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DUNMAN HIGH SCHOOL

Preliminary Examination

Year 6

Economics

8819/1

Higher 1

17 September 2012

Section A Case Study

3 hours

Section B Essay

Additional Materials:
Writing Papers

PLEASE READ THE FOLLOWING INSTRUCTIONS FIRST

Write your name and class 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.

Please start on a fresh sheet of paper for a new question.

Section A

Answer **all** questions.

Section B

Answer **one** question.

At the end of the examination, fasten all your work securely into two separate bundles for Section A and Section B.

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

Section A		Section B	
Q1	Q2	Q3	Q4

This document consists of **9** printed pages including this cover page.

[Turn over

Section A

Answer **all** questions in this section

Question 1

Debt Time Bomb

Extract 1: Public Finances in Dismal State

European Union (EU) figures showed that public finances across Europe were in a dismal state after governments spent heavily to keep their economies afloat. The combined deficit for all 16 eurozone countries more than trebled in 2009 to 6.3 per cent of Gross Domestic Product (GDP) from 2.0 per cent in 2008, more than twice the level permitted under EU budget rules. Ireland was the worst offender, followed by Greece.

There are fears that Greece's troubles in the international financial markets will trigger a domino effect, toppling other weak members of the eurozone such as the so-called "Piigs" – Portugal, Ireland, Italy and Spain as well as Greece – all of whom face challenges rebalancing their books.

And Greece's woes mean there are fresh fears about whether Portugal and Spain can repay their debts. That's because they all could face higher costs, as investors get nervous about lending money to governments through buying government bonds. Consequently, everybody's interest rates are heading higher as governments have to pay a greater risk premium to borrow money.

Source: Channel News Asia, 23 April 2010; BBC News, 16 February 2010

Table 1: Overall Fiscal Balance (*Percent of GDP*)

	2008	2009	2010	2011 (est)
Greece	-12.2	-15.6	-10.5	-9.2
Ireland	-7.3	-14.0	-31.2	-13.1
Italy	-2.7	-5.4	-4.5	-3.9
Portugal	-3.7	-10.2	-9.8	-4.2
Spain	-4.5	-11.2	-9.3	-8.9

Source: IMF

Extract 2: 'Austerity' Named Word of the Year 2010

As Greece faced a debt crisis, the government passed a series of strict austerity measures, including taxes hikes and cutting public sector pay. The move sparked angry protests, strikes and riots across the country as unemployment skyrocketed and the crisis spread to other European nations.

Austerity, defined as "the quality or state of being austere" and "enforced or extreme economy," set off enough searches that Merriam-Webster named it as its Word of the Year for 2010.

Source: Russell Contreras, 20 Dec 2010, Huffington Post

Extract 3: EU Austerity Drive

A new austerity drive has been sweeping across Europe, as governments struggle to trim huge budget deficits.

Greece

- curb its widespread early retirement schemes
- scrap bonus payments for public sector workers; freeze public sector salaries and pensions for at least three years
- raise sales or value-added tax (VAT); raise taxes on fuel, alcohol and tobacco

Ireland

- cut 24,750 public sector jobs; cut all public servants' pay by at least 5%
- cut social welfare spending
- raise sales or value-added tax (VAT); introduce carbon tax set at 15 euros per tonne of CO₂

Source: BBC News, 7 December 2010

Extract 4: Alternatives to Austerity

In the aftermath of the Great Recession, countries have been left with unprecedented peacetime deficits and increasing anxieties about their growing national debts. In many countries, this is leading to a new round of austerity – policies that will almost surely lead to weaker national and global economies and a marked slowdown in the pace of recovery.

Those hoping for large deficit reductions will be sorely disappointed, as the economic slowdown will push down tax revenues and increase demands for unemployment insurance and other social benefits.

To formulate a deficit-reduction package that boosts efficiency, bolsters growth, and reduces inequality, it is suggested that:

- spending on high-return public investments should be increased. Even if this widens the deficit in the short run, it will reduce the national debt in the long run.
- corporate welfare to be eliminated. Even as America has stripped away its safety net for people, it has strengthened the safety net for firms, evidenced so clearly with the bailouts of AIG, Goldman Sachs, and other banks. Corporate welfare accounts for nearly one-half of total income in some parts of US agro-business, with billions of dollars in cotton subsidies, for example, going to a few rich farmers – while lowering prices and increasing poverty among competitors in the developing world.
- with more than 20% of all income going to the top 1%, a slight increase, say 5%, in taxes actually paid would bring in more than \$1 trillion over the course of a decade

Source: Joseph E. Stiglitz, Project Syndicate, 6 Dec 2010

Extract 5: The European Debt Crisis: Implications for Asia and the Pacific

Asia-Pacific economies are increasingly concerned about the impact of the public debt crisis in a number of European economies. The measures being taken by affected European economies to decrease their public debt levels are likely to constrain GDP growth rates in the coming years.

Notwithstanding the above, it is important to recognise that, to date, the crisis has been contained within the small European countries, and that it is only these countries that are having to rein in budget deficits the hardest. Greece, Portugal, Ireland and Spain together account less than 20 percent of euro zone GDP.

In contrast, the exports of Asia-Pacific developing countries have continued to be bolstered by robust demand from within the region. Intraregional exports make up the largest share of total exports.

Source: UN ESCAP, Macroeconomic Policy and Development Division Policy Brief, No.4, Aug 2010

Questions

- (a)** Compare the fiscal balance of Greece and Spain in 2010. [2]
- (b)** Explain what determines the effectiveness of the tax increases outlined in Extract 3 in raising tax revenues. [2]
- (c)** With reference to Extract 3, using a supply and demand diagram, explain the effect of the austerity drive on the market for alcohol in Greece. [5]
- (d)** With reference to Extracts 3 and 4, discuss whether indirect taxes and subsidies hinder the effective working of the market mechanism. [8]
- (e)** Explain how, according to Extract 4, the austerity measures intended to trim governments' budget deficit may prove counter-effective while the spending on high-return public investment could reduce the national debt in the long run. [5]
- (f)** Discuss the effects of EU austerity drive on the Asian economies. [8]

Question 2

The Chinese Economy

Extract 6: Currency Questions Dominate China's Economic Agenda

Chinese trade surplus which had risen to its second highest level this year will fuel American accusations that the yuan is undervalued by anything up to 40%, effectively subsidising Chinese firms and allowing China to steal US jobs.

China recognises the need to appreciate her own currency, but does not want to do so quickly, and is keeping to its long-held position that it will reform its currency policy gradually. As the country's next five-year plan makes clear, China knows that it must restructure its economy and move away from export-led growth towards an economic model based on greater domestic consumption and the production of higher-value goods.

Yet others within China believe the government should be moving faster. A spokesman at the Chinese Academy of Social Sciences has urged Chinese officials to consider a one-off maxi-revaluation – to avoid the problem of speculative inflows – accompanied by a 3% annual limit on appreciation or depreciation.

But some in China are already starting to change. “Offering better products – in terms of quality and design – is the only way. We have just started to sell to domestic markets as well.” an executive secretary of Dongguan EVR Electronics said.

Adapted from: *The Guardian*, 11 Nov 2010

Extract 7: Barriers to Entrepreneurialism and Innovation in China

Chinese Premier Wen Jiabao hinted at policy action to improve disposable incomes, social security and the availability of affordable housing. The goal of economic policy, after all, is to maximise households' consumption and wellbeing. Nonetheless, Chinese consumption as a share of GDP has actually been falling during the past decade.

Creativity, ideas and innovation are the great enablers of economic progress. Nonetheless, some inherent weaknesses within the Chinese society still persist. State owned enterprises (SOEs) that dominate the Chinese economy are still rigidly hierarchical organisations to some extent, where low rates of innovation occur. Many of them are monopolies.

There is a fear of failure, or loss of face, which acts as a significant barrier to entrepreneurialism and innovation. The Chinese are taught to work for others rather than for themselves.

Adapted from: *The Telegraph*, 15 September 2010

Extract 8: China Surpasses Japan in R&D as Powers Shift

A new report shows that China is on the verge of overtaking Japan as the second biggest spender on research and development (R&D) after the U.S.. According to Battelle Memorial Institute, a non-profit organisation that does scientific research for the government and industry, China is expected to spend \$153.7 billion on R&D in 2011, up from the \$141.4 billion it will spend this year.

China has sustained this kind of growth in R&D spending for a number of years and is likely to stick to it regardless of the global economic cycle. For example, China continued to make a sustained R&D push in 2009, a year when the U.S. and many other advanced countries cut back in response to recessionary times.

China's overall R&D spending is still far behind that of the U.S., which remains by far the biggest R&D spender, making up one-third of the global total. Nonetheless, the government is making a concerted push in certain cutting-edge areas — such as alternative energy and life sciences — while the U.S. and Japan have a good chunk of their R&D tied up in older fields, such as the automotive industry.

Adapted from: The Wall Street Journal, 13 December 2010

Extract 9: China's Factories Hit by Wave of Strikes

Industrial unrest has been spreading through China's factories, with strikes breaking out from factory to factory, including Foxconn, which churns out iPhones and iPads for Apple, along with products for other big-name brands. It has been forced to promise a near doubling of wages after the recent suicide cases among its workforce. Analysts believe the 30% hike alone will reduce company earnings by a fifth this year.

All of these amount to growing pressure for wages in China's factories to rise and they are creeping up, which may, slowly, feed into higher prices for products in the West. In the textile industry, labour can make up as much as a third of overall production expenses, according to the Economist Intelligence Unit. But labour costs in other industries may represent only a small percentage – 3% to 5% by some estimates. Worker productivity is also rising, which will help offset higher wages.

While the largely youthful workforce at big companies like Foxconn has attained double-digit wage increases, the wages of millions of other workers have not caught up as rapidly. Furthermore, the streets of Shenzhen are still packed with migrant workers.

Nonetheless, minimum wages were raised throughout China. The remote western province of Qinghai became the 27th of the country's 31 provinces and regions to do so this year.

Still, wages here have a long way to increase before they reach the levels of those in other emerging economies. China's pay packets are on average still just a quarter of the size of those in Brazil. Higher wages should encourage people here to save a little less, to spend a little more, which is not just good for the economy but also rebalance the world economy.

Adapted from: BBC News, 13 and 28 June 2010

Figure 1: Sizing Up Options | Looking Outside China for Garment Production

China

Pros: Highly skilled labour and quality of available fabrics; familiarity with American retailers

Cons: Rising labour costs; capacity filling up; high import duties

2010 Labour Cost: \$1.84 an hour, up 14% from 2009

Vietnam

Pros: Very low labour costs; Chinese-affiliated factories; moderate skill level

Cons: Limited garment construction and embellishment capabilities; lower-quality sewing

2010 Labour Cost: 49 cents an hour, up 2% from 2009

India

Pros: Good at home textiles and advanced skills such as beading

Cons: Less-efficient factories; longer transportation time

2010 Labour Cost: \$2.99 an hour, up 17% from 2009

Source: Economist Intelligence Unit and Kurt Salmon Associates, 2010

Table 2: Selected Economic Indicators of China, 2007 – 2010

Year	2007	2008	2009	2010
GDP (constant 2000 US\$ billion)	2456.7	2692.5	2940.2	3246
Real effective exchange rate (REER) index, 2005 = 100	105.6	115.3	119.2	118.7
Nominal interest rate (%)	4.7	3.6	5.2	2.5
Average hourly wages (in US\$)	1.06	1.36	1.62	1.84
Gross domestic savings (% of GDP)	50.5	51.8	52.7	51.7
Composition (% of GDP)	%			
Private consumption	36.0	34.9	33.9	35
Gross fixed capital formation	39.1	40.8	46	45.4
Government consumption	13.5	13.3	13.4	13.4
Exports of goods and services	38.4	35	26.7	29.6
Imports of goods and services	29.6	27.3	22.3	25.6
Current account balance (current US\$ billion)	354	412.4	261.1	305.4
Fiscal Balance (current US\$ billion)	69.9	45.2	-84.9	-53.4

Source: Various

Questions

- (a) Describe the trend in China's real effective exchange rate (REER) between 2007 and 2010. [2]
- (b) (i) With reference to Table 2, identify the relationship between China's current account balance and her fiscal balance from 2007 to 2010. [1]
- (ii) Account for this relationship. [4]
- (c) Explain the factors that influence speculative inflows into China. [4]
- (d) To what extent would the near doubling of wages in China hurt its balance of payments? [8]
- (e) (i) Identify and explain any evidence contained in the data that would help you estimate the likely size of China's multiplier. [3]
- (ii) With reference to the data and your own knowledge, discuss whether the policy to promote research and development would be appropriate to raise "households' consumption and wellbeing". [8]

Section B

Answer **one** question from this section

3. (a) Explain, with the use of examples, whether all goods and services that are provided by the government are necessarily public goods. [10]
- (b) To control the emissions generated by motor vehicles, Singapore's National Environment Agency (NEA) regulates the type and quality of fuel that can be used in Singapore. It also sets minimum exhaust emission standards for all vehicles, taking stringent enforcement actions against smoky vehicles on the roads.
- Discuss the view that rules and regulations is the best way to tackle the market failure described above. [15]
4. (a) Explain why countries deploy protectionist measures. [10]
- (b) Discuss whether monetary policy is the best policy for a government to bring its economy out of a recession. [15]