in the prices of fuel and the artificially low prices of fuel encourage more consumption leading to allocative inefficiencies. However, given that the removal of subsidies may lead to a worsening of inflation, the govt may need to use other measures to dampen the inflationary pressure and also offer more assistance to help the people to better cope with the rising prices.

L1	One sided answer or answer that lacks explanation.	1-3
L2	Well balanced view with clear economic analysis and good reference to data	4-6
E1	Able to given unsubstantiated comments	1-2
E2	Able to form judgement and justify the need for a fuel hike	3-4

Suggested Answer Scheme for Case Study Q 2

ai) Explain the meaning of inflation.

[2]

Inflation is a situation of sustained increase in the general price level in an economy (1)
With inflation, the internal value of money falls as one unit of the currency buys less of goods and services. (1)

aii) Explain the relationship between credit growth and inflation rate as shown Chart 3.

[4]

As seen in Chart 3, there is a positive relationship between credit growth and inflation rate. (1m)
As credit growth increased over the period with the exception for the years 2004 and 2005, inflation rate also increased.

The positive relationship between credit growth and inflation rate can be explained by 'too much money chasing after too few goods.' When credit growth increases, more loans are extended to consumers and investors. This will cause a rise in consumption and investment and thus AD increases, ceteris paribus. This increase in AD will pull up inflation rate when it is not accompanied by an increase in AS. (1m)

However, between 2004 and 2005, there was a negative relationship between credit growth and inflation rate. (1m)

This negative relationship between credit growth and inflation rate indicates that inflation can be caused by other factors. For example, higher inflation rate could be due to higher prices of imported goods or higher cost of production (cost push inflation). (1m)

bi) Compare the trend in the trade balance with current account balance of Vietnam from 1997 to 2007.

[2]

Both the trade and current account deficit worsen over the 10 year period. (1m)
The deficit in the current account was generally smaller than that of the trade balance in most years. (1m)

bii) Account for the trend observed in the trade and current account balances.

[4]

The increasing current and trade deficit over the years could be due to the increase in the value of imports as Vietnam's strong economic growth enabled her citizens to spend more on imported goods.

The current account deficit was relatively less serious than the trade balance deficit due to the surpluses from the other accounts in the current balance. Extract 1 mentioned that Vietnam experienced high remittance inflows which could have offset the deficit in the trade balance leading to a smaller deficit in the current account balance.

2 marks for explanation of the worsening of deficits in both accounts
2 marks for explanation of the relatively smaller deficits in the current account.

c) Based on the extracts given, assess the advantages and disadvantages of Vietnam's transition towards a market-based economy.

[8]

A market-based economy relies more on market forces of demand and supply (price mechanism) to allocate scarce resources. This economic system also allows more private ownership of resources and this leads to greater competition and more incentives of individuals such as workers and firms to be efficient in order to reap higher income and profits.

Benefits of such a move towards a market-based economy:

- high rates of economic growth for the last decades since Vietnam opened up its economy ; one of the highest rates of EG in Asia (extract 5).

These high rates of EG is due to the greater dependence on the private sector, especially foreign firms, to generate more income and growth for the economy. With more private ownership of resources, there is greater incentives for workers and firms to increase efficiency in order to earn greater income and profits. In addition, greater reliance on the price mechanism also results in more efficient allocation of resources. Hence, Vietnam is able to achieve greater economic growth compared to other economies around the region.

- The increased in reliance on the price mechanism and private sector to determine how resources are allocated also attracts more foreign investments in the country. This increase in foreign investment is an important factor to generate more jobs in the economy (Ext 5 mentioned that 90% of the jobs were generated by the private sector). With more jobs generated, the citizens experience a higher standard of living.

- higher growth and an increase in real GNP also reduce the poverty rate as shown in Chart 3. As national income increases, more resources and funds are available to help the poorer sector of the economy. Also, with the jobs generated by trade and foreign investments, more job opportunities for the labour force in the economy. Higher growth also means the government has more funds available to give more assistance to the low income group. Hence, there is a sharp decline in the poverty rate from 58% in 1993 to 15% in 2007.

Disadvantages

However, the move towards a market-based economy may also bring about negative impact such as the worsening of income gap between the rich and the poor. As Vietnam becomes part of the global economy, she will also experience the adverse impact of globalization. For example, the lowly skilled and educated in the workforce experience a slower growth in their income compared to those who are more productive and possess skills needed in the globalised economy.

The Vietnamese economy benefitted greatly from the move towards a more market-based economy and free trade. Vietnam experienced high economic growth of 7.5% for the last decade and her citizens' SOL have improved with a reduction in poverty rate. Thus, moving towards a market-based economy is the right choice for Vietnam if she wants to continue with her economic success. However, the govt must also intervene to ensure that the negative impact of a free market is minimized.

L1 (1-3)	For an answer which list some advantages and disadvantages of a market-based economy
L2 (4-6)	For an answer which is able to explain clearly the advantages and disadvantages of a market-based economy, with reference to the data given.
L3 (7-8)	For an answer which is able to comment that despite some disadvantages, Vietnam has taken the right decision to move to a market-based economy as shown by the economic success since the move.

d) Discuss the measures which the Vietnamese government could adopt to ensure a sustained economic growth for the economy. [10]

- meaning of sustained growth : the ability of the economy to expand its productive capacity leading to an outward shift in its PPC and higher AS in the LR. Sustained growth is achieved if the potential growth is greater than the actual growth.
- Vietnam needs to focus on improving the quality of its investment and labour force (extract 6) in order to promote a sustained economic growth.

Measures:

- a) Vietnam should identify new key areas of growth and attract the right FDI into these new industries to ensure a sustainable growth. Extract 6 mentioned that Vietnam needs to focus on quality investment to sustain its economic growth. Thus, Vietnam needs to identify new areas of comparative advantage and attract more FDI into these new sectors.

However, it is difficult to identify industries with potential CA. Identifying the wrong industries to promote will result in wastage of resources and inefficiency. The promotion of new industries may also result in the closure of old industries which may worsen structural unemployment in the short run.

- b) Vietnam needs to attract high quality investment in the country to improve its level of technology. With more capital and knowledge intensive investments, the economy would be able to increase its efficiency and productive capacity and thus ensure an outward shift of its PPC to achieve sustainable growth. Thus, more tax incentives could be given to attract high level investment into the country.

However, Vietnam may not be able to attract the right type of investment, especially in the short run given that the poor quality of its infrastructure and labour force.

- c) Provide a pool of efficient and highly skilled labour force who are able to meet the job demands of FDI. More funds should be allocated to educate and train the labour force to improve literacy rate as well as to ensure that the labour force is equipped with the relevant skills needed in the new industries.

However, the literacy rate in Vietnam is still low and she may have difficulties improving the skills of her current labour force in the short run. Thus more emphasis on basic education to improve the quality of her future labour force is needed. In addition, training and education to improve the quality of the labour force take time to see results.

- d) Provide a more efficient infrastructural investment to attract more FDI
Govt should provide on efficient infrastructural as mentioned in Ext 6, para 8. For example, ensure that the airport is run efficiently by negotiating for more international air routes to improve the inter-connectivity between Vietnam and the rest of the world in order to increase the efficiency of running business in the country. Govt can also provide the infrastructure for R&D to attract more technology and knowledge intensive investment into the economy.

However, improving the quality of investment requires substantial amount of govt funds. The use of these funds involved opportunity costs in terms of other projects which have to be sacrificed.

- e) Free trade policy – signing of more free trade agreements with other countries to sustain her export-led growth given that Vietnam is also highly dependent on trade as her engine of growth. Also, FTAs make it easier for FDI inflows which help to ensure increase the productive capacity and ensure sustainable growth.

However, more FTAs may not necessarily ensure Vietnam is able to attract more quality investment into the country.

Synthesis:

Vietnam's strong economic growth is largely dependent on FDI and exports. Thus, the ability to identify new niche areas for growth and attract the right kind of FDI into the new industries are the most important factors for a sustained growth.

L1(1-3)	For an answer which briefly mention one or two measures for a sustained growth.
L2 (4-6)	For an answer which is able to develop clearly at least 3 measures to promote a sustained growth, with reference to data given.
E1 (1-2)	For an answer which gives an unexplained evaluation.
E2 (3-4)	For an answer which is able to fully evaluate the relative importance of the various measures for a sustained growth.