Candidate Name: ____________________________ CT Group: ________

Index number: ___________

PIONEER JUNIOR COLLEGE
JC 2 Preliminary Examination 2012

ECONOMICS 8819/01

Higher 1

Paper 1 **12 September 2012**

3 hours

Additional materials: Writing Paper

READ THESE INSTRUCTIONS FIRST

Write your class, 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.

Section A
Answer **all** questions.

Section B
Answer **one** question.

At the end of the examination, fasten your answers for Questions 1, 2 and 3 or 4 separately.
The number of marks is given in brackets [ ] at the end of each question or question part.

Section A

Answer all questions in this section.

Question 1 Housing Markets in China and Singapore

Extract 1: The effects of falling house prices

The problems in housing usually have important implications outside the construction industry. For example, a decline in housing wealth reduces households' ability and willingness to spend. Lower sales of goods and services also reduce the incentives for firms to invest and hire. These consumer-related effects are on top of the direct consequences of low rates of home construction for job creation and income. In short, housing problems affect not just the homebuilding industry, but also the vitality of the economy as a whole.

Source: Adapted from *a speech by Chairman Ben S. Bernanke for 2012 National Association of Homebuilders International Builders' Show, Orlando, Florida,* 10 Feb 2012

Extract 2: Singapore's housing market

Prices for property in Singapore have reached a record high. Singapore's low crime rate, good schools and low taxes mean that expatriates and investors are increasingly attracted to the property market. Alvin Tan, director of residential sales for Savills' Singapore's office said: "A firmer economic recovery, the continued robust GDP growth, and optimism surrounding the two new [casino] integrated resorts could be possible factors that continue to draw buyers into the market, lending support for the current prices."

Officials have promised to release more government land this year for real estate development.

Peter Evans, sales director at property consultants Forbes Le Brock, said that Singapore's high prices had also been driven by its small size, which restricts the amount of development possible. "Investing in Singapore, despite its high prices, is therefore a good opportunity, as there will be a more limited supply of land in the future."

Source: Adapted from *The Telegraph,* 16 Jul 2010

Extract 3: China's Property: Bubble, Bubble, Toil and Trouble

In 2009, total investment accounted for more than 90% of China's overall growth; residential and commercial real estate investment comprised nearly a quarter of that. Given that it was a huge property bust in the US that caused the world to fall into recession in 2008, many analysts are now beginning to fear the worst. "China's property market," says independent Shanghai economist Andy Xie, "is a massive bubble."

During his opening address to the National People's Congress, Premier Wen said that 2010 was going to be a year of unprecedented economic complexity. A real estate downturn, perhaps a severe one, will hit China sooner or later if the government is unable to manage this ballooning bubble. The problem is that if it arrives sooner, the world's fastest-growing economy doesn't have a whole lot to fall back on. Its export markets are still weak and its capacity to increase infrastructure spending again, after the massive increases of the past two years, is limited. With the rest of the world still trying to regain its economic footing, the authorities in Beijing are hoping they can shrink a bubble without bursting it entirely.

Source: Adapted from *Time Magazine, 22 Mar 2010*

Extract 4: China's housing bubble

It's not a surprise that China is worried about a potential housing bubble. House prices rose by 7.7% in November, despite the government prohibiting mortgages (housing loans) for third homes and announcing plans to introduce a property tax. In fact, sales volume jumped 14.5% from a year earlier.

Even though China's central bank raised interest rates in October for the first time in three years to stem the flow of credit, the problem is that savers still face negative real interest rates (inflation is 5.1% while the deposit rate is 2.5%). Savers would rather buy assets since they are losing money by depositing their cash in banks. And, as China has capital controls that limit overseas investment and an underdeveloped financial sector, the assets of choice are the stock markets and real estate.

Source: Adapted from *The Guardian*, 22 Dec 2010

Extract 5: Singapore Budget 2010: Expenditure in Public Housing

Public housing has played a critical role in promoting rootedness and social cohesion among Singaporeans. It has given our people a tangible stake in the country and has facilitated upward social mobility. It has also given Singaporean households an asset that they can monetise to meet retirement needs. The Ministry of National Development will continue to provide affordable and quality public housing that meets the needs and aspirations of Singaporeans, and promote home ownership for the vast majority who can afford it. $534 million will be allocated to Housing Development Board as an operating grant for this purpose.

Source: *Singapore Budget 2010 Expenditure Overview*, www.mof.gov.sg, 12 Mar 2010

Extract 6: Singapore Tightens Loan Limits to Cool Housing Market

Singapore increased down payments for second mortgages and imposed a stamp duty on property held for less than three years to curb speculation after home prices surged 38 percent in the second quarter. Singapore joins China in introducing measures this year to cool their property markets amid concerns that asset bubbles are forming as home prices surge.

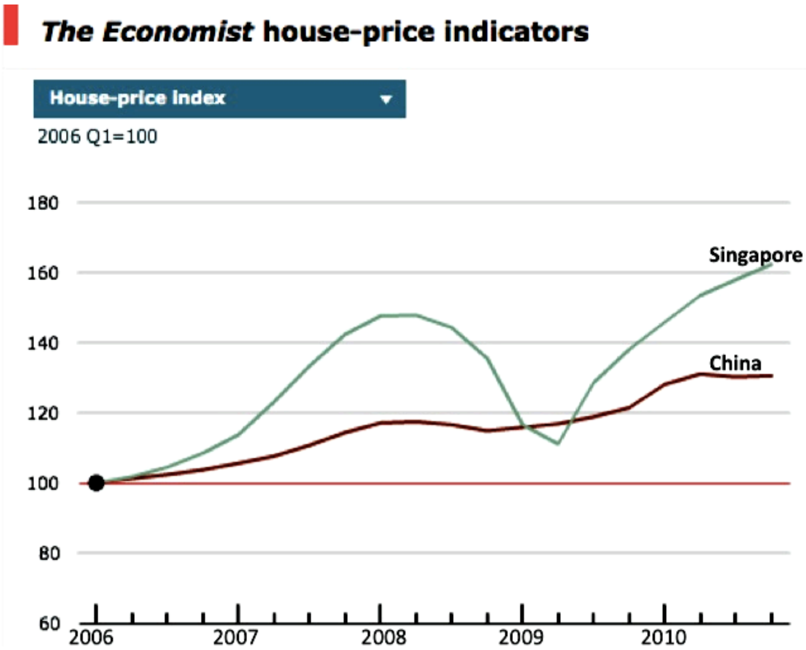
The government is taking a preemptive approach to target repeat buyers and speculators who buy and sell over the short term, which is now defined as within three years. Previously, the government in February said it will levy a seller's stamp duty - a form of tax - on all residential properties and land that are sold within one year from the date of purchase. The city-state then also lowered the loan-to-value limit to 80% from 90% for all housing loans provided by financial institutions regulated by the Monetary Authority of Singapore.

These new measures were implemented as previous measures failed to keep prices in check and the government believes that Singapore's property market would form a bubble if the current momentum continued.

Source: Adapted from *Bloomberg*, 30 Aug 2010

[Turn over

Figure 1: House prices in Singapore and China



Source: *The Economist,* accessed 30 Aug 2012

Questions

(a) **(i)** Using Figure 1, compare the trend in house prices of Singapore and China from 2006 to 2010. [2]

(ii) Extract 2 states that prices for property in Singapore have reached a record high. Using a diagram, account for the change in house prices in Singapore. [6]

(b) "A real estate downturn, perhaps a severe one, will hit China sooner or later if the government is unable to manage this ballooning bubble." Explain and comment on the likely effects of such a collapse of the property market on the Chinese economy. [8]

(c) Explain the case for government intervention in the housing market in Singapore. [6]

(d) Evaluate the government policies used to control house prices in Singapore and China. [8]

[Total: 30 marks]

Question 2 Currency War

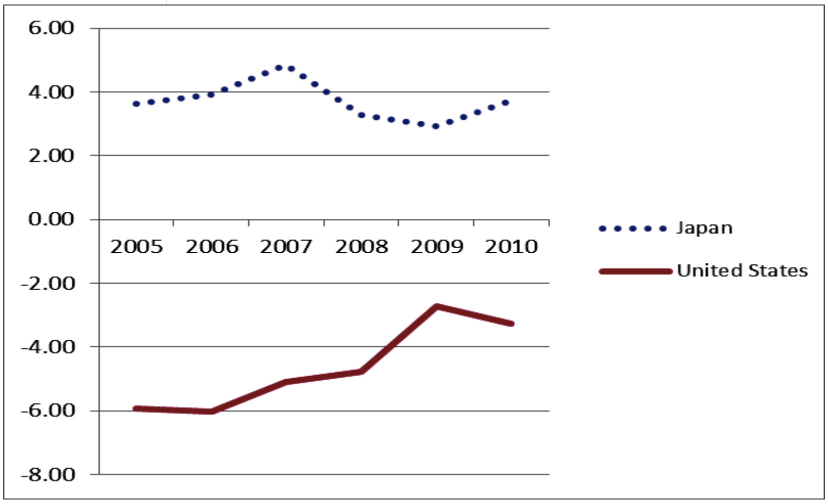
Extract 7: What's the currency war about?

Over the past decade, the world has been divided into "deficit" countries and "surplus" countries. Countries with trade deficits, like the US and the UK, borrow from the rest of the world, so they can import more than they export. Surplus countries, like China, Japan and many other Asian countries, do the opposite. They lend to other countries to help finance their exports.

This has led to tensions. The US says it wants to export more to help its economy recover. But the surplus countries don't want their exporters to lose their comparative advantage. The quickest way to gain a comparative advantage is through a weaker currency. And with the global recovery so weak, nearly all countries have been complaining that their currencies are too strong.

The People's Bank of China has bought up trillions of dollars in order to keep its currency weak against the dollar. And the US is not happy, saying that it helps keep Chinese exports artificially cheap. China's critics complain that the country runs a huge trade surplus, even though China is booming, while much of the world - notably the US - remains economically weak. Privately, the Chinese worry that if they raise their currency too quickly, it could bankrupt many export companies and seriously destabilise their economy. And China is not the only one to manipulate its currency. Korea and others have also intervened to keep their currency values down.

Figure 2: Current account (as % of GDP)



Source: World Bank

What can countries like the US and UK do to reduce their current account deficits? One option is austerity. Consumers and companies are already cutting back on borrowing and spending less. If governments do the same, the entire country borrows and spends less, and its deficit falls. The problem is that austerity measures by the governments in deficit countries can cause recession. Many in the developed countries hope that the government will try another option - trade sanctions against surplus countries. But that raises a spectre that is haunting the G20 meeting - the ghost of the 1930s, when protectionism started by the US led to a collapse of trade that was a big contributor to the Great Depression.

Source: Adapted from BBC, 22 Oct 2010

[Turn over

Extract 8: Japan intervenes to stem yen's rise

Japan stepped into the currency markets for the first time since 2004 on Wednesday in a bid to stem the yen's appreciation against the dollar and safeguard a faltering recovery. The yen fell to 85.03 to the dollar following the yen-selling, dollar buying intervention. The yen's appreciation has put many Japanese exporters at a disadvantage against foreign rivals as it erodes their repatriated earnings and competitiveness.

"Our country's economy is still in a very severe situation with continued deflation," said Finance Minister Yoshihiko Noda. The yen's appreciation "harms the stability of the economy and finances. We cannot tolerate it." A recent government survey suggested many companies were considering moving production overseas if the yen stayed high, casting a shadow over the nation's recovery. "Japan needed to intervene in order to try to prevent the yen rising to levels that would push exports lower and send the economy back into recession," said Macquarie Bank's Richard Jerram. But analysts are divided on how effective such a move to stem yen's rise will be in the long term, given the yen remains a safe haven compared to other major units amid fears over the global economy.

Source: Adapted from Telegraph, 15 September 2010

Extract 9: Japan GDP figures show sharp slowing of economic growth

Economic growth in Japan weakened significantly in the last financial quarter, official figures show. Between April and June this year gross domestic product - the sum of the nation's goods and services - grew by 0.1%, much lower than expected. Analysts say the country's export-led recovery appears to be faltering as the value of the yen appreciates.

The Japanese government and the authorities are worried. The Bank of Japan has kept interest rates super low at 0.1% in the hope that that will encourage people to borrow. The problem is, in a stagnant economy, people don't want to take on loans, however much they cost. Weakening exports are not the only problem confronting Japan. Prime Minister Naoto Kan recently said Japan was "at risk of collapse" under its huge debt, and with weak domestic demand, the prices of goods are falling. The country's central bank has already announced a scheme to offer 3 trillion yen ($35bn; £22bn) in low-interest loans in an effort to spur economic growth.

The BBC's Roland Buerk in Tokyo says Japan remains one of the wealthiest and most prosperous countries in the world, but the trajectory of its economy has been clear for years. World Bank figures show that in the first eight years of this century Japan's economy expanded by just 5% while China's grew by 261%. The GDP figures give further credibility to the widely held belief that China will soon overtake Japan as the world's second biggest economy.

Some economists expect China to overtake Japan as the world's second biggest economy in about six months. But such comparisons, while important, offer an incomplete picture of life in China. Income per head at $6,675 a year is still far lower than Japan's ($32,443). In the poorer parts of the country there is evidence of growing investment and infrastructure spending that is making a real difference. But in many parts of rural China, people live in conditions that would be unacceptable in Japan. Its achievements in pulling hundreds of millions out of poverty should be lauded. But the amount of work still to be done should not be underestimated.

Source: Adapted from BBC News, 16 August 2010

Table 1: Economic Indicators: China

	2006	2007	2008	2009	2010
Real GDP growth	12.7	14.2	9.6	9.2	10.4
Unemployment rate (%)	4.1	4.0	4.2	4.3	4.1
Inflation (%)	1.5	4.8	5.9	-0.7	3.3
Government budget (% of GDP)	-0.8	0.6	-0.4	-2.3	-1.7
Exchange rate (Yuan/US$)	7.97	7.60	6.95	6.83	6.77
Mortality, infant (0-1), per thousand live births	20	19	18	17	16
Expected Years of Schooling	10.9	11.2	11.4	11.6	11.6

Table 2: Economic Indicators: Japan

	2006	2007	2008	2009	2010
Real GDP growth	1.7	2.2	-1.0	-5.5	4.4
Unemployment rate (%)	4.1	3.9	4.0	5.1	5.1
Inflation (%)	0.3	0.1	1.4	-1.4	-0.7
Government budget (% of GDP)	-0.9	-2.4	-2.9	-7.6	-6.7
Exchange rate (Yen/US$)	116.3	117.8	103.4	93.6	87.8
Mortality, infant (0-1), per thousand live births	3	3	3	2	2
Expected Years of Schooling	15.0	15.1	15.1	15.1	15.1

Source: United Nations Statistics Division

Questions

(a) **(i)** Compare the change in Japan’s current account balance as percentage of GDP between 2005 and 2010 with that of USA over the same period. [2]

(ii) “China's critics complain that the country runs a huge trade surplus, even though China is booming.” Explain how this could be used as an evidence to prove that China is deliberately keeping its exchange rate weak. [4]

(b) Comment on the use of austerity measures by US government to correct her current account deficit. [4]

(c) The yen’s appreciation “harms the stability of the economy and finances.” Explain the meaning of this statement. [4]

(d) Discuss whether the data provided are sufficient to assess changes in the economic performance and standard of living in Japan and China over the period. [8]

(e) “The quickest way to gain a comparative advantage is through a weaker currency”. To what extent should countries practise free trade rather than seek to gain a comparative advantage through a weaker currency. [8]

[Total: 30 marks]

[Turn over

Section B

Answer **one** question from this section.

3 Price is viewed by economists as a rationing and allocative mechanism. In the presence of negative externalities, the price mechanism fails to achieve efficiency.

(a) Explain how the price mechanism allocates scarce resources among competing needs in a free market. [10]

(b) Discuss whether regulation or taxation is a better policy to address the market failure due to negative externalities. [15]

4 If there is evidence of rising inflation rates, it supports the view that the time has come to ease inflationary pressures by raising interest rates and tax rates.

(a) Explain how raising interest rates and tax rates can influence the inflation rates in an economy. [10]

(b) Discuss whether reducing inflation is always the most important macroeconomic objective for a government. [15]