

TAMPINES JUNIOR COLLEGE

Preliminary Examination 2008

ECONOMICS

9732/01

Higher 2
Paper 1 (Case Study)

Monday 18 August 2008

13 30 – 15 45 (2 hours 15 mins)

INSTRUCTIONS TO CANDIDATES

Write your name and civics class in the spaces provided on the answer paper.

Answer **all** questions.

Write your answers on the separate answer paper provided.

If you use more than one sheet of paper, fasten the sheets together.

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

You are reminded of the need for good English and clear presentation in your answers.

This question paper consists of 11 printed pages.

Answer **all** questions.

Question 1 Rising oil prices putting pressure on the airline industry

Extract 1: Trouble ahead for the world's airlines

High oil prices and widespread economic gloom are putting the squeeze on the airlines. Delta and Northwest have plans to merge despite objections from powerful unionised pilots. Costs are not the only problem. Just as worrying is that passenger numbers look vulnerable to a slowdown in the world's big economies.

Merging is one way that the industry will cope. Airlines are also being forced to cut costs and capacity. American Airlines said that it would slash domestic capacity by as much as 12% by the end of the year, with others promising steep cuts too. Many are introducing fuel surcharges and other costs for travellers, for example for carrying baggage in the hold or for in-flight meals and drinks. Such measures, however, will only go so far to mitigate the high costs. Worse, the more ruthless the airlines become in cutting costs, the more the impact on travellers. Weaker airlines will be knocked out of the sky and fares will rise. Some airlines may not have the financial means to replace older gas-guzzling aircraft with newer more frugal models. That sounds unpleasant for airlines and their passengers. Consolidation and lowering capacity may mean that profitability eventually improves again, but a period of widespread, dirt-cheap, air fares seems to be coming to an end.

Some industry critics are sceptical of the airlines' claims about the efficiency gains that mergers of airlines will make possible. They counter that the airlines are already big enough to enjoy economies of scale and that the difficulties of knitting together complex organisations with different cultures will distract managers and divert scarce cash. Low-cost carriers, they say, will quickly move to occupy abandoned hubs and routes, replenishing capacity almost as soon as it is reduced. The success of big airline mergers is certainly not guaranteed. More than two years after their merger, US Airways and America West are still struggling with integration. That said, Air France's experience after taking over KLM, and Lufthansa's after buying Swiss, have been largely positive. Even without trying to integrate their businesses fully, the airlines have cut costs and benefited from economies of scale more quickly than investors expected, so they are now confident of being able to pull off more ambitious deals.

And there are good reasons to think that the Delta-Northwest and United-Continental deals would make sense. For one thing, airline managers have become more professional during the past few years, focusing on cutting costs. One measure of their success is that the market share of low-cost carriers appears to have stabilised at around 30%, at least for the moment. Furthermore, the big network carriers know that their future depends on developing their long-haul business, where there is greater scope for savings. With Northwest's strength on the Pacific, a merged airline would be able to offer a more comprehensive set of destinations. Success of the big airline mergers would

mean a much bigger pay-off. The prize for passengers, investors and regulators would be a globally competitive American airline industry that no longer needed to shelter behind bankruptcy laws and outdated bilateral agreements that keep foreign investment and ownership at bay.

Source: Adapted from The Economist, 14 Feb and 3 June 2008

Extract 2: British Airways traffic down 3.7% as fuel surcharge hits business flyers

British Airways added to the turmoil in the airline industry by confirming that a deterioration in traffic had accelerated in June. It said a 0.7% dip in traffic in May had become a fall of 3.7% in June, with the highly profitable business-class segment falling by 3.1% which contributed significantly to the falling sales. The worsening sales outlook indicated that a significant increase in fuel surcharges in late May has turned away passengers, including the premium customers who are deemed less sensitive to prices than economy-class travelers.

According to BA's own forecasts, the airline will not make a profit this year if the oil price stays at the current level of more than \$140 a barrel. Even at \$125 per barrel, BA's profits are wiped out. The UK flag carrier has a profit margin of 10% and is one of the world's most profitable airlines, but the relatively smaller airlines are not expected to survive if customers are put off by higher fares and a weakening global economy. "Oil is a huge cost and it's clearly having an impact," said Gert Zonnefeld, an analyst at Panmure Gordon.

British Airways has plans to buy French business class airline L'Avion in a £54m deal. The takeover represents a statement of confidence by BA in the airline market and in business class sales - the customer segment that generates most of BA's profits. Willie Walsh, BA chief executive, said: "L'Avion is a successful airline that has built up a premium business in a relatively short period of time. It has a larger schedule and an established customer base in the Paris-New York market."

It is also reported that the BA is close to applying for anti-cartel laws to be waived so it can form a joint venture with American Airlines and Spain's Iberia, which would allow the carriers to share profits and revenues on certain routes and collaborate on setting ticket prices.

Source: Adapted from The Guardian, July 3 & 4, 2008

Extract 3: British Airways ups fuel fees in premium seats

British Airways has increased the fuel surcharge for passengers travelling in its premium classes to compensate for rising fuel costs. Flyers in first class, Club World and World Traveller Plus will pay up to £24 more per flight than those in economy. A BA spokesperson said the move was "appropriate" as premium passengers enjoyed more space in the cabin and a higher baggage allowance.

This is the first time British Airways has introduced different levels of surcharges depending on which class passengers travel in. Economy-class passengers pay a £109 fuel surcharge on one-way flights of more than nine hours. The changes mean that World Traveller Plus customers will pay £121 and travellers in Club World and First Class will pay a fuel surcharge of £133. On a typical long-haul flight in a 747 plane, there would be 14 first-class passengers, 38 in Club World, 36 World Traveller Plus passengers and 263 economy customers, BA said.

Source: BBC News, 23 June 2008

Figure 1

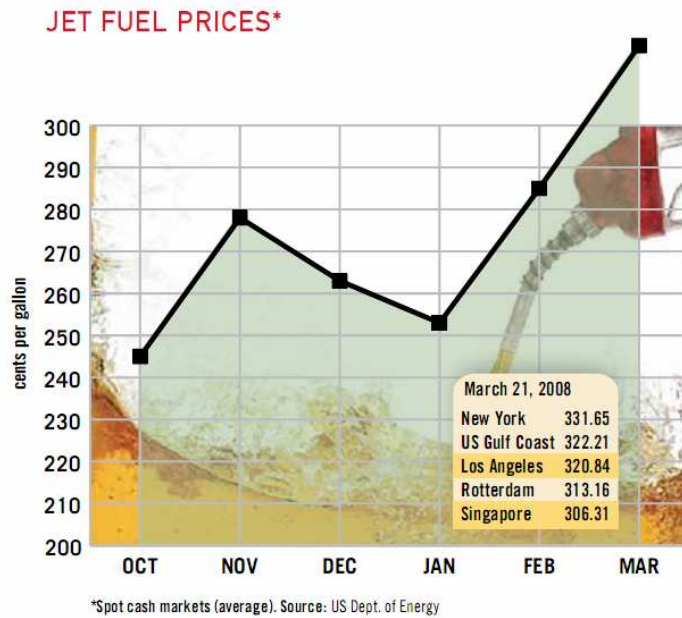


Table 2

SIA Airfare from Singapore to London, 2008

Month	Airfare
July	S\$1,768
August	S\$2,247
September	S\$2,247
October	S\$1,899
November	S\$2,057
December	S\$1,977

Source: AsiaTravel.com

Table 1

**United States Airline Domestic Market Share
May 2007 - April 2008**

Airlines	Share
American	14.6%
Southwest	12.5%
United	11.2%
Delta	10.8%
Continental	7.8%
Northwest	6.6%
US Airways	6.5%
JetBlue	4.2%
AirTran Corporation	3.0%
Alaska	2.7%
Others	20.1%

Market share based on Revenue
 Passenger Miles May 2007 - April 2008
 Source: US Department of
 Transportation

Questions

- (a) (i) Describe the trend of jet fuel prices from October 2007 to March 2008 in Figure 1. [2]
- (ii) Explain one possible reason for the difference in jet fuel prices in New York and Los Angeles. [2]
- (b) With the aid of suitable diagram, explain the outcome on the equilibrium price and quantity of air ticket due to the 'high oil prices and widespread economic gloom'. [4]
- (c) Justify the type of market structure for the airline industry. [4]
- (d) To what extent does the data support the practice of price discrimination in the airline industry and its benefits to society? [8]
- (e) Discuss the impact of mergers of airlines on consumers, producers and the economy. [10]

[30 marks]

Answer **all** questions

Question 2 Grim Prospect for Economic Growth

Extract 4: Can the US economy be revived?

The extent of intervention in the US economy since the credit crunch began in August has been both swift and unprecedented. The US central bank, the Federal Reserve (Fed), has been particularly aggressive in cutting interest rates from 5.25% to 2.25%. The US government moved quickly during the winter to pass an emergency stimulus package, with cash rebates to individuals and tax breaks for businesses. The US economy has expanded for the last six months at annual rate of just 0.6%. The Fed has also lent billions of dollars to the banking sector to avoid a financial breakdown, including \$29bn in government guarantees to keep investment bank Bear Stearns from collapsing.

Housing slump

At the root of the problems in the US economy is the collapse of the housing market. Nationwide, US house prices are dropping for the first time since the Great Depression, and the rate of contraction is still accelerating.

Recession fears

Consumer confidence is at a record low, and borrowing much higher, so many people may choose to repay debt rather than spend. In addition, the effect of high oil prices on the price of petrol - which has reached record levels - may add about \$35bn to consumer costs this quarter, wiping out one-third of the rebate.

Two out of the three main candidates for the presidency are calling for a temporary abolition of Federal petrol taxes over the summer to help ease this burden - although many economists argue this would merely encourage excess consumption.

Inflationary pressures

The fiscal stimulus package doubled the size of the US government's budget deficit, just as the economic slowdown is likely to reduce tax revenues. With both oil and food prices still spiralling across the world, the Fed will have to move cautiously from now on to limit inflationary expectations and prevent further speculation in the commodity markets. That also means stabilising the falling dollar, which has been adding to inflationary pressures, and has been hit by the low US interest rates.

Adapted from BBC News economics reporter, 30 April 2008

Figure 2: US – Economic Growth



Figure 3: US – Inflation

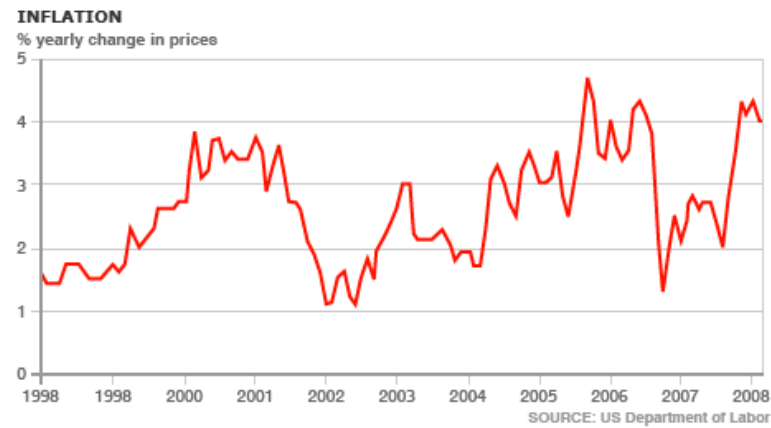
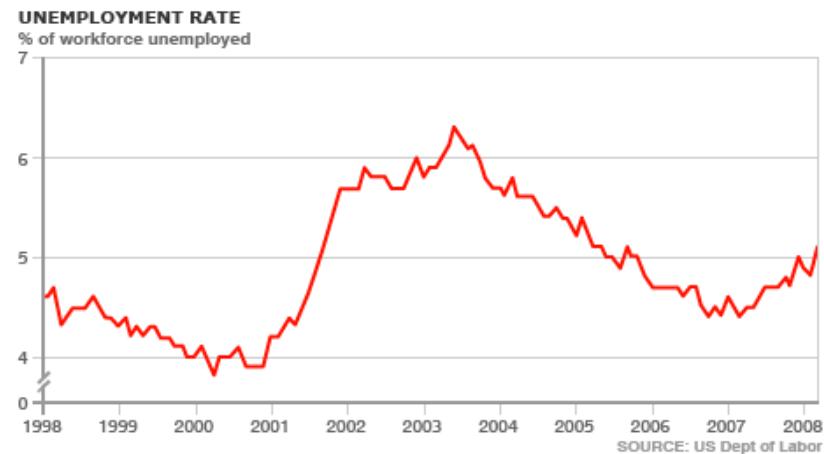


Figure 4: US – Unemployment



Extract 5: UK Seen Heading Towards Recession

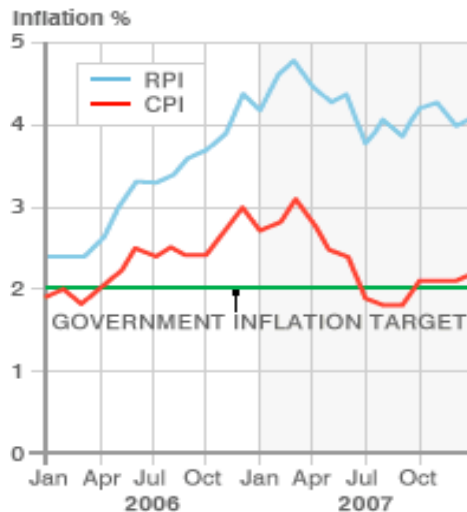
British businesses say a fall in sales of manufactured goods in the second quarter poses serious risks that the economy will tumble into a recession. But inflationary pressure is also escalating, fuelled by surging energy prices. This makes it hard for the Bank of England (BOE) to justify lowering borrowing costs for some time to come unless hard evidence comes through that the economy is diving into a prolonged period of contraction.

The British Chambers of Commerce (BCC) said the business sector was on the verge of a recession and unemployment could rise by as much as 300,000 by the end of 2009. Its second-quarter survey showed domestic conditions in the services sector at their weakest since the last time Britain's economy shrank for two successive quarters - a technical recession. Manufacturing also suffered in Britain, the report showed, but export sales and orders in both sectors were still growing. That indicates the weaker pound is boosting demand for British goods and services overseas. The government said annual house price growth slowed to 3.7 per cent in May from 4.9 per cent in April.

Source: BBC News, 9 July 2008

Figure 5: UK – Inflation

RIISING PRICES AND RIISING TAXES



RPI - retail price index
includes mortgage costs
CPI - consumer price index
excludes housing costs - government's preferred measure

Key tax rises



SPIRITS
UP 55P PER BOTTLE



PETROL
2P PETROL DUTY DELAYED
UNTIL OCTOBER



GAS GUZZLERS
ROAD TAX OF £950 FOR
MOST POLLUTING
VEHICLES BY 2010

SOURCE: CEBR, Bank of England, ONS

Extract 6: Slowdown in China will affect global growth

A slowdown or recession in China could be almost as important for global growth as one in the United States. Will Beijing be able to engineer a soft landing for its racing economy, or will the world be hit with a triple- whammy of weakness in the United States, Europe and China? The globalisation of China's economy has not just seen Chinese products enter billions of homes around the world, it has also linked the world's fortunes to China's economic future. China's exports, clocked at about US\$1.2 billion last year, make up almost 9 per cent of the world's total. But its imports, at US\$900 billion, are also helping to keep other economies afloat.

About a third of that total comes from nearby East Asia countries (Japan, South Korea and Taiwan). With Japan trying to cement its long-awaited recovery and South Korea worried about slowing demand for its exports, a dip in China's growth could be dangerous. The United States and Germany, China's other major suppliers, will also be looking on with concern.

If the dip comes, how big will it be? China's government clearly realises that its economy is in danger of overheating, but it has been reluctant to take severe measures to put the brakes on growth. A moderate but steady increase in the value of the yuan may help to erode China's trade surpluses. Interest rates, however, have yet to rise substantially.

For the past couple of years, China has been seeking to dial down its economic growth from 11 or 12 per cent annually to a figure more like 8 per cent or 9 per cent. Even that change has been difficult to achieve. So far, inflation in China has been partially driven by domestic demand and partially by increases in global commodity prices.

Adapted from Business Times, 3 July 2008

Questions

- a** **(i)** Explain what is meant by real GDP. [2]
- (ii)** To what extent does the data support the theoretical relationship between real GDP growth and unemployment from 2003 to 2008? [4]
- b** With reference to Figure 3 and Figure 5, compare the rising prices in US and UK in the period 2006 – 2007. [2]
- c** Does the data indicate that US is heading towards stagflation? Justify. [4]
- d** Critically examine the difference in the monetary policy stance between BOE and Fed in their attempts to prevent their economies from heading towards prolonged period of recession. [8]
- e** Discuss the likely impact of a slowdown in China's economic growth on the US economy and East Asia economies. [10]

[30 marks]