

RIVER VALLEY HIGH SCHOOL
YEAR 6 Preliminary Examination II
in preparation for General Certificate of Education Advanced Level
Higher 2

ECONOMICS

9732/01

Paper 1 Case Study

14 September 2016

2 hours 15 minutes

Additional Materials: Answer Paper

READ THESE INSTRUCTIONS FIRST

Write your index 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 staples, paper clips, highlighters, glue or correction fluid.

Answer **all** questions.

Start each case study on a new sheet of paper.

At the end of the examination, fasten your work securely together.
Your answers for each case study are to be handed in **separately**.

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



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

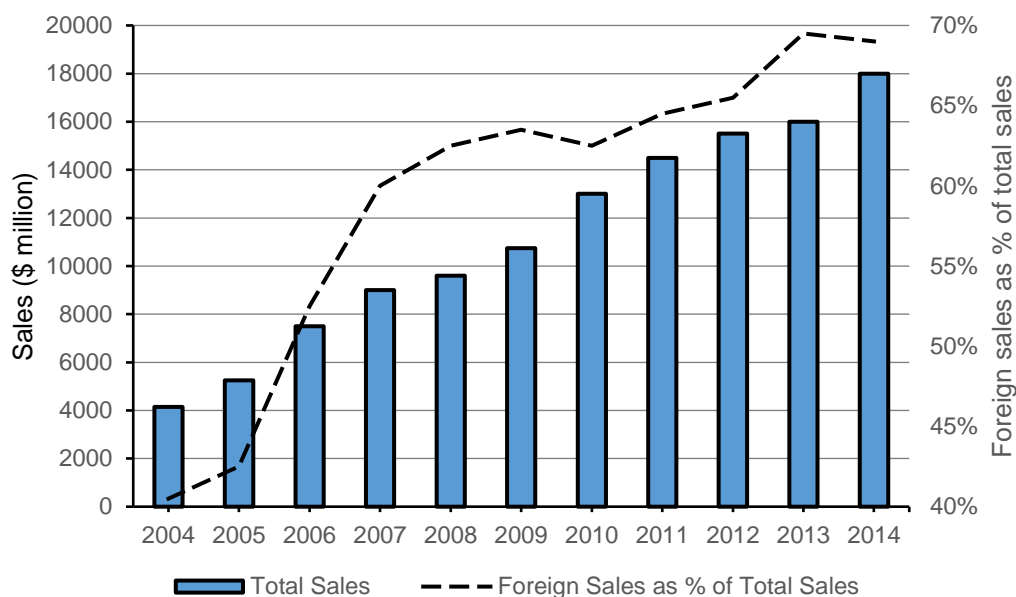
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Answer **all** questions.

Question 1

Issues in the pharmaceutical industry

Figure 1: Sales of Indian generic drug companies



Source: *Pharmabiz*

Extract 1: India's New Drug-Price Controls: Unintended Consequences?

The new price controls on diabetes and heart drugs are bad news for Indian pharmaceutical companies. According to research, the total value of diabetes and heart-medicine sales in India could decline around 12%.

India's National Pharmaceutical Pricing Authority, which regulates drug prices, says the prices of these medicines will be capped as the current large price differences between different brands of the same drug were "indicative of a severe market failure."

Some companies may face a smaller hit. Market researchers expects the effect on earnings to be less than 1% for Sun Pharmaceutical Industries Ltd. despite 30% of its India sales coming from diabetes and heart medicines. This is probably because the company's prices are nearer to the price cap imposed. Overall, the actual effect on earnings will be minimal for many companies.

On the other hand, the price control could have negative consequences on the availability of some drugs. That is because, when other medications have had price caps set in the past, sales have declined because some companies cut back on production of the drugs for domestic use. As a result, India has begun importing some older antibiotics from China.

Ultimately, price caps at home could lead the pharmaceutical industry to look elsewhere for growth. If price controls are expanded further, the industry could move production elsewhere. Most of India's largest drug makers already have plants outside India, particularly in the U.S. and Europe. But they are increasingly expanding into Africa, Southeast Asia and China where, like in India, labor is cheaper and the cost of running a plant is lower.

Source: *The Wall Street Journal*, 15 July 2014

Extract 2: Debates on pricing practices

Of all the goods and services traded in the market economy, pharmaceuticals are perhaps the most contentious. There is a widespread belief that people have a right to health care. Yet, the price of drugs is much higher than their cost of production, making them unaffordable to many poor people.

However, pharmaceuticals have argued that prices of drugs are high as they need to recover the high cost of innovation. Moreover, they have been trying to make drugs more affordable in emerging markets. By varying their prices more—charging Americans more than others—firms can pep up their profits and at the same time expand their markets, making both shareholders and the sick better off. Some companies are trying this by creating new brands and packaging for lower-priced drugs in India.

Nonetheless, there are also critics who said that emerging markets are gradually making bigger contribution to pharmaceutical company revenues. As such countries get more prosperous, their elites get richer and it is not fair that the Americans should subsidise the cost of research and development for drugs while rich Indians benefit from the lower prices.

Source: *The Economist*, 4 January 2014

Extract 3: Rapid price increases of generic drugs

In recent years, generics have curbed the rise of drug prices. This is because generic medicines are far cheaper to produce than brand-name drugs because they involve little research and development and they are also priced lower because generics typically face intense competition. After the patent for Ambien (a sleeping pill) expired in the last few years, generics entered the market and prices plummeted.

But increasingly, experts say, the price of some generic drugs are going the other way. The prices of some generic drugs have more than doubled since last year. In late 2013, one of the three companies producing digoxin, one of the oldest known heart medicines, increased its price, and the others soon followed. There was no drug shortage that might explain the increase. There were no new patents and it is also not hard to make. Though there are many newer types of drugs to treat heart disease, for some patients there are no effective substitutes for digoxin.

One of the companies cited higher costs of acquiring raw material, increased costs of ensuring quality of the drugs and manufacturers exiting the market as reasons for the increase in price. The Federal Trade Commission has been examining anticompetitive practices in the generic drug industry, but there is often little which the agency can do if businesses take advantage of the market power they gain if it happens naturally through companies leaving the market.

Source: *The New York Times*, 8 July 2014

Extract 4: Firms face more threats on India patents

The pharmaceutical industry relies on patent that give them the exclusive right to sell a drug. The rationale is that they need these patents to recover their high capital expenditure in researching the drug. India's government is looking to study more than 20 drugs and recommend that compulsory licenses be issued to allow local firms to make low-priced copies in India. These licenses are needed as the drugs are protected by patents. Compulsory licensing, a form of relaxation of patent laws, occurs when a government allows someone else to produce a patented product without the consent of the patent owner.

The heightened scrutiny illustrates how emerging markets are becoming harder to navigate for global drugmakers. "Moves by policymakers like compulsory licensing results in the feeling that you're not very comfortable investing," a consultant said. "You can't build predictability, and pharmaceutical companies don't like that." Moreover, any award of compulsory licenses will take time because the process is fraught with bureaucracy.

Source: *Bloomberg*, 28 January 2014

Questions

- (a) (i) Compare the foreign sales relative to the total sales of Indian generic drugs from 2004 to 2014. [1]
- (ii) Identify and explain **one** factor that could account for the observation noted in (a)(i). [2]
- (b) Using a diagram, explain how the expiry of a patent of a drug like Ambien will affect the profitability of a firm. [4]
- (c) Extract 2 mentions that Americans are charged higher prices than consumers in the emerging markets for pharmaceutical drugs. Explain how this might be a form of price discrimination. [5]
- (d) With reference to Extract 2 and 3, discuss the factors that can affect the price and output decisions of drug-makers for digoxin. [8]
- (e) Extract 2 says that "there is a widespread belief that people have a right to health care. Yet, the price of drugs is much higher than their cost of production, making them unaffordable to many poor people." Using evidence from the data, discuss whether a price control would be the most appropriate way to make drugs more affordable to consumers in India. [10]

[Total: 30]

Question 2

Economic Rebalancing in China and the UK

Table 1: GDP growth rates (Annual % change at constant prices)

	2009	2010	2011	2012	2013	2014
China	9.2	10.6	9.5	7.8	7.7	7.3
UK	-4.2	1.5	2.0	1.2	2.2	2.9

Table 2: Balances on current account (US\$ billion)

	2009	2010	2011	2012	2013	2014
China	243.3	237.9	136.1	215.4	148.3	219.7
UK	-69.5	-67.7	-43.7	-86.5	-122.3	-151.9

Source of Tables 1 and 2: World Bank

Table 3: Government budget balance (% of GDP)

	2009	2010	2011	2012	2013	2014
China	-1.1	-0.7	0.1	-0.3	-0.7	-1.2
UK	-11.2	-10.0	-7.9	-6.3	-5.9	-5.3

Source: OECD

Extract 5: China Approaching the End of Export-Led Growth Story?

Over the last three decades China has experienced a remarkable transformation. Strong and relentless economic growth was achieved on the back of productive investment, an ample and industrious labour force, relatively low wages resulting in a parabolic rise in exports.

China's growth strategy proved highly successful but its weaknesses became more evident around the time when the global financial crisis erupted and international trade suffered a sudden collapse. Subdued export demand was to a large extent offset by huge domestic stimulus measures and a credit-driven construction boom. The credit-fuelled investment boom helped to maintain economic growth rates close to pre-crisis levels. The flip side of this was a worrying rise in debt levels, inefficient capital allocation, industrial overcapacity and a housing bubble. Moreover, relatively high food price inflation against the backdrop of high income inequality and slowing income growth indicates that a large part of the less well-off population remains vulnerable to price rises.

With prospects for export growth weakening, Chinese optimists hoped for a seamless transition to a sustainable domestic consumption-led growth model. In 2012, the share of household consumption in GDP stood at 36%, which is extremely low by global standards, with a global average of around 60%.

In a bid to encourage consumption-led growth and push the economy to shift away from low-cost manufacturing which is polluting, the government is driving wage growth by gradually increasing minimum wages. The downside of these developments is that wage growth is outpacing labour productivity growth. This is leading to rising real labour costs and a decline in the international competitiveness of Chinese companies, thus affecting employment.

Source: *Euromonitor Research*, 16 March 2014

Extract 6: For China, a Shift from Exports to Consumption

China is in the midst of a major overhaul aimed at weaning its economy off its decades-long reliance on often inefficient state-driven investment and a manufacturing sector that has been highly geared to exporting to the rest of the world. The government has made it clear that it is now prioritising economic rebalancing over short term growth.

Data released underlined just how rapidly the overall economy has been cooling as Beijing has sought, over the past two years, to rein in often poorly allocated lending and close down inefficient or polluting industries. Many analysts expect the pace to cool further this year as Beijing's "tough love" approach to overhauling the economy continues to crimp lending and industrial activity.

Wages have risen as millions of Chinese have moved from the countryside into the cities. And because China is rapidly aging, this means it is gradually getting harder for employers to find and retain workers. That has made life harder for many exporters, who are finding it difficult to deliver goods inexpensively.

For China to generate more domestic consumption, said Richard Ho, who recently founded Athenee, a boutique advisory firm in Shanghai, it needs to foster a more vibrant private sector.

"If you can unleash the power of private enterprise and create a level playing field for private and state-owned businesses," he said, "employment and wage growth can continue — supporting domestic consumption."

Source: *The New York Times*, 20 January 2014

Extract 7: There's Something Very Wrong with UK's Recovery

Britain's economic recovery is leaving the country's manufacturers behind, according to new European Commission figures. The stats show UK investment in equipment has fallen, even as the economy has picked up. Recovery is being driven by the services sector and domestic consumption rather than by manufacturing, business investment and exports. Weak investment in the sector will concern British policymakers who have been looking to rebalance the economy toward exports.

The manufacturing sector has performed particularly poorly despite a shift towards high-tech, advanced manufacturing with global supply chains. What should concern the government is that the Commission's figures show investment in new technology falling well behind international peers. Failure to keep pace could result in the UK becoming less competitive and ultimately impact the future prospects for the sector. This threatens to exacerbate the trend of its declining importance.

The worst news for policymakers is that the traditional currency devaluation for manufacturing no longer appears to have the intended effect. Despite a 20-25% decline in the value of sterling, the cheaper relative prices of their goods did not appear to benefit manufacturers much. Globalisation has turned lots of countries into stopping-points in the manufacture of individual products. Components are imported, augmented and re-exported. This suggests the shift in the manufacturing sector has weakened the impact of currency devaluation.

Source: *Business Insider*, 12 September 2014

Extract 8: UK Policies and Economic Growth

The IMF says that growth has rebounded more strongly than anticipated in the UK on the back of easier credit conditions and increased confidence. But it cautions that the recovery has been unbalanced, with business investment and exports still disappointing. Furthermore, an external shock involving further growth disappointment in emerging market economies could spill over to the euro area and the UK.

In the UK, monetary policy should stay accommodative, and recent modifications by the Bank of England to the forward-guidance framework are therefore welcome. Forward guidance is the term used by central banks to communicate to consumers and investors what their future monetary policy will be and allow them to manage their expectations.

Similarly, the government's efforts to raise capital spending while staying within the budget limit in the medium term should help bolster recovery and long-term growth.

Source: *BBC News*, 8 April 2014

Questions

- (a) (i) Compare the change in China's current account balance with that of the UK between 2009 and 2014. [2]
- (ii) With reference to the data, suggest the reason for the improvement in the UK's budget balance from 2009 to 2014. [1]
- (b) Explain why China's growth is one that is referred to as investment and export driven. [2]
- (c) Explain how creating a level playing field for private and state owned businesses can increase employment. [2]
- (d) Explain why "the traditional currency devaluation for manufacturing no longer appears to have the intended effect." [5]
- (e) Discuss the effectiveness of the policies the UK government has implemented to shift away from consumption-driven to investment-driven growth. [8]
- (f) The data provides an explanation of two different policy approaches to generating economic growth. Assess the economic case for these two different approaches. [10]

[Total: 30]

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