INNOVA JUNIOR COLLEGE
JC2 PRELIMINARY EXAMINATIONS 2
in preparation for General Certificate of Education Advanced Level
Higher 2

ECONOMICS 9732/01

Paper 1

15 September 2008

2 hour 15 minutes

Additional Materials: Answer Paper

READ THESE INSTRUCTIONS FIRST

Write your index number and name 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 staples, paper clips, highlighters, glue or correction fluid.

Answer **all** question.
You are advised to spend no longer than 1 hour 15 minutes on this paper.

At the end of the examination, fasten all your work securely together.

The number of marks is given in brackets [ ] at the end of each question or part question.
You are advised to spend several minutes reading through the data before you begin writing your answers.

You are reminded of the need for good English and clear presentation in your answers.

This document consists of **9** printed pages and **1** blank page.

Answer **all** questions

Question 1 Hollywood and the Internet

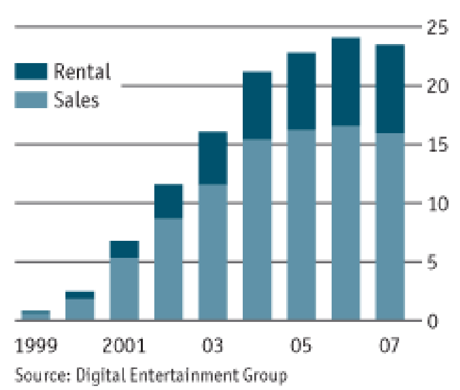
Extract 1: DVDs or Online Downloads?

For the moment, most people are still happy with DVDs, so the studios have had little incentive to switch to an unproven new format. The DVD business is huge, bringing in $23.4 billion in America last year, against $9.6 billion from the box office. The studios are terrified of damaging that source of revenue. In 2006, when Disney made a deal with Apple to sell movies via iTunes, Wal-Mart, America's biggest retailer, reportedly threatened to retaliate: the internet, after all, bypasses it. Wal-Mart accounts for about 40% of DVD sales in the United States and if it sharply cut shelf-space for DVDs, the lost sales would far outweigh new digital sales in the near term.

Not everyone agrees, however. Wal-Mart and other big retailers rely heavily on DVDs to bring higher-income people into their stores, says a studio executive. “So they don't have a leg to stand on threatening to pull shelf-space.” For this reason, he believes that Hollywood should be able to cultivate online revenues without greatly disrupting its existing businesses.

In any case, there are now signs that the DVD boom has come to an end (see Figure 1) — which should also encourage the studios to worry less about Wal-Mart and to move faster online.

Figure 1: US Consumers' Spending on DVDs (US$ billion)



Moreover, as well as boosting sales overall, the internet will make it easier for the studios to make money from their libraries—bricks-and-mortar retailers, after all, have limited shelf-space, and mostly stock new releases. Digital sales yield a higher profit margin too. Virtual distribution does away with manufacturing, packaging, transport and inventory costs. At the moment, the studios get $18 per film from a Wal-Mart or a Best Buy and about $16 for a digital sale, but because of the lower costs they make about $3 more on each film when sold electronically.

The second reason for Hollywood's sluggishness is that the studios and the consumer-electronics industry have not overcome three technological hurdles. Downloading a film still takes a long time—in America, about 30-40 minutes on average. Movies in high-definition format would take about four times that. But broadband speeds are increasing all the time. In Japan and South Korea it now takes between five and ten minutes to download a film in standard definition.

Another obstacle is that most people want to watch films on television, not on personal computers—especially if they have wide, “home-theatre” TV screens. Products connecting PCs and televisions have been available for years but have not caught on, because they are hard to install and operate. That is changing. Apple has just overhauled its linking gadget, Apple TV, to make it easier to use. At the CES in Las Vegas, says Alan Bell, Paramount's chief technology officer, new televisions and set-top boxes that connect directly to the internet were on show, “so the PC is not the bottleneck in getting digital content from internet services to the TV screen that people saw a year ago.”

The last hurdle, and perhaps the highest, is the lack of common standards among websites and devices. “Imagine if you went to Wal-Mart to buy a new DVD player and then found that your DVDs from Best Buy didn't work on it,” says Mitch Singer, Chief Technology Officer of Sony Pictures Entertainment. Movies on the internet, he says, is “a format war on steroids”. Each download store sells different usage rights. Hollywood is trying to do something about this. Late last year a group of studios, retailers and consumer-electronics firms met to discuss an idea of Mr Singer's for a standardised electronic movie product called Open Market. But the talks are at an early stage, and it will be tricky to get companies such as Apple and Microsoft to agree to common standards.

Hollywood's dealings with the consumer-gadget companies also betray its habitual caution. The studios fear that Apple could become the Wal-Mart of the internet—a giant with power to push them around, continually pressing prices down.

Adapted from: *www.economist.com*, 21 Feb 08

Extract 2: Online Content Distribution Trends

Online Music

With revenues in the UK in 2006 at £45 million, the online music market is already the model that other online content distributors emulate. By 2011, Screen Digest forecast that 191 million single tracks and 21 million albums will be downloaded, with UK revenue at £285.6 million. Dan says “The rapid growth of online music constitutes an invaluable lifeline for the record industry as the decline in physical sales shows no sign of letting up. So the question remains whether the growth in digital will be able to fill the revenue gap left by the fall in physical sales.”

Online TV

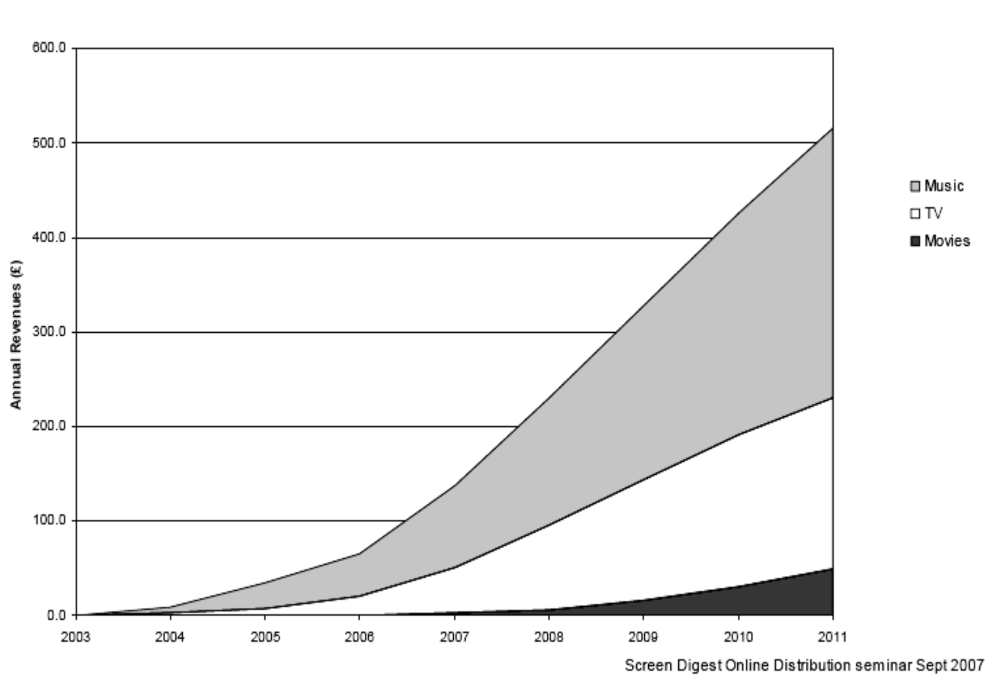
Despite a slow start, Screen Digest forecasts that the online TV market will generate annual revenues of £181 million by 2011. Arash Amel, Senior Analyst says “Broadcasters and pay-TV operators will come under increasing pressure from many major ‘virtual networks’, such as YouTube and Joost, who will be competing for viewers’ time and attention. This will be exacerbated by hardware manufacturers, such as Apple, Microsoft and Sony, who will be far more adept at selling TV shows because of their existing device relationships with the consumer. The result is that the UK online TV market will be increasingly fragmented, with the new entrants trapping considerable market share. The threats and opportunities for traditional broadcast networks and pay-TV platforms is clear. They must adapt their online strategies quickly and efficiently, whether it is focusing on maximizing the potential of video offered through their own websites and online outlets, or co-operating with the new platforms to syndicate as widely as possible in order to tap significant additional revenue."

Online Movies

Yet it is the forecasts for the value of the online movies market that reveals the slowest market growth. There are a number of reasons for the comparatively small size of movie downloads compared to music and TV. Screen Digest believes that consumers will be reluctant to watch three hour long films on their PC, preferring to view them on their plasma screens and home entertainment systems. For movie downloads to make it into the British front room, film fans need to update their hardware to make transferring them possible – and this is a long way off.

Ben Keen, Chief Analyst says “While the Internet offers an important new opportunity for movie distribution, studio fears of a ‘single dominant platform’ and revenue cannibalization are in danger of limiting development of digital services, and damaging consumer attitudes towards downloads.”

Figure 2: UK Annual Online Revenues for Music, TV and Movies 2003 to 2011 (Forecast)



Adapted from: *Screen Digest*, 24 Sep 07

Questions

(a) With reference to **Figure 1**, compare the US consumers' spending on sales and rental of DVDs between 1999 and 2007. [2]

(b) Use cross-elasticity of demand to explain the suggested relationship between DVDs and Online Downloads such as iTunes. [4]

(c) **(i)** Identify **two** characteristics of Wal-Mart that suggest that it has monopoly power in the US DVD market. [2]

(ii) To what extent is the retaliation threat made by Wal-Mart viable? [4]

(d) **(i)** Using **Figure 2**, compare the UK Annual Online Revenues for Music, TV and Movies between 2003 and 2011(Forecast). [2]

(ii) Explain and evaluate why the UK Online Music and TV Revenues markets are projected to have higher growth rates. [6]

(e) To what extent will the US Hollywood studios' fear of 'Apple could become the Wal-Mart of the internet' limit the growth of world online movies revenue market? [10]

[Total: 30]

Question 2 United States and the world economy

Extract 3: Asia, an alternative engine to United States

American consumers have been one of the main engines of global growth for the past decade. But now, as United State's housing boom threatens to turn into a bust, many forecasters expect household spending to stall. Previous American downturns have usually dragged the rest of the world economy down. Yet this time its fate will depend largely upon whether China and the other Asian economies can decouple[1] from the slowing American locomotive.

The importance of United State's role in global growth is often exaggerated: American consumers have single-handedly kept the world economy moving, whereas cautious Europeans and Asians have preferred to save. However, the doomsayers argue that Asia's growth has itself been based largely on exporting to United States, whereas domestic demand in the region has weakened. Their evidence for this is that Asia is running a combined current-account surplus of over $400 billion.

Asia's export growth would certainly slow sharply, but it is the change in net exports that contributes to a country's growth rate, not the absolute size of that surplus. Since 2001 the increase in emerging Asia's trade surplus has added less than one percentage point a year on average to the region's average growth rate of almost 7%. Contrary to the received view, the bulk of Asia's growth has been domestically driven. True, domestic demand (investment and consumption) has grown more slowly than GDP over the past year everywhere except in Malaysia. But in most cases the gap has been small, especially in China, India and Japan.

It is true that exports account for 40% of China's GDP, but those exports have a large import component; only a quarter of the value of China's exports is added locally. The impact of a slowdown in export growth would therefore be partially offset by a slowdown in imports. China's GDP growth has come mainly from domestic demand, which has been growing by an annual 9% in recent years.

The notion of the frugal Asian consumer is equally flawed. Although consumption has fallen as a share of GDP in most Asian countries, this does not mean that households are saving more. Excluding China and India, household saving has fallen sharply, from 15% of GDP in the late 1980s to 8% today. Amazingly, the savings rate of Japanese households has fallen more sharply than that of American households over the past decade. Furthermore, most Asian economies have small budget deficits or even surpluses. This means they have plenty of scope to ease fiscal policy to support domestic demand so as to offset some of the fall in exports. One of the exceptions is Japan, which has a massive public debt.

Not only is growth in China and the rest of Asia chiefly domestically led, but America's share of Asia's total exports has fallen from 25% to 20% over the past five

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[1] Decoupling does not mean that an American recession will have no impact on developing countries. It means that developing countries' GDP growth rates will slow by much less than in previous American downturns.

years. Regional trade links within Asia have also deepened, thanks partly to growing Chinese demand. Chinese exports to the European Union are now almost as big as those to America and are growing faster.

United States takes only 23% of Japan's exports, down from almost 40% in the late 1980s. However, this understates Japan's total exposure. Japanese firms send a lot of components to China for assembly into goods, which are then exported to United States as finished products.

Source: *The Economist*, 19 Oct 2006

Extract 4: The falling dollar

Against the euro, the dollar had been dropping, before it broke through $1.30, going on to hit a 20-month low. Against the pound, the greenback was at its weakest for two years. It slipped against the yen too, though it later made up the ground. Against the yuan—politically the most sensitive exchange rate these days—it continued a stately decline. The main reason for the dollar's jitters was evidence that the housing bust may be infecting the broader economy. Consumer confidence fell further than expected this month.

The falling dollar would help to reduce global current-account imbalances and, by shifting production into United State's tradable sector, would cushion her economy as its housing bubble bursts. True, a weaker dollar would tend to hurt exporters in Europe and Asia. But the impact on those economies could be offset if central banks hold interest rates lower than they otherwise would, thereby boosting domestic demand—exactly what is required for global rebalancing. The current strength of growth in Europe and Asia will also help to prevent an American downturn from turning in to a worldwide slump.

If a steady slide in the dollar would be good news, a sharp plunge as investors take fright and run would be another matter. That could increase risk premiums and unnerve frothy financial markets around the world.

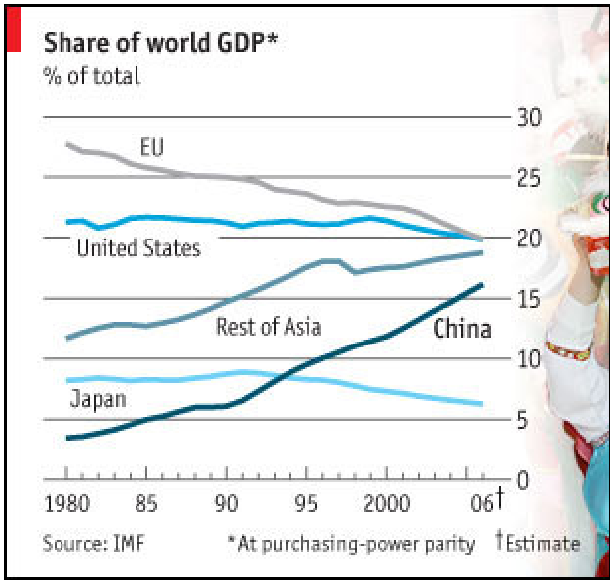
Source: *The Economist*, 30 Nov 2006

Extract 5: The knock-on effect

The International Monetary Fund (IMF) has cut its forecast for American growth to 2.2% in 2007, while raising its estimates for the euro area and developing countries in Asia. Looking at previous recessions, synchronised declines tend to be the result of global causes, such as the bursting of the tech bubble in 2001. So far, though, the fund notes that the current situation is similar to that of previous mid-cycle slowdowns, in which other regions were not badly affected.

Source: *The Economist*, 16 April 2007

Figure 3: Share of world GDP



Source: *The Economist*, 19 Oct 2006

Table 1: Trade Sector in China

	1998-2000	2001-2003	2004-2006
Real growth in trade of goods and services (%)	17.17	21.50	21.16
Real growth in exports of goods and services (%)	49.83	6.40	25.32
Real growth in imports of goods and services (%)	40.92	7.57	16.07
FDI inflow (% of GDP)	3.69	3.20	3.11
Total trade share of world market (%)	2.98	4.36	6.10

Table 2: Trade Sector in United States

	1998-2000	2001-2003	2004-2006
Real growth in trade of goods and services (%)	8.91	0.028	7.79
Real growth in exports of goods and services (%)	5.16	-2.143	8.12
Real growth in imports of goods and services (%)	12.08	1.59	7.58
FDI inflow (% of GDP)	2.83	1.02	1.17
Total trade share of world market (%)	15.39	14.65	12.82

Note: Figures are period averages, including growth rates.

Source: *World Trade Indicator 2008, The World Bank Group*

Questions

(a) Using Figure 3:

(i) Explain what is meant by purchasing power parity. [1]

(ii) Compare the share of world GDP (at purchasing power parity) of Asia with that of United States and European Union between 1980 and 2006. [2]

(b) Explain two factors that might have caused US dollar to depreciate. [5]

(c) In the light of current problems in United States, do you consider that a reduction in interest rate to be an effective way to achieve her macroeconomic goals? [6]

(d) How far does the data demonstrate there has been decoupling of United States and the rest of the world? [8]

(e) Discuss and compare the likely impact of the depreciation of US dollar on any of **two** of the other major Asian economies mentioned. [8]

[Total: 30]

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