1 Outline the evidence that suggests the Dollar is very strong.

2 Show what evidence there is that the “very strong” Dollar has been caused by the Fed’s actions.

3 Explain the (theoretical) causal link between the exchange rate and the interest rate.

4 Explain two points you could make to evaluate this causal link.

5 Explain two reasons why a “very strong” Dollar could be undesirable for US firms.

6 Explain two reasons why a “very strong” Dollar could be undesirable for the US macroeconomy.

7 Explain two other reasons (other than the Exchange Rate) why high interest rates could be undesirable for the US macroeconomy.

Extract A
President Trump’s twitter rants against the Fed

Donald J. Trump @realDonaldTrump
As your President, one would think that I would be thrilled with our very strong dollar. I am not! The Fed’s high interest rate level, in comparison to other countries, is keeping the dollar high, making it more difficult for our great manufacturers like Caterpillar, Boeing, ... 55K: 5:50 PM - Aug 8, 2019

23K people are talking about this

Donald J. Trump @realDonaldTrump
Replying to @realDonaldTrump
...John Deere, our car companies, & others, to compete on a level playing field. With substantial Fed Cuts (there is no inflation) and no quantitative tightening, the dollar will make it possible for our companies to win against any competition. We have the greatest companies...

23.7K: 3:36 PM - Aug 8, 2019

Extract B
US Feds Funds Rate (base rate of interest) for last 5 years

Source: Tradingeconomics.com   Federal Reserve

Extract C
1 $US Dollar to Chinese Renminbi for last 5 years

Source: Tradingeconomics.com
### USA (An Example of Tight Monetary Policy) Suggested Answers

| 1 Outline | the evidence that suggests the Dollar is very strong. Extract C suggests that the Dollar has appreciated against the Chinese Renminbi from 6.2 to 7.2 (16.1%) in the last 5 years. |
| 2 Show | what evidence there is that the “very strong” Dollar has been caused by the Fed’s actions. Extract B shows that US interest rates have climbed from 0.25% to a peak of 2.5% (now 2.25%) in the same period. It is possible that the increase in the base rate has caused an appreciation of the exchange rate. |
| 3 Explain | the (theoretical) causal link between the exchange rate and the interest rate. When interest rates rise, speculators tend to buy of a currency because they anticipate greater returns when savings in the bank. Therefore the demand for the currency increases and this puts upwards pressure on the value of the currency (appreciation). |
| 4 Explain | two points you could make to evaluate this causal link. 1 Extract C only shows the US dollar against the Chinese Renminbi. The value of the dollar against other currencies is not shown. 2 The appreciation of the dollar may have been caused for other reasons such as high business confidence, low business confidence in other countries. |
| 5 Explain | two reasons why a “very strong” Dollar could be undesirable for US firms. 1 Exports are less competitive. Therefore export sales fall and US firms see less revenue (and profit). 2 Imported raw materials and component parts (as used by manufacturing firms like Caterpillar and Boeing) will be more expensive which causes the cost of production for US firms to increase. |
| 6 Explain | two reasons why a “very strong” Dollar could be undesirable for the US macroeconomy. 1 Jobs at large companies like Caterpillar and Boeing, that are now struggling to be competitive, may be under threat. There may be job losses (unemployment). 2 Cost-push inflation (from higher costs of imports) may push some US citizens into poverty and erode the value of people’s savings. |
| 7 Explain | two other reasons (other than the Exchange Rate) why high interest rates could be undesirable for the US macroeconomy. 1 High interest rates incentivize saving rather than spending. Therefore, aggregate demand is likely to slow as people would rather save their money than spend it. 2 High interest rates are likely to discourage investment. The cost of borrowing is greater when interest rates are high, so firms may delay or cancel their future investment. They may even move abroad to expand their operations. |
Describe any evidence suggesting that Japan has suffered from a “liquidity trap”.

Explain two reasons why low interest rates should stimulate the economy.

Explain two reasons why “monetary policy is unable to stimulate the Japanese economy”.

Define the term ‘moral hazard’.

State the 5 stages of a speculative bubble.

Explain two problems associated with deflation.

Calculate the % change in Japan’s GDP between 1995 and 2007.

**Extract A**

The Lost 20 years was a period of economic stagnation in Japan following an asset price bubble’s collapse in late 1991. According to Wikipedia, “over the period of 1995 to 2007, Japanese GDP fell from $5.33 trillion to $4.36 trillion in nominal terms, real wages fell around 5%, while the country experienced deflation”. This was before the Great Recession of 2007/08 which had its own negative impact on the country too.

**Extract B**

Economist Paul Krugman has argued that Japan’s lost 20 years is an example of a liquidity trap (a situation in which monetary policy is unable to stimulate the economy because nominal interest rates are already close to zero).

Krugman argued that the asset bubble in Japan had tripled land and stock market prices during the prosperous 1980s. In most countries, firms raise their funds through capital markets like the stock market. In Japan, however, the high personal savings rates mean that Japanese firms could rely heavily on traditional bank loans from supporting banking networks. This created a moral hazard problem – not so present with the stock market – and reduced lending standards. When the bubble burst, financial institutions were eventually bailed out through capital infusions from the Government and cheap credit from the central bank. Now, loose monetary policy is unable to stimulate the Japanese economy.
1. **Describe** any evidence suggesting that Japan has suffered from a “liquidity trap”.

   Extract C shows that the base rate of interest fell dramatically from 6% in 1991 to 1.9% in 1995 and then continued to fall. It has hovered around 0% since the turn of the century in 2000. Since 2017, the base rate has been negative at -0.1%.

   Extract A tells us that the economy shrank by a significant amount between 1995 and 2007 and that economic stagflation has plagued the country for the last two decades.

   This all points to the definition of a ‘liquidity trap’ – low nominal interest rates which fail to stimulate the economy.

2. **Explain** two reasons why low interest rates should stimulate the economy.

   1. Low interest rates encourage spending rather than saving. Consumption is a large component of AD and if C increases then AD should increase.
   2. Low interest rates should incentivize firms to invest more. Low interest rates mean that the cost of borrowing is low and more firms are willing and able to borrow money for the purpose of expansion/investment.

3. **Explain** two reasons why “monetary policy is unable to stimulate the Japanese economy”.

   1. If the economy has just experienced an economic downturn (like an asset crash(!)) then confidence is likely to be very low and low interest rates are unable to stimulate demand.
   2. If lots of firms are struggling with very large debts, it is unlikely that they will want to take on even more debt regardless of how low interest rates are.

   **3.** There is a time lag between reducing interest rates and the effect on the economy. Each stage of the transmission mechanism has its own frictions. However, this is clearly not the case in Japan. There is not a two decade time lag!!

4. **Define** the term ‘moral hazard’.

   When the party with superior information alters his/her behaviour in such a way that benefits himself while imposing costs on those with inferior information. For example, moral hazard occurs when banks are likely to take greater risks, knowing that their investments are being made with depositors’ money rather than investors’. Shareholders have AGMs and hold the managers to account, depositors simply deposit and forget.

5. **State** the 5 stages of a speculative bubble.

   Displacement, boom, euphoria, profit taking and panic.

6. **Explain** two problems associated with deflation.

   1. Firms will see a fall in their revenue which, ultimately, may not cover their costs. They may start to make negative economic profit.
   2. If people believe that prices are falling in the future then they may be unwilling to spend their money today. This is because they will believe that their money will go further tomorrow – and they would rather save it than spend it. If everyone saves their money (withdrawal from circular flow) rather than spending it, then National Income will fall.

7. **Calculate** the % change in Japan’s GDP between 1995 and 2007:

   \[
   \left(\frac{4.36 - 5.33}{5.33}\right) \times 100 = -18.2\% 
   \]
1 Explain two reasons why a fiscal austerity policy could be beneficial for an economy.

2 Outline the evidence suggesting that Germany has achieved its “Schwarze null” aim?

3 Comment on the data in Extract C.

4 Explain the (theoretical) causal link between fiscal austerity and economic growth.

5 Explain two points you could make to evaluate this causal link.

6 Explain two advantages and two disadvantages of abandoning the “Schwarze null policy” and embarking on a Government spending programme.

**Extract A**

For 10 years, Germany has had a “Schwarze null” (black zero) policy. This was a self-imposed commitment to reduce Government spending and balance the budget (i.e. fiscal austerity).

The policy was introduced in 2009 after the global financial crisis. At that time, the Government embarked on two fiscal stimulus packages and a €500bn bank bailout – the result of which was an €86bn deficit and a debt-to-GDP ratio of 81%. The new law, which is in the German constitution, banned the federal government from having a fiscal deficit any larger than 0.35% of GDP.

**Extract B**

German Government budget for last 10 years (% of GDP)

Source: Federal Statistical Office

**Extract C**

Germany quarterly growth rate since Q3 2016

Source: Federal Statistical Office
GERMANY (AN EXAMPLE OF AN ECONOMY AIMING FOR A BALANCED BUDGET)  
SUGGESTED ANSWERS

1 Explain two reasons why a fiscal austerity policy could be beneficial for an economy.
   1 Enables a Government to reduce (or at least slow down the rate of growth of) its national debt.
   2 Prevents the Government from subsidising inefficient industries. Resources are reallocated to their optimal use via the price mechanism.

2 Outline the evidence that Germany has achieved its “Schwarze null” aim?
   Extract B shows that, since 2010, the Government’s fiscal position has steadily improved. In 2010, the deficit was 4.2% of GDP. 2 years later, in 2012, they balanced the books. In 2018, the budget is now in surplus at 1.7% of GDP.

3 Comment on the data in Extract C.
   Economic growth in Germany has been largely positive over the last 3 years. However, out of the last 4 quarterly figures, 2 have been negative. Germany is not yet in recession but growth is slowing and a second successive quarter of negative growth in Q3 2019 would mean Germany is in recession.

4 Explain the (theoretical) causal link between fiscal austerity and economic growth?
   Government spending is a large component of AD (G) and an injection into the circular flow. By contrast, T (taxes) is a withdrawal. When a Government embarks on a fiscal austerity programme (G<T), this implies that G is falling and AD will fall too as a result. Therefore, it should be expected that economic growth will fall.

5 Explain two points you could make to evaluate this causal link.
   1 Germany has only seen negative growth in the last few quarters. Clearly fiscal austerity did not cause negative growth for an entire ten years.
   2 Some other factor may have caused the negative economic growth such as low business confidence (Brexit and decline of exports to the UK).

6 Explain advantages and two disadvantages of abandoning the “Schwarze null policy” and embarking on a Government spending programme.
   Advantages
   1 It should cause AD to increase and create economic growth. In other words, it acts as a fiscal stimulus.
   2 It could provide Germany with some much needed ‘new’ infrastructure or helping to restructure the economy away from inefficient industries.

   Disadvantages
   1 It will send Germany into a fiscal deficit again and this will enlarge the national debt, which is already very high after 2009.
   2 It could cause inflation if the Government spending programme takes the economy up to full capacity. Demand-pull inflation.
1. Using an AD/AS diagram, show how the fiscal policies outlined in Extract A are likely to have affected the Price Level and Real National Output of the Chinese economy.

2. Explain the (theoretical) causal link between government spending and economic growth.

3. Explain how the size of the multiplier might affect the relationship between government spending and economic growth.

4. Outline evidence showing that “massive expansion of lending” has kept up China’s “pace of economic growth”.

5. Explain two reasons that could be used to explain why GDP slows even though Government spending increases.

6. According to Extract C, state how many recessions has China experienced over the last 20 years.

7. Explain two disadvantages of a large national debt.

8. Explain the difference between a fiscal deficit and a debt.

**Extract A**

Since the financial crash of 2008, China’s leadership has sought to keep up its pace of economic growth through a massive expansion of lending. Debt as a proportion of the economy has soared, from 140% of GDP in 2007 to nearly 260% in 2019.

Infrastructure spending has mushroomed, with thousands of miles of new railways and dozens of new underground systems and airports constructed. 

Source: www.bbc.co.uk/news/business-46865466

**Extract B**

Chinese Government Spending over last 20 years.

Right-hand figures in Chinese Yuan (hundred million)

**Extract C**

Chinese GDP annual growth rate over last 20 years

Source: National Bureau of Statistics of China
1 Using an AD/AS diagram, show how the fiscal policies outlined in Extract A are likely to have affected the Price Level and Real National Output of the Chinese economy.

AD/AS diagram showing AD and AS shifting to the right, increasing real GDP. The impact on the price level will depend on the relative sizes of the shifts in AD and AS.

2 Explain the (theoretical) causal link between government spending and economic growth.

G is a large component part of AD. In 2019, it is approx. 15% of GDP. If G increases (an injection into the circular flow) then National Income should rise and we should see positive economic growth.

3 Explain how the size of the multiplier might affect the relationship between government spending and economic growth.

The multiplier is the idea that an injection into the circular flow of income can cause an even greater change in the level of National Income of an economy. If the size of multiplier is very small (which indicates that people tend to save their money rather than spend it), then National Income is likely to grow by only a slightly greater amount than the injection. By contrast, if the size of Multiplier is very large (which indicates that people tend to spend their money rather than save it), then National Income is likely to grow by a much greater amount than the injection.

4 Outline evidence showing that “massive expansion of lending” has kept up China’s “pace of economic growth”.

Extract B shows that the Chinese Government has increased its fiscal spending over the last 20 years. In 1999, it was spending 2,000,000,000,000 (2trn Yuan) to 22,100,000,000,000 (22.1trn Yuan) in 2019. This is 900% increase.

At the same time, Extract C shows that China’s economy has seen positive growth throughout the period. The annual growth rate figure never dips below 6%. However, since 2010, the growth rate has slowed from 12% to 6%. China is slowing down, spending ever increasing Government spending.

5 Explain two reasons that could be used to explain why GDP slows even though Government spending increases.

1 Other components of AD are falling at the same time that G is rising. For example, exports may be falling to do a trade war or an international down turn in demand.

2 As GDP rises, it is increasingly difficult to achieve the same % change. This is because the base is larger and the same nominal increase in GDP is an ever decreasing % change.

6 According to Extract C, state how many recessions has China experienced over the last 20 years.

None. A recession occurs when there has been two successive quarters of negative growth. Extract C tell us that the Chinese has been growing every year for the last 20 years, albeit at faster or slower rates. The graph plots GDP growth rate rather than GDP, therefore when the line slopes downward this merely indicates a slowdown rather than negative growth (or a recession).

7 Explain two disadvantages of a large national debt.

1 The opportunity cost of future repayments. China will have to service the debt with regular repayments. The money spend on this is money foregone from other (perhaps more deserving) areas such education and healthcare.

2 As debt levels rise, credit rating falls. This increases the bond yield (or the cost of repayments). Therefore, China will find that their cost of borrowing will go up and up – which then leads to even greater repayments in the future.

8 Explain the difference between a fiscal deficit and a debt.

Debt is the accumulation of deficits. A fiscal deficit is simply the annual overspend of the Government (when G>T).
1 Define the term "contractionary fiscal policy".

2 Describe the evidence showing that the Indian Government is pursuing contractionary fiscal policy.

3 Explain the (theoretical) causal link between economic growth and tax revenue.

4 Explain two reasons why India has struggled to reach its fiscal targets.

5 Explain the (theoretical) causal link between contractionary fiscal policy and economic growth.

6 Draw a diagram to show the impact of a subsidy on fuel. Show the Government’s expenditure on the subsidy.

7 Explain two reasons why contractionary fiscal policy could be beneficial for an economy.

Extract C
In recent years, India has set itself several ambitious fiscal targets in order to try and reduce its large fiscal deficit. However, it has been a difficult road for Prime Minister Modi. It is easy to blame India’s economic growth rate, which has slowed from 8% in early 2018 to just 5% in late 2019. This has hampered tax revenues. But, there is another culprit: tax evasion. According to The Economic Times, “poor tax compliance adds to the government’s revenue collection woes amid a broader slowdown in the economy, where demand for everything from cookies to cars has taken a knock”1. In the second quarter of 2019, the Indian Government only just made its deficit target of 3.4% by cutting last minute expenditure plans and delaying fuel subsidies.

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1. economictimes.indiatimes.com/articleshow/70732480.cms?from=mnn&utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst
1 Define the term “contractionary fiscal policy”.

Fiscal policy involves the use of government spending, direct and indirect taxation and government borrowing to affect the level and growth of aggregate demand in the economy, output and jobs.

Contractionary fiscal policy involves increasing taxes, decreasing government expenditures or both in order to fight inflationary pressures. Due to an increase in taxes, households have less disposal income to spend, which reduces consumption.

2 Describe the evidence showing that the Indian Government is pursuing contractionary fiscal policy.

Extract A shows that Indian Government spending as a % of GDP over last 10 years has fallen steadily. In 2009, it was 15.82% and in 2019 it was 13.04%. Therefore G, as a component of AD, is falling.

Extract B shows that India’s budget deficit as a % of GDP over last 10 years has narrowed. In 2009, the budget deficit was -6.46% and in 2019, it had closed to -3.42%.

To some extent, this shows that contractionary fiscal policy is occurring. You would expect G to fall and the budget deficit to narrow. On the other hand, whilst the budget deficit is narrower it is STILL A DEFICIT! Even though G is falling, G>T. And this, to some degree, is expansionary rather than contractionary.

3 Explain the (theoretical) causal link between economic growth and tax revenue.

Economic growth should lead to greater tax revenues. This is because economic growth means that people have higher income. This means that they will pay more in income tax and sales tax (on their spending). Firms should see greater sales, since consumption goes up, and this means they will pay more corporation tax.

4 Explain two reasons why India has struggled to reach its fiscal targets.

1 Economic growth has slowed and so the tax revenues associated with growth (see previous question) have not been as plentiful as expected.

2 Tax evasion. Households and firms are simply not paying as much tax as they should be. Therefore, the level of tax revenue is not as much as expected.

5 Explain the (theoretical) causal link between contractionary fiscal policy and economic growth.

Government spending is a large component of AD (G) and an injection into the circular flow. By contrast, T (taxes) is a withdrawal. When a Government embarks on a contractionary fiscal policy (G<T), this implies that G is falling and AD will fall too as a result. Therefore, it should be expected that economic growth will fall. Extract C implies that this has happened in India.

6 Draw a diagram to show the impact of a subsidy on fuel.

Show the Government’s expenditure on the subsidy.

Diagram required. D and S diagram with subsidy. Subsidy rectangle to be shaded.

7 Explain two reasons why contractionary fiscal policy could be beneficial for an economy.

1 Enables a Government to reduce (or at least slowdown the rate of growth of) its national debt.

2 Prevents the Government from subsidising inefficient industries. Resources are reallocated to their optimal use via the price mechanism.