WELSH JOINT EDUCATION COMMITTEE
General Certificate of Education
Advanced

CYD-BWYLLGOR ADDYSG CYMRU
Tystysgrif Addysg Gyffredinol
Uwch

374/01

ECONOMICS EC4

A.M. WEDNESDAY, 16 June 2004

(1¼ hours)

ADDITIONAL MATERIALS

In addition to this examination paper, you will need a 12 page answer book.

INSTRUCTIONS TO CANDIDATES

Answer **one** of the questions.

INFORMATION FOR CANDIDATES

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

You are reminded of the necessity for good written communication and orderly presentation in your answers.

Answer **one** *question.*

1. Newcomer '3' can't find magic numbers

Despite aggressive price cuts by new entrant '3', the big players in the mobile phone network market have the means to hang on to customers and avoid a price war.

Mobile Phone Network Operator market share and profits 2002

	Market Share %	Profit/loss £ million
Vodafone	42	751
Orange	26	344
O2 (now MMO2)	20	-259
T-mobile	12	-261

Phone company '3' has entered the UK mobile phone market like a marauding Viking. Owned by a Hong Kong-based multinational, '3' has unleashed a ferocious media marketing blitz. Undercutting its rivals on third generation (3G) phone calls, it is subsidising handsets and offering generous commission to sales teams in a bid to win one million customers from a standing start.

'3' hopes that its new 3G phones, which are more technologically advanced than those of the existing 'Big 4' operators, will give it the crucial advantage needed to break into the market. This ought to be great news for consumers, who are expected to upgrade phones and contracts in increasing numbers this Christmas. But those expecting an all-out price war had best think again.

True, the established operators are tinkering with what they offer to consumers. But they are still working out whether '3's' technology and call coverage will be attractive to customers. Until it is convincing enough to win consumers in large numbers, the main players will sit on their hands.

T-Mobile and O2 have dropped prices while Orange has reintroduced subsidies to make mobile phones cheaper for new customers. Rates are becoming more competitive but we are a long way from a price war. Competition still largely takes the form of extensive advertising and sponsorship of sports teams such as Manchester United and the England rugby union side.

If '3' begins to take customers from the established giants - Vodafone, O2, Orange and T-Mobile - maybe prices will be slashed. A price war, though, would be disastrous for the big four operators coming hot on the heels of enforced price reductions by the Competition Commission on calls made to rival networks. The cost of calls to mobile phones will fall by up to 50% over the next three years.

The new rules - which will begin to come into effect at the end of next month - could save consumers £190m each year until 2006. The latest estimate from Oftel is that by 2006 the cost of a call from a BT fixed line to a mobile will fall from 17p/min to 12p/min on average. As for cross network mobile phone calls, the average cost will fall from 24p/min to 19p/min. The Competition Commission's ruling could cost the phone industry up to £2 billion.

It may have slashed its charges and created high demand, but '3' may run short on supplies as it only recently took delivery of a consignment of camera and speaker phones and may not get another delivery until shortly before Christmas. It racked up a £317m loss in its first six months of trading.

'3', which paid £4.4bn for its British 3G licence, was the first mobile network in Europe to offer services using the new technology. But the launch was marred by technical problems and costs way above those of its main competitors which have reassured analysts that a price war won't be too severe at this stage.

This feeling was bolstered after last week's news when '3' admitted that it may not be able to launch a pre-pay product in time for Christmas, scuppering its chances of winning those elusive one million customers before the year end.

In June, '3' cut management staff and introduced an aggressive tariff that offers customers 500 minutes of calls for £25 a month, or 750 minutes for £35. It now has a bargain basement £15 per month tariff.

BT, meanwhile, is to re-enter the UK mobile phone market in partnership with Deutsche Telekom-owned T-mobile. The company unveiled two initiatives earlier this year aimed at domestic and business customers and designed to re-establish it in the mobile market.

'For people over 35, BT is an instantly recognisable brand and this could win them custom, particularly from families,' says Stephen Pentland, a partner with leading TMT consultancy, Spectrum Strategy. 'This grouping isn't served well by the existing operators. BT's reputation is of a safe and trusted operator.'

Tesco Mobile - a 50:50 joint venture with O2 - is a pre-pay service which will charge a flat rate of 20p a minute for calls to all British mobiles and landlines. It operates at the cheap end of the market. Text messages will be 10p. The service will offer a favourite numbers scheme, where users can select three UK landlines or Tesco mobile numbers, where calls will cost 10p a minute and texts 5p. It will initially be available at the 97 largest Tesco stores.

The existing operators are running scared, not helped by a recent survey which showed that only 27% of mobile phone users are committed to staying with their existing network (a much lower loyalty figure than banks or car manufacturers command).

Adapted from *The Observer, Sunday 26 June, 2003*

(a) What does the data suggest about the market structure of the mobile phone network market? [8]

(b) Explain the barriers to entry which exist in the mobile phone network market. [8]

(c) Discuss how successful new competitors are likely to be in overcoming these barriers to entry. [12]

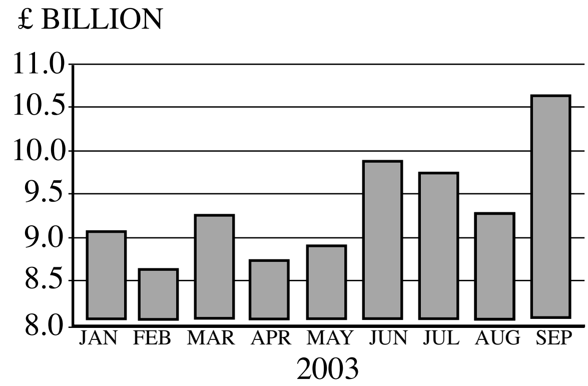
(d) Evaluate the case for and against the Competition Commission forcing mobile phone network operators to cut their charges. [12]

2. Bricks and mortar could turn into a house of cards

The nation’s wealth is tied up as never before in property. In the first of a series, Faisal Islam argues an interest rate rise may be disastrous for homeowners.

Figure 1 – Consumer borrowing 2003

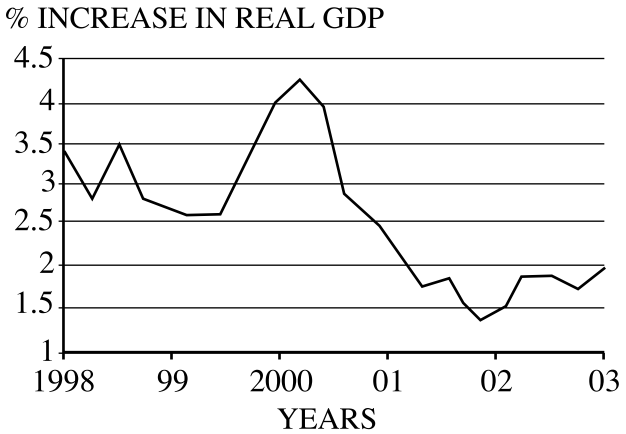
Borrowing Trends 2003



Source: Bank of England

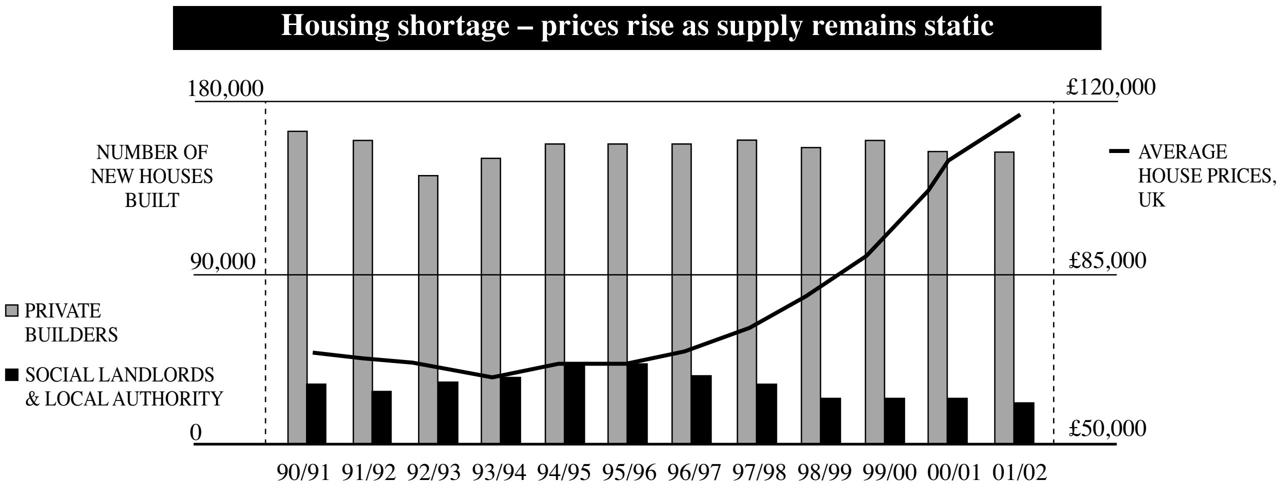
Figure 2 – UK economic growth 1998-2003

UK Growth



Source: ONS

Figure 3 – House-building and prices 1990-2002



As the Bank of England primes itself for the first increase in interest rates since February 2000, the British housing market, lifeblood of the economy in recent years, faces a critical moment.

Higher rates will begin to impact on house prices and inject some realism into the market,’ says Edward Stansfield, property expert at Capital Economics, which is predicting ‘a 20 per cent fall in house prices over the next 18 months’.

The immediate news is likely to come from the Bank of England at noon on Thursday. During the past four years, its conscious strategy has been to stave off the ill effects of a weak global economy by propping up the housing market, making it easier for UK consumers to borrow and spend. But the red lights are now flashing in the Bank's control room because of concern about consumer spending fuelling inflation and widening the largest-ever £8.6 billion current account deficit which occurred in the last quarter.

The most significant domestic economic trend this year has been the fall in take-home pay. Real wages, after taking into account inflation and tax rises, have fallen between 0.5 and 1 per cent. But instead of a generalised fall in high street spending, Britain has gone out and borrowed even more (a record £10.7 billion in September) fuelling a surge in September retail sales.

In the past few months the housing market has shown renewed vigour. Friday's figures showed average prices were up 2 per cent during October and 16.1 per cent since October 2002. So this week the Bank is almost certain to step in and stop the party getting out of hand. But what will this do to the housing market?

The predicted modest rise in interest rates - a quarter point this week, slowly reaching 5 per cent by the end of 2004 - is peanuts compared with the 12 per cent summit reached in 1992. No one is suggesting that rates will scale those skyscraper-like heights. However, economists point out that even small rises from the Bank could have a huge effect on confidence and on spending.

HSBC's UK economist John Butler, says that very high levels of debt mean interest rates do not have to go up much to cause considerable pain. He has calculated that rates of 5 or 6 per cent next year will hamper the consumer as much as 10 or 12 per cent rates did in 1990.

Other forecasters, however, argue that increased interest rates may not necessarily lead to a large fall in house prices. Yet against the evidence for falling house prices is the desperate shortage of housing in some areas, particularly London and South-East England. There are very few new homes being built by councils and 'social landlords' such as housing associations, and the number is declining.

Not enough homes are being built, and yet more people want them. The principal problem is that no agency is building enough affordable homes. Councils used to take on this role, but no more. With land prices accelerating, housing associations cannot afford to buy land on budgets which have not increased in real terms since 1992.

Builders are often hanging on to unused land on which they have obtained planning permission to build houses. Some are simply waiting for the value of the land to rise before selling it on. The Government is proposing a tax on any profit made in this way to encourage builders to use the land for housing.

Adapted from *The Observer, Sunday 2 November, 2003*

(a) Explain why the Bank of England was concerned about the extent of consumer borrowing in 2003. [8]

(b) Explain why Edward Stansfield thought that there would be "a 20 per cent fall in house prices over the next 18 months". (Lines 4-5) [8]

(c) Discuss the view that "increased interest rates may not necessarily lead to a large fall in house prices." (Lines 27-28) [12]

(d) Discuss the possible effects of increased interest rates upon the Government's ability to achieve its macroeconomic objectives. [12]