Suggested Answers

(a)(i) Define Stagflation [1]

- Stagflation refers to the situation where the economy is facing rising inflation and slowing growth and/or rising unemployment.

Or

- Stagflation refers to the situation where the economy is facing high inflation and low growth and/or high unemployment.

(ii) With reference to data, comment on the evidence of stagflation for developing countries. [3]

Evidence from the case (any one of the following to score the first two marks)

- Evidence from extract 1 suggests that growth in developing countries may be slowing down. Signs such as 'fast-growing emerging markets losing pace' and 'fast-growing economies slowing slightly' provide prima facie evidence of slowing growth. Evidence from extract 2 suggests rising inflation from developing countries. Signs include 'average inflation rising from 5.4 to 5.6 per cent' and 'high inflation, especially in South Asia and Africa.' [2]

- Extract 2 mentions that average inflation in the developing economies will increase slightly from 5.4 per cent in 2012 to 5.6 per cent in 2013 partly due policy measures such as lower fuel subsidies and higher minimum wages. As these causes of inflation are cost push in nature, this provides evidence of stagflation [2]

- Extract 2 mentions that various economies, especially in South Asia and Africa, will continue to face high inflation rates partly due to structural bottlenecks such as energy shortages. As these causes of inflation are cost push in nature, this provides evidence of stagflation [2]

Since the command word is 'comment' and not 'explain', there needs to be a comment on the extent of the evidence to score the 3rd mark e.g.

- However, more data such as actual growth rate or unemployment rate is required to make a more accurate judgment on whether there was indeed stagflation. [1]

(b) Explain what the author of extract 1 means by "synchronized growth" and the policies that had "set the stage" for such growth to be achieved. [4]

- According to extract 1 "synchronized growth" "means that the demand from developed markets will support developing-market growth, and they will support each other." What this means is higher growth in developed countries generates more income for them to purchase imports from developing countries. This raises the growth and income of developing countries which then enables them to buy more imports from the developed countries. Since their growths are mutually reinforcing, they are therefore synchronized [2]

- According to extract 1, central banks in the U.S., Japan and Europe showered money on their economies, held interest rates low and promised to continue to do so in a bid to animate a recovery. This suggests that these developed countries engaged in expansionary monetary policy to stimulate consumption, investment and hence AD, thus causing their output, income and hence demand for imports from the developing countries to rise [2]

(c) Identify and explain one demand and one supply factor in Extract 2 that might affect inflation. [4]

- Demand factor: Continued high unemployment in developed countries implies that demand is not yet high enough to ensure employment of workers. This suggests that demand-pull inflation is unlikely. [2m]
- Supply factor: Easing of international commodity prices may reduce cost of production for countries that needs to import raw materials. This reduced cost-push inflation. [2m]

(Other demand such as rapid credit growth, elevated inflationary expectations and supply factors such as higher minimum wage, lower fuel subsidies are also acceptable)

(d) Based on the data, discuss the effectiveness of expansionary fiscal and monetary policies in facilitating the recovery of the US economy? [8]

Question interpretation

- What is meant by expansionary fiscal and monetary policies?
- How do these policies work?
- What are the limitations of these policies?
- How effective are these policies in facilitating the US economic recover?

Introduction

- As the US was facing an economic downturn since the 2008/2009 financial crisis, both expansionary monetary and fiscal policies were used to stimulate the economy in order to generate an economic recovery.
- The budget deficits in Table 1 suggests the use of expansionary fiscal policy while the terms “ showered money” and “held interest rates low” in extract 1 suggests that the use of expansionary monetary policy

How can these policies be used to stimulate the US economy?

- Expansionary fiscal policy refers to deliberate increases in government spending (G) and reduction in direct taxation (T) in order to boost aggregate demand (AD)
- Raising G provides a direct boost to AD while lowering T causes AD to rise by stimulating consumption (C) and investments (I)
- Expansionary monetary policy refers to the deliberate lowering of interest rates in order to boost AD via stimulating I and C from borrowing by firms and households respectively
- A rise in AD along the horizontal or upward sloping portion of the AS curve (i.e. there exists spare capacity) causes real output and employment to rise
- Subsequently, AD, output and income rises further due to subsequent rounds of diminishing rises in income induced consumption caused by the multiplier effect

How effective have these policies been for the US economy?

- Although extract 1 suggests some signs of a recovery, this was challenged by extract 2 where ‘large output gaps and high unemployment are still wide-spread’.

- This suggests that the effectiveness of monetary policy was limited, possibly due to poor economic outlook blunting firms and households desire to borrow, hence causing investment and consumption to be interest insensitive
- This is further strengthened by Extract 3 which states that 'monetary policy has limited room' to support growth further, which suggests that US could be facing a liquidity trap, which occurs when interest rates are already so low that any further rate reductions become meaningless.

- Similarly, the lack of strong and decisive economic recovery seems to also suggest that the effectiveness of expansionary fiscal policy was limited.
- The size of US multiplier and crowding out are both unlikely reasons to explain the ineffectiveness of expansionary fiscal policies. This is supported by extract 5 where the low interest rates environment negates the risk of crowding out.
- The ineffectiveness could therefore be attributed to bleak economic outlook that blunts the effectiveness of the payroll tax cuts mentioned in extract 3 to stimulate household spending. The high unemployment mentioned by in extract 2 also reduces the effect of cutting taxes. There could also be long time lags needed for fiscal policy to take effect and also the high and increasing level of US government debt (table 1) constraining its ability to spend even more that what has already been done.

Conclusion

- Although both policies were arguably ineffective in facilitating a recovery, extract 3 suggests that these policies probably helped to curb the worsening of the recession. In other words, the recession would be much worse if the policies were not implemented.
- Despite implementing the sequester in 2013 (extract 1), resulting in the smallest budget deficit over the last few years (table 1), 'developed nations (including the US) gained strength' during that time period (extract 1), implying that monetary policy was more effective than fiscal policy in aiding economic recovery.
- Extract 3 highlighted the importance of the role of fiscal policy when it suggest reducing the rate of deficit cuts would help with economic recovery when liquidity trap has set in. This implies that perhaps fiscal policy in terms of government spending can still maintain a role amid the bleak economic outlook to kick-start the recovery.

L1: Define expansionary monetary and fiscal policies [1]
L2: Explain how these policies work and their limitations [2-4]
L3: Analyze the effectiveness of these policies using case data [5-7]
E: Evaluate the overall effectiveness of these policies in facilitating the US economic recovery [+1]

(e) Discuss the justifications for implementing the 'sequester' and the likely effects on the world economy. [10]

Question interpretation

- What is the 'sequester'?
- What are the arguments for and against implementing the 'sequester'?
- What are the likely effects of implementing the 'sequester' on the US and world economy?

Introduction

- The 'sequester' is a form of automatic spending cuts that that is self-imposed to reduce the massive amount of debt accumulated by the US govt.

- The answer aims to explain the arguments for and against implementing the 'sequester' before analyzing and evaluating the likely effects on the US and world economy.

Arguments for implementing the 'sequester'

- From table 1, US debt to GDP ratio has been rising and by 2013 it has exceeded 100%
- By reducing the level of debt, it prevents the US government from falling into a debt trap where debt gets bigger due to the higher interest needed to secure more borrowings (like Greece mentioned in extract 4)
- If the debt is held by foreigners, the greater interest payment in the future means "building less for the future" and "worsen government ability to invest for competitiveness and higher living standards" (extract 5) in the future
- If the debt is not reduced and becomes unsustainable, a stage will come when no one will be willing lend to the US government anymore as they will doubt its ability to pay them back

Arguments against implementing the 'sequester'

- However, extract 5 suggested increasing borrowing since risk of crowding out private investment is negligible in the current pessimistic climate.
- Furthermore, unlike Greece, which has to borrow in Euro but has no ability to print it, the US can always resort to printing US$ to finance its debt (extract 4) so it does not necessary have to engage in such drastic austerity measures
- Nevertheless if the US government were to resort to monetizing their debt, the main worry is that this could eventually lead to 'runaway inflation' (extract 4).

What are the likely effects on the world economy?

- As the sequester originates from the US, we first analyse the effect it has on the US before the implications on the rest of the world.
- The effect on the US in the short term is a weakening of a stimulus to growth amid a situation where recovery is still weak. This would reduce the rate of recovery and may even cause growth to become negative.
- Given that interest rates at already at zero hence "monetary policy has limited room to support" growth (extract 3) the impact of the sequester on US growth <u>is likely</u> to be quite adverse in the short run
- In the long-run, "indiscriminate reductions in education, science, and infrastructure" (extract 3) will <u>arguably</u> reduce US growth <u>even further</u> as such spending reduction if protracted will inevitably hamper the growth in country's productive capacity

- For the world economy, the uncertainty caused by US's sequester is likely slow down and prolong global economic recovery. This is especially so when extract 1 suggests that growth in fast-growing developing countries showed signs of slowing down.
- As these are the economies that supported the developed countries during the recession of 2008, the world economy might be facing another downturn after a brief recovery.
- However, for some developing countries, the slowdown in the US might bring some relief from inflation as extract 1 shows evidence of overheating in these countries e.g.
    - In emerging markets such as Brazil and India, domestic demand softened and exports sagged as rates were boosted to stem inflation.
    - Cyclical factors, including a pick-up in demand in parts of East Asia and Latin America and the Caribbean
    - Various economies, especially in South Asia and Africa, will continue to face high inflation rates, mainly owing to elevated inflationary expectations, rapid credit growth

Conclusion

- Overall, the effect of the 'sequester' on the US economy <u>seem undoubtedly</u> adverse while the impact on the world economy is <u>arguably</u> mixed as the current economic conditions differ from country to country.

L1: Recognize the meaning of the sequester [1]
L2: Explain whether the sequester was justified [2-5]
L3: Analyze the possible effects on US and the global economy [6-8]
E: Evaluate the likely effects on these economies. [+2]