INNOVA JUNIOR COLLEGE
JC 2 PRELIMINARY EXAMINATION 2
in preparation for General Certificate of Education Advanced Level
Higher 2

ECONOMICS 9732/01

Paper 1: Case Study

14 September 2015

2 hours 15 minutes

Additional Materials: Writing Paper and Cover page

READ THESE INSTRUCTIONS FIRST

Write your name and class on all the work you hand in.
Write in dark blue or black pen on both sides of the paper.
You may use a soft pencil for any diagrams, graphs or rough working.
Do not use staples, paper clips, highlighters, glue or correction fluid/tape.

Answer **all** questions.

Section A: Case Study
Answer **all** questions.

Section B: Case Study
Answer **all** questions.

Please begin each question on a **fresh sheet of paper**.

At the end of the examination, **submit Sections A and B separately**.
Attach a **cover sheet** to Section A only.

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

You are advised to spend several minutes reading through the data before you begin writing your answers.

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

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

Section A

Answer **all** questions

Question 1

Unfair flights: Competition between American and Gulf Air Carriers

Table 1: Passenger traffic growth of major airlines in 2014

Airline	2-year change (%)
Etihad (Gulf)	43.4
Emirates (Gulf)	34.2
Qatar (Gulf)	27.3
British Airways	11.9
Lufthansa	8.7
Singapore	8.2
Air France	2.6
American (US)	1.5
Delta (US)	1.1
Southwest (US)	0.6
United (US)	-1.8

Source: *Airline Business World Airline Rankings, The Wall Street Journal*

Extract 1: The rapid growth of Gulf carriers

In the last five years, Gulf carriers Etihad, Emirates and Qatar Airways have flooded the market, with some 252 direct flights a week from their respective hubs to 10 U.S. cities alone, from Seattle to Chicago to New York. Their rise has coincided with the emergence of a new global middle class and a surge in global air travel. Unsurprisingly, the fastest-growing market in air travel comes from emerging economies — places that the Gulf carriers serve well. The three hubs of Dubai, Abu Dhabi, and Doha are blessed with fortunate commercial geography: They are a four-hour flight to one-third of the world's population and an eight-hour flight to two-thirds. Foresighted Middle Eastern governments built air hubs and national airlines to exploit their comparative geographic advantage.

Delta, United, and American Airlines — the three largest U.S. carriers — are displeased with the rise of the Gulf airlines. The Gulf airlines, after all, are cutting into the U.S. long-haul business, the most lucrative in aviation. It is not surprising to see Americans flying domestic flights within the US, but switching to the more attractive gulf carriers to reach global destinations.

Now, Delta, United, and American are engaged in an orchestrated campaign to demand that Washington curtail those carriers' direct flights into the United States. The message of Americans for Fair Skies is simple: The Gulf carriers are operating on an uneven playing field, deriving tremendous benefits from their state ownership, including a slew of alleged subsidies of some $40 billion from Gulf governments over the past decade.

The Gulf carriers generally retort that consumers enjoy their award-winning premium service and benefit from their global connectivity all across Asia, Africa, and the Middle East. "What Emirates is doing is competing in the marketplace — we don't 'take' or 'steal' customers. We offer a great product at a competitive price, which appeals to the consumers who choose to fly with us." Besides, a good number of flight routes of the Gulf carriers do not directly overlap with those of the U.S. carriers.

A broad network of American businesses — from Boeing to JetBlue (a budget domestic carrier) to a constellation of airport councils and travel services companies — are crying foul against the American carriers' actions. It is obvious why Boeing is uncomfortable with the U.S. carriers' effort to limit the Middle Eastern airlines. After all, the Gulf carriers are among the biggest foreign buyers of its aircraft. At the 2013 Dubai Airshow, Emirates and Etihad dazzled the aviation world with some $100 billion in orders for Boeing aircraft. A few months later, Qatar Airways ordered another 50 Boeing aircraft, at a list price of $37.7 billion. If you're keeping tabs, that's nearly $140 billion of aircraft orders in less than six months. And between now and 2027, the Gulf carriers will add another 534 new wide-body aircraft to their fleets, according to Credit Suisse. That's a lot of Boeing and Airbus planes — and lots of American and European manufacturing jobs.

Since 2005, U.S. airlines have also been consolidating at a rapid rate: America West with U.S. Airways, Northwest with Delta, Continental with United, AirTran with Southwest, and then, most recently, U.S. Airways with American. The U.S. Airways-American merger prompted a Justice Department antitrust lawsuit. "In recent years, major airlines have, in tandem, raised fares, imposed new and higher fees and reduced service," the Justice Department noted. Then Attorney General Eric Holder said in an August 2013 statement that "This transaction would result in consumers paying the price — in higher airfares, higher fees and fewer choices." Ultimately, the merger was approved. Today, as a result of these consolidations, only four carriers handle 80 percent of U.S. airline seat capacity.

Source: Adapted from *Foreign Policy*, May 2014

Extract 2: Continued consolidation of the airline industry

Globally, International Air Transport Association (IATA) forecasts $3 billion profits this year for the entire industry, on revenues of more than $600 billion. Even those razor-thin margins are down to a handful of major carriers that continue to boom in China and the Asia-Pacific countries. IATA's chairman said, "The number of airlines in the industry is too many. It's too fragmented, and consolidation is a good thing."

Consolidation, most agree, will continue and accelerate. The International Airlines Group (IAG) chief executive agrees that there are too many carriers. "Many will disappear. And you won't see new airlines appear. The barriers to entry are much higher now." The future, he says, will be waiting for the weakest "to go bankrupt – it's the cheapest form of consolidation". Walsh points to the US, where the consolidation of major airlines has left a "stronger, more rational industry over time".

Source: Adapted from *The Guardian*, June 2012

Extract 3: A step towards a new global standard for emissions

The US Environmental Protection Agency (EPA) has said that greenhouse gases from aircraft endanger human health, taking the first step toward regulating emissions from the domestic aviation industry. The EPA's finding kicks off a process to regulate greenhouse gas emissions from the aviation industry. Aviation accounted for 11% of energy-related carbon dioxide emissions from the transportation sector in 2010 in the United States, according to the International Council on Clean Transportation.

The airline industry has favoured a global standard over individual national standards since airlines operate all over the world and want to avoid a patchwork of rules and measures, such as taxes, charges and emissions trading programs. But some environmental groups are concerned that the standard being discussed will do little to change the status quo since it would only apply to new and newly designed aircraft that will not be in operation for several years. They instead argued for a harsh carbon tax which would cost airlines more.

Source: *The Guardian*, June 2015

Questions

(a) Compare the passenger traffic growth of Gulf carriers and other major airlines for the period 2012-2014. [1]

(b) Comment on the value of the cross-elasticity of demand between flights by American Airlines and Emirates. [3]

(c) Explain, with a relevant example, why a "broad network of American businesses… are crying foul against" the American carriers trying to limit the expansion of the Gulf carriers in extract 3. [3]

(d) Extracts 1 and 2 mention the consolidation of the airline industry either through the disappearance of firms or mergers.

(i) Explain how the weaker airlines will eventually 'disappear'. [3]

(ii) Assess the impact of the US Airways-American merger on consumers and producers. [8]

(e) **(i)** Explain how negative externalities could arise in the airline industry. [2]

(ii) In light of the data provided, discuss whether you would recommend the U.S. government to intervene in the airline industry for a more efficient outcome. [10]

[Total 30 marks]

Section B

Answer **all** questions

Question 2

Globalisation and Economic Growth

Extract 4: BRICS economies face challenges over growth

By the standards of the developed world, the BRICS economics – comprising Brazil, Russia, India, China and South America are still surging. But their growth rates are a fraction of what it once was – thanks to stagnation on the developed world, in particular the Eurozone.

India's economy will grow by the lowest in a decade this year. Reforms undertaken by Finance Minister Palaniappan Chidambaram, including reduced fuel subsidies, faster privatisation, curbing the budget and current account deficits, and easing of restrictions on foreign investment in retail and airlines will take time to bear fruit. Meanwhile, corporate chiefs grumble privately about the difficulties of doing businesses. A reluctance to make sweeping reforms to labour and land laws deters entrepreneurs from undertaking investments.

South Africa's economic growth has been badly hit by strikes in the mining sector last year. 50 lives were lost, and it cost the industry massively. Unsurprisingly, the current account deficit worsened and the currency depreciated. South Africa's growth had already been sluggish since the 2008 global economic crisis. With a third of manufactured exports shipped to Europe, it is exposed to the current Eurozone crisis. It is also adversely affected by infrastructure constraints and poor investor sentiment.

The BRICS economy, worst affected by the Eurozone crisis, is Brazil. But some of its problems are self-inflicted. A softening of commodity prices and global risk aversion coincided with a crackdown by Brazil on capital inflows, which it feared contributed to an appreciation of its currency against the dollar and was making local industry uncompetitive. At the same time, a consumer credit boom was losing steam and investors were becoming more cautious about a perceived increase in government intervention in the economy. Industries struggled because of high costs, rising wages and weak productivity gains.

Source: Adapted from *Financial Times,* March 2013

Extract 5: Wine and shine

China is investigating European wine exports on anti-dumping grounds and because of suspicion of unfair subsidies to winemakers. This comes a day after the EU imposed tariffs on Chinese solar panels, and has sparked fears of a trade war. France which exported 71% of the €763m of wine sold to China last year was the biggest backer of the solar tariffs.

China is by far the world's leading producer of the panels, dominating 80% of the global market. European business lobbies argue that Chinese producers receive state subsidies and cheap loans. The EU bought €21bn of Chinese solar panels in recent years. The European Commission accused China of undercutting European rivals by selling panels below-cost and threatening 25,000 jobs in the European solar industry. It described the tariffs as "an emergency measure to give life-saving oxygen to a business sector in Europe that is suffering badly from this dumping." This is the largest anti-dumping case undertaken by the commission.

While tariffs have been imposed, the EU is still negotiating with China before a final decision on duties is made in December. Observers note that it remains unclear how a final settlement will look like, because Europe's interests are divided since only a few countries produce solar panels but there are many jobs associated with the installation of the panels.

Source: Adapted from *The Guardian,* June 2013

Extract 6: The many hidden faces of protectionism

While countries are reducing import tariffs and imposing fewer quotas on their trading partners, protectionism has crept back in other guises. In contrast the World Trade Organisation (WTO), which focuses on measures designed to explicitly keep exports out, the London-based Centre for Economic Policy Research which runs Global Trade Alert (GTA) defines protectionism more broadly. Anything that hurts another country's commercial such as government bailouts of domestic firms, wage subsidies, export and tax rebates and preferential financing from state-owned banks, including France's loan guarantee to carmaker PSA Peugeot Citroën, counts as protectionism.

Industrial policy, used to build up a country's capability in specific manufacturing sectors, is another such measure. Last year, the Brazilian government increased sales tax under its Inovar-Auto programme designed to provide vehicle technology innovation. But foreign manufacturers who increase spending on local R&D, meet new fuel-efficiency standards and increase the number of domestic production processes, will get tax credits. Brazilian Biotech companies receive low-interest loans and equity capital injections from BNDES, the state-owned bank. Supporters point out that Australia, Britain and America subsidise basic biotech research.

With their state-capitalist model, the line between industrial policy and export subsidy is blurred in the BRICS economies. China has long used compulsory joint ventures, technology transfer and access to cheap land and loans from state-owned banks to boost companies in strategic sectors. This was how Chinese firms came to dominate the domestic and increasingly global market for wind-power turbines and solar panels. The EU's trade commissioner, Karel De Gucht, alleges that to discover which industries are dumping, "you read China's last five-year plan." This may be true, but it is difficult to punish protectionism in industries where industrial policy is the rule, not the exception.

But many such policies are riddled with problems. Brazil's Petrobras ability to exploit new deep-sea oil deposits is hampered by the country's limited oilfield equipment producing capability. While industrial policy may boost specific industries, the increased role of state which comes with it stifles private enterprise and cause under-investment in human and physical capital. Brazil and India have been held back because state resources have gone to preferred sectors and constituencies instead of boosting their productive capacities.

In a globalised economy, countries can better attain economic prosperity with lesser protectionism

Source: Adapted from *The Economist,* Oct 2013

Table 2: GDP Growth Rates (%)

Country/Year	**2010**	**2011**	**2012**	**2013**
Brazil	7.6	3.9	1.8	2.7
China	10.6	9.5	7.8	7.7
India	10.3	6.6	5.1	6.9
South Africa	3.0	3.2	2.2	2.2

Table 3: External balance on goods and services (% of GDP)

Country/Year	**2010**	**2011**	**2012**	**2013**
Brazil	-1.0	-0.8	-1.4	-2.3
China	3.0	2.1	2.7	2.7
India	-4.4	-6.5	-6.7	-3.0
South Africa	1.2	0.9	-1.3	-2.3

Source: *World Bank*

Questions

(a) Compare the change in India's external balance on goods and services as a percentage of GDP with that of South Africa between 2010 and 2013. [2]

(b) Explain how might the change in external balance on goods and services in Table 3 affect the GDP growth of India. [3]

(c) With the aid of a diagram, explain why the imposition of tariffs benefits some parties but not others. [4]

(d) Explain the case for considering China's industrial policy as a form of protectionism. [3]

(e) To what extent can the slowdown of the BRIC economies be attributed to economic conditions in developed countries? [8]

(f) Discuss the view expressed in Extract 6 that "in a globalised economy, countries can better attain economic prosperity with lesser protectionism". [10]

[Total 30 marks]

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