

RAFFLES INSTITUTION  
2016 YEAR 6 PRELIMINARY EXAMINATION  
Higher 2

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**ECONOMICS**

**9732/01**

Paper 1 Case Studies

**31 August 2016**

**2 hours 15 minutes**

Additional Materials:      Answer Paper

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**READ THESE INSTRUCTIONS FIRST**

Write your name, index number and CT 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 diagrams, graphs or rough working.  
Do not use paper clips, highlighters, glue or correction fluid.

Answer **all** questions.

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

**Begin answering each question on a fresh sheet of answer paper.**

**At the end of the examination, fasten your answer to each question separately.**

**Attach this cover sheet to your answer for Question 1.**

Cover Sheet

**Name** : \_\_\_\_\_  
**Civics Class** : \_\_\_\_\_  
**Economics Tutor** : \_\_\_\_\_

Question No.	Marks
1	/30

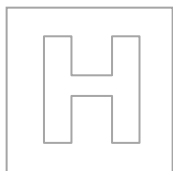
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**Attach this cover sheet to your answer for Question 2.**

Cover Sheet

**Name** : \_\_\_\_\_  
**Civics Class** : \_\_\_\_\_  
**Economics Tutor** : \_\_\_\_\_

Question No.	Marks
2	/30



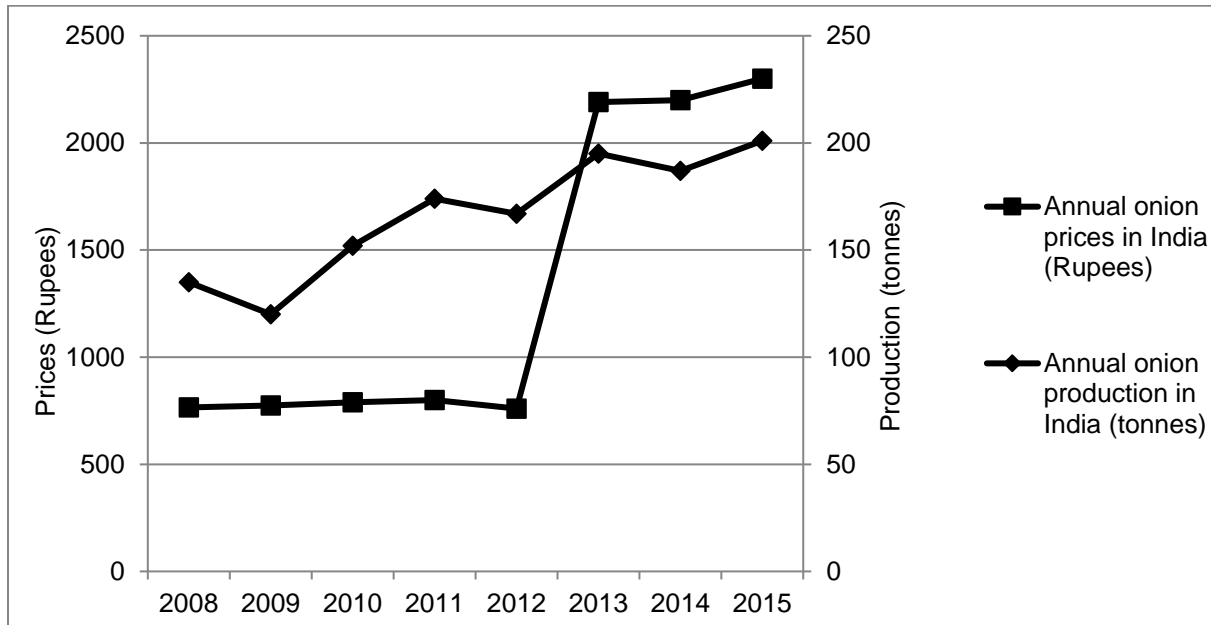
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Answer **all** questions.

### Question 1

**Figure 1: Onion prices and production in India**



Source: Estimates from Indian government data

### Extract 1: Onion prices in India

A doubling in retail prices across major cities is especially troubling for staples such as onions, an ingredient that is present in just about every Indian meal. Onion prices have surged, adding to the country's inflation woes according to data from the ministry of consumer affairs. Seasonal factors, hoarding and price manipulation have led to dramatic price rises.

Onion production in India is carried out mostly by small and marginal farmers who neither set prices nor reap any profits from high prices, hence are incapable of manipulating market supplies. Barriers such as lack of trading expertise and government administered licenses to traders have prevented most of the farmers to make any dent in onion trading. Rather, the supply chain that extends right up to the retailer consists of few powerful trader-intermediaries who operate as cartels and made huge profits by hoarding.

Onions bought from these wholesale traders flow into grocery stores to serve over a billion consumers. There are no laws to prevent retailers from charging what they please. Even when the produce is plentiful, these traders hold back stocks to keep prices artificially high. Consumers have little price information or any mechanism to bypass this system. Farmers receive at best 45 paise (100 paise = 1 rupee) from every rupee spent by the consumer while the rest is pocketed by traders.

Aside from cartelisation, which helps sustain a price spiral when needed, there are long-term problems such as India's low productivity and lack of cold storage.

Singh, the laborer working on the Delhi metro, says he has stopped eating onions altogether because they are so expensive. Instead he is buying cabbage because he needs to send

some savings home to support his parents, wife and two children, he said. "A poor man like me has no voice," said Singh.

In response to the high onion prices, the government has stepped in with measures such as a ban on exports and slashing of import duties. The government has also tried importing cheaper onions from Pakistan, Iran, Afghanistan and China. However, Economist DK Joshi says that short-term measures such as limiting price rises or exports will not solve the real problem. "Inefficiencies in the system supply chain cause prices to shoot up," he says. There is a need for training programme on cash crops such as onion, potato and tomato that often have fluctuating rates resulting in the farmer getting either good value for his crop or heavy losses. With grants to farmers to invest in technology for proper storage facility for quality crop yield, this will increase the production and consequently establishing good sales of the crop.

Source: Adapted from various sources

### **Extract 2: Fall in price of vegetables to hurt Australia vegetable growers**

AUSVEG is Australia's leading horticulture body representing the interests of Australian vegetable and potato growers. AUSVEG warned that plummeting vegetable prices would make it difficult for Australian vegetable growers to break even. "Any fall in vegetable prices of this magnitude will inevitably cause knock on effects for Australian growers, who will likely bear the brunt when retailers pass on these losses," said AUSVEG Chairman, John Brent.

"This has been a particularly hard year for growers, who've been faced with high energy, water and labour costs," he said. "Together with pressure from increasing imports from countries such as China and New Zealand and the strong Australian dollar, many Australian growers and their families are finding it difficult to break even."

Some Australian processed vegetable growers have started to accept significantly reduced contracts this year. If this situation continues, the livelihoods of hundreds of Australian families and rural communities will be at risk and the overall revenue of the Australian vegetable industry will be under serious threat.

"Governments need to do more to support the Australian vegetable industry which employs 30,000 Australians and is worth \$3.2 Billion annually. They should give consideration to any measures, such as improved country of origin labelling, which will help consumers support the viability of Australian growers," Mr Brent said.

Source: ausveg.com.au, 2016

### **Extract 3: Crop subsidies put India in bind**

The nose-dive in global commodity prices has led to a hefty bill for the Indian government as it spends billions to mop up wheat, rice, sugar and cotton at government-fixed prices with its guaranteed minimum prices for certain crucial crops.

When prices plunge, the government has to buy more. It usually sells the commodities it collects at a loss - some to India's needy and some on global markets. Some of the stockpile just rots in government warehouses. With wheat, sugar, rice and cotton prices down 15% to 30% in the last two years, the Indian government has been procuring record amounts of these commodities.

The extra billions being spent on subsidies are inflating the country's budget deficit, economists say, and draining the pool of funds available for other important programs for farmers, including road, power and irrigation networks as well as education and health-care infrastructure. Farm subsidies hurt an economy simply because they are a distortion.

The government's commodity price support has also the potential to hurt world markets as the farm subsidies encourage farmers to produce much more of the subsidized commodities than they would have otherwise, exacerbating the global glut. India has already been looking for ways to release more of its wheat and sugar surplus on the global markets in what some complain is a beggar-thy-neighbour move.

Indian officials say they have no plans to reduce the subsidies. In fact, in the face of global pressures to reduce them, the government has consistently refused to budge. It even threatened to scuttle an important World Trade Organization agreement in 2014 unless it was given a guarantee that it could continue its subsidy and stockpiling programs.

"Government subsidies are not to lower cost but are meant to encourage productivity and better farming practices," said Sudhir Singh, an official at India's agriculture ministry. "We are committed to our social-welfare programs to help our poor farmers."

Source: The Wall Street Journal, 1 May 2016

### Questions

- (a) Compare the trends in both price and production of onions in India between 2008 and 2015. [2]
- (b) Using a diagram, analyse the impact on society arising from the slashing of tariffs on onions in India. [6]
- (c) With reference to Extract 2, account for the likely fall in the overall revenue of the Australian vegetable industry. [4]
- (d) Discuss whether the disadvantages to society outweigh any advantages that might arise from the likely market structure existing in the onion distribution industry in India. [8]
- (e) Discuss the factors that are likely to influence whether the minimum price support scheme adopted in India should be carried out by governments for agriculture products. [10]

[30 marks]

## Question 2 Oil prices and the Russian economy

### Extract 4: How falling oil prices complicate monetary policy

How should the recent fall in oil prices affect monetary policy? To start with, a lot depends on why the price of oil has dropped. The main reason in 2014 has been an increase in global supplies, which lower the price. Europe is heavily dependent on oil imports, and its close proximity to Russia means it is cheaper for pipeline infrastructure to be built between them. So cheaper oil makes Europeans a lot better off but it's bad news for Russians.

Confusion next arises because cheap oil not only increases real output but also reduces inflation. Does this call for a loosening of monetary policy, to push inflation back up to target? Remember, we're assuming that the price of oil has fallen mainly because of supply, not because of a slump in the global demand for oil. So it's not as though the oil-induced fall in inflation is associated with an upward blip in unemployment or the appearance of spare capacity. Indeed, output will be higher. Hence, central banks would have to "look through" the temporary drop in inflation, and see no need to loosen policy.

Now for the complications and three deserve to be stressed. First, technology may be a reason oil prices are lower, but it isn't the only one. James Hamilton of the University of California, San Diego, reckons that the decline in oil prices could be due to "indications of weakness in the global economy." Those indications suggest spare capacity and excess unemployment, and call for a loosening of monetary policy. On this view, cheap oil in its own right doesn't call for additional monetary stimulus; it's the worsening demand conditions that first gave rise to cheap oil.

Second, the effects of cheap oil vary from country to country and industrial sector to industrial sector. These differences can have implications for monetary policy. For instance, cheap oil tends to weaken the currencies of oil exporters such as Russia. By the same token, this puts upward pressure on the Euro. An appreciating currency constitutes a tightening of monetary conditions. Again, that might be a reason to apply new monetary stimulus.

Third, and most important, there's the danger that the temporary fall in inflation due to cheaper oil will lower long-term inflation expectations. Financial markets might deduce that cheap oil will suppress inflation in the longer term. The ensuing new forecast will tend to be self-fulfilling.

These possibilities are a concern for the European Central Bank, because the Euro area stands on the brink of a recession and outright deflation partly brought about by years of fiscal austerity. A further downward push to EU inflation, could tip the balance in 2015, and put the euro area on a deflation path.

Source: Bloomberg.com, 2014

### Extract 5: What's gone wrong with Russia's economy

Russia is in the middle of a currency crisis. In December its currency lost 10% of its value, having already lost about 40% this year. The Central Bank increased interest rates sharply, but instead of calming the market, the hike was seen as a sign of desperation. Inflation is currently at 10% but is expected to accelerate rapidly. Russians are panic-buying; banks are running out of Rubles. Recent data confirm Russia's entry into recession, with GDP growth of - 2.2% for the first quarter of 2015, as compared to the first quarter of 2014.



The problems were long in the making. Russia is highly dependent on oil revenues (hydrocarbons contribute over two-thirds of exports) and over the past decade it has failed to diversify its economy. During 2015, Russia's firms must also repay \$100 billion-worth of foreign debt. But as the Ruble falls, paying back dollars becomes more difficult. The Kremlin is praying for a resurgence in the oil price. Given the widespread use of oil in many industrial activities, this would increase export revenue significantly, but at the moment that seems unlikely.

Source: The Economist 16 Dec 2014

#### **Extract 6: Sanctions on Russia after Crimea: Have they worked?**

When Russia illegally annexed Crimea and started interfering in Eastern Ukraine, the West responded with economic sanctions. In July 2014, sanctions were enacted in a coordinated manner by the European Union and the United States. For the Russian economy, the sanctions are generally assessed to have exacerbated the macroeconomic challenges it was already facing, notably the rapid and pronounced fall in oil prices that started in the last months of 2014.

The combined effect of these sanctions and of the fall in oil prices caused significant downward pressure on the value of the Ruble and increased capital flight. At the same time, the sanctions forced Russia to use part of its foreign exchange reserves to shore up government agencies. These developments forced the hand of the Central Bank of Russia, which abruptly ceased to defend the value of the Ruble and hike interest rates in December 2014. Russia's ban on Western food imports had a compounding effect on this challenging picture, as it led to higher food prices and hence to further inflation. This was in addition to the effect of the fall in the value of the Ruble, which had already raised the price of imported goods and services in Rubles.

Source: NATO Review Magazine

#### **Extract 7: Do sanctions on Russia affect EU nations?**

European economies are affected by the sanctions and by Russia's current recession principally through trade, i.e. by losses in export revenues. Losses are caused:

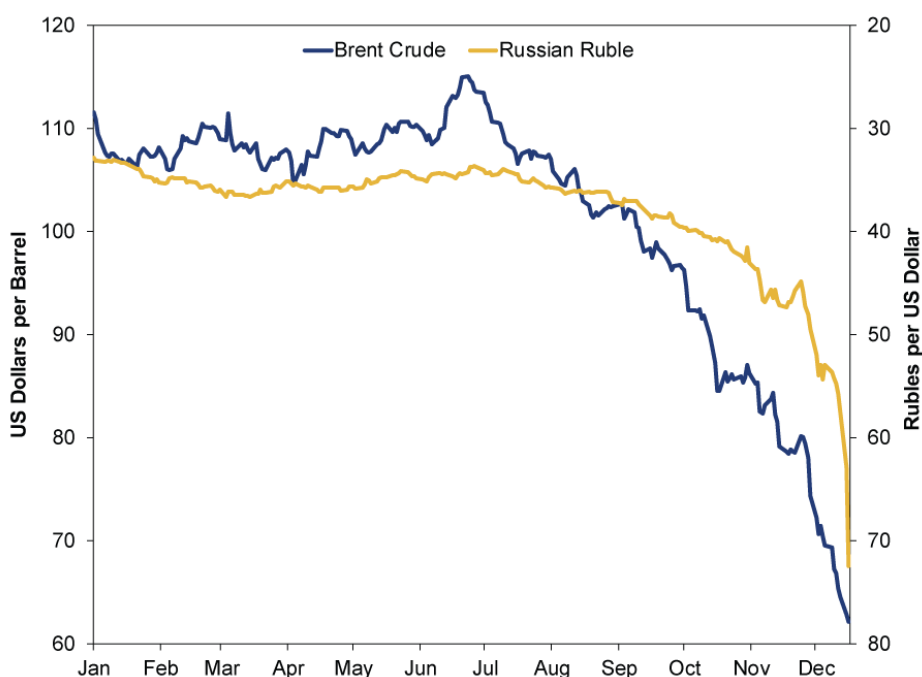
- directly by Western sanctions (exports of oil-producing equipment and of military and dual-use goods);
- directly by Russia's food import ban;
- and indirectly due to Russia's recession and lower exchange rate, which together lead to much lower demand for imports (from anywhere in the world).

For European allies and partners, recent data demonstrates that the losses incurred due to Russia's general economic downturn have been well contained. Of course, exports to Russia have fallen substantially, on average by around one third when comparing the first quarter of 2015 with the first quarter of 2014. However Russia's importance as a destination market is quite limited for most European countries and, more importantly still, European businesses have been able to find new markets for their products, both within Europe and beyond.

Majority of EU Member States experienced a net gain in exports to the world in spite of the Russian downturn, thanks to increases in exports to other markets (both within and beyond the EU) that more than compensated for the falls in exports to Russia. Apart from the three Baltic states, all the other Central and Eastern European Member States were able to more-than-compensate for the losses related to Russia.

Source: NATO Review Magazine

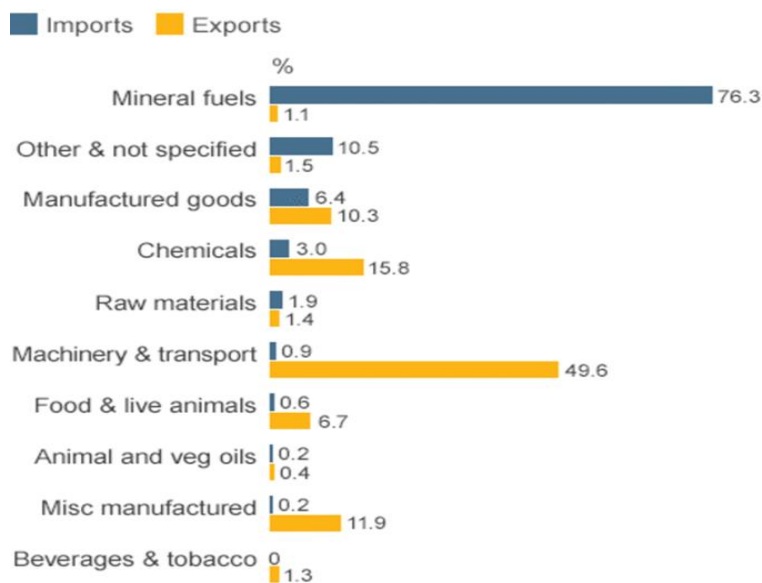
**Figure 2: Brent Crude Oil Price and Russian Ruble 2014**



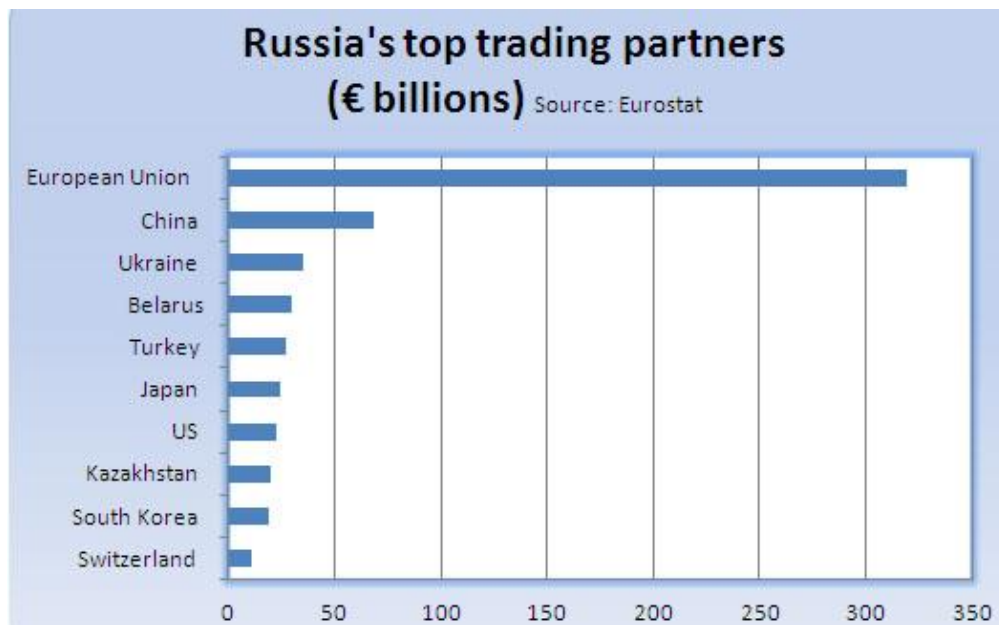
Source: FactSet

**Figure 3: Trade between EU and Russia**

**EU imports from and exports to Russia**



Source: EuroStat 2014

**Figure 4: Russia's major trading partners 2012**

Source: EuroStat 2014

**Questions**

- (a) (i) With reference to Figure 2, compare the trend of the price of Rubles per US Dollar with that of Brent Crude (oil) between Jan 2014 and Dec 2014. [2]
- (ii) With reference to the data, to what extent does the price of Brent Crude oil account for the trend in the value of the Russian Ruble? [4]
- (b) State and explain one difficulty Russia would face when deciding to appreciate the Ruble. [2]
- (c) How far does the Theory of Comparative Advantage explain the pattern of trade between Russia and her trading partners, shown in Figures 3 and 4? [4]
- (d) Assess the macroeconomics effects of trade sanctions and falling oil prices on EU member states. [8]
- (e) In light of falling oil prices and economic sanctions, consider the choice of macroeconomic policy options for EU and Russia. [10]

[30 Marks]

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*Copyright Acknowledgements:*

Question 1 Figure 1	© Indian Government Data, <a href="https://data.gov.in">https://data.gov.in</a>
Question 1 Extract 1	© BBC News, "India prices: No winners as families and farmers suffer", 13 Jan 2011; The Quartz, "The solution to India's onion price inflation is an obvious one. Hint: it's not the hoarders", 1 Jul 2014; Forbes, "The Mysterious Case Of Levitating Onion Prices In India", 27 Aug 2013
Question 1 Extract 2	© ABC News, "Cheap vegetable imports pushing Australian growers out of industry", 28 Mar 2016
Question 1 Extract 3	© The Wall Street Journal, "Farm Subsidies Put India in Bind", 1 May 2016
Question 2 Extract 1	© Bloomberg, 'How Oil Complicates Monetary Policy', written by Clive Cook, 18 Dec 2014
Question 2 Extract 2	© The Economist, 'What's gone wrong with Russia's economy', 16 Dec 2014
Question 2 Extract 3	© NATO Review Magazine, 'Sanctions after Crimea: Have they worked?', 13 July 2015
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