

<b>Name:</b>		<b>Index Number:</b>		<b>Class:</b>	
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# **DUNMAN HIGH SCHOOL** **Preliminary Examination** **Year 6**

**ECONOMICS**

9732/1

**(Higher 2)**

**23 September 2014**

**Paper 1**

**2 hours 15 minutes**

Additional Materials:  
 Writing Papers

## **READ THESE INSTRUCTIONS FIRST**

Answer **all** questions.

Write your name and class on all pieces of work handed 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.

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

At the end of the examination, fasten all your work securely into two separate bundles (one for Question 1 and one for Question 2). Please attach the respective cover sheet at the front of your answers.

This document consists of **7** printed pages including this cover page.

**[Turn over**

Answer **all** questions.

### Question 1

#### The Blessing and Curse of Palm Oil

##### Extract 1: Crude Palm Oil

The oil palm is currently the most efficient vegetable oil crop in the world. High yields and low land requirements make palm oil the least expensive vegetable oil in the market. Palm oil is also versatile, as it is readily usable for baking, frying, soaps, cosmetics, and biofuel.

The palm oil industry has been a boon to small landowners in Southeast Asia, where it has helped reduce poverty. And in Indonesia and Malaysia, which account for almost 90 percent of world production, palm oil accounts for approximately five percent of gross domestic product, generates roughly five percent of export earnings, and provides a source of employment and livelihood for more than three million people.

Sources: (1) New Oils for the New World, (2) Modern Oil Palm Cultivation by the FAO

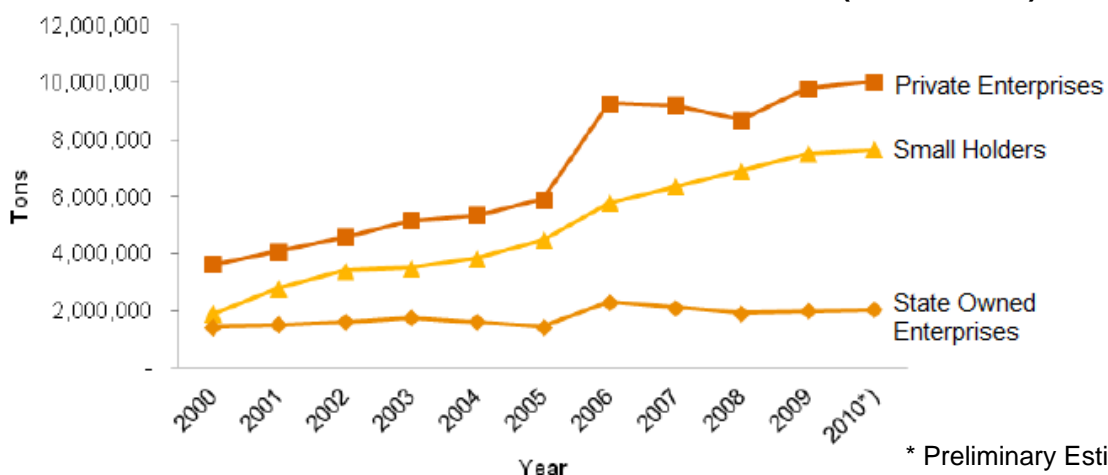
##### Extract 2: Overview of Palm Oil Industry Landscape in Indonesia

Indonesia is the world's biggest producer of palm oil. About 75% of palm oil production in Indonesia is exported to the world market. Based on a 2011 study, the value of the demand elasticity of its own export price in the short run is estimated to be -0.54 while the estimated value of foreign countries' income elasticity of demand is +0.61.

Being the third largest export earner, palm oil plantation and its processing industry is an important industry to Indonesia. Other than its contribution in foreign exchange earnings, the cooking oil produced from the palm oil plantation is one of the dominant factors in determining the inflation rate of the Indonesia economy. Furthermore, the palm oil plantation industry actively provides opportunity for small-scale farmers, develops the rural economy and generates significant employment.

Sources: various

**Chart 1: Crude Palm Oil Production in Indonesia (2000 – 2010)**



### **Extract 3: Leaders fiddle as Sumatra burns**

For Sumatra, it is an annual environmental trauma. But when the haze drifts across the Straits of Malacca to cover Singapore and Malaysia, it is a regional nightmare, too. The Asian Development Bank (ADB) estimated that the 1997-8 haze had cost Indonesia between USD8.5 and 9.4 billion.

The fires are usually started deliberately, often to clear land to make way for palm-oil plantations. Burning is quick, cost-effective, and enriches the soil. It is therefore the preferred land-clearing method for both smallholders and large companies. Successive governments have passed a mountain of laws and regulations outlawing burning, yet enforcement is so poor that people carry on regardless.

The fire and haze problem has persisted due to the confluence of factors such as the Indonesian's government development policies that encourage resource exploitation, the increase in global demand for pulp and palm oil, and weak forestry governance.

Sources: (1) The Economist, 22 Mar 2014  
(2) Gill and Tan (2013) Transboundary Haze: How Might The Singapore Government Minimise Its Occurrence? Lee Kuan Yew School of Public Policy

### **Extract 4: Environmental group WWF name and shame top global buyers**

Palm oil continues to proliferate in everything from ice cream to shampoo but sustainable palm oil has failed to catch on. Fewer than half of the companies surveyed purchase palm oil that meets the social and environmental standards set by the Roundtable for Sustainable Palm Oil (RSPO), a non-governmental organisation. Some buyers have already joined the 100% club. Unilever, one of the largest palm oil buyers in the world, buys all its palm oil from certified providers despite higher costs.

Naming and shaming will certainly chivvy some reputation-conscious companies along. Environmental groups would like to see certified growers rewarded. But certification is a free-market game and, unlike in the movies, the good guys don't always win.

Source: The Guardian, 28 January 2014

### **Extract 5: The eternal battle between Procter & Gamble and Unilever**

Unilever is winning market share from Procter and Gamble (P&G). The slow economic recovery in America and the deteriorating economic situation in Europe have hit P&G harder, because it earns a greater share of its revenues in those developed markets and its brands tend to be more expensive than Unilever's—and thus more likely to be sacrificed by consumers who are being forced to count the pennies. In contrast, Unilever, with its innovation focused on providing post-recession westerners with what they want: good enough products at affordable prices, has thrived.

Source: The Economist, 30 Jun 2012

## Extract 6: Cartels

France's competition regulator has fined three of the world's biggest consumer goods firms, Procter and Gamble, Henkel and Colgate-Palmolive for colluding to fix the price of laundry powder, tablets and liquids in France between 1997 and 2004. A fourth, Unilever received immunity for coming forward first.

The report illustrates how difficult it was to maintain cooperation. Executives had been meeting in some form since the 1980s to share price information, but in the early 1990s a price war broke out. Following this, a formal cartel was contrived in 1996 and stricter controls were implemented. Special offers were banned and cost savings were not to be passed on. In the end, however, the scheme unravelled: while fixing prices was easy, monitoring special offers proved difficult. In 2004 Unilever launched a 10% discount that proved terminal. A cascade of deals and special offers from the others followed.

Leniency regimes, which have been widely adopted around the world, aim not only to destabilise cartels, but also to reduce investigation and legal costs. The first member to come forward receives full immunity from fines and prosecution.

Source: The Economist, 11 Dec 2011

## Questions

- (a) (i) Summarise the trend in crude palm oil production in Indonesia. [2]
- (ii) Explain how the small holders' share of the total crude palm oil production affects the price and profit of the crude palm oil industry in Indonesia. [6]
- (b) Explain what a value of
- (i) -0.54 for the demand elasticity of Indonesia's own export price of crude palm oil, and
- (ii) +0.61 for foreign countries' income elasticity of demand for Indonesia's palm oil exports
- mean. [4]
- (c) How far does the behaviour of Unilever support the fundamental assumption that firms are profit maximisers? [10]
- (d) Discuss whether the Indonesian government's promotion of development policies that encourage resource exploitation is justifiable. [8]

**[Total: 30]**

## **Question 2**

### **Economic Growth and Challenges**

#### **Report on Indonesia, Japan and South Korea**

##### **Extract 7: Indonesia**

Indonesia grew about 5% annually in 2009-12. During the global financial crisis, Indonesia outperformed its regional neighbours and joined China and India as the only G20 members posting growth in 2009. The government has promoted fiscally conservative policies, resulting in a debt-to-GDP ratio of less than 25%, a fiscal deficit below 3%, and historically low rates of inflation.

Indonesia still struggles with poverty and unemployment, inadequate infrastructure, corruption, a complex regulatory environment, and unequal resource distribution among regions. The government faces the challenge of improving Indonesia's insufficient infrastructure to remove impediments to economic growth, labour unrest over wages, and reducing its fuel subsidy programme in the face of high oil prices.

##### **Extract 8: Japan**

Japan, a technologically advanced economy, has two notable characteristics – firstly, the close interlocking structures of manufacturers, suppliers, and distributors; secondly, the guarantee of lifetime employment for a substantial portion of the urban labour force. Both features are now eroding under the dual pressures of global competition and domestic demographic change. Japan's industrial sector is heavily dependent on imported raw materials and fuels. A small agricultural sector is highly subsidised and protected, with crop yields among the highest in the world.

The economy has fallen into recession three times since 2008. A sharp downturn in business investment and global demand for Japan's exports in late 2008 pushed Japan into recession. Government stimulus spending helped the economy recover in late 2009 and 2010, but the economy contracted again in 2011 as the massive 9.0 magnitude earthquake and the ensuing tsunami in March disrupted manufacturing. Newly-elected Prime Minister Shinzo Abe has declared economic growth as his government's top priority; he has pledged to reconsider his predecessor's plan to permanently close nuclear power plants and is pursuing an economic revitalisation agenda of fiscal stimulus, regulatory reform and loose monetary policy. The new government will continue a longstanding debate on restructuring the economy and reining in Japan's huge government debt, which exceeds 200% of GDP. Persistent deflation, reliance on exports to drive growth, and an aging and shrinking population are other major long-term challenges for the economy.

## Extract 9: South Korea

South Korea is currently the world's 12th largest economy. The government promoted the import of raw materials and technology at the expense of consumer goods, and encouraged savings and investment over consumption. Korea adopted numerous economic reforms following the Asian financial crisis, including greater openness to foreign investment and imports. Growth moderated to about 4% annually between 2003 and 2007. Korea's export focused economy was hit hard by the 2008 global economic downturn, but quickly rebounded in subsequent years, reaching 6.3% growth in 2010. The US-South Korea Free Trade Agreement was ratified by both governments in 2011 and went into effect in March 2012. Throughout 2012 the economy experienced sluggish growth because of market slowdowns in the United States, China, and the Eurozone. The incoming administration in 2013, following the December 2012 presidential election, is likely to face the challenges of balancing heavy reliance on exports with developing domestic-oriented sectors, such as services. The South Korean economy's long-term challenges include a rapidly aging population, inflexible labour market, and heavy reliance on exports – which comprise half of GDP.

Source: [www.indexmundi.com](http://www.indexmundi.com)

**Table 1: Macroeconomic Indicators: Indonesia**

	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
Annual Rate of Growth Real GDP (%)	4.6	6.2	6.5	6.3
Rate of Inflation (%)	4.8	5.1	5.3	4
Unemployment Rate (%)	7.9	7.1	6.6	6.1
Current Account Balance (% of GDP)	2	0.7	0.2	-2.8
Current Account Balance (USD billion)	10.6	5.1	1.7	-24.4
Visible Exports (USD billion)	116.5	157.8	203.5	190.0
Visible Imports (USD billion)	96.8	135.7	177.4	116.5
Public Debt (% of GDP)	27	24.6	22.5	22.4
Exchange Rate per USD	9,425	9,010	9,068	9,638

**Table 2: Macroeconomic Indicators: Japan**

	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
Annual Rate of Growth Real GDP (%)	-5.5	4.7	-0.5	1.4
Rate of Inflation (%)	-1.4	-0.7	-0.3	-0.0
Unemployment Rate (%)	5.1	5.1	4.6	4.3
Current Account Balance (% of GDP)	2.9	3.9	2.1	1.0
Current Account Balance (USD billion)	145.3	217.2	126.5	58.5
Visible Exports (USD billion)	580.7	768.1	823.4	798.0
Visible Imports (USD billion)	552.4	692.5	856.1	885.4
Public Debt (% of GDP)	185.0	190.5	203.4	210.5
Exchange Rate vs USD	92.9	81.2	77.0	86.7

**Table 3: Macroeconomic Indicators: South Korea**

	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
Annual Rate of Growth Real GDP (%)	0.7	6.5	3.7	2.3
Rate of Inflation (%)	2.8	2.9	4.0	2.2
Unemployment Rate (%)	3.7	3.7	3.4	3.2
Current Account Balance (% of GDP)	3.7	2.6	1.6	4.1
Current Account Balance (USD billion)	33.6	28.9	18.7	50.8
Visible Exports (USD billion)	363.5	466.4	555.2	547.9
Visible Imports (USD billion)	323.1	425.2	524.4	519.6
Public Debt (% of GDP)	33.8	33.4	34.2	35.0
Exchange Rate vs USD	1,276	1,156	1,108	1,127

Source: Organisation for Economic Co-operation and Development

### Questions

- (a) Compare the trade balances in Japan and South Korea between 2009 and 2012. [2]
- (b) Using the data in Table 1:
- (i) Account for the difference in Indonesia's current account balance and trade balance. [2]
  - (ii) Identify the year which Indonesia had the highest nominal GDP growth. [1]
  - (iii) Explain the relationship between the two indicators: rate of inflation and unemployment rate. [3]
- (c) Comment on the significance of changes in exchange rates on the visible export revenue in Japan. [4]
- (d) Discuss whether the data provided are sufficient to assess changes in the standard of living in these Asian economies over the period. [8]
- (e) As a consultant economist, what options would you present to the governments as possible responses to the challenges faced by any **two** of these economies, and what would you recommend? Justify your answer. [10]

**[Total: 30]**

<b>Name:</b>		<b>Index Number:</b>		<b>Class:</b>	
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# DUNMAN HIGH SCHOOL

## Preliminary Examination

### Year 6

Economics

9732/2

Paper 2 Essay Questions

15 September 2014

2 hours 15 minutes

Additional Materials:  
Writing Papers

### READ THESE INSTRUCTIONS FIRST

Write your name and Civics Class in the spaces provided on the answer paper.

Answer three questions in total, of which **one** must be from Section A, **one** from Section B and **one** from **either** Section A or Section B.

Write your answers on the separate writing paper provided.

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.

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

At the end of the examination, fasten all your work securely into three separate bundles, one for each question.

Please indicate all questions attempted in the boxes below.

Section A			Section B		
Q1	Q2	Q3	Q4	Q5	Q6

This document consists of **3** printed pages including this cover page.

**[Turn over**



Answer **three** questions in total.

### Section A

**One or two** of your three chosen questions must be from this section.

- 1 Consumers should be allowed to have what they want because they are often the best judges of what is good for them. Government intervention that 'corrects' consumer choice is not only unnecessary but counterproductive. Discuss. [25]

- 2 UK bread manufacturers are facing difficult times with competition from supermarkets' own brands and rising wheat costs. Own brands are able to offer recession-hit consumers cheaper value. In-store bakeries mean that supermarkets offer freshness that the bread manufacturers find hard to match. Bread manufacturers are increasingly under pressure to engage in promotional activities.

Source: Bread & Bakery Products 2012

- (a) Explain how elasticity concepts can assist in understanding the effect of the increase in wheat price on the market for bread. [10]
  - (b) Discuss how the above combination of factors might affect expenditure by consumers in the two different bread markets. [15]
- 3
  - (a) Explain the conditions for price discrimination. [8]
  - (b) In US, the Federal Trade Commission (FTC) blocked the mergers of two hospitals in the state of Illinois. On the other hand, the Competition Commission of Singapore (CCS) has granted clearance for Heineken's acquisition of Asia Pacific Breweries, the maker of Tiger Beer from Fraser and Neave (F&N). Heineken has a global network of distributors and breweries, owning more than 250 beer brands.

Assess the economic case for these two different approaches. [17]

**Section B**

**One or two** of your three chosen questions must be from this section.

- 4**    **(a)**    The Singapore government spends on development expenditure such as road works and public infrastructure. Explain how a rise in government spending can lead to a larger increase in national income. [10]
- (b)**    Discuss whether the multiplier size is the most significant factor influencing governments' approach towards macroeconomic stabilisation. [15]
- 5**    **(a)**    Explain the causes of a balance of payments deficit on the capital and financial account. [10]
- (b)**    Discuss whether protectionism is the best policy to help a country correct its balance of payments deficit. [15]
- 6**    **(a)**    Account for the trend towards globalisation. [8]
- (b)**    How far do the benefits from globalisation that Singapore enjoys conflict with some of the main government objectives? [17]



# **DUNMAN HIGH SCHOOL**

## **Preliminary Examination**

Higher 2 Economics

Suggested Answers and Mark Schemes

**Suggested Mark Scheme (9732/1)****Question 1**

- (a) (i) **Summarise the trend in crude palm oil production in Indonesia.** [2]

*General trend [1]*

- *Increasing*

*Trend refinement [1]*

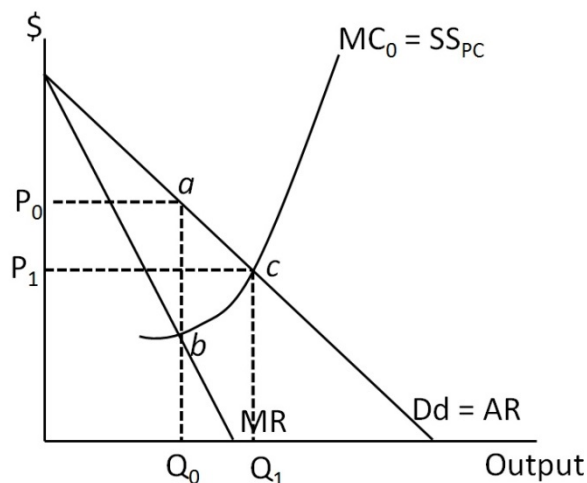
- *While production by small holders and private enterprises have been increasing, production by state owned enterprises remained largely constant.*

- (ii) **Explain how the small holders' share of the total crude palm oil production affects the price and profit of the crude palm oil industry in Indonesia.** [6]

*<P1> With the small holders' share of the total production closely matching the share of the large enterprises over the years, small holders keep the market competitive and price low.*

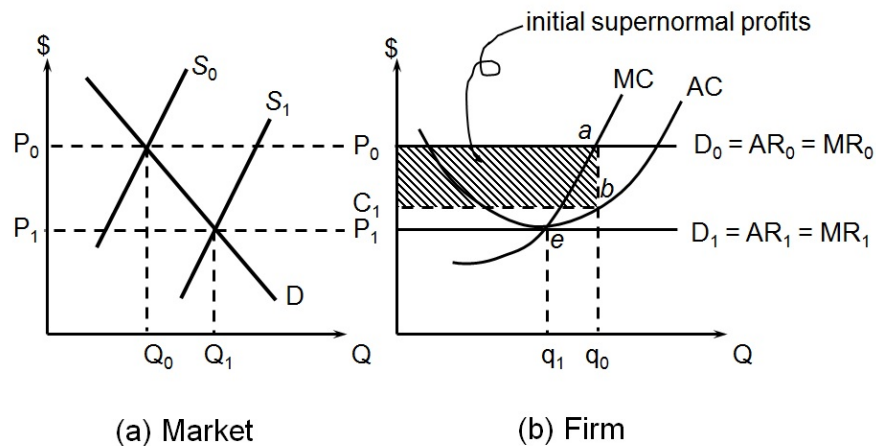
*In the extreme case of perfectly competitive industry, price is determined by the interaction of market forces of demand and supply. Price that prevails would be at  $P_1$  where  $Dd = SS$  (MC). In the other extreme where all the firms are merged to form a monopoly, the price that prevails will rise to  $P_0$ , the maximum price that the market is willing to pay for the profit-maximising output  $Q_0$  at which  $MC = MR$ .*

*Referring to Chart 1, small holders' share of palm oil production rose from one-quarter to close to 40% while the large enterprises' share rose from one-quarter to just past 50%. Even as the private enterprises output and share increased rapidly, the pace of increase of small holders' output and share was closely matched. This prevents the market from being dominated by the large enterprises which is critical as it greatly limits larger firms' ability to fix prices by restricting their own output. This keeps prices closer to the level that would have prevailed in a perfectly competitive industry ( $P_1$ ) than would have been the case had the market been dominated by large firms in which prices might have been closer to  $P_0$ .*



**<P2> With the small holders' share of the total production closely matching the share of the large enterprises over the years, small holders keep the market competitive and profits low.**

Similarly, the rapid increase in the output of small holders hints at the low BTE into the industry. Any initial supernormal profits earned by small holders attract entry of new firms. The increase in market supply pushes prices (AR) down. This process continues until the marginal firm earns only normal profits. Larger private enterprises, reaping iEOS face lower AC and may still earn supernormal profits though the size of the supernormal profits would nonetheless fall following the fall in price (AR). <explain graph>



(b) Explain what a value of

- (i) **-0.54** for the demand elasticity of Indonesia own export price of crude palm oil, and
  - (ii) **+0.61** for foreign countries' income elasticity of demand for Indonesia's palm oil exports
- mean. [4]

*A 1% increase in the price of Indonesia's crude palm oil export brings about a 0.54% decrease in the quantity demanded for it, ceteris paribus*

*A 1% increase in foreign income brings about a 0.61% increase in the quantity demanded for Indonesia's crude palm oil export, ceteris paribus.*

*[1] for the direction of change, [1] for the relative magnitude of change*

- (c) How far does the behaviour of Unilever support the fundamental assumption that firms are profit maximisers? [10]

Thesis	Antithesis
<p><b><i>Non-price competition through innovation as a means to increase profits</i></b>            &lt;Evidence&gt; Unilever, with its innovation focused on providing post-recession westerners with what they want: good enough products at affordable prices, has thrived. (Extract 5)            &lt;Analysis&gt; Unilever introduced products that better meet consumers' tastes and preferences – post-recession consumers trading down to inferior goods with negative YED when their income falls.            Here, we assume that even if there had been a recovery, income has not returned to its pre-recession level.</p> <p><b><i>Collusion to fix prices is a means, albeit illegal, to increase profits</i></b>            &lt;Evidence&gt; Unilever, Procter and Gamble, Henkel and Colgate-Palmolive for colluded to fix the price of laundry powder, tablets and liquids in France between 1997 and 2004            &lt;Analysis&gt; There is a tendency for firms in oligopoly to be stuck in a low-price-low-profits equilibrium as they attempt to undercut each other to gain market share. Cartel is an attempt by firms to break out of this situation by entering into an agreement in which they act as if they were a single monopoly to maximise their combined profits.</p> <p><b><i>Even cheating on the price-fixing agreement helps increase SR profits</i></b>            &lt;Evidence&gt; Despite the formation of a formal cartel in 1996, Unilever went against the agreement to give discounts in 2004. (Extract 6)            &lt;Analysis&gt; Unilever, by cheating, and give discount when all its competitors maintain high prices → more than proportionate increase in <math>Q_d</math> → increase in TR and where the increase in TC is less, profits increase</p> <p><b><i>What appears to be departure from profit-maximising behaviour may in fact be Unilever's attempts to increase its profits</i></b>  <u>CSR</u></p>	<p><b><i>&lt;P&gt; Unilever prioritises CSR over profits</i></b>            &lt;Evidence&gt; Unilever, one of the largest palm oil buyers in the world, buys all its palm oil from certified providers despite higher costs. (Extract 4)            &lt;Analysis&gt; c.p. profit falls → Unilever appears to be prepared to sacrifice profits for CSR</p> <p><b><i>&lt;P&gt; Unilever has been always the first firm to back out from price-fixing arrangement that is aimed at maximising profits</i></b>            &lt;Evidence&gt; Despite the formation of a formal cartel in 1996, Unilever went against the agreement to give discounts in 2004. (Extract 6)            &lt;Analysis&gt; Unilever, by cheating, has led to tit-for-tat strategy by other firms. Industry as a whole enter into price war → all firms cut price to protect their market share, profits diminished</p>

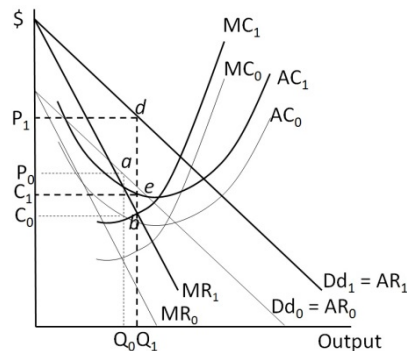
Given original cost and revenue conditions,

- profit-maximising,  $Q_0$ , occurs where  $MC_0 = MR_0$
- supernormal profit  $= C_0baP_0$

The use of sustainable palm oil adds to the firm's variable cost, raising AC to  $AC_1$  and MC to  $MC_1$ . Such a move may attract crs who are environmentally conscious and are prepared to pay a premium for green products raising AR to  $AR_1$  and MR to  $MR_1$ .

- New profit-maximising,  $Q_1$ , occurs where  $MC_1 = MR_1$
- New supernormal profit  $= C_1edP_1$

Where the increase in TR > increase in TC, profits increase



#### Cooperation with regulators

- Benefit to firm: avoidance of fine, rescue reputation which may mean avoidance of loss of dd and profits
- Cost to firm: loss of additional profit that cartel brings

Where benefit > cost, voluntary cooperation with the regulators may be the optimal strategy for the profit-maximising firm

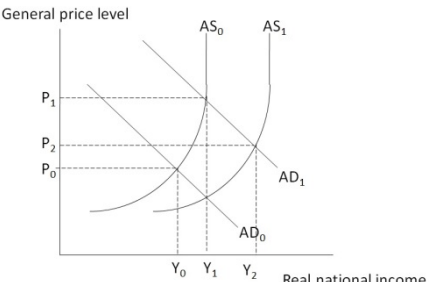
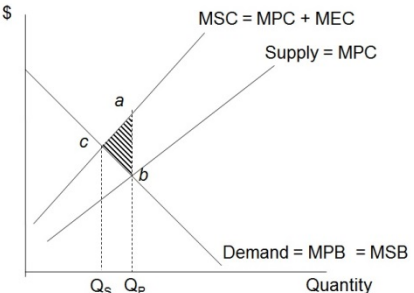
#### **Evaluation**

Unilever as a large listed firm tends to suffer from the principal-agent problem. The separation between ownership (shareholders of the company) and management (managers) may lead to a departure from profit-maximisation when the interests of the managers are in conflict with the interests of the shareholders but given information asymmetry and high cost of monitoring, the management team will be able to pursue their own interests, to the detriment of the interest of the shareholders. The firm may end up satisficing rather than maximising profits. Nonetheless, the watchful eye of the media makes it less costly for shareholders to monitor the actions by the firm and helps align the behaviour of the managers closer to profit-maximising goal.

Level	Descriptors	Marks
L3	For an answer which <ul style="list-style-type: none"> <li>• displays both scope and depth of economic analysis</li> <li>• considers both profit-maximisation and alternative goals of firms</li> <li>• makes effective use of diagrams and other tools of economic analysis to analyse the effect of the various strategies on firm's profits</li> <li>• well-applied to the given context</li> </ul>	7 – 8
L2	For an answer with limited reference to data that is <ul style="list-style-type: none"> <li>• insufficient SCOPE: one-sided argument</li> <li>• insufficient DEPTH: not consistently analytical throughout</li> <li>• limited application to given context</li> </ul>	5 – 6
L1	For an answer without reference to data that is largely descriptive and/or contains substantial conceptual flaws.	1 – 4
E	For a reasoned judgement on which the behaviour exhibited by Unilever is consistent with the profit-maximisation assumption	1 – 2



- (d) Discuss whether the Indonesian government's promotion of development policies that encourage resource exploitation are justifiable. [8]

Thesis	Antithesis
<p><b>Raise SOL</b>  <i>&lt;Evidence&gt; The oil palm grows well where it is hot all the year round. (Extract 1), Indonesia is the world's biggest producer of palm oil (Extract 2)</i>  <i>&lt;Analysis&gt; Specialisation and trade based on theory of comparative advantage → consume outside PPC → raise material SOL</i></p> <p><b>Achieve macroeconomic goals</b>  <i>&lt;Evidence&gt; About 75% of palm oil production in Indonesia is exported to the world market. Being the third largest export earner, palm oil plantation and its processing industry is an important industry to Indonesia. Other than its contribution in foreign exchange earnings, the cooking oil produced from the palm oil planation is one of the dominant factors in determining the inflation rate of the Indonesia economy. Furthermore, the palm oil plantation industry actively provides opportunity for small-scale farmers, develops the rural economy and generates significant employment. (Extract 2)</i></p> <ul style="list-style-type: none"> <li>• Healthy BOP position – C/A balance (X of palm oil) &amp; K&amp;F/A balance (FDI)</li> <li>• Increase AD (X, I) → increase real NY, reduce unemployment through the multiplier</li> </ul>  <ul style="list-style-type: none"> <li>• Increase AS → sustained, non-inflationary growth</li> </ul>	<p><b>Inefficiency</b>  <i>&lt;Evidence&gt; 1997-8 haze had cost Indonesia between USD8.5 and 9.4 billion</i>  <i>&lt;Analysis&gt; Resource exploitation e.g. use of forest for oil palm plantation → generation of negative externalities → allocative inefficiency &amp; DWL</i></p>  <p><b>Lowere SOL</b></p> <ul style="list-style-type: none"> <li>• Pollution → reduce non-material SOL</li> </ul>

Evaluation	
<p><i>In the SR, it is less of a matter of whether the Indonesian gov is right in encouraging resource exploitation but how it goes about it.</i></p> <ul style="list-style-type: none"> <li>• <i>At its current stage of economic development, Indonesia might need to be more reliant on its natural resources - its area of comparative advantage given the suitability of its climate (Extract 1) - as it is limited in its other capabilities. Given its current low per capita income, there still exists a strong correlation between EG and SOL – many basic needs are still unsatisfied e.g. access to quality education and healthcare. It may thus prioritise SR growth over other economic goals.</i></li> <li>• <i>However, the Indonesian gov has a choice on how it goes about promoting resource exploitation – the country is not lacking in laws and regulations. What it needs is to strengthen its enforcement ability.</i></li> <li>• <i>Also, there exists market incentive (albeit weak) for oil palm to be grown sustainably e.g. RSPO certification, i.e. resource exploitation need not come at too high a cost to the environment.</i></li> </ul> <p><i>Nonetheless, it is not a sustainable solution in the LR in view of the tradeoffs. Indonesia still needs to develop new areas of comparative advantage to allow it to diversify away from commodities exports.</i></p>	

Level	Descriptors	Marks
L3	<p>For an answer which</p> <ul style="list-style-type: none"> <li>• displays both scope and depth of economic analysis</li> <li>• considers (i) both micro and macroeconomic goals, (ii) possible compatibility / conflicts in goals</li> <li>• makes effective use of diagrams</li> <li>• well-applied to the given context</li> </ul>	6 – 7
L2	<p>For an answer with limited reference to data that is</p> <ul style="list-style-type: none"> <li>• insufficient SCOPE: one-sided argument, or considers only micro or only macro goals</li> <li>• insufficient DEPTH: not consistently analytical throughout</li> <li>• limited application to given context</li> </ul>	4 – 5
L1	For an answer without reference to data that is largely descriptive and/or contains substantial conceptual flaws.	1 – 3
E	For a reasoned judgement on the desirability of its economic development model, well-contextualised to the Indonesian economy	1

**Suggested Mark Scheme (9732/1)****Question 2****(a) Compare the trade balances in Japan and South Korea between 2009 and 2012. [2]**

- Both countries' trade balances have worsen
- Japan – surplus to deficit while South Korea has a surplus trade balance

*Students cannot explain the current account balance*

*Workings for the trade balances are not required nor credited for marks*

**(b) (i) Account for the difference in Indonesia's current account balance and trade balance. [2]**

- Current account includes both trade (visible) and invisible trade account
  - trade in services such as shipping, aviation, banking and insurance and tourism
  - factor income (i.e. interest, profits and dividends received from or paid to abroad)
- Indonesia Data: in 2012 has trade surplus but a current account deficit => outflow more than the inflow for invisible account balance

**(ii) Identify the year which has the highest nominal GDP growth. [1]**

2011

**(iii) Explain the relationship between the two indicators, rate of inflation and unemployment rate. [3]**

- There is a *trade-off* between rate of inflation and unemployment rate - a little more unemployment meant a little less inflation (Phillips Curve).
- Supported by the data, except 2012, rate of inflation has increased from 2009 to 2011, while unemployment rate has slowed down
- Increasing AD, might be due to an increase in the demand for labour as government spending generates growth. The pool of unemployed will fall. Firms must compete for fewer workers by raising nominal wages. Workers have greater bargaining power to seek out increases in nominal wages. Faced with rising wage costs, firms pass on these cost increases in higher prices.

**(b) Comment on the significance of changes in exchange rates on the visible export revenue in Japan. [4]**

- Yen appreciated against USD from 2009 -2011, visible export (value) has increased
- Yen has depreciated against USD in 2012 while export revenue has decrease
- In theory: Prices of Japanese exports in USD increased, PEDx is price elastic (students can quote from Extract 2, Japan main exports are manufacture products & explain why PED >1), quantity demanded will decrease by a larger, export revenue should decrease.
- Not supported by the data => not significant
  - ✚ Cause and effect. Eg. Increase in demand for export => demand for yen increase (appreciation of Yen against USD)
  - ✚ Other factors – contract, lacked of substitutes, change in other non-price factors

**(d) Discuss whether the data provided are sufficient to assess changes in the standard of living in these Asian economies over the period. [8]**

Introduction

- Assess **changes**, students have to identified - as an improvement in SOL
- Define SOL – both material and non-material aspects

Body

- Balanced answer with data from case materials

Material aspects:

- In general, real GDP growth rates for the 3 economies are rising while unemployment rates are decreasing (from the 3 tables). This means that while materially, people are better off than before (and hence higher SOL). [Students do not need to consider inflation rate; as we are looking real GDP growth, which has eliminated the effects of inflation]
- Current account balance shows improvement in South Korea and Japan except for Indonesia. However, the higher imports in Indonesia could lead to higher SOL since this is due to strong private consumption. Furthermore, if the imports are primarily on capital goods for investments, then this could translate into higher SOL only in the future. While current account improvement means higher export earnings, goods produced are meant for foreigners and hence may not translate into higher SOL but it generates income and employment for the economies.
- Public debt as a % of GDP is rather stable for South Korea and Indonesia but increasing for Japan. Indicating the economies are doing well except for Japan. In future, Japanese government will implement contractionary fiscal policy to repay the public debt, leading to lower SOL, ceteris paribus.

Hence the data does provide an indication of the changes to the material aspect of the SOL over the time period.

However it provides an incomplete picture. E.g.: per capita income figure should be considered to take into account population changes. Other indicators to take into account non-material aspect could be:

- Gini coefficient to account for differences in income distribution on living standards
- Pollution index esp. as there is high level of production in China which could contribute to increased pollution

- Amount of leisure time: high economic growth may mean better material well-being but this could imply more stress, less leisure time and hence possibility of lower SOL.

<b>Knowledge, Application, Understanding and Analysis</b>		
<b>L3</b>	- Structure & linking sentences are present - Rigour in economic analysis – balanced answer whether the data provided are sufficient to assess improvement in the standard of living in these Asian economies over the period. - Use of case material	<b>5-6</b>
<b>L2</b>	- An accurate but undeveloped/ lapses in explanation - refer to the 3 Asian economies	<b>3-4</b>
<b>L1</b>	- Content: Weak - Mainly irrelevancies and substantial glaring conceptual errors	<b>1-2</b>
<b>Evaluation</b>		
<b>E</b>	For an evaluative assessment based on economic analysis or empirical evidence.	<b>1 –2</b>

**(e) As a consultant economist, what options would you present to the governments as possible responses to the challenges faced by any two of these economies, and what would you recommend. Justify your answer. [10]**

- 2 economies with 2 challenges each
- Any 3 different policies used to solve the above challenges
- Explain the limitations of the policies.

<b>Knowledge, Application, Understanding and Analysis</b>		
<b>L3</b>	-TAS structure should be used when discussing the benefits and costs of policies (preferably cover both demand-management and supply-sides) used to solve the challenges in any 2 economies. - Rigour in analysis – use AD/AS framework - Good exemplification – use case material to support their answer	<b>10-13</b>
<b>L2</b>	- An accurate but undeveloped explanation of the policies used to solve the challenges in any 2 economies - Listing the limitations of the policies without making reference to the characteristics of the economies.	<b>6-9</b>
<b>L1</b>	- For an answer that shows some knowledge of the challenges - One-sided answer - No economic framework used	<b>1-3</b>
<b>Evaluation</b>		
<b>E</b>	For an evaluative assessment based on economic analysis or empirical evidence.	<b>1-2</b>

**Suggested Mark Scheme (9732/2)**

## Essay Q1

Consumers should be allowed to have what they want because they are often the best judges of what is good for them. Government intervention that 'corrects' consumer choice is not only unnecessary but counterproductive. Discuss. [25]

**Thesis 1:**

**Government intervention that 'corrects' consumer choice is unnecessary as free consumer choice brings about efficient allocation of resources.**

<P> Consumer, assumed to be rational utility maximiser, constrained by his budget, will consume a good up to the point where the  $MPB = MPC$ .

The **marginal private benefit** is the marginal utility or additional utility or satisfaction that the consumer derives from consuming one more unit of the good.

Assuming the consumer is just one of the many buyers in the market, the consumer faces a perfectly elastic supply curve, i.e. the consumer is a price-taker, able to buy as many units as he wishes at the current market price. The **marginal private cost** is the price that the consumer pays (hence the value of alternative goods forgone) to consume one more unit of the good.

At  $Q_1$ ,  $MPB > MPC$ . The last unit consumed brings the consumer  $aQ_1$  of additional benefits (marginal utility) but cost the consumer only  $bQ_1$  (price), adding  $ab$  to his consumer surplus. **A rational consumer, attempting to maximize his consumer surplus** will therefore consume additional units of the good. As more units are consumed, the MPB or the MU declines as explained by the Law of Diminishing Marginal Utility. Holding MPC or P constant – the consumer being a price-taker – the consumer surplus from consuming additional units declines. Eventually, at  $Q_e$ ,  $MPB (MU) = MPC (P) = eQ_e$ , i.e. the additional utility derived from the last unit of good consumed exactly equals the price the consumer paid for the good and no more consumer surplus can be gained. At this point, their optimum level of consumption has been reached: consumer surplus has been maximized.

<insert diagram>

With complete and accurate information, i.e. "crs are often the best judges of what is good for them" and if we further assume perfect competition and absence of externalities,

- perceived MPB = actual MPB = MSB
- perceived MPC = actual MPC = MSC

<L> The last unit consumed where perceived MPB = perceived MPC, actual MPB = actual MPC and MSB = MSC. The last unit consumed adds as much to society's benefit as it does to society's cost, all positive net benefit has been exhausted and no further relocation of resources can increase welfare further. **Free consumer choice maximizes economic welfare of the society.**

**Antithesis 1a:**

**Free consumer choice does not always bring about efficient allocation of resources.**

**Market failure** is said to occur when free markets, operating without government intervention, fail to deliver a socially efficient allocation of resources, i.e. economic welfare is not maximised in the allocation of resources by the free market.

(Explain 2 relevant sources of market failure)

A traditional example is to be found in the attitude of the **uninformed** to the benefits of preventive health services. Consumers may put off health screening as they are not aware of the full extent of benefits e.g. early detection will increase chances of recovery and reduce the cost of treatment. Their  $MPB_{\text{perceived}}$  is thus  $<$  the  $MPB_{\text{actual}}$ .

Consumers will consume healthcare up to the point where their  $MPB_{\text{perceived}} = MPC$  (price of health screening)

For healthcare, there exists another source of **uncertainty** – individuals are unable to predict when and what kind of illness / accident may strike, how severe it will be and hence the exact cost of treatment. As a consequence, they may not save enough for healthcare. In the event of catastrophic illness, costs of treatment may be so high that it is beyond the means of the individual or his family to pay for it.

And even if consumers realise the need for such precautionary saving, they may **lack the self-control** to defer current consumption e.g. to put off buying that latest model of smart phone to save for future medical expenses.

For these various reasons, there will be an under-consumption of health care.

**Distorted preferences** can also lead to over-consumption. The increasing trend of obesity in many countries is one such case – when young children, under the influence of cartoons and free gifts that come with a fast food meal, may see the  $MPB_{\text{perceived}} > MPB_{\text{actual}}$ . In addition, it is accepted that many young children **do not have the cognitive ability** to weigh the short-term benefits of consuming fast food with the long-term cost to their health, **neither do they have the self-control** to deny themselves of the immediate gratification.

**Externalities** are spillover or third party effects resulting from the production or consumption of a good. Explain and exemplify the positive externalities that arise from the consumption of health care services like vaccination and how free consumer choice results in inefficient allocation of resources.

<insert diagrams>

**Antithesis 1b:**

**Under such circumstances, government intervention that aims to correct consumer choice may be necessary to reduce inefficiency**

(Explain 2 relevant measures)

### CLOSING THE INFORMATION GAP

Where the problem arises from imperfect information or misinformation, the government can

- (i) engage in public education campaign, or
- (ii) legislation to mandate disclosure of information / prohibit false and misleading advertisement

so that consumers are able to make consumption decisions based on full and accurate information.

Examples include the Health Promotion Board (HPB) short film “Kaki” (better known as Ong and Raj) on colorectal cancer screening. In addition to TV advertisement, the HPB website also provides information on topics such as “Food for Health”, “Smoke Free Living”, etc. The Singapore Food Regulations require all prepacked food products for sale in Singapore to be labelled according to the guidelines set by HPB. Nutrient function claims may be allowed if the following criteria only under strict regulation.

### TAXES AND SUBSIDIES

When faced with negative externalities, a government may choose to impose an indirect tax. Imposition of an indirect tax raises the price the consumers have to pay, and the MPC of consumption relative to the MPB. (Explain graph) Examples include taxes on cigarettes, cars and petrol.

Where the problem is one of under-consumption, the government could provide subsidies to reduce the MPC of consumption relative to MPB to incentivise rational consumers to increase consumption. Examples include the education and healthcare subsidies in many countries.

Other acceptable measures:

- compulsory savings and health care insurance (opt-out system)
- mandatory MMR vaccination for all infants
- hybrid measures like the VQS and COE to control congestion

<insert diagrams>



**Thesis 2:**

**Even when free consumer choice brings about inefficient allocation of resources, government intervention does not necessarily help reduce the inefficiency but may instead prove counterproductive<sup>1</sup>**

**Government failure** occurs when government intervention proves to be unwarranted, either because markets are performing adequately or public policy does not correct a market failure efficiently. In such cases, government intervention may actually exacerbate a problem or produce unintended negative results making the cost of government failure considerably greater than the cost of market failure

(Explain 2 relevant sources of government failure)

**IMPERFECT INFORMATION**

**<P>** Government, even if it intervenes in the market with the intent of correcting market failure could, given imperfect information, create more inefficiencies. **<E&E>** Rational economic agents in pursuit of their self-interest produce (consume) up to the point where  $MPB = MPC$ , ignoring the external benefit/cost their production (consumption) impose on 3<sup>rd</sup> parties. One solution to this problem is indirect tax to raise MPC so as to get consumers to cut back consumption towards the socially optimum level. Without accurate information on the PED and PES value, the government is not able to determine the indirect taxes required to bring the consumption level exactly to the socially optimum level. Referring to Figure 3, the government may overestimate the tax required, shifting the MPC to  $MPC_2$ . The new private equilibrium output will be at  $Q_2$ , lower than the socially optimum amount  $Q_S$ . The underproduction, while producing a cost saving of  $Q_2eaQ_S$  to the society denies the society of the potential benefit of  $Q_2daQ_S$ , creating a DWL of  $dae$ . **<L>** Should area  $dae$  (DWL after the intervention) > area  $abc$  (original DWL), government intervention makes the society worse off.

<insert diagram>

**ADMINISTRATIVE COST**

**<P>** Even if there were no serious information imperfection problem, government intervention can also produce inefficiency when administrative cost is high. **<E&E>** Following from the above example, administrative cost of an indirect tax could include the wages paid to customs officers and police to conduct checks to keep out contraband cigarettes from being smuggled into the country and sold over the counter. The reduction in DWL from the cutback in consumption has to be weighed against the administrative cost incurred in the intervention. **<L>** Should the administrative cost > reduction in DWL from overconsumption, government intervention makes the society worse off.

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<sup>1</sup> Counterproductive: thwarting the achievement of the intended goal

## Evaluation

The risk of government failure should not be the reason for government inaction:

- As the ***cost of gathering information declines*** or ***the accuracy of information improves*** with technological advancement and scientific research, government intervention can be even more efficient for example the development of satellite technology and wireless connectivity has made it easier and less costly to implement distance-based congestion charging which the LTA will be rolling out in the future.
- Also, as the ***strategies of firms and lifestyle change, government policies need to keep up***. The rising trend of childhood obesity is one such case in point – proliferation of processed food, the use of cartoon characters to sell snacks high in sugar and sodium content and the decline in exercise have all contributed to the problem.

There is little disagreement on protecting the most vulnerable in the society and consumers from firms' marketing strategies that are deliberately designed to distort information. Where extensive cost-benefit analyses have been conducted e.g. cost of congestion to the economy, the case for government intervention is also clear cut. The issue becomes more divisive in areas rooted in ideological beliefs and social values e.g. the socially conservative groups in the society may favour tighter regulation on content that the public can view on free-to-air TV and in the movies while the liberals, who uphold free choice and self-determination, see such intervention as acts of the nanny state.

**Essay Q1**

Consumers should be allowed to have what they want because they are often the best judges of what is good for them. Government intervention that 'corrects' consumer choice is not only unnecessary but counterproductive. Discuss. [25]

<b>Knowledge, Application, Understanding and Analysis</b>	
L3 (15-21m)	<p>For an answer that</p> <ul style="list-style-type: none"> <li>demonstrates depth and scope, using economic framework</li> <li>well-developed analyses of: <ul style="list-style-type: none"> <li>free consumer choice brings about an efficient allocation of resources</li> <li>market failure associated with free consumer choice e.g. imperfect information and externalities</li> <li>government policies that influence consumer choice</li> <li>government failure in the above policies</li> </ul> </li> </ul> <p>The highest L3 marks (19-21) may only be achieved by an answer that</p> <ul style="list-style-type: none"> <li>demonstrates that the meaning of the question has been grasped, i.e. analysis anchored on consumer choice rather than, say, firms' production decision</li> </ul> <p>AND</p> <ul style="list-style-type: none"> <li>is consistently exemplified</li> </ul>
L2 (10-14m)	<p>For an answer that</p> <ul style="list-style-type: none"> <li>may be limited in scope e.g. analyses the market failure associated with free consumer choice and government policies to correct the various sources of market failure only</li> <li>may be limited in depth: contains accurate though undeveloped explanations, not consistently analytical</li> <li>is largely theoretical, limited application to the real world context</li> <li>may contain a few minor misconceptions.</li> </ul>
L1 (1-9m)	<p>For an answer that</p> <ul style="list-style-type: none"> <li>is largely irrelevant with no indication that the meaning of the question has been properly grasped,</li> <li>is largely descriptive,</li> <li>has severe misconception(s)</li> </ul>
<b>Evaluation</b>	
E2 (3-4m)	For an insightful evaluative assessment supported by well-developed economic reasons
E1 (1-2m)	Unexplained statements or an evaluative assessment with weak substantiation

## Essay Q2

UK bread manufacturers are facing difficult times with competition from supermarkets' own brands and rising wheat costs. Own brands are able to offer recession-hit consumers cheaper value. In-store bakeries mean that supermarkets offer freshness that the bread manufacturers find hard to match. Bread manufacturers are increasingly under pressure to engage in promotional activities.

*Bread & Bakery Products 2012*

- (a) Explain how elasticity concepts can assist in understanding the effect of the increase in wheat price on the market for bread. [10]
- (b) Discuss how the above combination of factors might affect expenditure by consumers in the two different bread markets. [15]

### Part (a)

**<P> An increase in wheat price reduces the supply. Ceteris paribus, this would bring about an increase in equilibrium price and a decrease in equilibrium quantity.**

Increase in wheat price → increase marginal cost → (i) firms willing to supply the same output only at higher prices, shifting ss curve upwards OR equivalently leftwards → shortage created at the original price level → as competition for the good intensifies, consumers bid up the price of the good → higher price gives firms positive marginal profits, incentivising firms to increase quantity supplied; on the other hand, consumers who are unwilling or unable to pay the higher price drop out of the market, reducing quantity demanded → shortage is reduced as quantity supplied increases and quantity demanded falls. Process will continue until price rises such that  $Q_d = Q_s$  and the shortage is eliminated. Overall, the increase in wheat price causes equilibrium price to increase and equilibrium quantity to fall.

<Insert diagram>

**<P> Applying to the bread market, it is likely that the price increase is large though the reduction in equilibrium quantity might not.**

Supply of bread is likely to be price elastic relative to demand

- produced daily → manufacturers able to cut production at short notice → supply likely to be price elastic, i.e. a decrease in price brings about a larger than proportionate decrease in quantity supplied
- staple in UK diet → dd likely to be price inelastic, i.e. an increase in price brings about a smaller than proportionate fall in quantity demanded since, as a staple, it is difficult for the people of UK to switch away quickly or completely even in response to higher prices (here, we consider bread as a single class of good rather than the different brands of bread)

Given that supply is likely to be elastic relative to demand, price increase following an increase in factor prices is likely to be large. This is because crs are less responsive to price changes than prs → firms are able to pass on the cost increase by raising prices without fearing large fall in  $Q_d$  → larger price increase, crs bear the higher share of the cost increase

Since the supply of bread is likely to be price elastic while the demand price inelastic,

- higher wheat price → manufacturers have to accept a lower net price (price less additional MC) → the more price elastic the supply, the larger the reduction in quantity supplied in response to a lower net price received

- as a staple, it is difficult for the people of UK to switch away quickly or completely even in response to higher prices → the more price inelastic the demand, the smaller the reduction in quantity demanded in response to a higher price charged

<Insert diagram>

Combined effect on the above PES and PED on the equilibrium quantity:

- the inelastic nature of the demand helps moderate the extent by which equilibrium quantity falls in response to the increase in wheat prices

## Part (b)

### Bread by manufacturers

#### **Demand factors**

##### **DIRECTION OF SHIFT**

- Recession → falling Y → falling willingness and ability of crs to buy bread given positive YED (normal goods) → fall in  $Q_d$  at each and every price → leftward shift of dd
- Promotional activity e.g. setting up of booths at fairs to reach out to consumers → increase in  $Q_d$  at each and every price → rightward shift of dd

Two factors have an offsetting effect though it is likely that the net effect is a fall in demand - promotional activities unlikely to be highly successful

- consumers are still budget conscious,
- supermarkets are likely to respond with their own promotional activities,
- supermarkets 'offer freshness that manufactured breads cannot match'
- in periods of falling profits (rising costs + falling demand), bread manufacturers might not have the means to spend aggressively on promotional activities

#### **Supply factors**

##### **DIRECTION OF SHIFT**

- Rising wheat prices → decrease ss

#### **Effect on consumer expenditure**

Given:

- PED and PES are of similar magnitude
    - While bread as a single class of good may be staple, but manufactured bread is not → as bread manufacturers raise their prices in face of increase wheat cost, crs can easily switch to the lower-price own brand offerings by supermarkets → demand likely to be price elastic
  - Magnitude of fall in ss > magnitude of fall in dd
- At the original price, there is now a shortage → upward pressure on price → (i) firms incentivised to increase quantity supplied; (ii) crs who are unwilling and unable to pay the higher price drop out of the market, reducing quantity demanded → new equilibrium price settles as  $P_1$
  - Simultaneous fall in dd and ss reinforce each other to bring about a fall in equilibrium qty → new equilibrium price settles as  $Q_1$  → consumer expenditure falls

## Bread by supermarkets

### **Demand factors**

#### **DIRECTION OF SHIFT**

- Recession → falling Y → demand for inferior goods with negative YED rise with increasing willingness of crs to trade down to cheaper supermarket own brand → increase in dd
- Promotional activity by bread manufacturers → appeal to crs t&p, might cause a switch away from supermarket brands to manufacturers bread

### **Supply factors**

#### **DIRECTION OF SHIFT**

- Rising wheat prices → decrease ss

- (1) The two demand factors have an offsetting effect though it is likely that the net effect is that demand will increase:
  - promotional activities by bread manufacturers to reverse the shift in cr t&p unlikely to be highly successful (as explained above)
- (2) Increase in demand > decrease in supply  
The extent of fall in ss may not be significant:
  - wheat is a small % of the bread manufacturers' total COP,
  - other costs are likely to decline esp in a period of recession e.g. layoff full-time workers and engage part-timers with less benefits,
  - continuous improvement in management and operation → increase productivity, reduce MC

### **Effect on consumer expenditure**

Given:

- (i) PED and PES are of similar magnitude
- (ii) Magnitude of the rise in dd likely to > magnitude of fall in ss

Simultaneous increase in equilibrium P and Q → pay more per unit + purchase more units → increase in cr expenditure

### Essay Q2

UK bread manufacturers are facing difficult times with competition from supermarkets' own goods and rising input (wheat) costs. Own brands are able to offer recession-hit consumers cheaper value, yet similar, even better quality. Not only do supermarkets offer bagged bread, but in-store bakeries mean that they offer freshness that the bread manufacturers find hard to match. The intensification of competition has put pressure on manufacturers to engage in promotional activity.

*Bread & Bakery Products 2012*

- (a) Explain how elasticity concepts can assist in understanding the effect of the increase in wheat price on the market for bread. [10]
- (b) Discuss how the above combination of factors might affect expenditure by consumers in the two different bread markets. [15]

### Part (a)

<b>Knowledge, Application, Understanding and Analysis</b>	
L3 7-10	<p>For an answer that</p> <ul style="list-style-type: none"> <li>• displays depth of economic analysis throughout the essay</li> <li>• analyses how PED and PES together influence the extent of price and quantity changes</li> <li>• contains well-explained diagrams and sound economic reasoning</li> <li>• is well-applied to the given context</li> </ul> <p>Answers at the lower end of the mark range may contain very few minor misconceptions [If use XED instead of PES, cap at 8m]</p>
L2 5-6	<p>For an answer that</p> <ul style="list-style-type: none"> <li>• may be limited in scope e.g. analyses the influence of one elasticity concept on equilibrium P and Q changes, OR</li> <li>• may be limited in depth: contains accurate though undeveloped explanations, not consistently analytical</li> <li>• some, though inconsistent, application to context</li> <li>• may contain a few minor misconceptions.</li> </ul>
L1 1-4	<p>For an answer which</p> <ul style="list-style-type: none"> <li>• is largely irrelevant with no indication that the meaning of the question has been properly grasped, e.g. no attempt to analyse how and to what extent equilibrium P &amp; Q change,</li> <li>• is largely descriptive,</li> <li>• has severe misconception(s)</li> </ul>

**Part (b)**

<b>Knowledge, Application, Understanding and Analysis</b>	
<b>L3</b> 9-11	<p>For an answer that</p> <ul style="list-style-type: none"> <li>• displays depth of economic analysis throughout the essay</li> <li>• analyses how the combination of factors together influence consumer expenditure on the two distinct bread markets</li> <li>• contains well-explained diagrams and sound economic reasoning</li> <li>• is well-applied to the given context</li> </ul> <p>Answers at the lower end of the mark range may contain very few minor misconceptions</p>
<b>L2</b> 6-8	<p>For an answer that</p> <ul style="list-style-type: none"> <li>• may be limited in scope e.g. analyses the influence of some of the factors on consumer expenditure in the two bread markets</li> <li>• may be limited in depth: contains accurate though undeveloped explanations, not consistently analytical</li> <li>• some, though inconsistent, application to context</li> <li>• may contain a few minor misconceptions.</li> </ul>
<b>L1</b> 1-5	<p>For an answer which</p> <ul style="list-style-type: none"> <li>• is largely irrelevant with no indication that the meaning of the question has been properly grasped, e.g. no attempt to analyse effect on consumer expenditure</li> <li>• is largely descriptive,</li> <li>• has severe misconception(s)</li> </ul>
<b>Evaluation</b>	
<b>E2</b> 3-4	For an insightful evaluative assessment supported by well-developed economic reasons
<b>E1</b> 1-2	Unexplained statements or an evaluative assessment with weak substantiation



**Question 3**

- (a) Explain the conditions for price discrimination. [8]
- (b) In US, the Federal Trade Commission (FTC) blocked the mergers of two hospitals in the state of Illinois. On the other hand, the Competition Commission of Singapore (CCS) has granted clearance for Heineken's acquisition of Asia Pacific Breweries, the maker of Tiger Beer from Fraser and Neave (F&N). Heineken has a global network of distributors and breweries, owning more than 250 beer brands. Assess the economic case for these two different approaches. [17]

**Suggested Answers for Part (a)**

*Candidates are expected to identify and explain the prerequisites for firms to engage in price discrimination (P.D.), namely second degree P.D. and third degree P.D.*

***Introduction***

Define price discrimination (P.D.) – a pricing strategy whereby a firm charges different prices for the same product for reasons not associated with differences in costs of production.

***Body***

To identify and explain the prerequisites for firms to engage in P.D.:

- (1) Ability to set prices or market power,
- (2) Ability to separate / segregate the market into different sub-groups of consumers, and prevent the resale of the good between different consumers or different markets
- (3) Differences in price elasticity of demand (PED) for the good in each market / between different consumers

Explain and exemplify

- Hospital context – price of health screening bundle v.s. a la carte

L1	<ul style="list-style-type: none"> <li>➤ May show some understanding of the question.</li> <li>➤ May make serious conceptual errors.</li> </ul>	1 – 4
L2	<ul style="list-style-type: none"> <li>➤ Undeveloped explanation on the conditions for price discrimination.</li> <li>➤ Lacks application to real world examples.</li> </ul>	5 – 6
L3	<ul style="list-style-type: none"> <li>➤ Well-developed analysis on the conditions for price discrimination.</li> <li>➤ Provides application to real world examples.</li> <li>➤ Only need to explain either second or third degree P.D. in detail.</li> </ul>	7 – 8

### **Suggested Answers for Part (b)**

Candidates are required to analyse the economic benefits and costs for both cases / scenario to justify which approach adopted by which government is more appropriate.

#### ***Introduction***

Governments have different microeconomic and macroeconomic objectives / aims / goals to achieve – efficiency and equity; low inflation, low unemployment (UN), high and sustained economic growth as well as healthy balance of payments (BOP) respectively.

#### ***Body***

#### **Thesis: economic case for blocking merger of hospitals**

##### **Background information**

Federal Trade Commission (FTC) filed a complaint against an acquisition deal between two Illinois health systems – OSF Healthcare System and Rockford Health System, as it will substantially reduce competition among hospitals and primary care physicians in Rockford, Illinois. This will significantly harm local businesses and patients in the general acute-care inpatient services market and primary care physician services market. In the Rockford area, the proposed acquisition, OSF, will control 64% of general acute-care inpatient services, and face only one competitor, SwedishAmerican Health System. Together they control more than 99% of the general acute-care services market. In the primary care physician services market, there are three significant primary care physician groups. Post-acquisition, OSF and SwedishAmerican will control almost 60% of all primary care physician services.

The reasons for blocking the merger of the hospitals are as follows:

- (1) Prevent anti-competitive behaviour from occurring, as reduced competition may lead to
  - higher price-setting ability, allocative inefficiency → DWL and inequity

Price; Revenue; Cost (or \$)

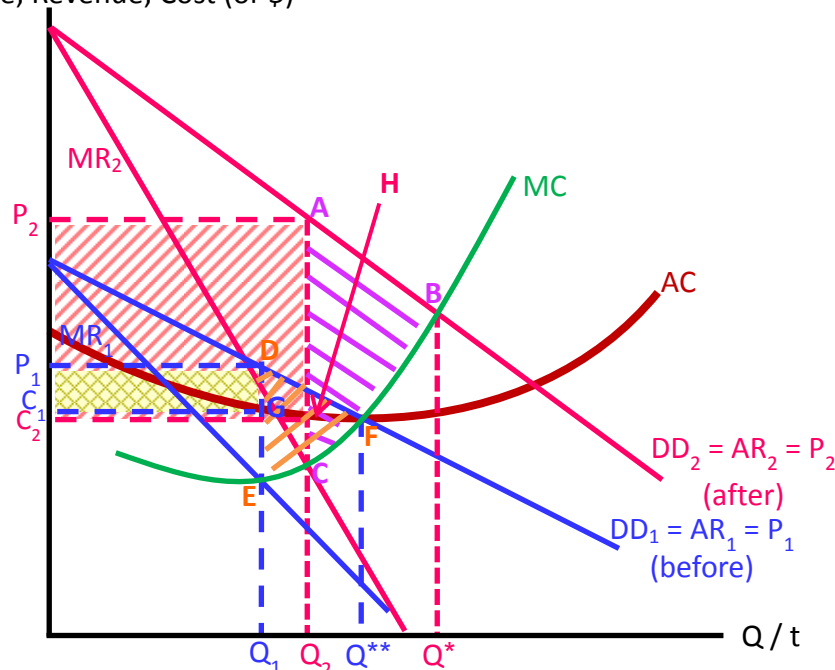


Diagram 2: demand and cost structure of hospital before and after merger

- The hospital being a profit maximising firm sets price and output where marginal revenue (MR) = marginal cost (MC), where the last unit is transacted. At  $MR > MC$ , the last unit sold adds on more to revenue earned by the firm than to costs incurred by the firm, hence, a rational profit-maximising firm should continue to sell more so as to gain additional profit margin. Similarly, at  $MR < MC$ , the last unit sold adds on less to revenue earned by the firm than to costs incurred by the firm, hence, a rational profit-maximising firm should sell lesser so as to gain additional profit margin.
- Assuming the same total market share before and after the merger, the DD curve for the hospital after the merger is higher, as market DD is spread over less number of firms before the merger. Also, DD becomes more price inelastic since there is only one remaining competitor, SwedishAmerican Health System (fewer availability of close substitutes) for consumers to choose from → higher market power.
- Assuming that MC remains the same before and after the merger, a higher and more price inelastic DD for the hospital consequently leads to a steeper and higher MR curve, resulting in a higher profit-maximising price ( $P_2 > P_1$ ) than before. This causes consumers to pay higher prices for healthcare, which compromises on consumers' welfare as they can now consume lesser healthcare services or of other goods for any given income. Since healthcare is a basic human right and necessity for everyone in society regardless of one's income, the higher price charged due to the merger is unjustified especially to the low-income households as healthcare services become increasingly unaffordable to them. This leads to greater under-consumption of healthcare which is undesirable, since healthcare is a merit good and confers positive externalities → allocative inefficiency → DWL
- With the rise in market power due to the merger, the hospital is able to restrict output by a greater extent since DD is more price inelastic than before → able to charge much higher prices,  $P_2$  (without fear of losing significant sales) and under-produce the good by a greater extent ( $Q_1Q^*$ ) than before ( $Q_2Q^{**}$ ) → extent of allocative inefficiency is greater → DWL is bigger (area ABC since the marginal social benefit (MSB) of  $ABQ^*Q_2$  that is not enjoyed for  $Q_2Q^*$  units > marginal social cost (MSC) of  $CBQ^*Q_2$ ) relative to before merger occurred (area DEF, where the MSB of  $DFQ^{**}Q_1$  that is not enjoyed for  $Q_1Q^{**}$  units > MSC of  $EFQ^{**}Q_1$ )
- In addition, as analysed earlier the hospital can now charge a higher price due to greater market power → higher supernormal profits of  $P_2AHC_2$  relative to  $P_1BGC_1$  due to high BTEs that allow the hospitals to retain the supernormal profits in the LR → sustained redistribution of income from the consumers who are usually the poorer group to the hospital providers that are the richer group → greater inequity problem due to the unfair distribution of income in society.
- greater X-inefficiency since both hospitals (after the merger) are non-profit motivated, and the fall in competition may cause them to be even more complacent → do not keep a check on their costs → no active cost-minimisation efforts
- significant financial burden on local employers and employees in the US, either directly or through higher insurance premiums, co-payments and other out-of-pocket expenses since each hospital has a significant market share and hence possesses:
  - ❖ greater price setting ability to charge a higher price, and also pass on higher costs due to X-inefficiency to consumers as higher prices → fall in consumers' welfare
  - ❖ greater bargaining power over its suppliers e.g. insurance companies to negotiate higher prices for healthcare services paid by the insured, i.e. greater leverage to charge insurance companies a higher premium for healthcare services, and in turn they pass on as higher premium to consumers who buy the healthcare insurance policies. Research has shown that prices are significantly higher for different procedures in consolidated than competitive hospital markets.<sup>2</sup> In the US, worker's health insurance premiums have risen 9.3% in 2012 and 40% since 2007.

<sup>2</sup> <http://www.berkeleyhealthtech.org/docs/Vol.3.2.Hospital-Markets.pdf>

- fall in vital non-price competition among the hospitals → fall in dynamic efficiency due to lesser incentive to engage in research and development (R&D) → compromises on quality, convenience and breadth of services provided to the patients
- (2) Prevent possible loss of jobs, because mergers usually result in redundant workers due to replication of similar job scope or designation – for e.g. there is no need for two directors to manage one hospital → retrenchment of workers → higher unemployment

### **Anti-thesis: economic case against blocking merger of hospitals**

Merger → pooling of funds and resources as well as higher supernormal profits earned → greater ability to finance risky investments in R&D → process and product innovation

- Process innovation → lowers unit costs due to streamlining production processes → lower prices → increases affordability of healthcare
- Product innovation → setting up of laboratories to conduct clinical research and experiments → medical breakthroughs and discovery of new and better medicines, vaccinations against new and existing diseases → significant improvement in consumers' welfare as more people can be cured as well as dynamic efficiency
- Import better and new machinery to perform medical operations that could raise patients' survival chances or speed up recovery processes etc. → improve consumers' welfare

### **Thesis: economic case for approval of acquisition**

#### **Background Information**

F&N is a leading Asia Pacific Consumer Group with expertise and prominent standing in the Food & Beverage and Publishing & Printing industries. Its core businesses are the production and sale of soft drinks, beer and stout, dairy products, property investment and development as well as publishing and printing.<sup>3</sup> Listed on the Singapore stock exchange, F&N is one of the most established and successful companies in the region with renowned brands that enjoy strong market leadership. F&N is present in 12 countries spanning Asia Pacific, Europe and the USA, and employs close to 9,000 people worldwide.<sup>4</sup>

Dutch brewer Heineken is placed third of the world's four biggest brewers which they now account for over half the global market for beer.<sup>5</sup> Heineken is the leading brewer in Europe with over 250 brands in more than 70 countries<sup>6</sup>, such as Amstel, Scottish and Newcastle beers, Moretti and Tiger.

The acquisition of F&N by Heineken is a forward vertical integration, which brings about benefits such as:

- internal economies of scale (EOS) such as financial EOS and marketing EOS (explain) → lower unit costs (draw graph showing downward movement along LRAC with increased production) → Heineken may pass on cost savings to consumers as lower prices; produce closer to minimum efficient scale (MES) of production → reduces productive inefficiency (define)
- greater ability to control costs throughout the distribution process. In the traditional distribution process, every step in product movement involves mark-ups so the reseller can earn profit. By selling directly to end buyers, Heineken can eliminate the middle man, removing one or more steps of price mark-ups along the way. In this way, Heineken can better manage the distribution process, and hence has more ability to optimise resource

<sup>3</sup> [http://www.ccs.gov.sg/content/dam/ccs/PDFs/Public\\_register\\_and\\_consultation/Public\\_register/Mergers%20and%20acquisition/GD%20\(Non-Confidential\)%20Final\\_APB%20Heineken.pdf](http://www.ccs.gov.sg/content/dam/ccs/PDFs/Public_register_and_consultation/Public_register/Mergers%20and%20acquisition/GD%20(Non-Confidential)%20Final_APB%20Heineken.pdf)

<sup>4</sup> <http://www.fraserandneave.com/about-us>

<sup>5</sup> [http://www.economicsonline.co.uk/Business\\_economics/Brewing.html](http://www.economicsonline.co.uk/Business_economics/Brewing.html)

<sup>6</sup> <http://www.theheinekencompany.com/about-us/company-strategy/company-profile>

- utilisation and reduce costs such as lower transportation costs → lower prices and reduced productive inefficiency
- gaining more control over the production and sale of beer by Heineken → more reliable / stable retail channel → reduces vulnerability to shocks e.g. distributor demanding higher prices at a critical time that raises costs and hence prices for consumers → better control over production costs and distribution network
  - facilitating sharing of information and learning by doing spill-overs, allowing firms to better learn from each other's experience and knowledge → lower unit costs → lower prices
  - pooling of resources and higher supernormal profits earned → greater ability to finance risky investments in R&D → process and product innovation → the former lowers unit costs due to streamlining operations like eliminating duplication in marketing and corporate functions / technological advancements, while the latter results in new and improved products → better quality and more variety of beverages → achieves dynamic efficiency and higher consumers' welfare. Also, there is lesser wastage of resources → reduces allocative inefficiency
- Improvement in BOP since Heineken's acquisition of Singapore firm F&N is a foreign direct investment (FDI) inflow into SG.
  - Prevents possible domestic unemployment from occurring, since Heineken can either distribute its beer products in the Singapore market on its own or with another joint venture partner and/or licensee / distributor<sup>5</sup>, should the acquisition fail instead of getting F&N to distribute its beer → F&N is likely to face intense competition from Heineken → F&N may face a large fall in DD since Heineken may be able to charge at a much lower price due to higher iEOS → F&N may exit the industry if it earns subnormal profits → rise in local UN

### **Anti-thesis: economic case against approval of acquisition**

Higher market share → higher market power → able to set higher prices. However, the barriers to entry into the beer industry is not significant, as all brewers can enter the global duty-free beer market fairly easily. Also, the market for duty-free products is global and thus Heineken competes with many other larger international beer brewers globally, which will be able to restrict the behaviour of the merged entity. The marginal rise in Heineken's market share will not allow Heineken to unilaterally raise its beer prices in the global duty-free beer market. Furthermore, feedback from customers of Heineken and APB stated that they are able to source for other suppliers of beer relatively easily, including switching to suppliers not based in Singapore. The market from which customers of beer source their products from is global in nature, with the presence of product differentiation. As such, due to the highly competitive nature of the beer industry, and that customer bargaining power is present, it can be concluded that the acquisition does not raise competition concerns.<sup>5</sup>

### ***Conclusion***

The difference in the type of good results in different approaches adopted by the two countries. Beer is an internationally traded good, where Heineken's most significant competitors are based internationally. Given the increasingly globalised world, foreign competition becomes more prevalent, preventing possible tacit collusion among firms and anti-competitive behaviour. Globalisation also enables existing beer brewers with existing brand equity, global pricing and supply chain logistics to enter the relevant market relatively easily with the necessary capital expenditure on advertising and promotions, listing fees and marketing support fees. The acquisition is thus unlikely to significantly reduce market power. However, medical service is not an internationally traded good, and thus, hospitals face little foreign competition. The two hospitals will have significant market share and hence market power after merging, since the only competitor is SwedishAmerican Health System, and they may engage in anti-competitive behaviour such as tacit collusion since they control more than 99% of the general acute-care services market, which is likely to hurt consumers' welfare considerably. Especially since healthcare is a basic necessity, whereas beer is not, it

is even more important for governments to judiciously weigh the benefits against the costs of merger to ensure that the welfare of the low-income households will not be compromised. As such, the approaches adopted by the two different governments are justified.

L1	<ul style="list-style-type: none"> <li>➤ May show some understanding of the question.</li> <li>➤ May make serious conceptual errors.</li> </ul>	1 – 6
L2	<ul style="list-style-type: none"> <li>➤ Undeveloped analysis on the benefits OR costs of blocking the hospital merger OR Heineken's acquisition of F&amp;N, covering breadth OR depth:               <ul style="list-style-type: none"> <li>- Breadth: two-sided / balanced argument on benefits AND costs OR covers at least two govt. goals</li> <li>- Depth: rigorous analysis of benefits OR costs with the aid of diagrams</li> </ul> </li> <li>➤ Shows limited application to Heineken's acquisition and hospital merger.</li> </ul>	7 – 9
L3	<ul style="list-style-type: none"> <li>➤ Balanced discussion to explain the benefits AND costs of BOTH scenario</li> <li>➤ Shows application to Heineken's acquisition and hospital merger.</li> </ul>	10 – 13
E1	Unexplained judgement on whether the approaches adopted by the two different governments is justified or otherwise.	1 – 2
E2	Above judgement supported with economic analysis.	3 – 4

**Question 4**

- (a) The Singapore government spends on development expenditure such as road works and public infrastructure. Explain how a rise in government spending can lead to a larger increase in national income. [10]
- (b) Discuss whether the multiplier size is the most significant factor influencing governments' approach towards macroeconomic stabilisation. [15]

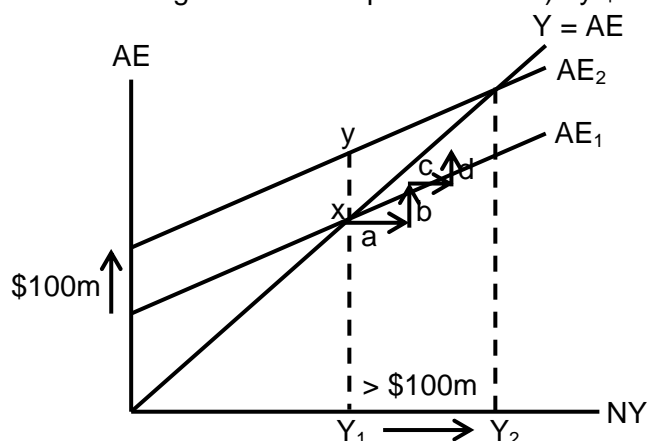
Candidates are required to explain how a rise in government spending in development expenditure (Singapore) leads to national income rising by a larger extent, through the multiplier ( $k$ ) effect. Candidates need to explain the full blown  $k$  effect, i.e. numerical figures of  $k$  effect.

**Suggested Answers for Part (a)*****Introduction***

Development expenditure such as building roads, repairing bridges and widening of drainage systems (public infrastructure) as well as developing new technologies may lead to potential economic growth as they raise productive capacity of the economy in the long run (LR). In the short run (SR), it results in higher national income and actual economic growth.

***Body*****Demand factor**

- (1) Define multiplier: The multiplier indicates the number of times income changes relative to the initial change in autonomous AE (or AD or injection).
- (2) Basis for the working of the multiplier: In the circular flow of income and expenditure and the fact that one group's spending becomes another group's income, expenditure creates income and income generates more expenditure. A reinforcing feedback loop is thus formed.
- (3) Numerical example (2 rounds and how it comes to an end + final impact): Based on the preamble, the Singapore government spends on development expenditure such as road works and public infrastructure e.g. repairing bridges or improve educational system, thereby devoting \$100m to build more schools. This increases the AE (or AD or injection) (via its effect on government expenditure –  $G$ ) by \$100m.



**Round 1 »** The rise in  $G \rightarrow$  at the initial level of  $NY$   $Y_1$ ,  $AE > Y$  by  $yx$  amount  $\rightarrow$  unplanned disinvestment  $\rightarrow$  signal to firms to step up production  $\rightarrow$  derived demand for fops (including labour) rises  $\rightarrow$  factor owners receive more factor incomes. Thus the \$100m of  $G$  becomes the revenue of firms selling goods and services, which then gets disbursed out as factor income to households (arrow 'a'). But households will not simply keep all of this \$100m in banks. Singapore is a small and open economy with small domestic market and lack of natural resources, hence the marginal propensity to consume domestically produced goods

and services ( $MPC_D$ ) is low and marginal propensity to import (MPM) is high respectively. In addition, there is high marginal propensity to save (MPS) due to the Central Provident Fund (CPF), a compulsory savings scheme<sup>7</sup> of up to 20% of monthly wage contribution by the employee<sup>8</sup> to set aside funds for retirement, as well as the Asian thrift culture. Given the low  $MPC_D$  and high marginal propensity to withdraw (MPW) due to high MPM and MPS, assume an  $MPC_D$  of 0.2 and MPW of 0.8. Income-induced consumption rises by \$20m (arrow 'b') and this goes on to become income for the next group of people in the economy (arrow 'c'). The remaining \$80m leaves the circular flow in the form of savings (S), taxes (T) and imports (M). However, the process does not stop here.

*Round 2* » In the second round, as income rises by \$20m (arrow 'c'), and assuming a constant  $MPC_D$  of 0.2, this second group will spend \$4m out of their additional income on domestically goods and services (arrow 'd'). The other \$16m form the leakages in the form S, T and M out of the circular flow.

*How it comes to an end* » the process of additional spending creating additional income which brings about yet another round of spending and income creation continues. Notice that at each successive round, the rise in income gets smaller and smaller because of the leakages in the form of S, T and M of the circular flow. Eventually the multiplier process will end, and a new equilibrium national income is attained when the additional leakages total \$100m, balancing the initial injection by the government.

*Final effect* » To calculate the final impact on national income, we just need to sum up the string of additional incomes created.  $\Delta Y = \$100m + \$20m + \$4m + \dots = \$125m$ . Here, we see that the multiplier size is  $\frac{1}{MPW} = \frac{1}{0.8} = 1.25$ . In total, the rise in national income to  $Y_2$  will be worth  $\Delta Y = k \text{ size} \times \Delta AE$  (AD, in this case is G) =  $\$100m \times 1.25 = \$125m$ .

Assumption – idle resources available, prices held constant

### Supply factor

Development expenditure → increase in AS, creates the capacity for further expansion in real NY

<insert diagram>

### **Conclusion**

The multiplier effect causes a rise in government spending to lead to a larger increase in national income.

L1	<ul style="list-style-type: none"> <li>➤ May show some understanding of the question.</li> <li>➤ May make serious conceptual errors.</li> </ul>	1 – 4
L2	<ul style="list-style-type: none"> <li>➤ Undeveloped analysis of the multiplier process, either no numerical examples but with graphical illustration OR with numerical examples but only one round OR gaps in explanation of the multiplier process.</li> <li>➤ Limited application to the Singapore context.</li> </ul>	5 – 6
L3	<ul style="list-style-type: none"> <li>➤ Well-developed analysis of the full multiplier process (at least two rounds) with numerical examples.</li> <li>➤ Application to the Singapore context.</li> </ul>	7 – 10

<sup>7</sup> <http://mycpf.cpf.gov.sg/CPF/About-Us/Intro/Intro>

<sup>8</sup> <http://mycpf.cpf.gov.sg/Members/Gen-Info/Con-Rates/ContriRA>



### **Suggested Answers for Part (b)**

*Candidates need to explain how multiplier (k) size and how other factors are significant / important in influencing governments' (govts') approach towards macroeconomic stabilisation, then weigh / rank relative importance of these factors.*

#### ***Introduction***

Macroeconomic stabilisation is a condition in which a complex framework for monetary and fiscal institutions and policies is established to minimise vulnerability to external shocks / volatility, as well as to achieve internal and external stability. The former refers to achieving the three internal macroeconomic goals of low and stable inflation, low unemployment (UN), high and stable economic growth (EG), while the latter refers to achieving exchange rate stability and the external macroeconomic goal of healthy balance of payments (BOP).

Governments approach → measure / instrument / policy implemented by govt → type of policy option adopted and how to implement

#### **Thesis: multiplier (k) size is a significant factor influencing governments' approach towards macroeconomic stabilisation**

The k size determines the type of policy implemented by the govt.

K size tends to be higher for

- transfers targeted at low Y households rather than tax cuts for high Y households
- economies with sound fiscal positions (otherwise, Ricardian equivalence will reduce k size)
- less open economies

Larger k

- more effective a policy like expansionary FP in providing stimulus to raise actual EG and reduce cyclical unemployment in times of economic recession

Where size is small,

- May need a larger stimulus (subject to feasibility)
- Need for alternative policies e.g. SR cost cutting measures to raise actual EG and reduce cyclical unemployment in times of economic recession

#### **Antithesis: multiplier (k) size may not be the most significant factor influencing governments' approach towards macroeconomic stabilisation**

Other factors such as (1) characteristics of the economy, (2) prevailing economic conditions, (3) size of the govt. or fiscal / budget position, (4) magnitude / severity and duration of the economic problem and (5) root cause of the economic problem are also crucial factors to determine govts' approach towards macroeconomic stabilisation.

L1	<ul style="list-style-type: none"> <li>➤ May show some understanding of the question.</li> <li>➤ May make serious conceptual errors.</li> </ul>	1 – 5
L2	<ul style="list-style-type: none"> <li>➤ Undeveloped analysis on how k size / other factors influence govts approach towards macroeconomic stabilisation, covering either breadth OR depth:               <ul style="list-style-type: none"> <li>- Breadth: explains how k size AND 1 other factor (2-sided answer) are important in influencing govts' approach towards macroeconomic stabilisation. Minimum of 2 different policies OR 2 macroeconomic goals</li> <li>- Depth: rigorous analysis of how a factor influences govts' approach towards macroeconomic stabilisation with the aid of diagrams</li> </ul> </li> <li>➤ Lack of real world exemplifications to support analysis.</li> </ul>	6 – 8
L3	<ul style="list-style-type: none"> <li>➤ Well-developed and 2-sided analysis on the importance of at least 3 factors influencing govts' approach towards macroeconomic stabilisation, covering both breadth AND depth, with at least 2 policies AND 2 macroeconomic goals.</li> <li>➤ Shows application to real-world context.</li> </ul>	9 – 11
E1	Unexplained judgement in weighing / ranking the importance of factors in influencing govts' approach towards macroeconomic stabilisation.	1 – 2
E2	Above judgement supported with economic analysis.	3 – 4

**Question 5**

- a) Explain the causes of a balance of payments deficit on capital and financial account. [10]
- b) Discuss whether protectionism is the best policy to help a country to correct its balance of payments deficit. [15]

**Part (a)**

Define BOP deficit on capital and financial account

- BOP measures the total international receipts and payments between a country and the rest of the world in a given time period, usually a year.
- Define Capital and financial account -
- Deficit – International receipts is less than payments/ outflow>inflow

Explain any 3 causes of capital and financial account deficit: (cover both short-term and long-term capital outflow exceeding capital inflow)

- Fall in domestic interest rate relative to other countries
- Expected fall in exchange rate of domestic currency
- Loss of CA leading to FDI outflow
- Fall in expected returns on investments

Level 1	Able to <b>define BOP deficit</b> and <b>vaguely explain</b> the factors causing capital & financial account deficit.	1-4
Level 2	<b>Adequate explanation</b> on the causes of capital & financial account deficit <b>Brief explanation</b> on causes for <b>both</b> short term & long term capital flows. Either short term or long term.	5-7
Level 3	<b>Good explanation</b> on causes for <b>both</b> short and long term capital flows. <b>Use of examples</b> to illustrate how various factors affect capital & financing account deficit.	8-10

## Part (b)

Students are expected to provide detailed illustration of how various protectionist measures, such as tariff and quota, can be implemented by a country to correct the BOP deficit through trade balance; prevent outflow through capital & financial. Limitations of such measures in correcting BOP deficit must be discussed, especially the issue of against the theory of CA. Students are to provide 2 alternative policies that a country can adopt to solve BOP deficit and be able to arrive at a reasoned judgment on whether protectionism is the best policy to correct a BOP deficit.

- Define BOP deficit
- Worsening of Current account
  - loss CA (cars, electronic equipment) due to the emergence of developing nations (including China, India). With abundant resources, hence lower factor prices, manufactured goods from developing economies are relatively price competitive than those from Japan. This lead to **fall in demand for the latter exports** has led to a fall in export revenue and **increase in import expenditure** (purchase of cheaper imports from developing economies by domestic consumers), **resulting in current account deficit.**
- Deficit in capital and financial account
  - Similarly, the relatively lower costs of production in developing nations have **attracting many FDIs from Japan**, causing capital outflow hence **capital & financial account deficit.**

**Thesis: Protectionism is a good policy to correct BOP deficit**

- Illustrate how the use of tariffs and quotas can be used to correct current account deficit / or slow down the worsening of trade balance
  - Tariff diagram is required => link to improvement in (x-m)
- Prevent out flow of FDI – correct capital & financial account
- Students may use managed its exchange rate as a form of protectionism

**Anti-thesis:**

- Limitations of using protectionist measures
  - Retaliation by trading partners might lead to a fall in export revenue of host country
  - Not solving the root cause (loss of CA) such as depletion of resources and inefficiencies. Hence, inefficient firms have no incentive to restructure to improve the competitiveness of the products
  - May harm export competitiveness due to the increase in costs of production for firms that are dependent on imported resources or intermediate goods
  - Unable to resolve the outflow of FDI due to loss of CA as protectionist measures mainly target imports to protect domestic industries, rather than preventing the outflow of capital. Instead, protectionism will inevitably lead to inefficiencies and higher costs of production, which discourage FDI (fall in the inflow of capital. The increase in capital outflow will worsen capital account, making efforts to correct BOP deficit counterproductive.
- 2 alternative policies:  
Fiscal Policy
  - Fiscal Policy (expansionary, reduce taxation or increase government subsidies) to restructure economy in finding new niche industries (attract FDI); as well as leading to an increase export revenue.

- FP (infrastructure development) to improve efficiencies so as to lower costs of production (improve export competitiveness and attract FDI)

#### Monetary policy

- higher interest rate (contractionary MP) attracts hot money inflow => reducing capital & financial account deficit However, this will lead to an increase in demand for the currency and a decrease in supply of the currency. This leads to an upward pressure on the exchange rate and exports become relatively expensive, thus decreasing the country's export competitiveness.
- Helps to correct inflationary pressure

#### Supply-side policies

- interventionist or market oriented, such as retraining the older workers to improve labour productivity (quality of FOPs) and support niche industries (improve export competitiveness and attract FDI)
- Relax immigration policy to expand labour force (quantity) -lower labour cost / or wage rate increase at a slower rate- improve export competitiveness and attract FDI
- Discover new area of CA – potential increase in export revenue

(Limitations of each measure must be provided)

#### Conclusion: Judgment

While use of protectionist measures is effective in correcting BOP deficit in the short run, are **unable to solve the issue of the loss of CA**. The use of such measures could be **counterproductive** as it **impedes efficiencies** and might lead to a **more severe BOP issue in the long run**. Hence, the use of appropriate **supply-side measures** would be a better solution albeit more time is needed for these measures to make a positive impact on the economy. (Consider the social values of the Japanese- willingness to accept foreign workers etc?)

Level 1	<b>One-sided argument</b> on how protectionist measure is able to correct BOP deficit. Lacked rigour in explain how the protectionist measure can correct BOP deficit, such as only explain the effect on either trade balance or capital & financial account only.	1-4
Level 2	<b>Good one-sided</b> illustration of how protectionist measures can correct BOP deficit provided with <b>adequate limitations</b> of the measures. Balanced answer, explain <b>1 alternative policy</b> that correct BOP deficit.	Max 6 5-8
Level 3	<b>Good illustration</b> and <b>evaluation</b> of protectionist measures in correcting BOP deficit and suggest at least <b>2 alternative policies (with limitations)</b> that address the threat of losing CA. High L3 marks will be given for <b>good use of real world examples</b> .	9-11
E1	<b>Make a stand</b> on whether the use of protectionist measure is the best policy to correct a BOP deficit.	1-2
E2	<b>Substantiate the stand.</b>	3-4

**Question 6**

- (a) Account for the trend towards globalisation. [8]  
 (b) How far do the benefits from globalisation that Singapore enjoys conflict with some of the main government objectives? [17]

**Part (a)**

Define Globalisation

The improvement in technology, physical and financial infrastructure, government policies are key drivers for increasing trend of globalisation due to the following reasons (non-exhaustive):

- Reduction in transport costs
- Reduction in information imperfection and immobility of factors
- Production Technology, increase in the likelihood of internal economies of scale and/or delays in the onset of internal diseconomies of scale
- New developments in information technology and communication capacity, software advances and huge expansions in global data transmission infrastructure have driven down telecommunication prices while at the same time increasing bandwidth. This has made it possible to share work across continents and oceans

**Link to freer trade, increase labour mobility, capital mobility and transfer in technology**

<b>Knowledge, Application, Understanding and Analysis</b>		
<b>L3</b>	- Structure & linking sentences are present - Rigour in economic analysis –3 factors why there is an increase in the freer trade, labour and capital mobility	<b>7-8</b>
<b>L2</b>	-An accurate but undeveloped/ lapses in explanation	<b>4-6</b>
<b>L1</b>	- Content: Weak - Mainly irrelevancies and substantial glaring conceptual errors	<b>1-3</b>

**Part (b)**

Introduction

Offer a short description regarding the economy of Singapore

List and explain the four macro-economic objectives and two micro-economic objectives

- sustained economic growth
- price stability
- low unemployment
- healthy BOP and strong exchange rate
- efficiency
- equity

Body

- link the benefits of globalisation such as-
  - greater trade, trade creation, opening of export markets to greater and sustained growth
  - Labour mobility
  - Capital mobility
  - Transfer of technology
    - Greater AD due to export demand, investment

- Ability to increase AS due to the import of input factors, lower labour cost, an increase in productive capacity
- Comment on the compatibility or conflict of above benefits with the other macroeconomic objectives
  - Price stability
    - Could lead to higher prices due to increased growth and demand
    - Could lead to lower prices if foreign goods are cheap, OR subjected to imported inflation
    - Over-reliance on imports/external markets, leading to greater vulnerability of the economy to external shocks.
    - Reliance on imports may threaten price stability
    - CPF policy (savings) and strong Singapore dollar (against imported inflation) also helps keep inflation low.
  - Unemployment
    - Could lead to structural unemployment
    - Could lead to higher employment in long run, if structural changes are dealt with
  - BOP equilibrium
    - Growth could lead to BOP deficits.
    - However, given the fact that Singapore is a value-added economy, the exports are usually of higher value than imports, thereby, lowering chances of BOP deficits
  - Efficiency
    - greater economic efficiency, small size of Singapore's domestic market, with greater export market, with increased competitiveness (with removal of tariffs), more earnings and higher wages, trade creation, greater employment, increase in technological know-how, greater FDI flows (demonstration and competitive effect)
    - With larger market, might be able to produce nearer to MES (depends on the products)
    - Enjoys IEOS or suffer x-inefficiency
  - Equity
    - Factor owners vs workers
    - Skilled vs unskilled workers
    - Structural unemployment – problem especially so with aging population and the difficulty to get older workers to re-train.
    - Dual economy, greater income inequality

#### Conclusion & Evaluation

- Overall, more difficult for government to stabilise the economy.
- Make an assessment of whether the benefits from globalisation are beneficial, weighing the benefits against the costs in Singapore's context.
- Recognise that FTAs are an integral part of Singapore's trade architecture; designed to generate higher level of economic growth by positioning Singapore as an integrated manufacturing centre in this region; promote research & development in our knowledge-based economy and drive the services hub. The main benefit of FTAs is sustained growth which may possibly conflict with price stability in the short run, depending on our expansion of our productive capacity
- Government policies may help to reduce the conflicts among the objectives
- Short run vs long run; the conflict may be present in the SR - current sacrifices may lead to future growth...

<b>Knowledge, Application, Understanding and Analysis</b>		
<b>L3</b>	TAS structure should be used when discussing the benefits and costs of globalisation. Discuss at least 3 macro + 1 micro objectives Good exemplification – Singapore context	<b>10-13</b>
<b>L2</b>	An accurate but undeveloped explanation of the rationale for globalisation. Able to recognise both the compatibility or conflict among the objectives for Singapore economy.	<b>6-9</b>
<b>L1</b>	For an answer that shows some knowledge of globalisation One-sided answer No economic framework used	<b>1-5</b>
<b>Evaluation</b>		
<b>E2</b>	For an evaluative assessment based on economic analysis or empirical evidence.	<b>3 – 4</b>
<b>E1</b>	For an evaluative assessment not supported by analysis.	<b>1 – 2</b>