

National Junior College
SH2 Preliminary Examination for General Certificate of Education Advanced Level
Higher 3

ECONOMICS

Paper 1

3 hours 15 minutes

Additional Materials: Answer Paper

9808/01

16 Sep 2016

READ THESE INSTRUCTIONS FIRST

Write your student registration number and name 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 paper clips, highlighters, glue or correction fluid.

Section A

Answer **all** questions.

Section B

Answer **two** questions.

Begin each question on a fresh sheet of paper.

At the end of the examination, staple a cover sheet on top of each answer and submit the answer to each question separately.

Indicate all the required information on the cover sheet.

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

This paper consists of **11** printed pages, including the cover sheet.

Section A

Answer **all** questions in this section.

1 The European Union

Article 1: The storm over new European Union climate-change targets

Energy and green policies should be ideal for common European action. Pollutants know no borders. The cost of renewables such as wind turbines and solar panels can be cut, and their drawbacks mitigated, if they are linked across Europe. When the wind stops blowing in Germany the sun shines in Spain; if both sources die down, French nuclear plants or Swiss hydroelectric stations can take up the slack. A proper European-level emissions-trading scheme should minimise the cost of reducing greenhouse gases. And a successful low-carbon transition should reduce dependence on imported fossil fuels.

Yet the reality is messier. The EU struggles with a hotch-potch of national policies, conflicting and expensive subsidies, Balkanised energy markets and ever-growing reliance on fuel imports. After years of crisis, Europeans are more concerned with the cost of climate-change policies than with their benefits. European industries pay three to four times more for gas, and over twice as much for electricity, as American ones (which benefit from cheap shale gas). One reason Europe has so far met its emissions targets is its long economic slump. Yet recession and deindustrialisation are hardly a climate-change policy.

So the EU's new planned emissions targets, announced this week, were contentious. When wages are being squeezed to regain export competitiveness, it is hard to sell the idea of higher energy prices, particularly when the rest of the world is doing too little to cut greenhouse gases. The current policy is known as 20-20-20: by 2020 its members should reduce greenhouse-gas emissions by 20% (relative to levels in 1990), with 20% of the mix produced from renewable sources and a 20% improvement in energy efficiency. After an unusually acrimonious internal debate, the European Commission called this week for the ambition to be raised to a 40% reduction in emissions by 2030. It wants a "binding" EU-wide target of at least 27% for the share of renewables, though there would be no new national targets for renewable energy. The commission also refrained from proposing new legislation to regulate the development of shale gas.

The decision to give greater flexibility for countries to determine their own energy mix is a victory for Britain. But there were protests from several quarters. Green lobbyists called the targets too tame. By 2030, many say, Europe needs a 55% emissions cut, with 45% of energy derived from renewables, if it is to meet a goal of cutting greenhouse gases by 80-95% in 2050 (the cut in rich-world emissions deemed necessary to limit the rise in global temperatures to below 2°C). By contrast the EU's business lobby is alarmed about rising energy costs, and says the EU is at risk of naively becoming "a lone front-runner without followers".

Increasingly, the commission has had to cast the argument in terms of saving Europe rather than the planet. In a concession to industry, the commission proposes to maintain free emissions allocations to an ever-growing number of sectors deemed to be vulnerable to rising energy costs (including makers of clocks and musical instruments).

The fury over emissions targets misses a deeper problem: Europe's carbon and energy markets are dysfunctional. The emissions trading scheme was meant to put a price on carbon to encourage alternatives. But poor policy design, a recession and too many exemptions mean the price has collapsed. The commission has proposed a sort of "central bank" of emissions permits to stabilise the market, but it will take years to sort out.

And although many are right to worry that Europe's energy prices are higher than its competitors', too little attention is paid to wild differences within Europe. Spain generates large amounts of solar and wind power, but can export little to France given poor grid interconnections. Unless Europe's markets are fixed so that emissions permits, gas and electricity can be traded across the continent, ever more ambitious climate-change targets risk becoming an ever more expensive failure.

Source: *The Economist*, 25 January 2014

Article 2: The Question Hanging Over Greek Debt

It is perhaps the thorniest question that will face Alexis Tsipras, Greece's left leaning firebrand, if he is voted into power next month: Should he keep servicing Greece's punishing debt load?

Having campaigned for months on a strong anti-austerity program, Mr. Tsipras will face pressure, if he wins, to secure better terms from Greece's creditors to cut the country's debt burden of 177 percent of gross domestic product, the second largest in the world among developed nations after Japan.

He does not have many options, however.

Next year, according to research from Nomura, Greece will need to pay 22.3 billion euros in principal and interest on various loans — a sum that is just a bit more than what the government is paying state employees this year, according to the International Monetary Fund.

A major recipient for this payday will be those who took some of the biggest risks in loading up on Greek bonds during the debt crisis: the European Central Bank (E.C.B.) and distressed investors.

According to Nomura, Greece is scheduled to pay to the E.C.B. 8 billion euros in bond payments next year, with 7.6 billion of that amount coming in July and August. Distressed investors like Dart, which refused to participate in Greece's debt restructuring in 2012, will also be getting paid in 2015 — to the tune of 459 million euros. Included among the original hold-out investors were Aurelius Capital, ABN Amro and Loomis Sayles.

Out of a budget of 85 billion euros, that sum is less than daunting. Still, with unemployment at 25 percent and with many middle-class families struggling to feed and educate their children, half a billion euros could buy a lot school lunches.

The other main lender on Greece's repayment schedule is the I.M.F., which by tradition, never accepts having its loans restructured. As for Greece's creditors in the eurozone, they have all agreed to restructure their claims by extending maturities so that Greece will pay hardly anything to Brussels next year.

With the elections approaching, Mr. Tsipras has been cautious in terms of approaching the E.C.B. about its debt and he has made no threats or proclamations. That is because the more uncertainty increases in the markets, the more reliant Greece and its banks will be on accessing emergency loans from Frankfurt.

As for reneging on the holdout investors, such a step, while no doubt popular, also carries risks like lawsuits from the types of deep-pocketed hedge funds that have battled Argentina over its debt. The Greek bonds were bought in 2010 and 2011 by distressed debt investors because they were foreign law securities, unlike most Greek bonds, which at the time were governed by Greek law. Holdout investors prefer foreign law to local law bonds because it is easier to file suit if the sovereign nation restructures or defaults on the bonds.

Indeed, it is for this very reason that Europe did not challenge these investors in 2012. The debt restructuring would be worth 105 billion euros and as more than 90 percent of bondholders participated, bureaucrats in Brussels reluctantly decided that the holdouts would be paid in full.

As result, analysts believe that Mr. Tsipras will do more or less the same if he sweeps into power in January — pinch his nose and keep on paying.

Source: *The New York Times*, 30 December 2014

Article 3: Eurozone approves next Greece bailout payment

Eurozone ministers have signed off the next 8.3bn euro (£6.8bn; \$11.4bn) instalment of Greece's bailout. A first tranche of 6.3bn euros will be paid at the end of April, Eurogroup chairman Jeroen Dijsselbloem said at a meeting of finance ministers in Athens. Two more payments of 1bn euros will be made in June and July, he added.

Greece continues to struggle with high debt and unemployment. Discussions at Tuesday and Wednesday's meetings include Greece's austerity programme and market reforms demanded under the terms of its international bailouts.

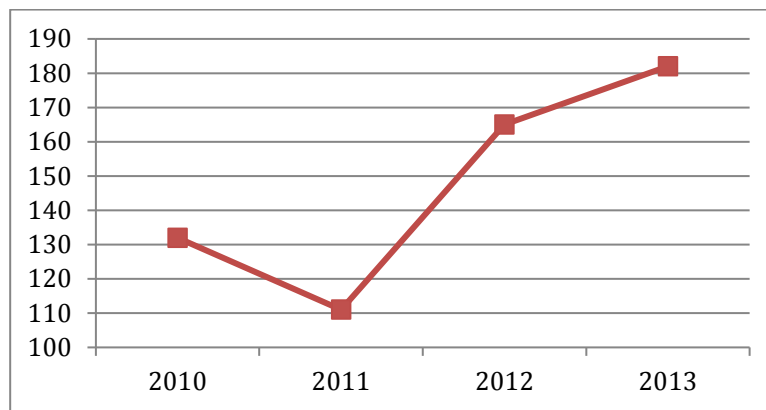
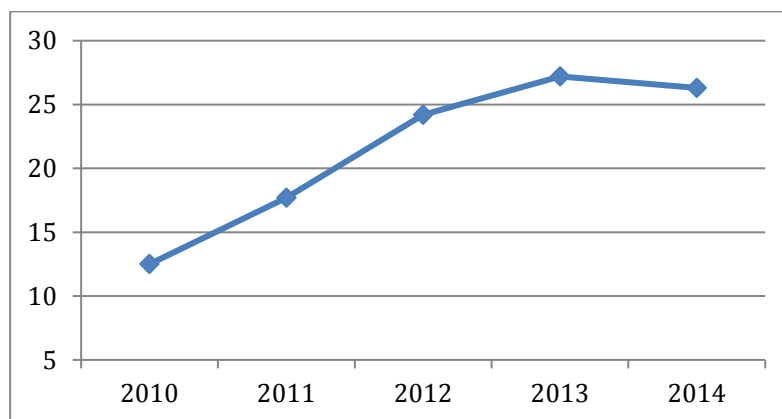
The latest bailout is one of the last Greece will get from the eurozone. The International Monetary Fund will continue to pay its instalments for some months. It comes after the Greek parliament narrowly passed a raft of reforms, mainly to open up retail sectors to competition.

The latest bailout announcement comes amid renewed optimism about Greece's economic recovery. Greece has wiped out its deficit, except for interest on its debt, and is forecast to exit six years of recession this year.

Athens hopes the progress will spur the Eurozone to consider debt relief in the coming months, by lowering the interest rate on its loans or extending the repayment period, our correspondent adds. But unions and left-wing groups have called for mass protests on Tuesday. They say people are still suffering under the austerity measures implemented under the bailout terms.

Unemployment is running at 27%, and many Greeks are still feeling the effects of tax rises and spending cuts.

Source: *BBC*, 1 April 2014

Figure 1: Greece's central government debt, total (% of GDP)**Figure 2: Greece's unemployment rate (% of total labor force)**

Source: *World Bank*

Article 4: Eurozone stagnation is a greater threat than debt

It would be wrong to think last week's global market gyrations signal a return of the Eurozone debt crisis. Sovereign bond spreads in the Eurozone did not move by much, except in Greece.

What happened last week is something rather different. Financial markets have woken up to the possibility of a Eurozone-wide economic depression with very low inflation over the next 10 to 20 years. This is what the fall in various measures of inflation expectations tells us. Investors are not worried about the solvency of a member state. That was clearly different two years ago.

But the present scenario is no less disturbing. The implications for those who live in such an economic snake pit are already visible: high unemployment; rising poverty; real and nominal wage stagnation; a debt burden that will not come down in real terms; a decline in public sector services, and in public investment.

Secular stagnation – the idea that a chronic shortfall of investment might produce a long period of weak demand – has disturbing implications. With secular stagnation comes a permanent fall in inflation to levels below the 2 per cent target. The real value of public and private-sector debt will not therefore come down as fast as it

should. This in turn will make it harder for governments, companies and individuals to reduce their debt. In such an environment, expect default rates to be high. German sovereign bonds become the only asset in the Eurozone that investors regard as more or less risk-free.

One would have thought that such a scenario would produce counteracting forces, for example a weaker exchange rate. Unfortunately, that is not necessarily true. The Eurozone is running a current account surplus of close to 3 per cent of GDP this year. One would normally expect the currency of an economy with a persistent current account surplus to be strong. In any case, the exchange rate matters a lot more for smaller and medium-sized economies than for large ones such as the US and the Eurozone because the share of trade in GDP tends to be smaller for large economies than for small ones.

The Eurozone is a large semi-closed economy, trading most of its goods and service internally, in euros. Whatever is going to save the Eurozone, it cannot be the exchange rate, unless the euro depreciates to an extreme extent.

Secular stagnation is thus a lot more dramatic than a debt crisis. With such a threat hanging over us, one would have thought every rational policy maker would want to avoid such a calamity. That would indeed be the case if the crisis occurred in a normal country. For a monetary union where policy is not co-ordinated and where policy makers take a national perspective, the risk of secular stagnation looms large. Even the European Central Bank, the only actor with a Eurozone-wide concern, faces legal constraints. This may explain its reluctance to go for quantitative easing (QE).

Eurozone policy makers face three choices. First, they can transform the Eurozone into a political union, and do whatever it takes: a eurobond, a small fiscal union, transfer mechanisms and a banking union worthy of its name. Second, they can accept secular stagnation. The final choice is a break-up of the Eurozone. The second and third choices are not mutually exclusive. As the political union is firmly off the table, this leaves us with a choice between depression and failure – or both in succession.

Source: *The Financial Times*, 19 October 2014

Table 1: Macroeconomic data on some Eurozone countries

	France	Germany	Lithuania
Merchandise trade (% of GDP) in 2014	44.4	69.8	138
Central government debt, total (% of GDP) in 2013	88.6	52.3	43.8
GDP per person employed (constant 2011 PPP \$) in 2014	89,700	84,100	54,300
Renewable energy consumption (% of total final energy consumption) in 2012	12.6	12.38	24.28

Source: *World Bank*

Questions

- (a) Discuss whether a “European-level emissions-trading scheme” will be effective in addressing the carbon emissions problem in the European Union. [8]
- (b) In the light of the uncertainty in Greece and the possible moral hazard, discuss whether “holdout investors” should continue to hold on to Greek bonds and whether the Eurozone should continue to pay the bailout to Greece. [8]
- (c) With reference to Figure 1 and 2, explain the possible relationship between a country’s central government debt and unemployment rate. [6]
- (d) Using your own knowledge and evidence in the data, discuss the validity of the view that Eurozone countries suffer rather than benefit by being part of the European Union. [8]

[Total marks: 30]

Section B

Attempt **TWO** questions from this section.

- 2** 'Statistics is the art of lying by means of figures' Wilhelm Stekel.

Discuss whether the reliance on statistical analysis and mathematical models has been an asset or a liability in advancing the usefulness of economics.

[35]

- 3** The British's National Health Service (NHS) is provided by a single payer — the British government — and is funded by the taxpayer. All appointments and treatments are free to the patient (though paid for through taxes), as are almost all prescription drugs.

Assess the economic justifications for British intervention in healthcare and discuss whether its intervention is the most effective.

[35]

- 4** In recent years, Chinese businesses have made aggressive moves onto the global stage. A decade ago, only very few Chinese companies had major operations beyond the country's borders. Yet by year 2014 some companies like Lenovo, Huawei and ZTE are earning more than half of their revenues abroad.

Source: *Forbes*, October 2014

Discuss the impact of entry of Chinese multinational enterprises on profitability of firms of the host country and on its economic efficiency and welfare.

[35]

- 5** Some motorist and drivers habitually commit minor parking and traffic offences. Some construction companies do not comply with the safety regulation required at work sites.

Assess the usefulness of the analysis of risk and uncertainty in helping to explain these actions and evaluate the measures that might be taken by the relevant authorities to reduce such offences.

[35]

- 6** Discuss whether government intervention in trade is desirable in an age of increasing globalisation.

[35]

- 7** "We are all aware that certain multinationals pay little or no tax on the vast profits that they make here in Europe and this is absolutely unacceptable. That's why we need to ensure that profits generated in the EU are taxed at an appropriate level where the activity takes place"

Pierre Moscovici, European Commissioner
for Economic and Financial Affairs, Taxation and Customs

Discuss whether Multinational Enterprises brings about benefits than costs to countries that they operate in.

[35]

