TEMASEK JUNIOR COLLEGE

PRELIMINARY EXAMINATION 2008

ECONOMICS: **8816/01**

PAPER 1

Wednesday 17 September 2008 1400-1700 Hours

READ THESE INSTRUCTIONS FIRST

Do not turn over until you are told to do so.

Write your name and CG number 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, glue or correction fluid.

Section A
Answer **all** questions.

Section B
Answer **one** question.

At the end of the examination, fasten your work for each question in Section A **separately**. Fasten your work for Section B and the Cover sheet together.
For each question, write your answer on the separate paper provided. Hand in your answer to each question **separately**.

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

This document consists of 7 printed pages.

[Turn over

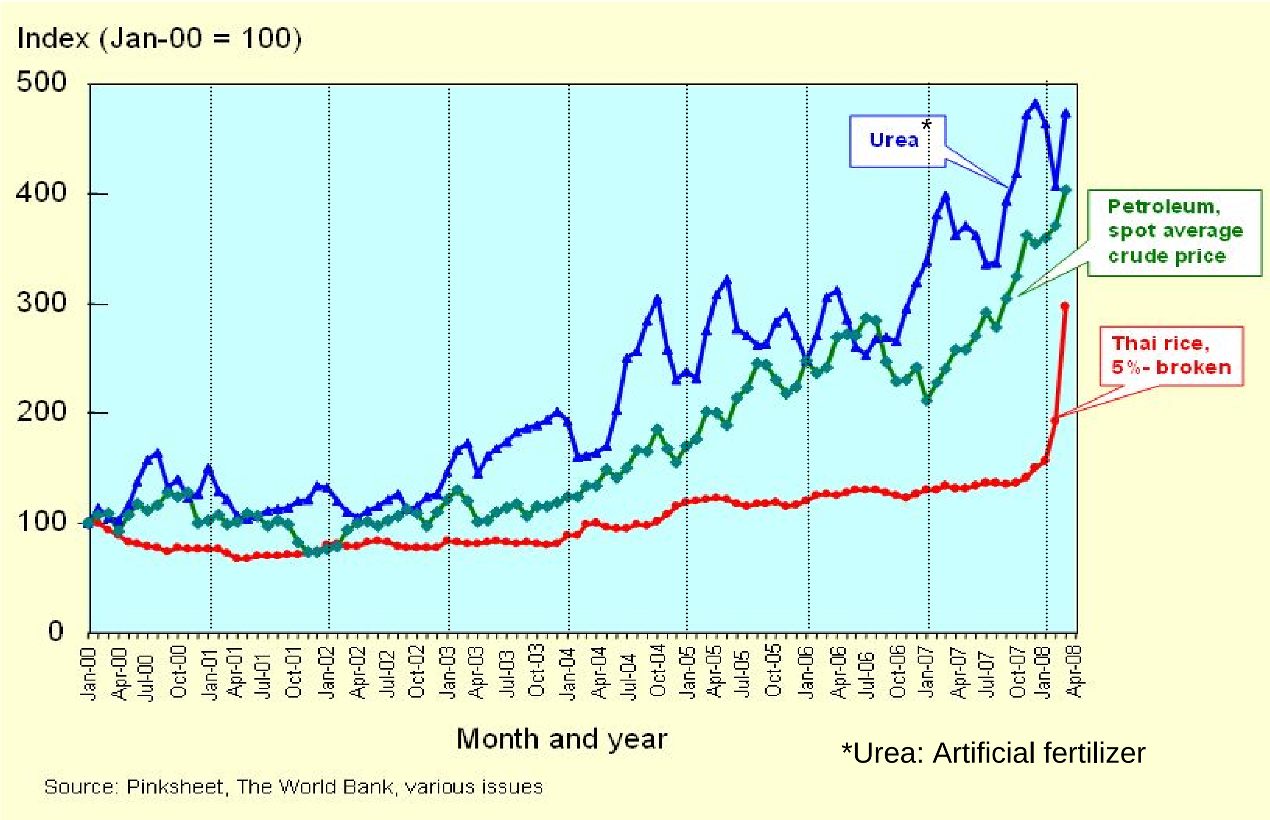
Section A

Answer **all** questions in this section.

Question 1 Rice Crisis

The soaring price of rice and dwindling stockpiles of Asia's basic food are causing anxiety across the region.

Figure 1: Prices of commodities



Extract 1: Structural factors driving food prices

What are the structural factors underlying the surge in food prices, aside from the direct impact of high and rising oil prices? Some economists cite factors such as rapid economic growth, urbanization, neglected agricultural sectors and climate change. The structural explanation for rising prices of cereals is evident in the case of rice – global rice stocks have fallen and are expected to reach 25 year lows at just 70 million tons this year, down from 150 million tons in 2000 (USDA 2008). Offsets of course are likely on the supply side but only if relative prices are allowed to provide the correct signals to farmers.

Adapted from *The Asian Development Outlook 2008* by Asian Development Bank

Extract 2: Globalisation under fire

Trying to curb soaring food prices at home, India, China, Egypt, Vietnam and Cambodia have imposed export bans. This will make it tough for poor, rice-importing countries, in Africa as well as Asia, to secure supplies. In India, the government there also, has stepped in to punish hoarders; action has been initiated against supermarkets trying to put restrictions on retail trade so that they can export more at higher prices. The government hopes that its actions will increase local supplies, thereby curbing price rises.

Such curbs may be politically expedient, but they are economically self-defeating. They demotivate farmers which disrupt global supply. Globalisation, is once again on trial and this time it appears to be under heavy fire.

Adapted from *The Navhind Times*, 14th Apr, 2008

Extract 3: Winners and Losers

For decades, the fall in commodity prices coupled with tariffs imposed by importing countries has led to widespread poverty and rural-urban labour drift that resulted in the neglect of the farms in primary producing countries. The way to alleviate poverty is through freer trade. Now with the price hike, when importing countries reduce their tariffs on farm produce, their households enjoy lower prices. The World Bank pointed out that with the recent price hike, since net food importers are richer than net food exporters, there is a redistribution of income between countries.

Adapted from the World Bank, Development Research Group, Apr 2008

Questions

(a) **(i)** Using figure 1, compare the trend in the price of rice with that of the price of petroleum. [2]

(ii) Apart from government policies, account for the changes in the price of rice. [5]

(b) With reference to extract 2, discuss how an export ban to curb rising prices could be "economically self-defeating". [8]

(c) Faced with the failure of the trade policies, discuss how the government could introduce other supply-side policies to ease the soaring price of rice. [6]

(d) In the light of the data provided, to what extent would freer trade create more winners than losers? [9]

[30 marks]

Question 2 China's Balance of Payments and Exchange Rate

Table 1: China's Balance of Payments (US$ billions)

Item	2001	2002	2003	2004	2005	2006	2007	2008^f
Current Account	**17**	**35**	**46**	**69**	**161**	**250**	**359**	**378**
Goods and Services	28	37	36	49	125	*Not Available*		
Goods	34	44	45	59	134			
Services	-6	-7	-9	-10	-9			
Income	-19	-15	-8	-3	11			
Current transfers	8	13	18	23	25			
Capital and Financial Account#	**30**	**40**	**71**	**138**	**46**	**-3**	**100**	**80**
Capital Account	0*	0*	0*	0*	4	*Not Available*		
Financial Account	35	32	53	111	59			
Direct Investment	37	47	47	53	68	60	75	60
Portfolio Investment	-19	-11	12	20	-5	*Not Available*		
Other Investment	17	-4	-6	38	-4			
Net Errors and Omissions	-5	8	18	27	-17			
Foreign Exchange Reserves	**210**	**285**	**402**	**609**	**816**	**1063**	**1522**	**1980**

f forecast
 # including errors & omissions
** small amounts of net capital outflows*

Source: *www.worldbank.org/china* Quarterly Update, February 2008 and *safe.gov.cn* Balance of Payments, 2001-2005

Figure 2: Exchange Rate Index of the Yuan

Source: *The Economist*, Lost in Translation, 17 May 2007

Extract 4: WTO Accession - Good for China

China was eager to join the WTO on the basis that membership of a large, multilateral organisation would enhance its ability to compete with other big countries. Late 2001, 15 years after its first application, China finally joined the World Trade Organisation (WTO). Many developing neighbours felt more than a twinge of discomfort. With China already an export juggernaut, they feared that the dismantling of tariff and other barriers that went with WTO membership would make the country irresistible to manufacturers, diverting foreign direct investment that might otherwise have gone to them. Certainly, foreign investment in China has increased, as have China's already heady exports, which since 2003 have been growing at their fastest pace since the early 1990s. In 2004 China overtook Japan to become the world's third-largest exporter, behind America and Germany.

In China, according to a paper last year by the Centre d'Etudes Prospectives et d'Informations Internationales (CEPII) in Paris, the processing and assembly of imported parts and components now accounts for more than half of all exports. William Fung, managing director of Li & Fung, a Hong Kong company that leads the field in finding suppliers and managing supply chains for Western retailers and brands, uses a talking toy as an example: the plush fabric was made in Korea and the voice chip in Taiwan, and the final assembly was done in Shanghai. China's export model, then, still consists in big measure of renting out cheap labour and land to foreigners. A number of high-tech firms, particularly Japanese ones, are wary of putting their research centres in China, fearing that their best design work will get pirated. Last year America's Intel greatly expanded its research facilities in Malaysia that design microprocessors, motherboards and chipsets, instead of relocating it to China.

Yet the model may already be changing. Home-grown exporters, especially privately owned ones, are honing their skills in China's cut-throat markets. Huawei, a telecoms company, already supplies handsets to Vodafone, the world's biggest mobile operator. Bo Xilai, China's commerce minister, promises vigorous support for his country's native car industry, which has leapt from nowhere to capture a quarter of the domestic market and is now poised to start exporting small, cheap cars.

Source: *The Economist*, <u>The export juggernaut</u>, 29 March 2007

Extract 5: Rising Yuan breaks past key level against US Dollar

Conceding to earlier pressures, China changed its decade-long policy of pegging the yuan at 8.28 to a US$ in July 2005. The yuan rose by more than 5% in the first year after that and yesterday, it rose past seven to the dollar for the first time since China scrapped its fixed exchange rate in 2005. It rose by as much as 0.16% to 6.99, bringing the currency’s advance to 18.4% since the end of the peg.

United States Treasury Secretary Henry Paulson said last week in Beijing that it was “dangerous” for the exchange rate not to reflect the fundamentals of the world’s fastest-growing major economy. A strong yuan helps to reduce the cost of food imports and slows the nation’s exports-led expansion. China’s consumer prices jumped 8.7% in February from a year earlier on higher food costs, raising the risk of unrest as Beijing prepared to host the Olympic Games this summer.

“Inflation can be a very serious threat,” said Ms Naomi Fink, a senior currency analyst at Bank of Tokyo-Mitsubishi UFJ, who forecasts the yuan would reach 6.3 in a year. “Certainly, China will keep accelerating the pace ahead of the Olympics, and I don’t think the authorities really want runaway inflation.” The Yuan has taken less than six months to break seven to the dollar after taking 1½ years to climb to 7.5 from eight. Forward contracts show traders are betting on an 11.2% advance to 6.29 in the next 12 months.

Chinese Premier Wen Jiabao pledged “forceful” measures last month to tackle inflation and narrow a record trade surplus that had flooded the economy with cash, swelled currency reserves to at least US$1.5 trillion and fuelled tensions with the US and Europe, China’s largest trading partners.

Billionaire investor George Soros said rising world food costs were “of grave concern” and might lead to “social and political disruptions”. “China is starting to deal with the problem of inflation by allowing the yuan to appreciate now at a faster rate.” Mr Soros, who made about US$1 billion betting against the pound in 1992, said in Washington. “You can do that only if you have a substantial trade surplus.”

China’s statistics bureau raised its estimate for economic growth last year to 11.9% from 11.4% because of higher growth in services industries, including telecommunications and retailing. The revision means last year’s expansion was the fastest since 1994, when the economy grew 13.1%.

Source: *The Straits Times* Rising yuan breaks past key level against US dollar,
Bloomberg News, 11 April 2008

Questions

(a) **(i)** Referring to Table 1, define Current Account and summarize its trend. [3]

(ii) Explain the likely reasons behind the trend in the current account. [4]

(b) **(i)** Define Capital and Financial Account and summarize its trend as shown in Table 1. [3]

(ii) Is it a good thing to have a surplus in the Capital and Financial Account? [5]

(c) Given the twin surplus in the current and the capital and financial accounts of the balance of payments, what can the monetary authorities do to counter the effects on money supply? How would this in turn affect the two accounts? [3]

(d) Assess China’s going-global policy in achieving its desired macroeconomic aims. [12]

[30 marks]

Section B

Answer **one** question from this section.

3 "Prices tell us what goods and services to produce and consume."

(a) Explain the workings of the price mechanism. [10]

(b) What would you expect to happen to the equilibrium price and quantity of ball-point pens if

i) wages paid to workers in the industry rose
ii) the price of felt-tip pens fell sharply
iii) free education became widely accessible to children and adults [15]

4 'Worried over job losses, the US and European Union initiated actions that could re-impose limits on Chinese exports following the end of a global textile pact – a move trade analysts say smacks of protectionism.'

Associated Free Press 28 April 2005

(a) Contrast quotas with tariffs as alternative forms of trade restrictions. [10]

(b) Assess the validity of the US and European Union's return to protectionism. [15]

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PRELIMINARY EXAMINATION 2008
ECONOMICS 8816
COVER SHEET

NAME: ______________________________ **CG:** __________

Circle the number of the question that you have attempted:

QUESTION NUMBER	MARKS
Section B	
3	
4	
Total:	25

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PRELIMINARY EXAMINATION 2008
ECONOMICS 8816

CG: Combined ECONOMICS TUTOR: ____________________

Max number of students: ______ **Number of absentees:** ______

Number sat: ______________

Q #	Number of scripts	Σ	Marked by	Remarks
3				
4				
	Total:			