ANDERSON JUNIOR COLLEGE

JC2 Preliminary Examination

Higher 2

ECONOMICS **9732/01**

Paper 1 10 September 2008

2 hours 15 minutes

Additional Materials : Answer Paper

READ THESE INSTRUCTIONS FIRST

Write your name, PDG and index number in the spaces provided on all the work you hand in.
Write in dark blue or black ink.
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** questions. Begin your answer to **each question** on a fresh sheet of writing paper.

At the end of the examination, **fasten your answers to each question separately**. Fasten **this cover page** in front of your answers **to Question 1**.

The number of marks is given in brackets [ ] at the end of each question or part question.

Name: ______________________________ (   )

PDG: ______________________________

Question Number	Marks Awarded
1	
2	
Total Marks	/60

Answer **all** questions

Question 1 **Deregulation of Airline Industry**

Extract 1: Freedom in the air

Europe deregulated air travel in 1997 almost twenty years after America in 1978. In the past, the industry was dominated by national 'flag' carriers or 'network carriers', such as British Airways, Air France and KLM (Netherlands). Flag carriers have often been regarded by their home government as being an important and highly visible symbol or totem of the country itself. As such, many governments have protected their national flag carrier from competition. Such measures might include direct government subsidy, government-dictated airfares and route networks, prevention of buying take-off and landing slots at major airports or simple price fixing. Since deregulation, airlines have been largely free to negotiate their own operating arrangements with different airports, enter and exit routes easily, and to levy airfares and supply flights according to market demand. Any technically qualified airline in the European Union (plus Norway and Iceland) will be able to run services inside any other country without any need for government approval. Competition between European airlines has increased. At present an all-out war rages not just between low-cost carriers but with network carriers as well. Network carriers such as British Airways have successfully adopted the internet-selling and yield-management techniques of low-cost rivals. They are not always as cheap as the likes of low cost carriers such as EasyJet and Ryanair, but often at busy periods, their fares to holiday resorts compare well. The traditional airlines also offer business travelers a wider range of flights to helpful destinations at prices from London Heathrow airport that are competitive with low-cost carriers flying from London's more distant, secondary airports like Stansted and Luton.

Extract 2 : Low-fare, no-frills airlines are shaking up Europe's national flag carriers

The rise of the two major budget airlines Easyjet and Ryanair, has been little short of stratospheric. The deregulation of the European airline industry gave Michael O'Leary and Stelios Haji-Ioannou, the charismatic heads of Ryanair and Easyjet respectively, the opportunity to seize market share from the flag carriers. A number of factors had coincided to assist them.

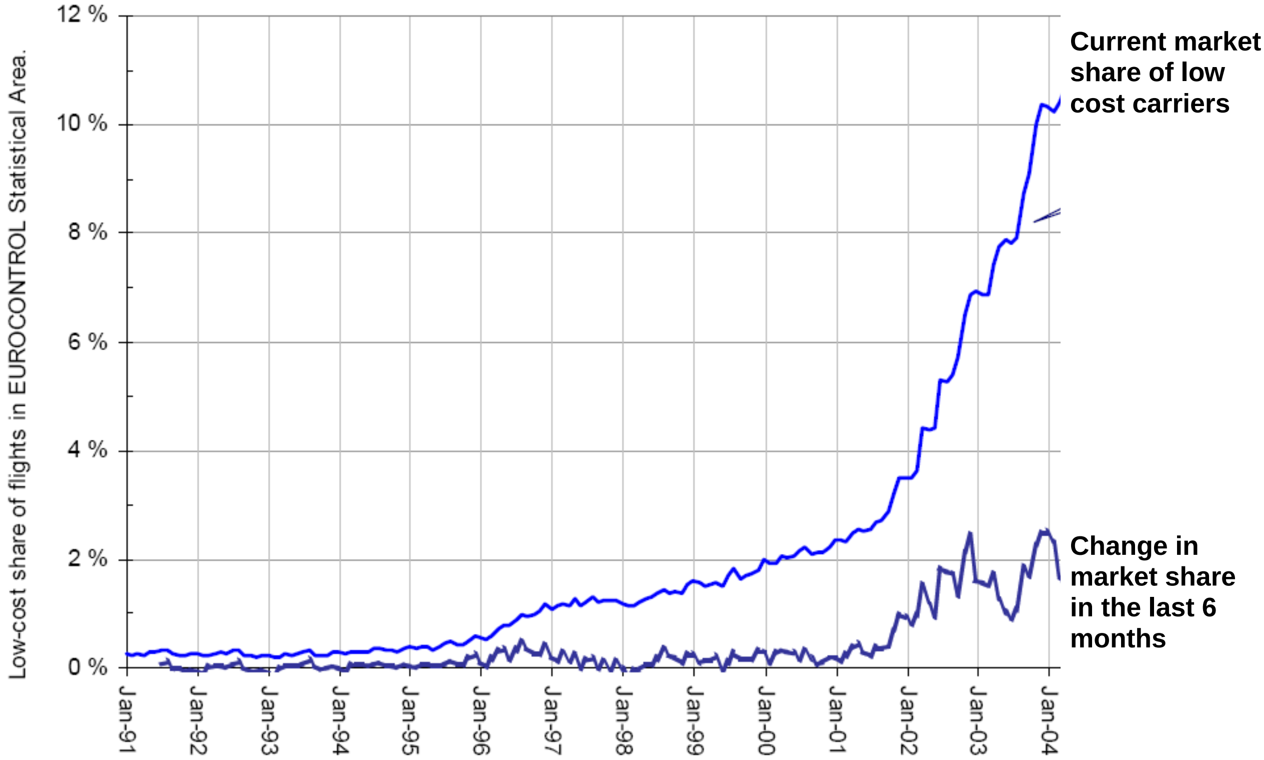
Real annual GDP growth in the UK and Irish economies was above trend at 3% and 7% respectively. Narrow-body Boeings and Airbuses, the sort favoured by budget airlines, are available at roughly half what they cost in the late 1990s. Off-the-shelf software that runs the internet-based bookings systems crucial to a low-cost carrier, handles the demand-management system that jacks up prices as a flight fills up. A budget carrier will typically multiply some fares tenfold in the run-up to a holiday such as Easter.

Perhaps the most basic push behind the flock of new little airlines is the availability of a simple and proven business model—developed in America by Southwest Airlines and copied first in Europe by Ryanair and EasyJet. The essential elements of the business model were: a single-type fleet of planes; fast turn-rounds (i.e. almost immediate take-off after landing); use of cheaper secondary airports; no provision of frills such as in-flight meals, free drinks and assigned seats. These cost-saving measures mean that budget airlines typically require 25% fewer staff per flight than the traditional flag carriers.

It is no surprise that loads of other budget airlines such as Air Scotland, bmiBaby have sprung up, keen to imitate the success of Easyjet and Ryanair. Aviation Economics, a London-based travel consultancy, estimates that it can cost as little as $10m to start up an airline. Aircraft can usually be hired, software is cheap and staff can be employed on short-term contracts.

Adapted from Economics Today, November 2005

Figure 1: Evolution of Low Cost Airlines' Market Share in the EuroControl Statistical Reference Area (ESRA)[1]



Source: EuroControl, 2004

Extract 3: Clean green flying machine

Airports want to grow because more people want to fly. Last year passengers took some two billion trips on scheduled airlines. In 2010 that number is forecast to have risen by a quarter. Much of the recent growth is attributable to short-haul low-cost airline travel. But cheap flying has come with costs attached. By most measures aviation generates 2-3% of man-made emissions of carbon-dioxide, the main greenhouse gas.

The contribution to global warming could be more severe. Jet engines also pump out nitrogen oxides, soot and water vapour at high altitude. Scientists disagree about the added consequences but a recent report commissioned by the British government suggests that this might double the warming effects of carbon-dioxide emissions from planes.

Most environmentalists think that the only solution is to stop people flying. Making air travel more expensive, say through hefty fuel taxes, would put off price-sensitive leisure flyers. Airlines are accused of having a free ride in terms of air pollution because they pay no tax on the fuel used for international flights. But airlines say that protesters have it in for them because they are an easy target. In fact, they say, the airline industry produces far more benefits than ills. Some studies suggest that aviation contributes as much as 8% to global GDP by transporting tourists, business travellers and cargo around the globe.

Governments and international bodies are intent on encouraging the industry to make greater efforts. A global emissions-trading scheme, drawn up under UN auspices, is set for consideration

[1] ESRA includes western Europe plus Greece, Turkey, Malta, Cyprus, Hungary, Norway, Denmark, Czech Republic, Slovenia, Slovakia, Sweden, Italy, Romania, Croatia, Bulgaria, FYROM, Moldova, Finland

later this year. The European Commission plans to introduce trading in 2011 for all carriers based in the European Union. Later the scheme might, possibly, extend to all airlines operating there. The introduction of carbon-trading is a welcome step by governments that are not yet willing to consider a carbon tax. The air-travel industry should have to stump up for the pollution it causes. And anyone priced out of a cheap holiday in Spain might like to consider a week-long camping break near Heathrow.

Adapted from The Economist, Aug 14th 2007

Questions

a **(i)** Distinguish between fixed and variable costs. **[2]**

(ii) Identify a fixed cost and a variable cost faced by an airline. **[2]**

b With the aid of a diagram, account for the changes in the market for low-cost air travel. **[6]**

c **(i)** State the type of market structure for the European airline industry with the entry of budget airlines. Justify your answer with reference to the data provided. **[4]**

(ii) Using the given data, analyse how budget airlines, like Ryanair, compete with the national flag carriers, like British Airways. **[6]**

d Evaluate whether deregulation brings about a more efficient allocation of resources. **[10]**

Total Marks: [30]

Question 2 Recent Developments in the Japanese Economy

Extract 4 : Japan's external trade

The global economy has continued to expand steadily with the engines of growth more broadly distributed worldwide, and the increase in global trade has outpaced global economic growth. Against the background of these important developments in the external environment, Japan’s current account surplus has been improving.

The improvement in Japan’s current account balance may well have resulted from the efforts of Japanese firms to adapt to the growing trend of globalization. In recent years, Japanese firms have been keen on overseas markets with higher growth potential. They have endeavoured to capture global demand by establishing appropriate supply chain networks, and have simultaneously stepped up overseas production. Moreover, with regard to domestic production, Japanese firms have made efforts to continue to add value to their products. Domestically, they have relied on advanced technological capabilities to produce higher-value added products, and this has resulted in an increase in exports. At the same time, Japanese firms have also made effective use of resources overseas, in particular, through the international division of labour with other East Asian economies. Profitability of overseas operations of Japanese firms has improved steadily, and the profits earned overseas have been repatriated back to Japan, as seen in improvements in the balance on services and on income.

However, attention should be paid to the possibility that the Japanese economy is now more susceptible to developments overseas, since it has become more closely linked to the global economy. With the population declining and increasingly aging, however, the Japanese economy needs to continue its efforts in capturing global demand in order to keep on generating income and to maintain its growth potential.

Adapted from: Research and Statistics Department,
Bank of Japan, 31 October 2007

Extract 5: Japan trade surplus down nearly 89 percent

Japan's trade surplus in June fell 88.9% from a year earlier marking the fourth straight month of decline, the government announced on Thursday. Japan's trade surplus with the U.S. fell 40.2%, down on slower exports of cars, auto parts and mineral fuels.

The Finance Ministry said the surplus shrank to 138.6 billion yen ($1.28 billion) as imports grew amid soaring oil prices and other commodities. Overall imports grew 16.2% to 7.21 trillion yen ($66.76 billion) in June, while exports dipped 1.7% to 7.16 trillion yen ($66.30 billion), the ministry said.

Japan's politically sensitive trade surplus with the United States fell by 40.2%, down for the 10th straight month on slower exports of cars, auto parts and mineral fuels. The nation's trade surplus with Asia dipped 6.3%, falling for the first time in three months due to rising imports of oil, natural gas and coal, the ministry said. The trade surplus with China fell 65.5%.

Japan's trade surplus in the first half of 2008, meanwhile, fell 42.1% from a year earlier to 2.959 trillion yen ($27.40 billion), the ministry said on Thursday. Imports grew 10.5%, outpacing exports that increased 3.9%.

Source: Cable News Network (CNN), 23 July 2008

Extract 6: Inflation makes a comeback in Japan

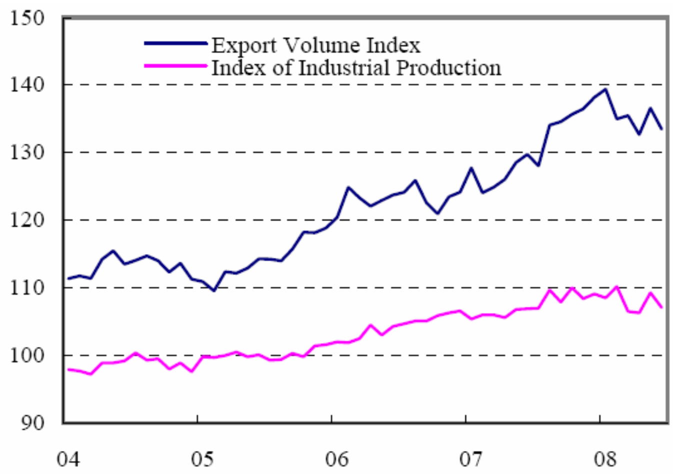
Japan has been experiencing deflation – meaning an annual drop in prices - since 1999. In 2008, however, the whole world has been buffeted by rising oil, food and commodity prices. Japan's inflation rate – excluding volatile fresh fruit, fish and vegetable prices – rose 1.5% in May 2008, its highest rate since 1998.

For a decade now, Japanese consumers have grown accustomed to dropping prices. With prices suddenly going up, consumer spending is expected to drop, spelling further trouble for the economy. Indeed, in the second quarterly report of 2008 issued by the Bank of Japan, 58.7% of those surveyed said they expect to cut their spending this year. This is the highest figure on record since the survey started in 1997. The Bank of Japan will be hard-pressed to rein in inflation which has become a global phenomenon.

At the same time, labour productivity growth in the service sector, which accounts for over 70% of Japan's economic output and employment, has slowed markedly in recent years in contrast to manufacturing. The disappointing performance is associated with weak competition in the service sector resulting from strict product market regulation and the low level of import penetration and inflows of foreign direct investment (FDI). Reversing the deceleration in productivity growth in the service sector is essential to raise Japan's growth potential. The key is to eliminate entry barriers, accelerate regulatory reform, upgrade competition policy and reduce barriers to trade and inflows of FDI.

Source: EconomyWatch.com, August 2008

Figure 2: Export and production in Japan, January 2004 – August 2008 (2000=100)



Note: seasonally-adjusted figures

Source: Bank of Japan & Ministry of Economy, Trade and Industry
12 August 2008
http://www.mofa.go.jp/policy/economy/japan/indicator2.pdf

Figure 3: Yen/US$ exchange rate, January 2004 – August 2008

Source: Ministry of Foreign Affairs of Japan, 12 August 2008

Questions

a **(i)** Compare the trend of Japan's Export Volume Index with that of the Index of Industrial Production from 2004 to 2008. **[2]**

(ii) With reference to the data where relevant, account for the trend identified in (ai). **[4]**

b **(i)** Explain how changes in world commodity prices could cause a country to experience inflation. **[2]**

(ii) How far does the data suggest that inflation in Japan is solely caused by higher world commodity prices? **[6]**

c Discuss whether the Japanese government should correct the falling trade surplus. **[6]**

d With reference to the data where relevant, discuss possible policies the Japanese government could implement to alleviate the economic problems currently faced by the Japanese economy. **[10]**

Total Marks: [30]

END OF PAPER 1