CATHOLIC JUNIOR COLLEGE
JC 2 PRELIMINARY EXAMINATIONS 2008
HIGHER 1

ECONOMICS — 8816/01

Paper 1

9th September 2008

3 hours

DO NOT OPEN THIS BOOKLET UNTIL YOU ARE TOLD TO DO SO

INSTRUCTIONS TO CANDIDATES

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.

Section A
Answer **all** questions.
Section B
Answer **one** question.

Begin each question on a separate sheet of paper.

Remember to write your name and class on every sheet of paper submitted.

This question paper consists of 8 printed pages.

Answer **all** questions.

Question 1 The Illegal Drug Market

Extract 1: The Drug Market in the USA

In the United States, as in most other countries, markets for drugs are heavily regulated. Drugs intended for medicinal purposes must be approved by the Food and Drug Administration, and psychotropic drugs with questionable medical benefit are often banned. Drugs like methamphetamine, cocaine, heroin, marijuana and LSD are deemed by the government so dangerous to users and society that their possession, use or sale is a criminal offense.

Making a product illegal does not eliminate the market for it. The Office of National Drug Control Policy estimates that Americans spent about $65 billion on illegal drugs in 2000, more than the amount spent on cigarettes.

www.minneapolisfed.org

Extract 2: The Cost of Cocaine in Europe and the USA

Despite being much nearer to the main coca-producing countries in South America, the price paid by American consumers for a gram of cocaine, at $86.40, is pretty close to the $94 paid in Europe. Stricter anti-drug policing in America may be a factor in keeping the cost high. The margin between the wholesale and retail price in America is higher than that in Europe.

www.economist.com, 14 July 2008

Table 1: Cocaine – Wholesale & Street prices

Europe	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Retail Price (US$)	180	170	169	145	152	157	135	116	113	106	82	85	80	92	94	89
Wholesale Price (US$)	105	77	82	61	64	64	61	55	54	47	42	41	40	46	50	49
USA	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Retail Price (US$)	284	262	245	205	186	174	162	159	154	142	151	111	96	82	93	107
Wholesale Price (US$)	70	71	69	62	57	51	46	43	40	37	35	24	26	24	24	21

Source: World Drug Report 2007

Extract 3: The Social Herbicide – The Use of Subsidies to Reduce Supply of Coca

The government of the United States has adopted policies aimed at decreasing the quantity of illegal drugs bought and sold in the United States with both programs that reduce supply and those that reduce demand. In 2000, the United States gave $1.3 billion in aid to finance Plan Colombia, ("Plan Colombia") an operation that would seek to reduce the supply of cocaine at its source by curbing the production of the coca plant. Two main strategies have been employed:

spraying herbicides on coca fields and giving subsidies to coca farmers who voluntarily replace their coca with other crops.

One way in which authorities have tried to reduce supply of cocaine is through spraying a glyphosate-based herbicide over areas where coca is grown. In 2001 and 2002, Colombian authorities and American contractors sprayed herbicides on 254,586 hectares of coca. However, this strategy is inefficient and not cost effective. Although their fields and crops may be destroyed once, there is a high incentive for coca farmers to move elsewhere and replant the illicit crop there as growing coca is a very profitable enterprise. It is four times more profitable than even the most profitable legal crops, oranges and avocados.

Another strategy used in Colombia to combat coca production is giving subsidies for crop substitutions. Under this program, the Colombian government (with American aid) provides up to $2,000 in subsidies, technical assistance, and seeds to each family who voluntarily destroys its illicit crops and substitutes legal crops such as rice, corn, and fruit.

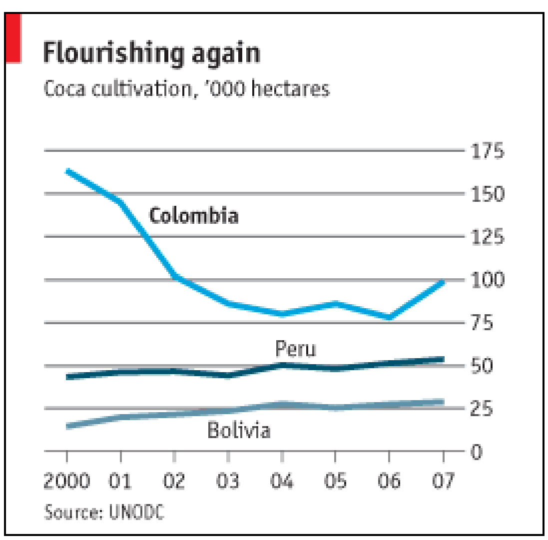
Adapted from Joshua Mollner, Saint Thomas Academy, Mendota Heights, Minnesota
www.minneapolisfed.org

Extract 4: Drugs in the Andes – A Big Rise in Coca in Colombia

It is almost a decade now since the United States and Colombia launched a joint plan to cut the output of coca (the raw material for cocaine) by 50% in six years. Plan Colombia has been effective as a counter-insurgency exercise, helping to beat back guerrillas and paramilitary warlords. But it has been a relative failure when it comes to coca.

According to a survey by the United Nations released this week, the area under coca in the three main producing countries increased by 16% last year to the highest figure since 2001 (see chart). The bulk of the increase came from Colombia (up 27%), though cultivation there is still almost two-fifths below its peak in 2000.

Figure 1: Coca Cultivation



This is despite superhuman efforts by Colombia's government to wipe the crop out. President Álvaro Uribe first unleashed American aircraft to spray weedkiller on the coca fields (153,000 hectares, or 378,000 acres, in 2007 alone). But the spraying hit food crops, and was not very effective. So the government has backed it up with manual eradication. Last year, gangs of labourers ripped out 67,000 hectares of coca.

But the UN survey shows much new planting near the Pacific coast, well away from the drug heartland in the south-eastern lowlands. Much of it is in smaller fields that are harder to detect.

www.economist.com, 19 July 2008

Table 2: United States Cocaine Use in Lifetime (Numbers in Thousands)

	2006	2005	2004	2003	2002
TOTAL	35,298	33,673	34,153	34,891	33,910
Male	20,668	20,388	20,562	20,988	20,325
Female	14,630	13,284	13,591	13,903	13,585
Age: 12-17	570	582	611	648	670
18-25	5,130	4,905	4,755	4,893	4,786
26 and Above	29,598	28,185	29,488	28,649	28,453

Source: OAS

Questions

a) i) Compare the trend in retail cocaine prices in Europe and the USA from 1990 to 2005. [2]

ii) With reference to the data and using economic analysis, account for the trend in retail cocaine prices observed above. [4]

iii) Account for the difference in wholesale prices of cocaine between Europe and the USA. [2]

b) i) Explain the market failure created by drug abuse. [4]

ii) Evaluate the use of a ban on illegal drugs to correct this market failure. [6]

c) With reference to the data, discuss the effectiveness of "Plan Columbia" and suggest alternative measures the government could adopt to bring about a more efficient allocation of resources. [12]

[Total: 30]

Question 2 The Vietnam Economy

Extract 5:

Vietnam's annual inflation rate has soared to 19.4% year on year in March, from 15.7% in February, hitting double-digits for a fifth consecutive month. Food-price inflation, which holds around a 40% weighting in the consumer price index and has been accelerating rapidly since mid-2007, continues to be the main factor driving up the general price level. Inflationary pressures have also been amplified by large capital inflows that have increased the money supply. The government's expansionary fiscal policy stance, combined with the central bank's inability to rein in credit growth thus far, has exacerbated the problem.

Vietnam's government is acutely aware of the challenges rampant inflation poses to the country's economic and social stability. In the past few weeks it has unveiled a raft of measures designed to dampen inflationary pressures. The government has begun to target consumer price inflation aggressively. In March it lowered import duties on certain products, raised interest rates and introduced a comprehensive strategy to fight rising prices. A key part of its strategy has been to require commercial banks buy a total of D20.3trn (US$1.26bn) in compulsory treasury bills, which has decreased liquidity in the market, and to cap dong deposit rates. In addition, the State Bank of Vietnam (SBV, the central bank) has raised the discount rate to 6% from 4.5% and the base rate to 8.75% from 8.25%.

In addition to draining liquidity from the market, the SBV has widened the trading band within which the dong is allowed to fluctuate on a daily basis, from 0.75% to 1%. The dong has been appreciating against the US dollar in recent months, owing to relatively high capital inflows and buoyant inward remittances. This latest move by the SBV is intended to allow the currency to strengthen further in order to alleviate inflationary pressures.

Adapted from The Economist, 4th April 2008

Extract 6:

Vietnam's inflation rate this month is the highest in more than a decade, despite a raft of government steps to stem rising prices. The consumer price index rose 21.4 per cent from a year earlier in April, driven by higher prices for food, housing and oil, according to government figures released last Friday.The index rose 19.4 per cent in March.It was the sixth consecutive month of double-digit inflation.In recent months, the ruling communist regime has taken several drastic measures, including curbing the money supply, raising interest rates and severely restricting bank loans, but they have failed to stem skyrocketing consumer prices.

Low-income workers and farmers have been especially hard hit.Already, there has been a record number of wildcat strikes by factory workers across the country demanding higher wages to survive.The latest government figures, which are widely believed to be understated, reveal that food prices rose 34 per cent this month compared with the same period last year.

Political leaders in Vietnam, a one-party state ruled by the Communist Party, have been rattled by the extent of the economic turmoil and their increasingly panicky responses have often reversed each other.Dr Vu Thanh Tu Anh, a Ho Chi Minh City-based economist, said: 'The government agencies in charge of running macroeconomic policies clearly lack coordination and consistency.'Party leaders are seeking measures to cushion the effects of the price hikes on low-income earners who are suffering most and who form the bedrock of the party.The leaders will need to move decisively since even party sources say the crisis has revealed how their complacency and naivete have grown during the past decade's boom times .

Adapted from The Straits Times, 28th April 2008

Extract 7:

Even by the standards of Asia's booms and busts, the turnaround in Vietnamese investors' sentiment has been remarkable, veering from wild optimism a few months ago to deep pessimism today. Surging inflation—it is now over 25% year-on-year—has aggravated a slump in the Ho Chi Minh City stock market, previously one of Asia's most bracing from worrying about upward pressure on the dong, the authorities now fear a currency collapse.

The central bank has announced a 2% devaluation, hoping to relieve the pressures on the currency. It also raised its base interest rate from 12% to 14%. It has been clear for months that Vietnam's economy is overheating. The trade deficit from January to May was over $14 billion, about the same as for all of 2007. Meanwhile, the government is trying to curb currency speculation by restricting foreign-exchange booths from selling dollars. To reduce imports, it is said to be allowing the central bank to sell dollars only to businesses that have its approval for their foreign purchases (such as buying capital goods). This, however, may push others towards the black market or offshore, further undermining the credibility of the official exchange rate. Despite the recent increases, real interest rates remain negative.

Adapted from The Economist, 19th June 2008

Figure 2: Vietnam's Trade Balance and Exchange Rate

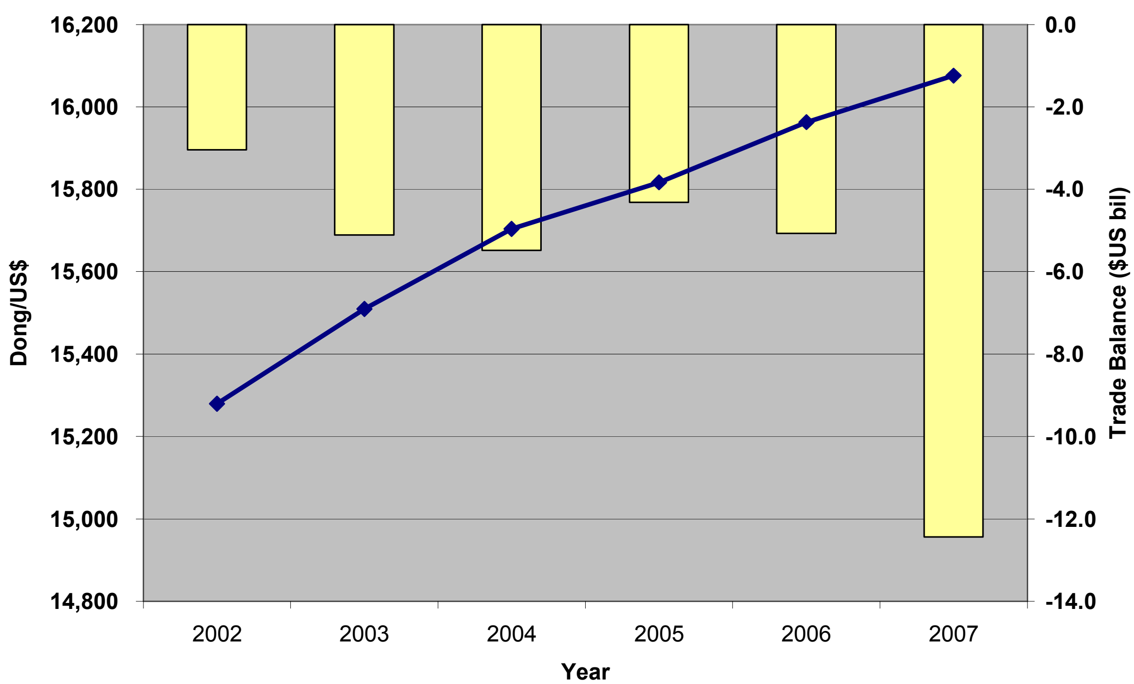


Table 3: Singapore – Selected Economic Indicators (in %)

	2002	2003	2004	2005	2006	2007
Growth of the gross domestic product , year-on-year	4.2	3.1	8.8	6.6	7.9	9.3
Inflation rate, year-on-year change of the consumer price index	- 0.4	0.5	1.7	0.5	1.0	2.1

Table 4: Vietnam – Selected Economic Indicators (in %)

	2002	2003	2004	2005	2006	2007
Growth of the gross domestic product , year-on-year	7.0	7.4	7.8	8.4	8.2	8.5
Inflation rate, year-on-year change of the consumer price index	3.8	3.1	7.8	8.6	7.2	7.1

Table 5: ASEAN 5 [a] – Selected Economic Indicators (in %)

	2002	2003	2004	2005	2006	2007
Growth of the gross domestic product , year-on-year	5.0	5.2	6.1	5.2	5.6	6.3
Inflation rate, year-on-year change of the consumer price index	3.4	2.7	3.6	5.2	5.7	3.1

[a] ASEAN 5 consists of Singapore, Malaysia, Indonesia, Thailand, Philippines

Questions

a) Using the data, identify the trend of Vietnam's exchange rate movements from 2002 to 2007. [2]

b) How far does the data suggest on the improvement of standard of living in Vietnam. [4]

c) (i) Compare the inflation rate of Vietnam with that of the ASEAN 5 nations from 2002 to 2007. [2]

(ii) Using economic analysis, explain the likely consequences of a rise in the wages of workers in Vietnam. [4]

d) Comment on the implications of a trade deficit on Vietnam's unemployment rate. [6]

e) Critically examine the effects of SBV's move to appreciate the Dong on Vietnam's Balance of Payment position and assess whether this is the best policy measure to adopt. [12]

[Total: 30]

Section B

Answer **one** question from this section.

3 **(a)** Explain how the price mechanism allocates resources efficiently in the free market. [10]

(b) Discuss the role of the government in achieving efficient allocation of resources in the economy. [15]

4 **(a)** Explain the impact of lower interest rates on the economy. [10]

(b) Discuss whether effective monetary policies are the best way for the Singapore government to achieve non-inflationary sustained economic growth. [15]