JURONG JUNIOR COLLEGE
PRELIMINARY EXAMINATION 2008

ECONOMICS **8816/01**

Higher 1 **13 August 2008**

Paper 1 **3 hours**

Additional Material : Writing Paper / Cover Page

READ THESE INSTRUCTIONS FIRST

Write your name and class on all the work you hand in.
Write in dark blue or black pen.
You may use a soft pencil for any diagrams, graphs or rough working.
Do not use staples, paper clips, highlighters or glue.

Section A
Answer **all** questions

Section B
Answer **one** question.

At the end of the test, place the cover page on top of your answer scripts and fasten all your work securely together.

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

JJ Economics

This document consists of **8** printed pages.

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Section A

Answer **all** questions in this section.

Question 1

Extract 1: Behind food crisis, a fertiliser shortage

Recently, with world economic growth at a brisk 5% a year, hundreds of millions of people began earning money to buy more meat from animals fattened with grains. That occurred at the same time that rising production of biofuels, like corn-based ethanol, put new pressure on grain supplies.

These factors translated into rising demand and higher prices for fertiliser. Prices at Florida, for one fertiliser, diammonium phosphate, jumped to $1,102 a ton from $393 a ton in the past year, according to JP Morgan Securities, which tracks the prices.

Manufacturers are scrambling to increase the supply. At least 50 new plants to make nitrogen fertiliser are under construction, and phosphorous and potassium mines are being expanded. But these projects are expensive and time-consuming, and supplies are expected to remain tight for years.

Fertiliser is virtually important in Iowa, whose farmers grow more corn than any other state, and depend on fertiliser to greatly increase their yields. In many countries, these cost increases have so far been offset by record high prices for crops. But fertiliser inflation has created a crisis in countries that subsidise fertiliser use for farmers.

In India, for instance, the government’s subsidy bill could be as high as $22 billion in the coming year, compared with about $4 billion three years ago, and has prompted calls to change the program that India depends on to maintain its food supply.

Once new supplies become available, the rising use of fertiliser will still pose difficulties. Environmental groups fear increased use, particularly of nitrogen fertiliser made using fossil fuels. Because plants do not absorb all the nitrogen; much of it leaches into streams and undergrounds.

Source: Adapted from Business Asia, 2 May 2008

Extract 2: Farmers doomed to pay price for export restrictions

Surging prices for agricultural commodities – and the fear of shortages at home – have prompted some countries to impose restrictions on exports. But their moves threaten to prolong the current global food crisis – and even exacerbate it.

Countries such as Argentine, India and Vietnam have stopped their farmers selling crops abroad or tax exports heavily in an effort to keep local markets well-supplied and local prices for those crops low. This means that farmers in these countries are not benefiting from record international prices. At the same time, these farmers are facing higher costs in the shape of higher prices for diesel, seed and fertilisers.

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In Argentine, the world's third largest soyabean exporter and the sixth largest wheat exporter, local wheat prices are about half the level of the international market. The result is that Argentine's farmers could sow up to 15% less wheat this session because of the continued uncertainty about when the government will permit exports. This reduction in acreage contrasts with the sharp increases in the EU and the US where local prices reflect the evolution of the international market.

Source: Adapted from Financial Times, 18 April 2008

Extract 3: The food crisis is a chance to reform global agriculture

Of the two crises disturbing the world economy – financial disarray and soaring food prices – the latter is the most disturbing. What action should be taken in response to this issue?

Protection, subsidies and other such follies distort agriculture more than any other sector. A host of countries are imposing export taxes instead, thereby fragmenting the world market still more, reducing incentives for increased output and penalising poor net-importing countries.

The present crisis is a golden opportunity to eliminate this plethora of damaging interventions. The focus should be shifting the farm sector towards the market, while cushioning the impact of high prices on the poor. Far greater resources need to be devoted to expanding long-run supply. Increased spending on research will be essential, especially into farming in dry-land conditions. The move towards genetically modified food in developing countries is as inevitable as that of the high-income countries towards nuclear power. At least as important will be more efficient use of water, via pricing and additional investment. People will oppose some of these policies. But mass starvation is not a tolerable option.

Source: Adapted from Financial Times, 30 April 2008

Figure 1: Cost of fertiliser Urea nitrogen ($ per tonne)

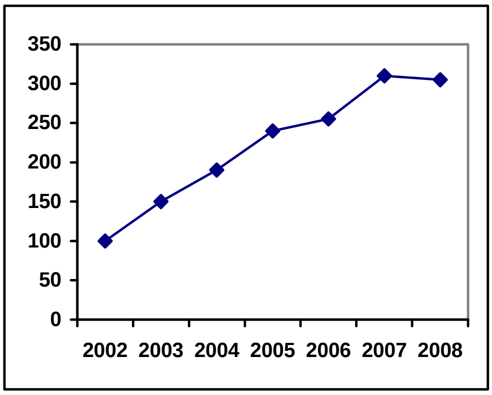
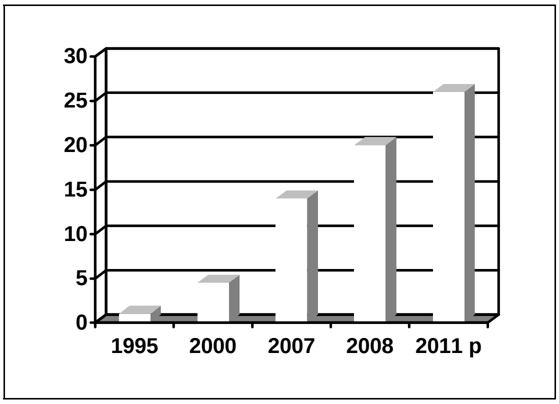


Figure 2: Percentage share of US corn production used to make ethanol



Source: Financial Times, 30 April 2008

Questions

(a) (i) With reference to Extract 1, briefly explain how the price mechanism works to allocate resources in the fertiliser market. [2]

(ii) Explain one negative externality that results from the consumption of fertiliser. [2]

(iii) Discuss the benefits of subsidising the use of fertiliser in India. [6]

(b) Using Figures 1 and 2, account for the soaring food crop prices in recent years. [4]

(c) Comment on the likely problems that may result from the policy of export restrictions adopted by the agricultural exporting countries. [8]

(d) Discuss whether "shifting the farm sector towards the market" is the best option to relieve the world food crisis problem (Extract 3). [8]

Total: 30 marks

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Question 2 **The India Economy**

Extract 4: India's Central Bank is ready for a fight

The Reserve Bank of India (RBI), India's central bank, surprised markets with a 25 basis point rise in its main lending rate on Friday and with a clear-cut declaration that fighting inflation now comes first.

For a central bank that was seen as pro-growth for the past couple of years, this was a decisive change. This implies the central bank is now willing to make the trade-off and is ready to sacrifice growth to address price stability.

The central bank increased its main lending rate by 25 points to 7.75 percent and said it was jacking up the amount of funds banks must deposit with it for the third time in four months. The rate increase was the fifth in the fiscal year. The RBI also had this to say, "The stance of monetary policy has progressively shifted from an equal emphasis on price stability along with growth to one of reinforcing price stability."

Source: Adapted from Business Times, 4 April 2007

Extract 5: OECD says India's current economic growth sustainable

India's current economic growth, averaging 8.5 percent annually over the past four years appears sustainable, but the country can do even better by opening its market and easing government control, the Organisation for Economic Cooperation and Development (OECD) said.

Separately, credit rating agency Standard and Poor's predicted 8.6 percent growth for India's gross domestic product in the current fiscal year ending March 2008. Such expansion will help India double its per capita income in a decade.

Still many economists remain concerned that much of the growth is concentrated in areas like telecommunications, information technology and other services sectors. Software services, for example, has been contributing much to exports.

OECD Secretary General said that it is possible for India to accelerate its economic growth to 10 percent if the country moves quickly to build infrastructure, reforms its labour market and further opens up to foreign capital, especially in the financial and energy sectors that are still dominated by state-run firms.

Meanwhile, foreign investors have increasingly flocked to India to seize opportunities in one of the world's fastest-growing economies. Foreign funds have already bought more than US$14.5 billion in Indian stocks this year and this is on top of the US$16 billion the country received in foreign direct investment through last fiscal year.

Source: Adapted from International Herald Tribune, 9 October 2007

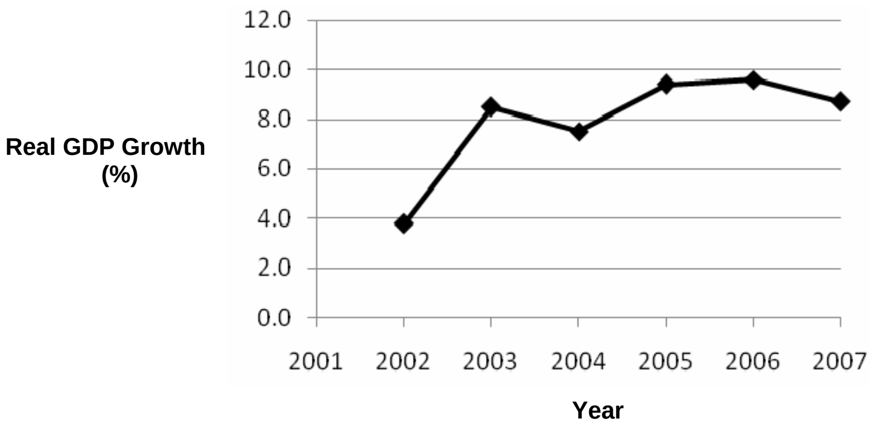
Extract 6: Taking the heat out of India's economy

In India, the soaring cost of fuel and food prices threatens to rob the Reserve Bank of India (RBI), the central bank, of its inflation-fighting credentials and undo the government's fiscal progress. It now falls on the central bank to stop inflation expectations rising. The RBI has promised to "act decisively, effectively and swiftly." But it is caught between competing objectives. It thought it had won the battle against inflation, which fell as low as 3.1% in October, and had turned its attention to the rupee, which was then uncomfortably strong. Its successful efforts to suppress the currency has made fighting inflation that bit harder.

Perhaps a slowdown will do the RBI's job for it. The OECD has forecast growth of 7.8% this year. But so far the weakening is not showing up in output figures. Despite a slowdown in manufacturing, the economy grew by a surprisingly strong 8.8% for the first quarter in the year. However there is a deep concern that India's remarkable run is coming to an end. Inflation will take some beating and the country's fiscal termites are gnawing once again. It is not just the oil subsidies. The government has promised to erase farm loans worth about 710 billion rupees. The combined budget deficit may reach 9.4% of GDP this fiscal year. Nine percent of $1 trillion is a very big number indeed.

Source: Adapted from Economist, 5 June 2008

Figure 3: Real GDP Growth



Source: Central Statistical Organisation

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Table 1: Economic Indicators of India

Economic Indicators	**2006**	**2007**
Real GDP growth (%)	9.7	8.7
Fiscal Balance (% of GDP)	-7.4	-6.1
Consumer Price Index (Annual % change)	6.7	6.1
Private Consumption (% of GDP)	56.4	-
Gross Domestic Fixed Capital Formation (% of GDP)	34.3	-
Government Consumption (% of GDP)	11.3	-
Current Account Balance (% of GDP)	-1.1	-1.2
Growth in Merchandise Exports (%)	23.2	22.8
Growth in Merchandise Imports (%)	25.2	30.1
Merchandise Trade Balance (US$)	-50.3 bil	-66.5 bil
Current Account Balance (US$)	- 14 bil	-16 bil
Overall Balance of Payment (US$)	110.5 bil	309.7 bil
Nominal Exchange Rate (Rupee/US$)	44.2	39.4

Source: Reserve Bank of India, ADB & OECD

Questions

(a) (i) Describe the trend in India's real GDP from 2002 to 2007. [2]

(ii) Comment whether there has been an increase in the standard of living in India from 2002 to 2007. [4]

(b) Using the data provided, identify two problems that India faces and suggest possible reasons for them. [4]

(c) Why has RBI's effort to suppress the currency made fighting inflation harder? [2]

(d) Comment on the usefulness of monetary policy to achieve price stability in India.[8]

(e) Discuss how an appreciation of the Indian rupee from 2006 to 2007 affects the Indian economy. [10]

Total: 30 marks

Section B

Answer **one** question in this section.

3 **(a)** Explain how production and consumption in a market economy lead to an inefficient resource allocation. [12]

(b) Discuss the measures a government may take to overcome such inefficiencies. [13]

4 **(a)** Explain why a government aims to achieve its economic objectives. [10]

(b) To what extent would the imposition of trade barriers help achieve the government's economic objectives? [15]