

## Extended writing unit 3 questions

Selected from past papers, for 12 marks:

*June 2002:* Discuss the alternative policies a government may use to improve a deficit in the balance of payments.

*June 2003:* Using AD and AS analysis, discuss the effect of an expansionary fiscal policy on the economy.

And the following are from older papers, for 20 marks.

*January 2003:*

- Discuss the impact an increase in demand for UK exports might have on government macro policies.
- Discuss the policies a government could use to reduce unemployment.

*June 2002:*

- Apart from interest rate cuts evaluate two other measures the government could use to stimulate aggregate demand.
- Discuss the effectiveness of monetary policy in achieving an increase in aggregate demand in an economy.

### Model answers

*Discuss the effectiveness of monetary policy in achieving an increase in aggregate demand in an economy.*

Monetary policy is the attempt by the government or central bank to control the level of economic activity within an economy by manipulating the money supply, supply of credit and interest rates.

To increase aggregate demand low interest rates will be required as these stimulate the components of aggregate demand,  $C + I + G + (X-M)$ .

For a policy to be viewed as effective a greater than proportional impact must be had with respect to the change made, that a  $\frac{1}{4}\%$  decrease in the rate of interest within an economy will lead to a greater than  $\frac{1}{4}\%$  increase in aggregate demand.

C, consumption is likely to increase if interest rates are lowered in an economy. Consumption becomes more attractive and saving less attractive as the rewards to individuals for saving become lower; the opportunity cost of dissaving decreases. The cost of taking on new debt decreases as repayments, at least at the present time, will be lower. By the same reasoning repayments on current borrowing becomes lower and as many households have a mortgage the combined effect of the above will result in increased discretionary income for individuals within the economy. As the UK has a high MPC any increase in discretionary income will lead to a large increase in consumption.

Investment, spending by businesses on capital is also likely to increase as loans are cheaper and the opportunity cost of dissaving decreases, so investment projects with projected lower returns become more attractive. Increased consumer spending will also motivate firms to increase investment as prospective return from projects will increase.

As many individuals own their own homes in the UK economy low interest rates are likely to increase the demand for housing as generally it is the cost of repayments that individuals take into account, not the cost of the property. Increased investment will also

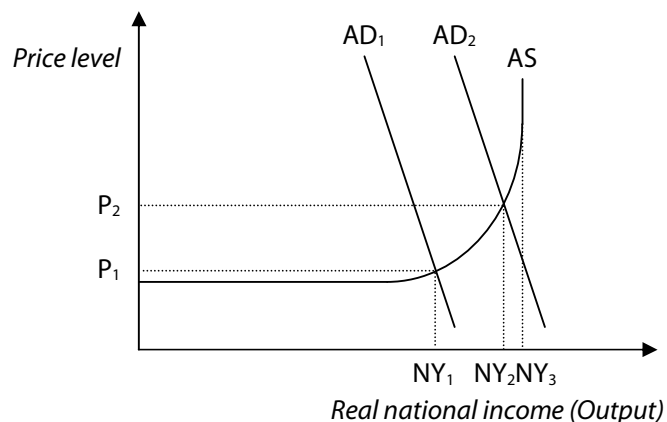
lead to higher future expectations and may increase the value of stocks and shares. The cumulative effect will therefore be that many consumers may experience a positive wealth effect and so increase consumption further.

Government expenditure is likely to remain reasonably unchanged as generally this is planned far in advance and not altered but a decrease in interest rates would lead to a decrease in repayments on the national debt so there may be small increase if the government chooses to spend this.

If the rate of interest in the economy is lower than in other global economies then 'hot money' stored in the UK may move overseas, however this will be very dependent on the magnitude of the change and the comparison of interest rates between different economies.

If hot money does flow out of the UK this will cause an increased supply for GBP so cause the equilibrium price and quantity demanded to increase, but more importantly for the price to fall. This deflation makes imports more expensive for UK consumers so demand for imports should decrease, and makes exports cheaper for overseas businesses. This will cause an increased demand for UK exports as they become more competitive with overseas manufacturers.

The change in net exports is very dependent on the size of the change, initially on the amount of hot money stored in the UK but then also on the elasticities of demand for both imports and exports. However there should be a general trend to some degree that exports increase and imports decrease which is likely to improve the balance of payments situation for an economy such as the UK which has a current account deficit.



The expansionary monetary policy aims to increase aggregate demand and so cause the aggregate demand curve to shift outwards from  $AD_1$  to  $AD_2$ . This will cause an increase in the price level in the economy of  $P_1$  to  $P_2$  and an increase in real national income (output) from  $NY_1$  to  $NY_2$ . This will cause a decrease in unemployment from  $NY_1NY_3$  to  $NY_2NY_3$ . Depending on how near to the full capacity the economy was previously acting the inflationary pressure may be larger or smaller depending on the scarcity of resources as at very low employment levels it is easy for firms to find resources without any increase in price.

Interest rates are likely to be very effective at increasing both consumer consumption and investment by private firms, and in the long run will bring about an increase in aggregate supply (due to increased investment) so will aid the economy to meet its long run growth potential.