**CSQ Q1 - GCE A Level H2 Economics 2012 Question 1 (Micro)**

**The Market for cotton**

**Extract 2: UK retail clothing firms far from cheerful about future of cheap fashion**

It was a sign of the times; fashion was so cheap it became "disposable’ as globalisation brought container-loads of low-cost clothes to the UK. But clothes retailers are now warning that the era of constantly falling prices is coming to an end and that prices could rise in 2011. A huge rise in the price of cotton to a 15-year high could not be ignored, they said. At the same time, retailers are facing higher labour costs in Asia, the impact of a weaker pound and a rise in Value Added Tax (VAT) from 17.5% to 20% from January 2011.

The chief executive of clothes retailer Next predicted that the prices of Next's clothes were going to rise by up to 8% in 2011. He said that he suspected that shoppers would have to cut back on the number of new outfits they buy: 'Our best guess is that if prices do rise by 8%, then volume of sales will be down by 10%. The clothing retail industry hasn't experienced price increases for 15 years and the truth is we don't really know what the response will be.’

The director of a leading research company said consumers are facing what could be a permanent change in the clothing market: 'Prices can't keep failing forever: they reach a floor, and we are now at a point where retailers' profits are really quite low. Because of the recession they are finding it difficult to maintain sales. This means that when costs rise, they have to be passed on to the consumer.'

Primark, a clothing company known for its ability to emulate designer looks at rock-bottom prices, has been at the forefront of the disposable fashion movement. Its breathtaking prices - this autumn you can still buy jeans for £8 and a top for £4 - caused a stampede when its first store opened, on London's Oxford Street in 2007, Another company. Asda, sold its cheapest pair of own brand jeans for £14.97 in 2000; now the price is down to £4.

Some have argued that the increase in the cotton price has its roots in the financial crisis of 2008, when farmers stopped planting low-value cotton and switched to higher-value crops such as corn and soya, When retail sales picked up, demand for cotton also rose and prices shot up - just at a time when major cotton-producing regions such as China and Pakistan were suffering devastating floods, and India, the second largest producer, was limiting exports.

The deputy chief executive of a well-known department store explains that 60% of the cost of clothing is in the fabric and about 30% of the fabric cost is in the raw materials: ‘The approach we are taking is to pass it on to customers and we think most other retailers will have to do the same.’ He says its prices will rise, like Next's, by up to 8%, He also points to Increased labour costs all around the world’, less spare capacity in Chinese factories, rising freight costs and the unfavourable impact of foreign exchange movements as other pressures being faced by retailers.

Some analysts argue, however, that the gloom is being overdone. The chairman of the department store John Lewis Partnership, which last week reported a 20% increase in fashion sales, certainty thinks the future is brighter than some of his peers say. ‘Prices may rise a little but tough competition will take some of the heat out of these rises.’

*Source: The Observer, 19 September 2010*

**Extract 3: Tesco, the supermarket chain, is set to take on its rivals with the opening of a specialist clothing store in London**

Tesco, which is more used to selling clothes in its supermarkets than high street boutiques, is planning to open a store dedicated to selling clothing in London's West End. The store would be branded F&F, after Tesco’s own-label clothing range. The move will see Tesco try to succeed where its competitors have failed. In 2008 arch-rival Asda closed its chain of specialist high street clothing shops following a four-and-a-half-year trial run, because it could not make sufficient profit,

Tesco's move could be partly driven by the fact that fashion brands are having to compete more aggressively in an ever-more-crowded marketplace. As well as being home to thousands of stores from established brands like Primark and Next, the UK is attracting a large number of international clothing brands. US chain Abercrombie & Fitch entered the UK market a few years ago, and chains such as Forever 21, Vero Moda and Victoria's Secret are also set to enter the UK.

If Tesco can get the look and feel right in a dedicated clothing store, then it could be a good way of building brand awareness.

*Source: Daily Telegraph, 9 July 2010*

**(f) Using the evidence in the data, discuss how the market structure of the retail clothing industry in the UK will affect the ability of firms in this industry to make excess profits in the long run when faced with an increase in the price of cotton. [10]**

In the examination on whether the firms in the UK retail clothing industry will make excess profit condition, it is imperative to consider the nature of the market structure and how the cost condition will affect the production of cloth as seen from the rise in price of cotton.

In the retail clothing industry, the firms will face a monopolistic market structure and it will affect the slope of the marginal and average revenue of the firms.

The change in the price of cotton will lead to a rise in cost of production which will affect the excess profit of the firms in the cloth retailing industry. It is also important to take note of the nature of the market structure of retail clothing as the market demand is affected by the characteristics of this type of industry.

To determine the level of profit in the retail clothing industry, we need to derive the production equilibrium of the firm in this industry, which is based on profit maximization where the price and output level is set at the level where MC=MR. As the firm in the cloth retailing industry is under the monopolistic competition market structure, where there are many buyers and product is differentiated in an imperfect market structure and immobility condition, the marginal revenue (MR) and average revenue (AR) will be downward-sloping but price-elastic as there is limited market power for the firm as it is created through product differentiation. As for the marginal cost (MC), it will slope upwards and from left to right as it is subjected to over-utilization of capacity of production in the short run. Thus, the firm will produce at the level where marginal cost is equal to marginal revenue and price is set based on the equilibrium on average revenue. As for the profit, it will be based on the difference between the average revenue and average cost, multiplied with the output level.

As seen from the diagram, the price and output is at P0 and Q0, where the firm’s marginal cost (MC) is equal to the marginal revenue (MR). The firm will experience normal profit at this level as average revenue (AR) is equal to average cost (AC) at Q­0.

The rise in the price of cotton will lead to a rise in the cost of production which will raise the marginal cost from MC0 to MC1 as the rise in raw material is seen as an increase in variable cost. Given that the profit maximization level is now at Q1, where the MR now intersects MC, and thus the price and output level is at P1 and Q1, contributing to the subnormal profit condition as AR is less than AC at Q1. Hence, it can be observed that the firm is making subnormal profit.

In the long run, the profit condition for the firm will be at normal profit, when the industry adjusts to the subnormal profit condition, contributed by the characteristics of the monopolistic market structure of the barriers to entry. Due to subnormal profit condition, firms which are experiencing loss will exit from the industry and this will lead to an increase in market demand for the remaining firms and the MR and AR will become more price-elastic as there are less firms in the monopolistic competitive market. This adjustment will continue until the firm reaches the production level where there is normal profit and production level will be at profit maximization level.

Price

LRMC

LRAC

P0

MR0

Qty

Q**0**

AR1

As seen from the diagram, the production level is set at P0 and Q0 based on profit maximization and the profit level is now at AR=AC.

It can be observed that the firm will adjust to the condition of normal profit in the long run despite the rise in the price of cotton which will raise the cost of production. This is due to the condition of low barriers to entry which will allow the exit of firms till the remaining firms in the industry attain normal profit. This is seen from how the industry adjusts the slope of MR and AR, which is influenced by the degree of substitution for goods produced by lesser firms existing in this industry.

**CSQ Q2 - China’s Automobile Industry**

**Figure 1: China’s Auto Sales, 2001 - 2009**

**Extract 2: Mergers and Acquisitions - A Key Development Strategy**

One weakness of the Chinese automobile industry is regional production fragmentation. There are more than 120 vehicle makers, which are almost equal to the combined figures of all auto enterprises in Europe, Japan and the U.S.A. Most of these firms suffer from weak competitiveness and low production capacity. Shanghai Automotive Industry Corporation Group (SAIC), First Automobile Works Co., Ltd (FAW) and Dongfeng Motor Corporation (DFM) are the top three vehicle producers. However, they shared less than 50% of overall auto sales in 2008. The Chinese government is thus pushing for mergers and acquisitions in the automotive industry which will support the emergence of a few leading national companies. The auto sector is an industry that enjoys economies of scale. Mergers and acquisitions can therefore substantially reduce the production cost per vehicle.

Adapted from *Background Brief No. 500, 14 Jan 2010, East Asian Institute, NUS*

**Extract 3: When will China produce a car brand people want to drive?**

Until the late 1970s China was making fewer than 3,000 passenger cars a year. In 1989 it exported just 6 cars. Now, its motor industry supports millions of jobs. Last year they exported almost 900,000 cars. However, this is not a fantastic success when measured against the Chinese government’s ambitions. The Chinese state planners had intended, by 2010, to have “three or four large, globally competitive auto firms” like America and Japan, and for these to have their own successful brands and technology. However, even the most innovative of China’s independent automakers have relied heavily on copying, cost control and public relations to give the appearance of innovation.

Japan and South Korea got their car-making industries going by shutting foreigners out of their domestic markets, giving domestic brands a captive audience to practise on. China let in the foreign carmakers, but on condition that they worked with local partners. The idea was that the Chinese makers would by now have learned the knack of producing world-beating cars, and presumably be in a position to dump their foreign partners. However, this hasn’t quite happened.

Surveys of foreign- and Chinese-branded cars’ mechanical faults show that the local brands are increasingly able to meet the safety standards of the western markets but changing motorists’ perceptions of the inferiority of domestically branded goods will take time. To catch up with their foreign rivals, some of the big Chinese makers are resorting to acquisitions to obtain foreign technology. Shanghai Automotive Industry Corporation Group (SAIC) bought some remnants of Rover, Britain’s former state carmaker, and is using its designers to create promising new models. Geely bought Volvo from Ford, and can now combine its own Chinese market access and strong supply chain with Volvo’s technology and image-making savvy.

However, while Chinese-branded cars may be getting better; but so are foreign ones. The rich world’s carmakers are loading their models with ever fancier navigation, entertainment and safety gear. Meanwhile the global giants’ adoption of standard “platforms”, on which a wide range of models can be built, combined with China’s rising wage bills, mean that Chinese makers’ cost advantages are fading.

Adapted from *The Economist, 5 May 2012*

**Suggested Answers**

**b) Explain two barriers faced by the Chinese automobile manufacturers in penetrating the global automobile market. [4]**

* Real product differentiation and product proliferation that involve research and development (extract 2). Research and innovation require time and money. Chinese car-makers being relatively new comers in the industry are behind their western counter-parts in R&D. (2m. 1 m for ID of barrier; 1m for explanation)

[For students’ info - They have sought to over-come this thru’ joint ventures with foreign producers but such joint ventures hasn’t yielded much technological transfer.]

* EOS (extract 3). Chinese car makers are small. This limits their ability to enjoy EOS. To price their cars as competitively as the foreign large car makers, they have to ensure tight profit margins which to some extent limits their R&D efforts. (2m. 1 m for ID of barrier; 1m for explanation)
* Trade barriers (extract 3). E.g. Korea and Japan had used trade barriers to protect their infant car industries from foreign competition.
* Western markets’ safety standards (extract 2). This serves as non-tariff barriers to imported cars from China. E.g. Failure in European crash tests by Chinese brands means that they are not allowed to sell in European markets. (2m. 1 m for ID of barrier; 1m for explanation)
* Product recognition from successful branding of European / US /Japanese cars (e.g. para 1 of extract 2 which says US and Japan have their own successful brands). This means Chinese car makers will have to spend heftily on advertising. (2m. 1 m for ID of barrier; 1m for explanation)

**c) Discuss the effectiveness of mergers and acquisitions by the Chinese automobile manufacturers to increase their share of the global automobile market. [8]**

* Currently, although Chinese car makers are increasingly exporting their output, their foothold in the global auto market is still very small. They are turning to **mergers and acquisitions.**
* A merger is a combination of two companies to form a new company, while an acquisition is the purchase of one company by another in which no new company is formed.
* **Mergers** will overcome the current fragmented nature of the Chinese auto industry thus enabling the local firms to enjoy scale EOS (extract 3). These include technical EOS like cost savings obtained from use of large automated assembly plants and cost savings from sharing costs of R&D. By lowering the average cost of production, the firm can lower the price and increase the quantity demanded to increase the market share in terms of change in quantity. The benefits of decrease in price can increase the sales revenue which increases the firm’s market share in terms of sales revenue.
* The need to tap into EOS is all the more pressing as the rise in wage bills in (extract 4) suggests that China’s competitive advantage derived from cheap labour is fading.
* The combined profits will provide the firm with more financial ability to engage in R&D, *which is a pressing need given the high quality foreign cars that the local manufacturers have to compete against and the high safety standards (extract 4) that the local manufacturers need to meet in foreign markets. The quality of the cars may improve to make the China’s cars a more favourable choice.*

However, 1 limitation of mergers is possible clash in working culture. This may result in productivity losses which will actually drive up unit production cost.

* **Acquisitions** of foreign car companies will enable the Chinese firms to acquire the needed technological know-how for them to compete more effectively with the foreign car-producers. Currently, local consumers still prefer foreign brands. Extract 2 notes that China’s top 3 local automakers have less than 50% of overall auto sales in 2013, showing that local automobiles are not as preferred by the Chinese themselves, probably due to the poorer quality of the local cars.
* This is a better strategy than joint ventures with foreign car companies which has yielded limited technological transfer (extract 3).
* By buying a car maker of reputation, it could help Chinese makers shed motorists perception of Chinese cars being of poor quality.
* This is also better than copying (extract 3) because copying is likely to result in expensive legal law suits by the foreign car makers for infringement of copyright or calls by foreign car makers for their govts to impose protectionism as retaliatory measures.
* 1 limitation is that the foreign governments may not allow their iconic car manufacturers be bought over by a Chinese car manufacturer.
* Also, the talent (e.g. car designers) of the acquired firm must not jump ship. However, this problem may be avoided with adequate remuneration.
* Foreign car makers are making concurrent advances in technology (last para, extract 3). Thus, the new improved automobiles made as a result of the M&A may still lag behind that of the other car makers

**Overall conclusion:**

M&A should be a rather effective approach as it would address the particular obstacles faced by the Chinese auto industry in competing with foreign makers. It will enhance the cost efficiency of the industry and the real and imaginary differences the cars produced in China. Managerial diseconomies from expansion in firm size can be avoided over time as the firms adapt. However, as other car makers are also engaging in R&D, the overall success would depend on whether the M&A enable the Chinese makers to jump ahead of the race for improved cars.

**CSQ Q3 - ACJC H2 Economics 2019 Preliminary Qsn 1**

**The UK Rail Industry**

**Table 3: Rail Ticket Prices for Southampton to Manchester (in UK pound sterling (£))**

|  |  |  |
| --- | --- | --- |
| Type of ticket | Direct route | Indirect route |
| Advance | 57.00 | \*n/a |
| Off-peak | 113.50 | 115.10 |
| Anytime | 124.80 | 221.50 |
| First Class Anytime | 276.30 | 305.00 |

\*n/a = not available

When buying a ticket for a rail journey, consumers often face an array of possible prices and types of rail ticket. Consumers could choose the following types of rail tickets:

1. Indirect route will require travellers to switch to another rail to reach the destination and the journey will usually include multiple stops.
2. Advance tickets have to be bought in advance (up to the day before the day of travel) and are sold in limited numbers and subject to availability. These tickets are only valid on the date/train specified.
3. Off-Peak tickets can be bought anytime. However, travellers have to travel during off-peak hours (exclude peak hours in the mornings, late afternoons and late evenings on Mondays- Fridays).
4. Anytime tickets can be bought anytime and allow travellers to travel anytime.
5. First Class tickets offer additional free Wi-Fi, complimentary food and drinks, free newspapers, extra leg room and reclining seats as well as access to first class lounges at certain stations.

Source: Economic Review February 2019 Vol 36 No.3

(d) Explain whether the UK rail ticketing strategies could be considered an example of price discrimination. [4]

Price discrimination: the practice of charging different prices to different groups of customers for the exact same product or for different quantities of a specific product at two or more prices or rest merely on different buyers’ valuation of the same product, they are discriminatory for reasons not associated with cost differences.

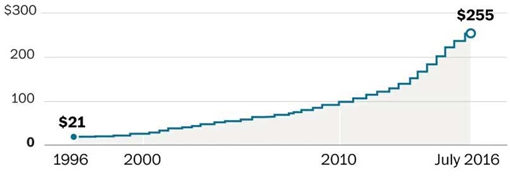
The above pricing of ticket is considered a form of price discrimination as the pricing is of different price level at different time period of travel although the distance of travel is the same, making it the same goods and services which can be considered to have the same cost condition. As the supply of the rail services can be controlled by the train service, it has full control of the supply and consumers can only buy from this source of supply.

It may not be considered a form of price discrimination as the direct and indirect route is of different distance of travel and this means that the cost of production may be different as the cost of petrol for traveling is different. Thus the price of services may not be the same. Although the train is traveling for the same distance for the Economy and First Class, the nature of goods for both level is not the same and this the cost of the services is not the same, contributing to price variation.

**CSQ Q4 - AJC H2 Economics 2019 Preliminary Qsn 1**

**The Pharmaceutical Industry**

**Figure 1: List Price of Humalog brand Insulin (US$)**

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Source**:** Truven Health Analytics, accessed 15 July 2019

**Extract 1: Why Insulin defies the normal rules of Economics and keeps getting more expensive**

Here's a basic economic principle: The price of a product usually falls over time. That's often because competitors offer alternatives, or new advances make past breakthroughs less valuable. Yet none of the typical pressures have driven down the price of insulin, a life-saving drug for diabetics.

"Insulin manufacturers charge so much for a really simple reason: because they can," said Shannon Brownlee, co-chair of the Lown Institute's Right Care Alliance, a Brookline nonprofit that advocates for affordable health care.

Here's one explanation for why life-saving drugs like insulin defy normal consumer economics: If a good is too expensive, consumers can hold off buying, but with insulin, Brownlee says, "Where is the downward pressure? Customers can't put downward pressure on it because they can't walk away. If they don't take insulin, they'll die."

According to Joseph Doyle, co-director of the Initiative for Health Systems Innovation at MIT's Sloan School of Management, a driver for insulin prices and other drug prices, is patents. He points out that patent laws allow the few dominant insulin makers to minimise competition by patenting incremental changes to their products, which makes it hard for cheaper generics to enter the market.

Talk of profit margins can seem a bit cold when lives are at stake. But drug companies wouldn't pursue lifesaving therapies if there weren't financial rewards, said Amitabh Chandra, director of health policy research at Harvard's Kennedy School of Government. The Massachusetts Biotechnology Council contends that pharmaceutical firms' ability to make large profits can actually save money in the health care system, overall. "If a drug can cure somebody and keep them out of the hospital, it will save trillions of dollars in the long run," said MassBio CEO Bob Coughlin. "And that's what we really need to focus on."

Source: Boston’s NPR News Station, 25 June 2019

**(b) (i) Define contestability and state how the expiry of a patent will affect the contestability of the pharmaceutical industry. [2]**

The contestability of the firm refers to the capacity of the firm being challenged for the market dominance. In the process, the degree of competition will be higher in this industry where the degree of substitution of the products purchased by consumers is higher. The expiration of the patent rights will mean that the exclusive right of the firm in the production can longer restrain other firms from producing the good in this industry, causing the firm to lose market dominance due to higher degree of competition.

**(ii) Using a diagram, explain how the expiry of a patent would lower the profits of a major insulin producer such as Humalog. [4]**

When the firm, Humalog, lost the patent rights to produce the good, it lost the exclusive rights to produce the good and allowed other firms to produce the goods in the industry. As a result, the industry becomes more competitive and the market power of the firms in the industry experiences higher degree of competition than before and this causes the firm’s price and output level to change and the profit level is lowered.

Diagram

As seen from the diagram, the original level of production is at Qm where MRo cuts MCo based on profit maximization and the firm is making supernormal profit as ARo exceeds MCo. However, as the expiration of patent raises the degree of competition and causes the pivotal inward shift of the MRo to MR1 and the production equilibrium is now lower than Qm at Q1 where MR1 cuts MCo. Consequently, the firm makes normal profit as the patent rights has reduced the market demand and make it more price elastic, causing the firm to reduce profit level

**Essay Question 1**

**Explain how firms will compete in markets with high degree of competition and in markets with low degree of competition. (15)**

**Introduction**

**In the imperfect market condition, firms will compete differently based on the different types of market structure and this will be affected by the pricing condition and how the firms behave in these types of market.**

**Main body**

1. **Explain the main differences of the different types of market structure based on the features of the firms in the MC, oligopoly and monopoly**

* imperfect market condition on price and cost of production, immobility of resources
* differs in terms of no of firms, nature of product, degree of barriers to entry
* the slope of MR and AR, the capacity lower cost (EOS)

1. **Link the market with low degree of competition to the firms in monopolistic and oligopolistic market and explain how they will compete**

For monopoly – prevent the market become contestable – barriers to entry

for oligopoly – collusive – reduce market unpredictability – increase market power – raise price – increase profit – how they collude

For non-collusive – price rigidity – no advantage to increase or decrease price – will not resort to price competition – adopt non-price competition (product differentiation / product recognition)

**2.1 It may adopt mergers and acquisition – why?**

* increase market share – reduce market competition – cut down cost in advertising as they can reduce the need to compete
* increase output to reap more EOS – lower AC – enable to increase profit or lower price to further raise competitiveness
* reduce risk and extend market diversification

1. **Link the market with low degree of competition in monopolistic competitive market and explain how they will compete**

price competition in the SR – why? capture new market demand / no knowledge of competitors / product recognition and customer loyalty

non-price competition in the LR – why? promote customer base – product differentiation, promotion – create their small degree of market power – raise price

1. **Analysis – key determinant in determining the nature of competition**

no of firms which determine the degree of competition – this will shape how the firms will compete as they determine the way the firms have to react with competition and market share

**Conclusion**

## Discuss the relative significance of input cost, consumer incomes and market concentration in influencing firms’ pricing decisions. [25]

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