



A LEVEL ECONOMICS

COMPONENT 2

Exploring Economic Behaviour

SPECIMEN PAPER

2 hours 30 minutes



ADDITIONAL MATERIALS

In addition to this examination paper, you will need a calculator and a 20-page answer booklet.

INSTRUCTIONS TO CANDIDATES

Answer all the questions.

Use black ink or black ball-point pen.

Do not use pencil or gel pen.

Do not use correction fluid.

INFORMATION FOR CANDIDATES

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

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

No certificate will be awarded to a candidate detected in any unfair practice during the examination.

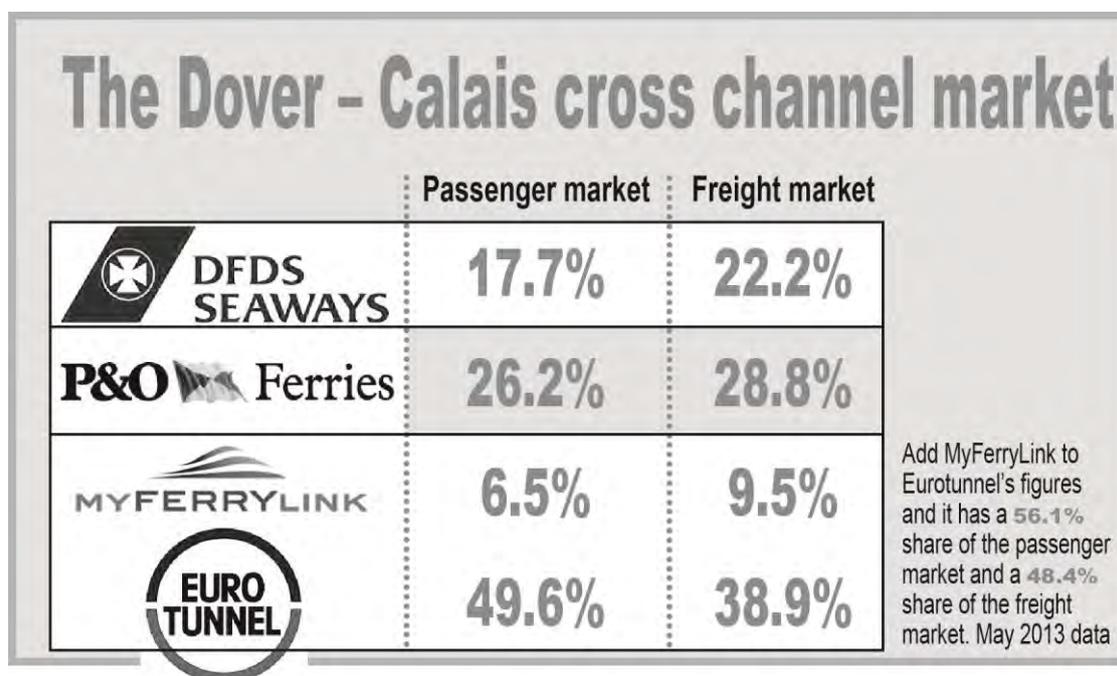
1. Eurotunnel in fight to control the English Channel

Crossing the English Channel has never been easier. Options are Eurotunnel via Eurostar, budget airlines, and ferry. For passengers and freight operators there is plenty of choice with low prices and heavy advertising. However, the English Channel has been the centre of a major dispute between ferry operators which has led to an investigation by the Competition Commission.

The dispute stems from a company called Sea France, which began ferry operations between Dover and Calais in 1996. Although initially profitable, by 2008 it was losing 3m euros a month. Falling passenger numbers and declining freight traffic were to blame for the losses. Operations were suspended in 2011.

In 2012 Eurotunnel purchased three ferries for 65m euros from the liquidators of Sea France. It then relaunched the service as MyFerryLink which meant that three ferry operators were again operating between Dover and Calais, the fastest sea route from Britain to France. Existing British operator P&O Ferries and the Danish DFDS Seaways instantly complained to the Competition Commission which declared in June 2012 that Eurotunnel's actions were anti-competitive and ordered MyFerryLink to cease operations.

Figure 1
Dover-Calais cross channel market data



According to Alastair Smith, the Deputy Chairman of the Competition Commission, 'It cannot be good for competition when Eurotunnel, which already holds a market share of over 40 per cent, moves into the ferry business, particularly when it did so to stop a competitor from buying these three ferries. Customers would lose out from Eurotunnel increasing its market share even further and being able to raise prices on the tunnel services. By preventing Eurotunnel from operating ferry services out of Dover, we can protect the interests of customers.'

Figure 2
Port of Dover figures

	2012	2013
Passengers	9 609 677	10 323 693
Cars	1 962 085	2 031 627
Coaches	68 562	74 316
Lorries and vans	1 451 179	1 643 448
Total ferry crossings	12 131	14 449

Source: The Port of Dover, year to date figures

However, Eurotunnel appealed to the Competition Appeals Tribunal which overturned the original decision and referred it back to the Competition Commission for further consideration. The Eurotunnel Chief Executive Jacques Gounon declared the appeal verdict a “victory for the consumer”. Robin Wilkins, MyFerryLink Managing Director said: “We are delighted with the ruling. We are already the highest rated cross channel operator and have built a substantial business based on quality of service and value for money. This is a very good day for our staff, our customers and our future customers”.

Eurotunnel always claimed that buying the ferries helped to keep the cross channel market as it was previously, with three operators on the Dover-Calais route. This was not the view shared by DFDS or P&O who said that the original Competition Commission decision was correct, claiming that MyFerryLink was being subsidised by Eurotunnel. This was supported by evidence from Eurotunnel’s recent accounts that showed that MyFerryLink had a six month pre-tax loss of £16m at the same time it was offering cut-price deals for passengers.

P&O Ferries said: “Our main concern is that Eurotunnel’s support of MyFerryLink allows it to trade below cost, incurring huge losses and thus causing a damaging price war. Other competitors are also trading at a loss with what they admit are unsustainable prices. Price wars might seem great for customers in the short term, but they damage the ability of operators to invest and, at their most extreme, put rivals out of business”. DFDS claimed to be losing £1m per month due to the cheaper competition from MyFerryLink. A DFDS source said that if Eurotunnel were allowed to keep operating ferries, there was a real possibility that DFDS would pull out of the Dover-Calais route entirely in a move that could lead to reduced competition. Eurotunnel, would then have an even bigger market share, and would be able to increase prices for passengers and freight alike. Was this their intention all along? That is something only Eurotunnel can tell us.

Source: The Mail on Sunday 5 January 2014 (adapted)

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- (a) Using Figure 2, calculate the 2013 index for total ferry crossings, using 2012 as the base year. [2]
- (b) With the aid of an appropriate diagram, explain how Sea France's profits had turned to losses by 2008 (paragraph 2). [6]
- (c) Using the data, consider the extent to which the Dover-Calais cross channel market might be considered to be an oligopoly. [8]
- (d) Consider the extent to which the Competition Commission was correct in banning Eurotunnel from operating cross channel ferry services. [12]
- (e) Assess the pricing and non-pricing strategies cross channel operators might use to increase their profits. [12]

2. Are Abe's arrows hitting the mark?

In 16th Century Japan, a famous lord, Mori Motonari, gave each of his three sons an arrow to break. Each managed it easily. He then tied three more arrows together in a bundle and asked them to try again – they were unable to do it. The point of the story was to show the power of co-operation, this idea of three things working together is at the heart of Japan's Abenomics.

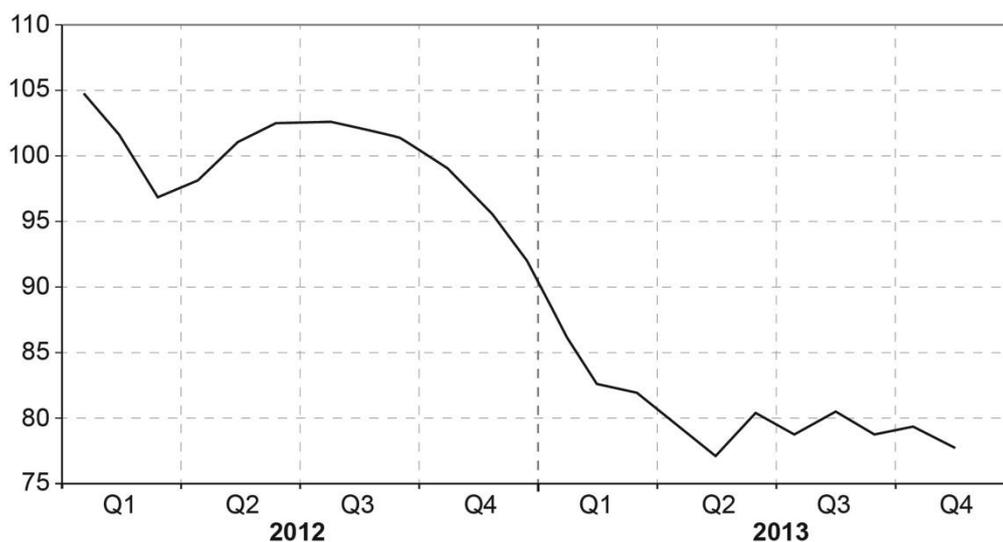
Abenomics is the name given to economic policies introduced by Japanese Prime Minister Shinzo Abe in December 2012. His aim was to revive the economy with "three arrows": aggressive monetary easing from the Bank of Japan, a massive fiscal stimulus and structural reforms to boost Japan's competitiveness.

Japan has been struggling with deflation for more than a decade. Falling prices decrease spending as consumers delay purchases in the hope of lower prices in the future. Deflation also deters businesses from borrowing to invest as deflation increases the real value of debt.

The first arrow

Monetary easing involved the Bank of Japan doubling its inflation target to 2% and increasing its purchases of government bonds by 50 trillion Yen (\$500bn; £330bn) per year. The move has also resulted in a sharp depreciation of the Yen (Figure 1), which it is hoped will boost the profits of exporters, in turn leading to investment in facilities and higher salaries for workers.

Figure 1 (Japanese Yen, trade weighted exchange rate index, 2010 = 100)

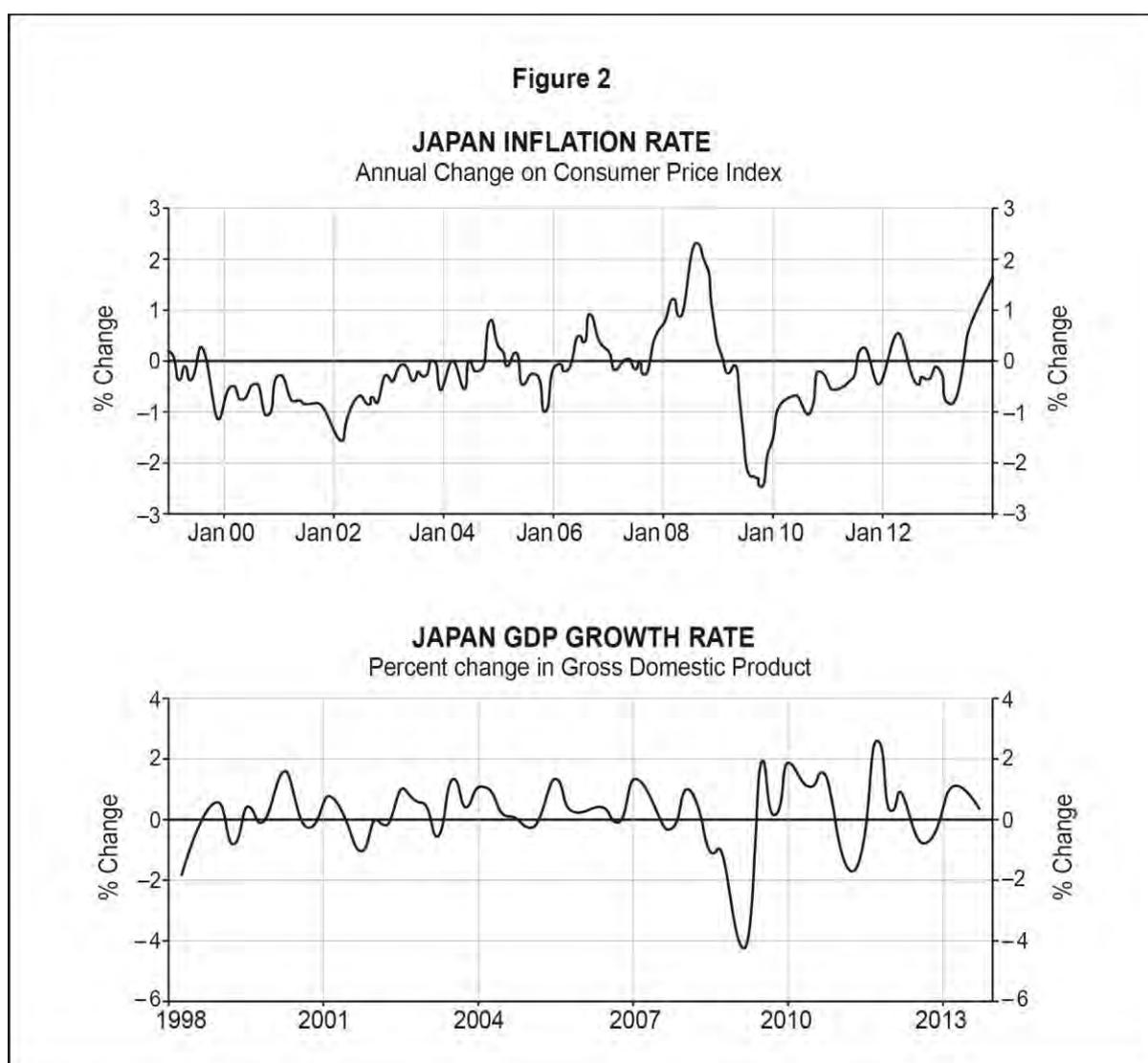


Critics of the policy point out that rising inflation may drive up interest rates, which will increase the cost of the government servicing its huge national debt (240% of GDP) and force the government into the type of austerity measures seen in Spain and Greece. Likewise, the falling Yen drives up the costs of imports, particularly energy, of which Japan is having to import more after its nuclear reactors were shut down following the 2011 tsunami and earthquake.

The second arrow

The second part of Abenomics involved boosting government spending to help stimulate growth. In just three months, from January to April 2013, Mr Abe said that his government would spend an extra \$114bn (£75bn). He said the extra funds would be used to fix schools and roads and reinforce earthquake defences. He also said that the government would make funds available for scientific research and renewable energy.

Critics say that Japan has been doing this for many years already, with little effect. Too much has already been spent on wasteful roads and bridges, and not enough in areas such as education and social services, which studies show have more impact on growth in the longer run rather than infrastructure spending. Further projects will simply add to Japan's already mountainous debt levels.



The third arrow

The third Abenomics arrow is structural reform in sectors such as agriculture, healthcare and labour markets. Labour market reforms are being introduced, with the aim of making it easier to hire and fire and to increase the female participation rate, which is one of the lowest in the developed world. Critics, however, point out that the pace of change is extremely slow, and a further worry is that increased flexibility might depress wages in the short term, reducing consumption.

Japan is also engaged in free-trade talks with the US and 10 other countries, which will create a free-trade area with a combined population of 650 million workers (the Trans-Pacific Partnership). The agreement is expected to substantially reduce tariffs between member countries and boost investment flows. The biggest risk is to agriculture, because tariffs (which can be very high in Japan, most famously the 777% tariff on rice) will fall sharply. A concern is that this may lower the incomes of Japan's many ageing farmers, who would then rely more on government support, adding to the burden on government finances and worsening regional inequalities.

Since Abenomics was launched, the output gap (the difference between actual and potential output) has dropped from roughly three percentage points to below 1.5. This suggests that the first two arrows are increasing actual GDP growth, but that the third arrow is not yet stimulating potential growth. Since December 2013, the stock exchange has soared by 40% (driven partly by the Bank of Japan's monetary easing), unemployment has fallen to 4% and the ratio of applicants to jobs has reached around 1:1. Growth in the first half of 2013 was close to 4% and inflation in November was at a five-year high of 1.2%.

The report card therefore reads "so far so good". The first and second arrows seem to be driving actual growth, but the big question is what happens when the output gap is eliminated. That is when the third arrow, which aims to boost Japan's potential growth through structural change (including increased private investment, technological innovation, improved trade links and reformed corporate-tax policy) will become far more important. Mori Motonari would no doubt agree.

Sources: BBC, New York Times, FT, adapted.

- (a) With reference to the data and Figure 1, explain:
- (i) What is meant by an exchange rate index; [2]
 - (ii) Why a fall in the Yen might increase the profits of Japanese firms. [2]
- (b) Explain how the first arrow of Abenomics might have helped to end deflation in the Japanese economy. [6]
- (c) With reference to the data and Figure 2, discuss the ways in which GDP growth and deflation might be linked. [8]
- (d) Discuss whether Japan's entry into the Trans-Pacific Partnership is likely to be beneficial for the Japanese economy. [10]
- (e) To what extent do you feel that Abenomics will be effective in creating sustained economic growth in Japan? [12]