TEMASEK JUNIOR COLLEGE
Preliminary Examination 2014
General Certificate of Education Advanced Level
Higher 2

ECONOMICS — 9732/01

Paper 1

29 August 2014
2 hours 15 minutes

Additional Materials: Answer Paper, Cover Page

READ THESE INSTRUCTIONS FIRST

Do not turn this page 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 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.

Answer **all** questions.

Begin each case study on a separate sheet of answer paper.
At the end of the examination, fasten your work for **each case study separately**.
The number of marks is given in brackets [ ] at the end of each question or part question.

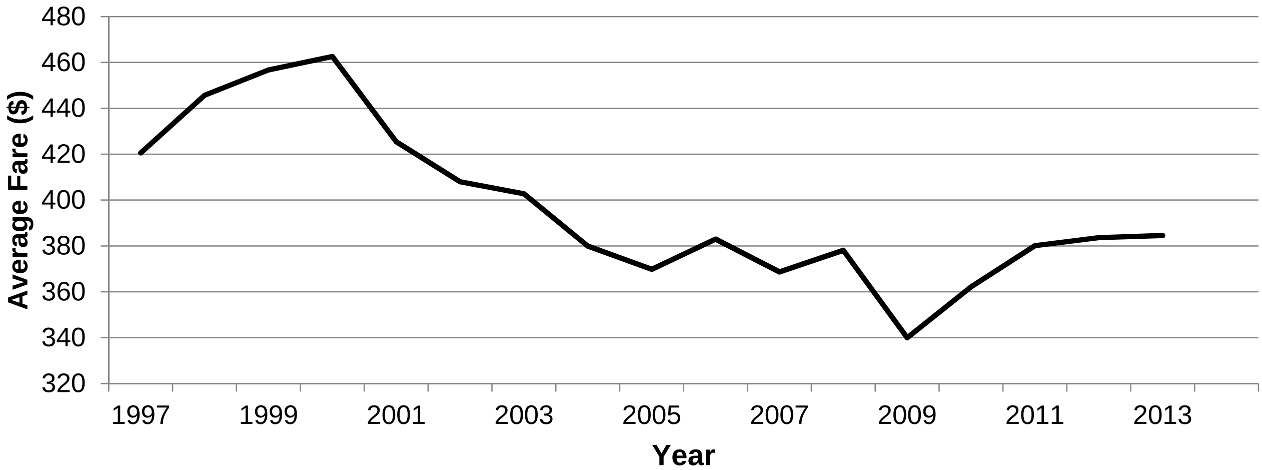
This document consists of **7** printed pages and **1** blank page

Answer **all** questions.

Question 1

The Evolution of the US Domestic Airline Industry

Figure 1: Annual US Domestic Average Itinerary Fare in 2014 Constant Dollars



Source: Bureau of Transportation Statistics, US

Table 1: Net Income of US Carriers (in millions of dollars)

Year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total	-9,104	-27,220	18,186	7,691	-23,750	-2,526	3,666	1,392	364	12,771

Source: Bureau of Transportation Statistics, US

Extract 1: Airlines: Who Can Tolerate Them

The "big bang" in the airline world was October 24, 1978. On that momentous day, the Airline Deregulation Act was signed into law. Prior to the new law, airlines were governed by the Civil Aeronautics Board (CAB). It sets fares and granted (or not) licenses to airlines for new routes. The system had functioned for over four decades when in the early 1970's, the Arab oil embargo drastically increased fuel prices and the economy suffered from stagflation. The rate system often subsidised inefficient routes. As airfares were escalating rapidly, congressional pressure mounted to scrap this antiquated bureaucracy. The theory was that an industry once untethered from government shackles would surely thrive under unfettered capitalism.

Post 1978, the stampede to compete was fast and furious. The "Act" basically allowed, perhaps encouraged, any sentient being who, satisfied adequate pecuniary requirements and experience, to join the fray. And in the intervening twenty-five year period, 129 enterprising souls did exactly that. By the end of 2003, only 15 of these start-ups remained, with that number much less today. Some of the great entrepreneurial success stories were Southwest, JetBlue, and America West (now merged into US Airways.) Of the twenty-three major and regional carriers licensed before the mass "airline rush", only seven survive today and three of those are small regional airlines in Alaska and Hawaii. Bankrupted are old great names of Eastern Airlines, Braniff and Pan American. Most of the others have been merged out of existence so that only United, Delta, US Airways and, with fate hanging, American remain extant. Of these remaining majors, it should be noted that all have been through at least one bankruptcy.

Source: Adapted from *Forbes*, 20 Aug 2012

Extract 2: How Airline Mergers Saved an Industry—and May Even Benefit Fliers

In the airline industry, the "turbulence" puns never seem to end, because there's always something that rattles the big carriers and shakes up the business. All the recent bankruptcies allowed the airlines to trim an excess supply of jets and cut labour costs that got inflated during the late 1990s, when the carriers were flush and the unions for pilots, flight attendants and machinists had the leverage to demand generous contracts. They also set the stage for a spate of mergers, including American and TWA in 2001; US Airways and America West in 2005; Delta and Northwest in 2008; and United and Continental in 2010. Once American and US Airways have merged, the industry will have shrunk from eight or nine big carriers in 2000 (depending on how you count) to just four. Delta, United, Southwest and the new American will control about 85 per cent of all domestic air travel.

Consolidation is finally helping a money-losing industry become profitable. Fliers may associate bankrupt carriers with fire-sale airfares, but on the whole, a dysfunctional airline industry is a net drag on the US economy. "What we should all root for is an equilibrium in which the airlines are stable enough to make some money for shareholders and provide steady employment, while not charging consumers too much," says Seth Kaplan, managing partner of the trade publication *Airline Weekly*.

Too much consolidation, of course, can generate monopolies that gouge consumers. But so far that hasn't happened. Since 2000, the average airfare, adjusted for inflation, has fallen by 18 per cent, according to the Department of Transportation. Airfares have risen more sharply since 2009, but that follows a plunge in fares during the recession, with ticket prices settling more or less where they were before the downturn. "Mega-mergers over the last seven years have not caused US domestic passengers to experience dramatically higher airfares or drastically reduced competition on most routes," a recent study by consulting firm PricewaterhouseCoopers concluded.

Profit-hungry carriers undoubtedly will push fares as high as possible if a shortage of competition on some routes lets them get away with it. But there are still discounters like Spirit and Frontier eager to find markets where they can undercut established carriers by offering lower fares. Airlines do charge more for extra baggage and other extras these days, but travellers have some control over whether to pay those fees or not. As much as travellers like to gripe about flying, the experience is actually getting better. Mild weather, better technology and other factors have contributed to the better performance, but larger route networks with more integration help, too.

Source: Adapted from *US News,* 14 Feb 2013

Extract 3: American and US Airways Officially Merge to Create World's Biggest Airline

The world's biggest airline was officially created on Monday with the merger of American Airways and US Airways, capping a round of consolidation that has worried the US government, rivals and consumer groups. The merged airline will take the American Airlines name and will have a global network of nearly 6,700 daily flights to more than 330 destinations in more than 50 countries, and more than 100,000 employees worldwide. The company has a firm order for 600 new aircraft.

Last month, the Justice Department gave the $11bn merger the go-ahead after initially raising anti-trust concerns. Under the terms of the settlement, American and US Airways must divest themselves of prime take-off and landing slots at six key airports in Washington, New York, Chicago, and other cities. The two carriers will be forced to sell those slots to low-cost carriers such as Southwest and JetBlue. "This agreement has the potential to shift the landscape of the airline industry. By guaranteeing a bigger foothold for low-cost carriers at key US airports, this settlement ensures airline passengers will see more competition on non-stop and connecting routes throughout the country," said attorney general Eric Holder.

Source: Adapted from *The Guardian*, 9 Dec 2013

[Turn Over

Extract 4: What's Next for the Industry?

With airline consolidation reshaping the industry, PricewaterhouseCoopers (PwC) identifies four key trends that will likely define the industry in the near-term:

Sustained profitability: Domestic airlines have been profitable since 2010, and analysts expect 2013 to be profitable as well. Network carriers have been able to exert capacity discipline, eliminating redundant or unprofitable routes and rescheduling flights to better align with customer demand. In addition, as carriers replace their aging fleets, they'll see additional gains from newer, more fuel-efficient planes.
Business model convergence: Low-cost carriers (LCCs) are contending with aging aircraft that are driving maintenance costs higher and a maturing workforce that increases labour cost pressure. As LCCs have increased prices to cover increasing costs, their fares are more closely matching those of the network carriers. According to the report, stable LCC markets experienced a 19 per cent increase from 2008 to 2013, over twice the nine per cent increase in non-LCC markets. Now that mega-mergers have changed the competitive landscape, the business models of these remaining airlines are converging.
Ultra LCCs and mainline unbundling: Ultra LCCs are rapidly growing. As LCC airfares continue to rise, ultra LCC airlines distinguish themselves by charging the lowest base fare and collecting the highest ancillary fees. Ultra LCC traffic has almost doubled from 2008 to 2013, according to PwC, and if this business model continues to prove successful, it will likely incentivise some carriers to unbundle their product and services mix, at least for certain passenger segments.
Improvements to product quality: More carriers are competing for customers based on product and service offerings, as passengers continue to search for and book flights based on best price, reliability, convenience and amenities. As a result, airlines are increasing investments in customer experience improvements such as in-flight Wi-Fi, premium seating options, and operational reliability infrastructure.

"Carriers today are able to make more investments in improving their operations, as merger-driven consolidation has had a positive impact on the financial stability of the domestic airline industry," continued Jonathan Kletzel, US Transportation and Logistics leader, PwC. "Customer experience will remain a priority for airlines, as companies continue to upgrade their operations and improve efficiency in this time of relative financial stability."

Source: Adapted from PwC US, 2014

Questions

(a) **(i)** State the theoretical relationship between market power and prices in an industry. [1]

(ii) Do the data reflect this relationship? Explain why or why not. [5]

(iii) Describe the trend of the net income of US carriers over the period of 2004 to 2013. [2]

(b) **(i)** Identify how the market structure for domestic US airlines has evolved since the early 1970s. [2]

(ii) Explain the reasons for the evolution identified in b(i). [4]

(iii) Discuss the costs and benefits of the consolidation. [8]

(c) Assuming you are the economic advisor to the CEO of Jetblue, justify your recommended strategies for Jetblue to remain competitive in the airline industry. [8]

[Total: 30]

Question 2

Singapore and the Dynamic Environment of Global Trade

Table 2: Singapore's Current Account Balance (S$ million)

2008	2009	2010	2011	2012	2013
39,251.70	47,068.60	76,278.90	78,728.70	62,671.60	68,264.00

Source: Adapted from Singstat

Table 3: Singapore's Imports by Source

Non-Oil Imports - Selected Countries (2007-2012) as a Percentage of Total Imports						
	2007	**2008**	**2009**	**2010**	**2011**	**2012**
United States	12.3	13.3	10.5	12.0	12.4	12.2
China	12.1	12.0	9.5	11.6	12.1	12.4
India	2.2	3.0	2.1	3.2	4.5	4.1

Source: Adapted from Singstat

Table 4: Singapore's Exports by Destination

Non-Oil Exports - Selected Countries (2007-2012) as a Percentage of Total Exports						
	2007	**2008**	**2009**	**2010**	**2011**	**2012**
United States	8.8	7.4	5.7	6.9	6.1	6.1
China	9.7	9.7	8.5	11.0	11.9	12.2
India	3.3	3.7	3.0	4.0	3.9	3.0

Source: Adapted from Singstat

Extract 5: Policy Reforms in China

Since the late 1970s, China's manufacturing-led economy has been characterised by rapid double-digit GDP growth. However, in the wake of the global slowdown, China became more cognisant that relying on the model of manufacturing and export-led growth is not sustainable. There is a pressing need to ensure a structural shift from an investment-led to a consumption-based growth, and the government is committed to develop a more sustainable and steady economy, albeit with slower growth. [China's growth rate is forecast at 7.5% p.a.]

One major development is to build a competitive and vibrant economy. Policies are needed to tackle existing market restrictions (ranging from state dominance of the market, to industrial overcapacity, as well as financial restrictions) and accelerate the opening up of China's economy. Reform policies aim to open the Chinese economy to more private and foreign participation, consequentially allowing the Chinese economy to be more efficient and integrated with the global economy. They also seek to enhance the ease of doing business and increase market participation. With the end goal of addressing overcapacity, the Chinese government will allow private and foreign investments to participate in State Owned Enterprises [SOEs] so as to make them more competitive.

Source: Adapted from *IE Insights*, 15 Feb 2014

Extract 6: India – the New Export Focus for Singapore?

India's GDP is forecast to grow an average of 6% to 8% through 2016 with a middle class that is expected to nearly double by then, indicating a huge potential in the domestic market.

India is one of the world's most important emerging markets and the second most populous nation after China. The country is Singapore's ninth largest trading partner, with total trade amounting to S$35.4 billion in 2011. It has a fast growing consumer market, and opportunities are ripe for Singapore companies to enter into the education, premium healthcare, F&B and retail sectors to meet the needs of the growing upper middle class which is expected to reach 129 million by 2025.

Source: Adapted from IE Singapore, 24 July 2013

Extract 7: Examples of Singapore's Success Stories

International Enterprise (IE) Singapore is the government agency driving Singapore's external economy. The IE Singapore vision is for a thriving business hub in Singapore with Globally Competitive Companies (GCCs) and leading international traders. The following are examples of successful overseas ventures.

Charles & Keith: From humble beginnings, in Ang Mo Kio, Charles and Keith Wong have built a significant international brand. With its growing reputation for producing top-quality women's shoes – and later men's shoes under the Pedro line – overseas businesses were eager to partner Charles & Keith in their respective markets. Over 30 factories in China and Malaysia supply shoes to a diverse range of outlets including Singapore, Japan, Dubai and Taiwan.

SATS: SATS is Singapore's leading provider of gateway services and food solutions with over 60 years of operating experience. Having forged a solid reputation as a reliable and premier provider of inflight catering as well as passenger, ramp, cargo and baggage handling services in the aviation industry, it has successfully expanded its presence beyond Singapore and ventured into the non-aviation sector. Today, SATS is present in 44 airports across 12 countries. SATS hoped to ride on the booming Indian aviation market as early as 2003. Today, there are more than 20 international airports in India. By 2011, the Mumbai-Delhi air route was the tenth busiest airline routes in the world with a total domestic passenger load exceeding 4.3 million. Growing incomes in India are likely to boost SATS future in this emerging market.

Source: Adapted from IE Singapore, 2013

Extract 8: US Trade Sanctions

US government moved to impose substantial punitive tariffs on hundreds of millions of dollars of imported steel products from South Korea and eight other countries, a much-anticipated decision that marks one of the largest anti-dumping cases in recent memory. Steel imports from the nine countries may be hit with tariffs up to 118%, but the lion's share in this case — from South Korea — was targeted for levies with much smaller duties of 10% to 16%.

In the short term, the tariffs, if finalised, are expected to curb steel imports and lift US prices of certain steel goods, which could be felt by American businesses and consumers. The tariffs also may help restore several hundred steel factory jobs idled because of pressures from imports and probably will embolden domestic steel makers to file more claims of unfair pricing against foreign shippers. Worldwide, China is a leading producer and exporter of steel, but the country didn't figure into Friday's announcement because the US already had levied big anti-dumping tariffs on its tubular steel goods in 2010, which nearly halted its imports in that category.

Source: *Los Angeles Times*, 13 July 2014

Extract 9: Singapore's Competitiveness at Risk

The Monetary Authority of Singapore's (MAS) traditional defence of a strong Singapore dollar policy is built on balancing imported inflation against export competitiveness. The MAS believes a strong currency does not hurt manufacturing as the heavy reliance on imported components - which are cheaper when our currency is strong - helps hold down costs.

But this leaves service exports in the cold - and subject to the vagaries of a strong currency - because they are typically much less reliant on imported inputs. The negative effect of an over-valued currency on service exports like tourism and medical care was very evident in the aftermath of the Asian Currency Crisis of 1997 and 1998. We saw inbound tourism from East and South-east Asian countries dry up. Singapore's private hospitals and clinics were also adversely affected.

Singapore has not benefited much from the US recovery. The EU is still in the doldrums, while Japan is vigorously re-structuring, beginning with aggressively weakening the yen via quantitative easing. China is re-balancing its economy towards domestic demand and services. The US is also regaining competitiveness due to shale oil and gas, lower wages and a resurgent industrial policy.

Meanwhile, the recent Indian elections may translate to a vigorous manufacturing drive by the Modi government. And, if it can straighten out its politics and policies, Myanmar, with abundant resources and cheap labour, may prove to be a big draw for foreign direct investments.

Source: *The Straits Times,* 29 July 2014

Questions

(a) **(i)** Explain how the current account of an economy is calculated and suggest an explanation for the 62% growth in the current account of Singapore from 2009 to 2010. [3]

(ii) Using Tables 3 and 4, explain the change in relative importance of the USA and China as Singapore's trading partners, from 2007 to 2012. [2]

(b) Explain one reason why the Chinese government is promoting structural change. [3]

(c) Extract 6 reports that the Indian middle class is expected to double by 2016. Explain how this might affect trade between India and Singapore. [4]

(d) Analyse potential impacts of the "punitive tariffs" on American producers and consumers. [8]

(e) Discuss the threats and opportunities facing the economy of Singapore in light of recent developments. [10]

[Total: 30]

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