

2014 J2 H1 Prelim Questions and Answers
Yishun Junior College Economics Department
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YISHUN JUNIOR COLLEGE
JC2 PRELIMINARY EXAMINATIONS 2014

ECONOMICS
Higher 1

8819/01

15 AUGUST 2014
0800h – 1100h

Additional materials:

Writing paper
Cover page



TIME 3 hours

INSTRUCTIONS TO CANDIDATES

Write your name, CTG and index number in the spaces provided on the cover page and on all sheets of writing paper handed in.

Write in dark blue or black pen.

You may use a soft pencil for any diagrams, graphs or rough working.

Do not use highlighters, glue or correction fluid.

Answer questions **1**, **2**, and **either 3 or 4**.

At the end of the examination, tie a cover page to **three** separate questions:

1. Case Study Question 1,
2. Case Study Question 2, and
3. Either Essay Question 3 or 4.

INFORMATION FOR CANDIDATES

Including this cover page, there are **seven** pages in this question booklet.

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.

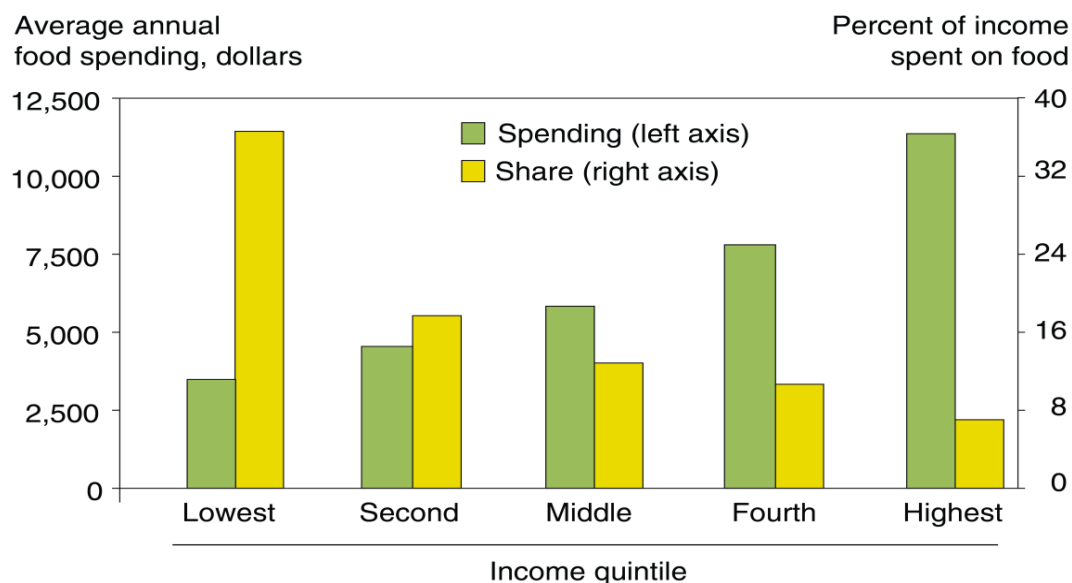
Section A

Answer **all** questions in this section.

Question 1

Agricultural Subsidies and International Trade

Figure 1: Food spending and share of income spent on food across U.S. households in 2012



Source: U.S. Bureau of Labour Statistics, *Consumer Expenditure Survey 2012*

Table 1: Agricultural share of GDP in 2012 for selected countries

Country	Agricultural Share of GDP (%)
<i>BRIC countries</i>	
Brazil	6
Russia	4
India	18
Indonesia	15
China	10
<i>Some developed countries</i>	
US	1
UK	1

Source: World Bank

Extract 1: Global Food Prices

Food price volatility has increased dramatically since 2006. Some price volatility is inherent in agricultural commodities markets, as they are strongly influenced by weather shocks. But the recent upward trend in food prices and volatility can be traced to additional factors including climate change, policies promoting the use of biofuels, rising energy and fertiliser prices, poor harvests, national export restrictions, global population growth, and low food stocks.

According to the Food and Agriculture Organisation of the United Nations, high food prices tend to have a heavy impact on the poor and aggravate poverty, food insecurity, and malnutrition. However, they also represent an opportunity to catalyse long-term investment in agriculture, which could boost resilience to climate change and augment global food security.

Source: Worldwatch Institute, 11 April 2013

Extract 2: Agricultural Subsidies

At the World Trade Organisation's Doha Round in 2001, many developing nations – including Brazil, China and India – opposed agricultural subsidies in the US and EU. They argued the high subsidies were artificially driving down global crop prices, unfairly undermining small farmers and maintaining poverty in many developing countries. Since then, developing countries have grown their own agricultural subsidies rapidly. And those in BRIC countries (Brazil, Russia, India, Indonesia and China) have increased the fastest. China's agricultural subsidies, estimated at \$160 billion in 2012, now dwarf those in the US (\$19 billion) and EU (\$67 billion) combined. Brazil's agricultural subsidies have doubled in just three years, and now total about \$10 billion, according to a recent government report.

If done well, these rapidly developing countries' agricultural investments could support innovation and help produce surpluses for export and pull millions of the rural poor out of poverty and into better lifestyles. But such spending must be very targeted and short term. If not handled carefully, it will stifle innovation and make producers both less competitive and more dependent on government. This could undermine efforts to promote efficiency and more sustainable agriculture. What we need, now more than ever, are producers who invest in efficiency, innovation and sustainability.

It is advisable for governments to be more wary of the long-term implications of agricultural subsidies. After all, many developing countries still struggle to provide basic services such as clean air and water, education, public services, infrastructure and healthcare for ageing populations. Within the context of these competing needs, we need to ensure that any agricultural subsidies increase productivity, efficiency and global competitiveness. Otherwise, it will be increasingly difficult to justify supporting one segment of the population when so many other priorities remain unfunded.

Source: Guardian Professional, 8 August 2013

Extract 3: The End of Globalisation and The Demise of Free Trade?

Economist Roger Bootle, explained in his recent book, *Money for Nothing*, the powerful popular appeal of the anti-globalisation message. He said, 'Protection remains a potent threat because for the large numbers of people affected by international competition, it apparently offers an obvious gain. Shutting out foreigners from "our" markets is obviously good for "us", although it is bad for "them". Trade is often viewed by the man in the street as a competition in which there can be only one winner, whose winnings are exactly balanced by the losses of the losers, or as economists would put it... a zero-sum game. But it isn't a zero-sum game. We all win.

A recent book by two World Bank economists, Kym Anderson and Will Martin, found that if politicians used the current 'Doha round' of world trade negotiations to throw open their agricultural markets to competition from overseas, world GDP would be boosted by up to \$300 billion over the next decade.

History has shown that the most successful economies are those that open themselves to foreign competition. Another World Bank report, from 2001, compared the fortunes of open economies - including China and the Asian Tigers - with countries that have protected their home industries from foreign competition - in general, protectionism was a losing bet.

Professor Joseph Stiglitz, Nobel prize-winning economist, says that is understandable that there is a tendency to blame foreigners for economic problems at home. Furthermore, the benefits of globalisation are uneven. Even if the long-term benefits of liberalising trade are enormous, they are thinly spread - among shoppers who can buy cheaper imported goods, taxpayers who can stop having to finance loss-making domestic industries, and the global population which is, as a whole, made wealthier. The short-term losers are far fewer in number, and their pain can be considerable. Workers in the rich world are seeing their wages depressed – or their jobs under threat – from low-cost competition. The answer, Stiglitz argues, is to have a strong social safety net, transferring resources from the winners to the losers from globalisation, to make sure everyone feels the benefits.

Many commentators believe protectionist pressures have only so far remained contained because the world economy has been growing strongly. If the US economy begins to slide, causing widespread job losses - and a potentially devastating impact on its trading partners - some fear a protectionist backlash leading to a collapse in global trade.

Source: *The Observer*, 5 March 2006

Questions

- (a) Using the information in Figure 1, identify **one** reason why rising prices of food would have a heavier impact on the lower income group in the US. [1]
- (b) With reference to Extract 1, identify and explain **one** demand factor and **one** supply factor causing world food prices to increase considerably after 2006. [6]
- (c) With reference to the case study, discuss the case for large agricultural subsidies by the BRIIC countries. [8]
- (d) Explain why according to economic theory, free trade is not a zero-sum game. [4]
- (e) Extract 3 mentions a group of short-term losers, the workers of the rich world, who would see their wages depressed or their jobs under threat.

Explain how globalisation can result in the problems faced by this group of workers. [5]

- (f) Extract 3 mentions that a downturn in the US economy would bring on a protectionist backlash. Comment. [6]

[Total: 30]

Answers

<p>(a) Using the information in Figure 1, identify one reason why rising prices of food would have a heavier impact on the lower income group in the US. [1]</p>
<p>Proportion of income spent on food is higher in the lower income group.</p>
<p>(b) With reference to Extract 1, identify and explain one demand factor and one supply factor causing world food prices to increase considerably after 2006. [6]</p>
<p>Identify one DD factor and one SS factor and explain how DD and SS curves shift [2] Demand factor---global population growth led to increase in demand=>DD curve shifts right Supply factor---Weather shocks → bad weather conditions resulting in fall in SS Policies promoting the use of biofuels→some crops directed to biofuel production→fall in SS of food Rising energy and fertiliser prices→increases in cost of production→fall in SS National export restrictions→world food SS falls =>SS curve shifts left</p> <p>Explain that the increase in DD and decrease in SS resulted in shortage in the market leading to upward pressure on the price</p> <p>Explain that food prices increase considerably due to extent of shifts in DD and SS and PED and PES (PED <1 due to lack of substitutes, PES<1 due to gestation period) [3]</p> <p>Full credit will not be awarded if:</p> <ol style="list-style-type: none"> 1. Separate analysis of DD and SS to explain increase in food prices with no attempt to explain the considerable increase 2. Separate analysis of DD and SS to explain increase in food prices with explanation of the considerable increase
<p>(c) With reference to the case study, discuss the case for large agricultural subsidies by the BRIIC countries. [8]</p>
<p>Argument for large agricultural subsidies by the BRIIC countries</p> <ul style="list-style-type: none"> - Unfair competition from US and EU. The agricultural subsidies of US and EU result in lower prices for their agricultural produce →BRIIC countries will suffer greatly as to compete they will need to lower their prices as well→ TR of farmers in these countries will fall as the DD for agricultural produce is price inelastic→ farmers in these countries will be badly affected. These BRIIC countries are likely to suffer most as the agricultural share of these countries is a significant proportion of their GDP (Table 1). BRIIC countries need to protect their farmers against such unfair competition. - Such agricultural subsidies can be targeted to support innovation→ promotes efficiency→ increases output and lowers unit cost of production→countries can export more→GDP increases→promotes actual growth. Furthermore, in the LR, productive capacity increases with these innovation→potential growth <p>Argument against large agricultural subsidies</p> <ul style="list-style-type: none"> - Producers may become dependent on the government and therefore will not have the incentive to be more efficient. - Subsidies to producers → increase SS of agricultural produce →overproduction → surpluses → resources are not allocated efficiently.

- High opportunity costs incurred as BRIIC governments channelled funds to the provision of agricultural subsidies → less funds available for other projects to improve the environment, to provide better education, healthcare and infrastructure and to provide more/better amenities and public services. Funds are needed to improve these areas especially in the developing economies to raise welfare of people in these countries.
- Large amount spent on agricultural subsidies in these countries → a strain on the fiscal balance of these countries.
- World Bank economists found that if countries open their agricultural markets to competition from overseas, world GDP would increase by up to \$300 billion over the next decade.

Conclusion:

- Large agricultural subsidies by BRIIC countries can be very costly
- These subsidies must be targeted and short term to promote efficiency and higher productivity if they are to be justified
- Should never be used as a tool for retaliation as this will only lead to a lose-lose situation for both BRIIC countries and the US and EU

L1	One sided argument either for large amount of agricultural subsidies or against such spending Or Skimpy answer presenting both argument for and against the use of large amount of agricultural subsidies	1 – 3m
L2	Balanced and thorough discussion on the need for these subsidies and the adverse impact of such spending Balanced but not thorough discussion – max 4m	4 – 6m
E1	Conclusion regarding large amount spent on agricultural subsidies without any substantiation	1m
E2	Justified conclusion regarding large amount spent on agricultural subsidies	2m

(d) Explain why according to economic theory, free trade is not a zero-sum game. [4]

State the theory of comparative advantage and the gains from specialisation and trade. [1]
and making reference to opportunity cost [1]

Explain that world output increases due to more efficient allocation of resources on a global level.

Explain that all countries participating in trade will be able to consume beyond what they can produce if a mutually beneficial terms of trade exists → all will gain.

Full credit will not be awarded if:

1. Explanation only contains gains from specialisation and trade

(e) Extract 3 mentions a group of short-term losers, the workers of the rich world, who would see their wages depressed or their jobs under threat.

Explain how globalisation can result in the problems faced by this group of workers. [5]

Globalisation → movement of labour from developing countries to developed (rich) countries in search of job opportunities → increase in SS of labour in these countries → wages are

depressed, *ceteris paribus*.

Globalisation→outsourcing and offshoring to take advantage of lower costs of production in some emerging and developing countries→workers in developed countries lose their jobs and remain unemployed with occupational immobility.

Globalisation→cheap goods from emerging economies→ increased competition from emerging economies which achieve comparative advantage especially in labour intensive industries→firms in developed countries may not be able to survive→workers lose their jobs.

Full credit will not be awarded if:

1. Explanation on either depressed wages **or** jobs under threat

(f) Extract 3 mentions that a downturn in the US economy would bring on a protectionist backlash. Comment. [6]

Explain how a downturn in the US economy will affect the economies of its trading partners

- Downturn in US→ Y falls → DD for trading partners' X falls and I also falls→ BOT and hence BOP adversely affected
- when X and I fall→AD falls→multiple fall in NI and employment

Explain why countries turn to protectionism to reduce the impact of the fall in exports on their economies

- Protectionist measures like tariffs and quotas will increase the prices of imports→Qty dded of imports fall→import expenditure falls when DD for imports is price elastic
=>BOT and BOP improves, fall in (X-M) and hence the fall in AD will not be as great, reducing the impact on NI and employment levels

Comment on the likelihood of a protectionist backlash/ appropriateness of protectionism in the light of the recession brought on by a downturn in the US economy [3]

- Once countries resort to protectionist measures to reduce the impact of a downturn in the US economy on their economies→protectionism begets protectionism→protectionist backlash
- There is strong evidence that open economies such as China and the Asian Tigers perform better than countries that engage in protectionism. Protectionism leads to contraction in world trade→reduces the gains from trade for all → protectionism is not a good option

Question 2

The Eurozone and the UK

Table 2: Economic Indicators of Eurozone*

Year	2007	2008	2009	2010	2011	2012
Change in real GDP (%)	3.0	0.4	-4.4	2.0	1.6	-0.7
Unemployment rate (%)	7.6	7.6	9.6	10.1	10.2	11.4
Population growth rate (%)	0.4	0.6	0.4	0.2	0.3	-0.2

*Based on original 17 countries in EU: Belgium, Spain, Austria, Cyprus, France, Portugal, Germany, Italy, Slovenia, Estonia, Luxembourg, Slovakia, Ireland, Malta, Finland, Greece, Netherlands

Source: Eurostat

Extract 4: If the Eurozone implodes, the UK economy will go with it

A Eurozone implosion would amount to the biggest bankruptcy in history. There could be no benign outcome to such an event. Banking systems would collapse, credit would dry up, and world trade would go into free-fall. The consequences would be felt everywhere, including in the US and China. But for the UK, which is on the front line, it would be much worse. An already likely home-grown recession would be multiplied several times over.

In such circumstances, it is impossible to think that sterling assets could maintain the “safe haven” status they enjoy today, with the UK government currently enjoying record low interest rates on their loans. A collapsing economy would comprehensively destroy the UK government’s deficit reduction strategy, and even in the event of further austerity measures, cause the debt to GDP ratio to rise to unsustainable levels. If there is a hint that the UK government is unable to meet its interest payment obligations, the UK would soon find itself in the same vicious cycle of economic decline and rising debt as Italy.

The UK requires a strong Eurozone to support economic recovery, as a lower risk of bankruptcy would bring about greater stability to the UK’s banking sector and encourage further investment into the UK. A strong Eurozone would also help the UK move from a consumption-led to an export-led economy. But the latest trade figures demonstrate a reversal of what was meant to happen. The UK’s trade balance is worsening, as strong demand for imports from the Eurozone, is coupled with weak demand from the Eurozone for goods and services. It was supposed to be the other way around.

Source: Adapted from *The Guardian*, 10 June 2011, and *The Telegraph*, 9 November 2011

Extract 5: Fiscal Debt and Its Drag on the Economy

While running a fiscal deficit is supposed to help boost economic growth, an economy that has fiscal deficits over a sustained period of time leads to increasing fiscal debt. This increases the government’s debt liability in terms of interest payments, and can become a factor that actually reduces economic growth, or what we sometimes call a drag on the economy. This is why governments engage in austerity measures, such as cutting

government expenditure and raising tax revenue, in order to obtain a fiscal budget surplus that will enable them to start reducing their fiscal debts.

The following are some reasons explaining why a fiscal debt can become detrimental to economic growth in a country:

- 1. Higher Interest Rates.** Creditors may lose confidence in the country's ability to service its debt and demand higher interest rates to offset the additional risk.
- 2. Higher Inflation.** The government could, through the central bank, increase the money supply leading to higher inflation.
- 3. Crowding Out Private Investment.** Government deficit spending usually means more borrowing from private households and firms, reducing the amount of disposable income and financial capital that households and firms have respectively.

Source: Adapted from *The Heritage Foundation*, February 2013

Extract 6: Inflation Outlook in the UK

The near term outlook for inflation is higher, due to further expansionary monetary policy from the Bank of England, together with unexpectedly large increases in prices for significant domestic household expenditure items – household energy prices and the tuition fees for undergraduate studies have both been increased by the government.

However, inflation rates may fall in the second half of next year, as the impact of external price pressures ease, and a partial recovery in productivity growth happens as expected.

Even so, considerable uncertainty surrounds the inflation outlook. How companies adjust their costs and prices as a result, may well have an important bearing on the path of inflation over the next few years.

Source: Adapted from Bank of England report, November 2012

Extract 7: UK should have delayed austerity, but not indefinitely

The U.K. government's austerity program received its strongest criticism yet when the National Institute for Economic and Social Research (NIESR), a think-tank independent of the government, said the government's pursuit of sweeping spending cuts during a period of economic difficulty have pitched the economy into recession and cost the country 200,000 jobs.

NIESR's findings are likely to intensify the debate within the U.K. and other highly indebted countries in the West about spending cuts versus stimulus amid increasing evidence that austerity is proving a major drag on the economy. The findings are also a further blow for Chancellor of the Exchequer (the Finance Minister for the UK) George Osborne, who has endured four months of policy reversals, slumping poll ratings and political stumbles, and is also facing increasing pressure to ease the pace of the austerity. NIESR's report comes two weeks after the International Monetary Fund told the government it should slow the pace of austerity if recent measures to boost bank lending fail to revive the economy by the beginning of next year.

However, NIESR said delaying spending cuts indefinitely was not an option because rising government debt would eventually put upward pressure on interest rates.

Source: Adapted from *The Wall Street Journal*, August 2012

Questions

- (a) (i) Using Table 2, describe the trend for real GDP in Eurozone from 2007 to 2012. [1]
- (ii) From the data, what can you conclude about the standard of living of the citizens living in the Eurozone from 2007 to 2012? [5]
- (b) Using AD/AS analysis, explain how a strong Eurozone would help the UK achieve sustained economic growth. [5]
- (c) Extract 5 mentions reasons why a fiscal debt can become detrimental to economic growth in a country.
- Using the concept of the circular flow of income, explain how a fiscal debt may affect the equilibrium level of national income. [5]
- (d) Explain whether 'inflation rates may fall' in the UK. [6]
- (e) As an economic advisor to the UK government, would you recommend to the UK government to continue its austerity measures? Justify your answer. [8]

[Total: 30]

Answers

- (a) (i)** Using Table 2, describe the trend for real GDP in Eurozone from 2007 to 2012. [1]

The question requires students to be able to convert real GDP growth rate data into an estimation of real GDP.

Acceptable answers:

- a) Real GDP generally increased. [1m]

- (ii)** From the data, what can you conclude about the standard of living of the citizens living in the Eurozone from 2007 to 2012? [5]

The question requires students to analyse the data provided to make a reasoned conclusion about the standard of living of the citizens. Analysis should cover both material and non-material standard of living.

Relevant data:

- a) Table 2, real GDP generally increased
- b) Table 2, real GDP per capita generally increased
- c) Table 2, unemployment rate increased
- d) Table 2, list of countries in Eurozone may suggest different standard of living depending on which country the citizen resides in
- e) Extract 4, weak demand from Eurozone (suggests poor consumer confidence)

*Arguments on how data is insufficient to make a conclusion about standard of living are acceptable as well. Answers based on erroneous data-reading in part (ai) should **not** be penalised once more.*

Acceptable answers (example of one well-explained argument):

- a) As **unemployment rate increases** (from Table 2), **material SOL falls**. [1m for stating argument]
- b) Some citizens will lose their income should they lose their jobs, while others who are still holding on to jobs may experience cuts in or at least stagnated wages as labour supply is likely to exceed labour demand at prevailing wages. This will lead to a likely fall in wages and disposable income... [1m for reasoning]
- c) ... and **purchasing power** falls; hence material SOL falls. [1m for keywords; however, it is possible to award full 3m as long as explanation is sufficiently detailed even if keywords is absent]

- (b)** Using AD/AS analysis, explain how a strong Eurozone would help the UK achieve sustained economic growth. [5]

The question focuses on explain "how", so the mark allocation will focus more on the process explanation on how a strong Eurozone would help the UK achieve sustained economic growth, i.e. both actual and potential growth.

Relevant data:

- a) Extract 4, "The UK requires a strong Eurozone to support economic recovery, as a lower risk of bankruptcy would bring about greater stability to the UK's banking sector and **encourage further investment** <reason why AD and AS increases> into the

UK. A strong Eurozone would also help the UK move from a consumption-led to an export-led economy <reason why AD increases>. "		
<p>(c) Extract 5 mentions reasons why a fiscal debt can become detrimental to economic growth in a country.</p> <p>Using the concept of the circular flow of income, explain how a fiscal debt may affect the equilibrium level of national income. [5]</p> <p><i>The question focuses on explain "how", so the mark allocation will focus more on the process explanation on how a fiscal debt affects the equilibrium level of national income.</i></p> <p><i>Relevant data:</i></p> <p>a) Extract 5, fiscal debt requires</p> <p><i>Mark allocation:</i></p> <p>a) 1m for identifying any change in injection / withdrawal</p> <p>b) Up to 4 marks for using concept of circular flow of income to analyse how a fiscal debt affects the equilibrium level of national income, e.g.:</p> <ol style="list-style-type: none"> Investment falls, i.e. injection falls Injections < withdrawals ($J < W$) Unplanned accumulation in stocks Firms will reduce production Hire fewer factors of production Income will fall as a result Process will continue until fall in initial injection = total fall in withdrawal <p>c) Up to 2 marks only if explanation is not in line with Extract 4, i.e. outcome of explanation is that equilibrium level of national income increases</p>		
(d)	Explain whether 'inflation rates may fall' in the UK.	[6]
<p><i>The question focuses on explaining "whether" inflation rates may fall, so students are required to explain why inflation rates may fall (disinflation or deflation) and why inflation rates may increase.</i></p> <p><i>Mark allocation:</i></p> <p>a) 3m for explaining why inflation rates may fall, e.g. partial recovery in productivity growth means AS is increasing even as AD is increasing</p> <p>b) 3m for explaining why inflation rates may increase, e.g. expansionary monetary policy leading to increases in AD</p>		
(e)	As an economic advisor to the UK government, would you recommend to the UK government to continue its austerity measures? Justify your answer.	[8]
<p><i>The question requires a discussion on whether the UK government should continue its austerity measures. The pros and cons of continuing austerity measure should be clearly linked to macroeconomic goals.</i></p> <p><i>Acceptable answers:</i></p> <p>a) Real GDP generally increased. [1m]</p> <p><i>Mark allocation:</i></p> <p>a) L3: 5-6m For a thorough, balanced argument on whether UK government should</p>		

continue austerity measure (1 thesis + 1 antithesis is sufficient to score full credit, if done well)

- b) L2: 3-4m For a under-developed or one-sided argument
- c) L1: 1-2m For a undeveloped explanation or no attempt to answer the question
- d) E2: 2m Using case material and/or own knowledge to make a reasoned judgement
- e) E1: 1m Unsubstantiated judgement

Section B

Answer **one** question from this section.

- 3 (a) Explain the causes of market failure that arise in the healthcare market. [10]
- (b) Assess whether subsidies can address the market failure above. [15]
- 4 (a) Explain the causes for a deteriorating Balance of Payments of a country. [10]
- (b) Discuss the view that an exchange-rate centred monetary policy is more appropriate than supply-side policy in mitigating a deteriorating Balance of Payments of a country. [15]

Essay Q3 Review

3	(a)	Explain the causes of market failure that arise in the healthcare market.	[10]
	(b)	Assess whether subsidies can address the market failure above.	[15]

Examiners' Comments for Q3a

It was clear that majority of the students were able to explain the existence of positive externalities in healthcare market that causes the market to fail.

However, there were several common weaknesses:

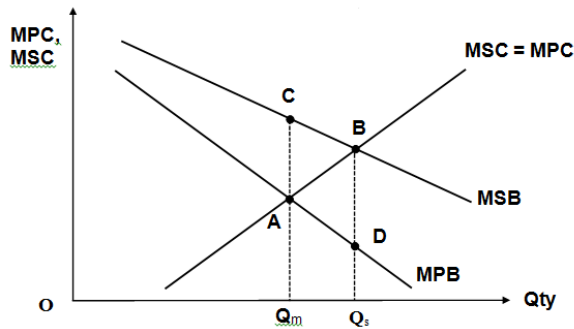
- A large number of answers did not consider at least one other cause that lead to the failure in healthcare market – question required an explanation of causes. For students who did, the understanding of imperfect information as a possible cause of market failure was generally not well-explained.
- Some answers contained rehearsed answers and failed to explain the process of how to arrive at Q_e , where $MPB = MPC$ but $MSB > MSC$ due to the existence of MEB.
- Some answers did not even attempt to link the explanation to the healthcare market, i.e. completely theoretical explanation of a positive externality.

Q3a Suggested Answer

- Introduction:** Define market failure

Body:

- Explain why healthcare is a market failure – the consumption of healthcare generates positive externalities
- Explain the divergence between private benefits and social benefits and under-allocation of resources
 - An individual will only take into account his private marginal cost (e.g. financial cost of healthcare) and private marginal benefit (e.g. good health).
 - However, this individual does not consider the positive externalities that would be generated by the healthcare (i.e. the marginal external benefits, MEB, e.g. positive impact on economy, less spread of diseases) to the third parties. These are not taken into consideration by the individual. Hence, there is a divergence between the marginal social benefit, MSB and marginal private cost, MPB
 - Based on the price mechanism, the market equilibrium level of healthcare is where marginal private cost (MPC) equates to the marginal private benefit (MPB).
 - Due to the presence of positive externalities as explained above, the marginal social benefit (MSB) is greater than MPB at the market equilibrium level of healthcare (i.e. Q_m). The socially efficient level of healthcare should be at Q_s where MSB equates to MSC i.e. the external benefits are taken into account. The price mechanism thus under-allocates resources to healthcare. This under-consumption of healthcare of Q_m results in welfare to society not being maximised or further consumption beyond Q_m to Q_s will increase net societal welfare (i.e. $MSB > MSC$).



Explain why the merit good argument could also be used to explain the existence of a market failure.

4. Merit good – The under-consumption for merit good occurs when either:
- Consumers lack the understanding of the possible positive effects of healthcare on themselves. Consumers do not have the perfect information of what is good for them (MPB is underestimated) and so their rational decision will be to under-consume.
 - The government deems that the consumption of such a good is socially desirable.

MARK SCHEME 1(a)

Level	Descriptor
L3 7-10	1. Well-developed explanation of how externalities and merit goods lead to market failure.
L2 5-6	2. Under-developed explanations of the causes of market failure. <u>OR</u> 3. Only one cause of market failure is explained.
L1 1-4	4. Answers contain statements without any clear attempts to explain the content. <u>OR</u> 5. Contains major conceptual errors.

3	(a)	Explain the causes of market failure that arise in the healthcare market.	[10]
	(b)	Assess whether subsidies can address the market failure above.	[15]

Examiners' Comments for Q3b

While the performance for Q3a was more encouraging, many students did not grasp the requirements of the question, and did not link their Part B answers closely to the material explained in Part A.

However,

- Some answers contained analysis of how subsidies work that was incoherent and/or not properly sequenced.
- Some answers misinterpret the question entirely, resulting in a discussion of the various measures that can be used to correct market failure instead of focusing on the issue at hand.
- A significant number of answers showed poor analysis, for example:
 - Subsidies are given to the consumers and it reduces the cost and thus, MPB shifts. When the reasoning is as such, it is not the cost that is reduced but the purchasing power that increases.
 - Subsidies are flexible – without any further explanation on what this means and whether this is supposed to be a plus or minus point for subsidies.

- iii. Stating that the government is unable to measure the correct size of subsidies, but not explaining that the correct size is MEB at Q_s and why it is difficult to approximate MEB.
 - iv. Stating that the disadvantage of subsidies is that it cannot solve imperfect information. Subsidies can solve the problem of imperfect information, just that it is not a sustainable policy as it doesn't tackle the root problem.
- d) A majority of answers contained regurgitation of content with little or no application to the context at hand.

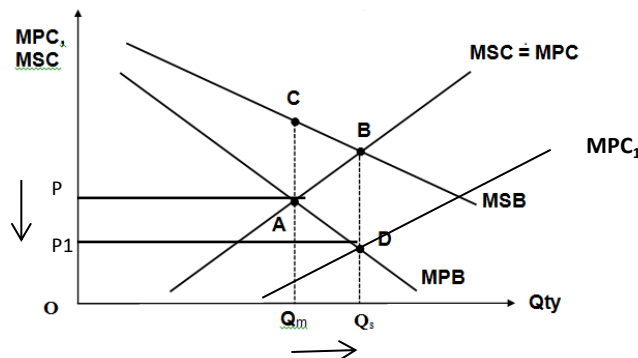
Q3b Suggested Answer

1. **Introduction** – Briefly explain the corrective measures taken by government.

Body:

2. Explain how subsidies work (1) – increase the supply of healthcare

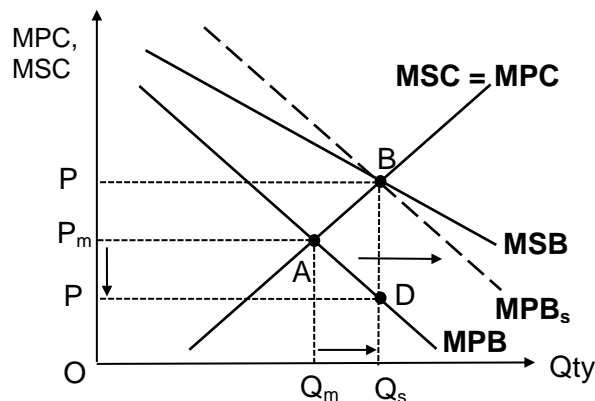
- a. The government estimates the socially optimal amount and provides subsidies to hospitals = MEB at Q_s (BD)
- b. As the subsidies lower cost of production, MPC of production will shift down, P reduces.
- c. Subsidies lower the price and encouraged consumption of healthcare.



- d. For e.g.: Singapore government gives subsidies to private healthcare institutions for training of healthcare professionals – this increases the supply of healthcare

3. Explain how subsidies work (2) – increase the demand of healthcare

- a. Subsidies that are received directly by consumers will act on the demand curve (MPB) as the subsidies increase their disposable income. Demand increases such that the market-optimal output now coincides with the social-optimal output.



- b. For e.g.: Polyclinic and public hospital fees are generally subsidised, though the quantum varies by nationality.

4. Explain the advantages of subsidies
 - a. Subsidies still allow market to operate. It encourages individuals and hospitals to internalise the external benefits. The size of the subsidy can also be adjusted (fairly easily) in accordance to the magnitude of the problem.
 - b. Targeted subsidies (e.g. means-testing) also allow the lower income group to receive basic healthcare.
5. Explain the disadvantages of subsidies
 - a. It will be administratively difficult and expensive to grant the amount of subsidy – might lead to under/over-subsidies.
 - b. Even if the government decides on the amount of subsidy, the measurement of external benefits will be a problem as the third party benefits are not quantifiable.

Evaluation

6. Able to increase the output consumed/ produced (due to affordability) but not solving the root cause of the healthcare problem.

Answer may contain a discussion on alternative policies. However, these should be used to illustrate why the subsidies may not necessarily be the most appropriate / effective to address both causes of market failure.

7. Explain alternative policy (1) – moral suasion
 - a. Government could reduce imperfect information through campaigns and advertisement – increase awareness of the beneficial effects of good health
 - b. Encourages consumption and reduces the gap between the perceived MPB and the true MPB of healthcare
 - c. For e.g.: Cervical Cancer campaign by HPB, IQuit campaign
8. Evaluate the effectiveness of moral persuasion
 - a. Providing necessary information of healthcare can correct the market due to imperfect information but sometimes individuals are reluctant to change their mindset towards healthcare. Individuals can interpret information given differently. As such, the result of moral suasion is not guaranteed and it might end up incurring a higher cost as compared to subsidy.
 - b. Even if the campaign takes effect, it requires time for the effects to show.
9. Explain alternative policy (2) – direct provision
 - a. Government takes over the role of provision of healthcare. This can increase the supply of healthcare. At the same time, it can help solve market failure arising from under-production in the healthcare sector. (a variant of this is nationalisation)
10. Evaluate the effectiveness of direct provision
 - a. In the event that market-based solutions don't work well, this could be a more direct approach.
 - b. However, this might create over-reliance on government / crowd out private investment. Also, publicly-run healthcare institutions around the world are generally more inefficient (long waiting times, incompetent medical staff) compared to privately-run healthcare institutions. It may also take time for the government to build up the necessary infrastructure and personnel with expertise, if these are not already readily available.

11. Explain alternative policy (3) – legislation

Conclusion

12. Evaluative comments can centre around a particular context, e.g. Singapore.

MARK SCHEME 3(b)

Level	Descriptor
L3 9-11	<ol style="list-style-type: none"> 1. Full marks can be awarded for a well-developed (rigour of analysis, use of relevant diagrams) and balanced (yes, subsidies can address the causes of market failure vs. no, subsidies are unable to address the causes) answer on whether subsidies can address the causes of market failure explained in Part A. 2. Credit can also be awarded to a discussion of other policies to complement / used in place of subsidies. 3. Answer may contain a few minor conceptual errors.
L2 5-8	<ol style="list-style-type: none"> 4. An under-developed, but balanced answer on whether subsidies can address the causes of market failure explained in Part A. <p><u>OR</u></p> <ol style="list-style-type: none"> 5. A well-developed but one-sided explanation of whether subsidies can address the causes of market failure explained in Part A. 6. Answer may contain some minor conceptual errors.
L1 1-4	<ol style="list-style-type: none"> 7. Answer is descriptive, irrelevant and/or contains too many major conceptual errors.
E2 3-4	A. Well-reasoned assessment on effectiveness (focusing on key word of “can” / “cannot” address causes of market failure) of subsidies and any other policy(ies) used as part of answer. Top credit may be awarded if answer contains a discussion based on a particular context, e.g. Singapore’s healthcare market.
E1 1-2	B. For an unsubstantiated assessment.

Essay Q4 Review

4	(a)	Explain the causes for a deteriorating Balance of Payments of a country.	[10]
	(b)	Discuss the view that an exchange-rate centred monetary policy is more appropriate than supply-side policy in mitigating a deteriorating Balance of Payments of a country.	[15]

Q4a Suggested Answer

1. Introduction:

- a. Define BoP.
- b. Explain what is meant by a deteriorating BoP, i.e. increasing deficit or falling surplus.

Body:

2. Explain the causes of a deteriorating BoP due to worsening current account:
 - a. Falling exports due to e.g. inflation rate relatively higher than trading partners', currency appreciation and/or
 - b. Rising imports due to e.g. rising income.
 - c. Candidates may consider the falling factor income to explain the worsening current account balance.
3. Explain the causes of a deteriorating BoP due to worsening capital & financial account:
 - a. Outflow of FDI increasing. and/or
 - b. Inflow of FDI falling due to e.g. lower expected rate of returns due to increased political instability, raising of corporate income tax rates or increased cost of production.
 - c. Candidates may consider the falling short term capital, hot money, and falling portfolio investments to explain the worsening capital account balance.

Conclusion

4. Conclude that the theory of comparative advantage forms the basis of trade between countries.

MARK SCHEME 4(a)

Level	Descriptor
L3 7-10	1. For a well-developed answer that has at least one well-explained reason to explain the worsening current account and at least one well-explained reason to explain the worsening capital account.
L2 5-6	2. For an answer that is undeveloped and poorly explains the causes for a deteriorating BOP. 3. Only either current or capital account is explained to account for the deteriorating BOP. 4. Only the reasons for a BOP deficit are explained by considering both the current and capital account, instead of the reasons for the deterioration in the BOP.
L1 1-4	5. For an answer that merely states the causes for a deteriorating BOP or have an answer that has many glaring conceptual errors.

4	(a)	Explain the causes for a deteriorating Balance of Payments of a country.	[10]
	(b)	Discuss the view that an exchange-rate centred monetary policy is more appropriate than supply-side policy in mitigating a deteriorating Balance of Payments of a country.	[15]

Q4b Suggested Answer

1. *Introduction – Summarise the reasons for deteriorating Balance of Payment [primarily a worsening current account is due to worsening trade balance due to falling exports or worsening capital account due to fall in the inflow of FDI].*

Body

2. **Explain how exchange rate policy helps to mitigate a deteriorating Balance of Payments of a country.**
 - a. *An appropriate exchange-rate centred monetary policy would be devaluation. Devaluation makes the prices of exports cheaper in foreign currency and prices of imports more expensive in domestic currency. Assuming ML condition holds, the balance of trade will improve, leading to an improvement in the balance of payments, ceteris paribus.*
 - b. *Devaluation would make investing in the country cheaper the country therefore encouraging inflows of foreign direct investments.*
3. **Explain that the exchange rate policy may not help to mitigate a deteriorating Balance of Payments.**
 - a. *May deteriorate the BOP further in the SR as the ML condition may not hold in the SR [J curve effect].*
 - b. *May worsen imported inflation, which has a negative impact on export prices if the economy has a large proportion of imported factor inputs. The resultant imported inflation may cause exports to lose its competitiveness and hence if exports are not competitively priced due to high cost of production, the impact of the devaluation would be limited.*
 - c. *Devaluation would not be effective if the cause of the deteriorating Balance of Payments is high import expenditure due to rising incomes in the domestic economy. So expenditure-reducing policy is more be more effective in this instance.*
4. **Explain how supply-side policies may help mitigate a deteriorating Balance of Payments.**
 - a. *A resource-constrained country, like Singapore, that is heavily reliant on imported factors of production would face a higher cost of production due to the devaluation of the exchange rate. Therefore supply-side policies would be more appropriate.*
 - b. *Supply-side policies could increase the competitiveness of exports thereby improving the current account balance.*
 - c. *Use examples of supply-side policies to explain how exports gain its' competitiveness and thereby improving the trade balance and the Balance of Payments, ceteris paribus.*
 - d. *Explain how supply-side improves the inflow of FDIs thereby improving the capital account and assuming ceteris paribus, improving the Balance of Payments.*
 - e. *Explain the inflow of FDIs is dependent on the economic outlook so the impact of devaluation of the currency and supply-side policies would be limited. If there is a poor economic outlook or political instability, devaluation and supply-side policies would not encourage the inflow of FDIs. Hence the government has to implement measures to improve the investors' confidence of the economy to encourage the inflow of FDIs.*
5. **Explain that there could be other reasons for a deteriorating Balance of Payments and a devaluation may not be effective.**

- a. *Other reasons: Falling net Factor income [High outflow of factor income due to a significant number of foreign workers or FDIs], Outflow of hot money and portfolio investments.*
- b. *Devaluation may curb falling factor income but it may worsen the outflow of hot money, ceteris paribus it may worsen the capital account.*

Conclusion

6. *Effectiveness of the policy would depend on the causes of the deteriorating Balance of Payments. Given that the primary cause is low exports, devaluation would assist in the mitigation of the Balance of Payments in the SR and a more sustainable LR approach would be to use supply-side policies to increase the export competitiveness.*
7. *If the primary cause is high imports, devaluation may not be effective. Other policies such as expenditure reducing would be more appropriate.*

Level	Descriptor
L3 9-11	<ol style="list-style-type: none"> 1. Thorough analysis, explaining both the policies well, along with the limitations. 2. The policy discussion should address the causes for the deterioration of the BOP in (a).
L2 5-8	<ol style="list-style-type: none"> 3. For an under-developed explanation that has limited economic analysis and justifications. 4. Only either exchange rate or supply-side policy is well-explained along limitations. 5. Students have explained the deterioration of BOP is due to both current and capital account in (a) but only explained how these policies mitigate either the change in current or capital account. 6. Students have explained the deterioration of BOP is due to either current or capital account in (a) but have only explained how the policies mitigate either the change in current or capital account.
L1 1-4	<ol style="list-style-type: none"> 7. For weak, superficial, descriptive answers which contain many glaring inaccuracies.
E2 3-4	A. Compares the effectiveness of the policies to mitigate the deterioration of BOP and thus is able to justify and conclude which is a more appropriate policy.
E1 1-2	B. Have indicated which policy is more appropriate and makes a weak attempt to explain.