2016 Prelims H1 EQ4

4 Policy-makers within the Japanese government, who advocated balanced budgets, pressured Prime Minister Shinzo Abe to increase national sales tax to help tame Japan's ballooning national debt, which has grown to be the largest in the developed world. However, after suffering from two consecutive quarters of recession, Abe defiantly postponed the second tax increase until 2017.

Adapted from New York Times, 2014

(a) Explain the possible causes of a recession. [10]

(b) Discuss the view that conflicts in macroeconomic goals would arise for a government seeking to address high fiscal debt. [15]

(a)

Introduction
- Define recession: negative economic growth

Body
1. Demand-side causes of recession
   - Provide possible causes to account for fall in C, I, and or G
   - Links to AD, ceteris paribus
   - Falling AD leads to multiplied fall in real NY
   - Assuming the economy is operating at intermediate range of AS curve or the fall in AD is significant to cause fall in real NY

2. Supply-side causes of recession
   - Provide possible causes of a fall in SRAS: rise in labour cost, rise in imported FOPs, etc.
   - Use diagram to show how fall in SRAS can lead to fall in real NY

Level	Knowledge, Application, Understanding and Analysis
L3 (7 – 10)	• Provides at least **three** possible causes of recession (mixture of demand and supply) • Excellent analysis of how both demand- and supply-side factors can lead to a recession • Effective use of economic framework (e.g. AD/AS) • Makes relevant and essential assumptions (e.g. holding other factors of AD constant, level of spare capacity etc.)
L2 (5 – 6)	• Incomplete analysis of how both demand- and supply-side factors can lead to a recession • Ineffective use of economic framework (e.g. AD/AS) • Lack of assumptions made
L1 (1 – 4)	• Conceptual errors • Insufficient elaboration and link to economic frameworks

(b) Discuss the view that conflicts in economic goals would arise for a government seeking to address high fiscal debt. [15]

Note: Question is <u>*not*</u> *about how austerity measures would lead to macroeconomic problems. Question is about how the goals achieved by addressing the fiscal debt—with, say, austerity measures—could conflict with other economic goals.*

Students need to explain the economic goals that can be achieved with measures used to address high fiscal debt and how these measures would <u>*and*</u> *would not lead to conflict with other economic goals.*

Introduction

- Governments may seek to address high fiscal debt with austerity measures which involve reducing government spending and/or increasing taxes
- Make a stand

<u>**Thesis: Conflicts in economic goals would arise for a country seeking to address high fiscal debt**</u>

T1: Raising taxes and reducing government expenditure to reduce fiscal debt would lead to conflict between short-term and long-term economic growth

- In the short-term, these austerity measures may cause AD and actual growth to fall, which also leads to cyclical unemployment

    - Governments with high fiscal debt may need to implement austerity measures which involve cutting government spending

    - Such fall in spending in areas such as infrastructure and education may lead to a stagnation in the growth of productive capacity

        - E.g. fall in education spending may lead to a fall in labour productivity and lower skill levels of the labour force in future
        - This would lead to a worsening of quality of FOP and affect the growth of productive capacity.
        - This prevents/reduces PEG.

- In the long-term, a fall in fiscal debt increases ability of government to implement expansionary fiscal policy to promote actual growth
    - In the long-term, government will have also have greater ability to implement supply-side measures to bring about PEG.

Students can also explain how austerity measures to achieve long-term economic growth might lead to cost-push inflation in the short-term:

- Austerity measures to reduce fiscal debt may also lead to tax-push inflation
    - Increase in corporate tax has the same effect as increasing cost of production of firms, hence leading to a fall in SRAS
    - The fall in SRAS can lead to an increase in GPL and hence cost-push inflation
    - This can also lead to a fall in real NY and higher unemployment (diagram)

T2: Austerity measures to achieve long-term economic growth may lead to short-term BOP deficit due to fall in FDI

- In the long-term, a fall in fiscal debt increases government's ability to implement expansionary fiscal policy to achieve AEG. It also increases government's ability to implement supply-side policies to achieve PEG.

- However, in the short-term, the rise in corporate taxes would deter FDI and may lead to capital account deficit and hence BOP deficit, ceteris paribus.

T3: Austerity measures to achieve long-term economic growth may lead to allocative inefficiency in short-term due to fall in provision of merit goods.

- Austerity measures involving a cut in government spending may also mean a fall in ability of government to provide merit goods, that are under-consumed by the free market, and hence worsening allocative inefficiency in the short-term

    - For instance, a fall in healthcare subsidies may mean under-consumption of healthcare, assuming consumption level was initially at socially optimal level.

    - If output levels continue to stay below socially desirable levels or falls even lower due to the cutting back of government spending, deadweight loss would persist and lead to allocative inefficiency.

<u>Anti-thesis: Conflicts in economic goals would not arise for a country seeking to address high fiscal debt</u>

AT1: Depends on how the government seeks to address high fiscal debt.

- Government may choose to implement expansionary fiscal and/or monetary policies to increase national income and government tax revenues in the long-term to reduce fiscal debt.

- This would achieve complementary goals like higher economic growth and lower unemployment. Investment, which promotes actual and potential growth, would also be encouraged.

- There are therefore no trade-off in macroeconomic goals in short- and long-term.

Evaluation: Exacerbation of fiscal debt in short-term would lead to/worsen economic problems too.

- Economies, like Greece, are not deemed credit-worthy and hence cannot borrow at realistic rates to finance spending anymore.

- If portfolio investors deem the fiscal debt to be unsustainable, it could lead to large-scale capital flight and large BOP deficit

AT2: Policies can be implemented to manage the trade-offs

- Even if government implements austerity measures in the short-term to address high fiscal debt and achieve long-term economic growth, the trade-offs that arise due to fall in economic growth and rise in unemployment in the short-term may be reduced via the use of other policies such as expansionary monetary policy/depreciation.

- These policies do not exacerbate fiscal debt, and can be used to reduce the short-term contractionary impact of austerity measures.

  Evaluation:

  Not all countries can implement monetary policies (e.g. individual Eurozone countries have no control over their interest rates). Monetary policies may not be able to increase actual growth (e.g. Japan).

<u>Synthesis</u>

Whether conflicts arise from governments addressing fiscal debt depends on the approach towards the debt – austerity or expansionary demand-management policies to grow economy and increase tax revenue from economic growth. That in turn depends on the credit-worthiness of the government. If the government were still deemed credit-worthy and able to continue borrowing to finance spending, it would be able to avoid austerity measures that lead to conflict of goals.

Level	Knowledge, Application, Understanding and Analysis
L3 (9 – 11)	• Discussion has excellent elaboration on the arguments raised. • Sound linkages between the measure to address fiscal debt and macroeconomic goal that can be achieved before linking to conflict with another macroeconomic goal. • Good balance of arguments; excellent elaboration on how governments addressing high fiscal debt may **and** may not lead to conflict of goals.
L2 (6 – 8)	• Incomplete explanation of how addressing high fiscal debt helps to achieve macroeconomic goals. • Incomplete explanation of how addressing high fiscal debt leads to macroeconomic problems as well. • Cap at 8m if answer only explains how addressing high fiscal debt leads to macroeconomic problems **or** achievement of macroeconomic goals but not both (TBC). • Cap at 6m if answer has no attempt at balance – i.e. only explained how measures to deal with high fiscal debt may **or** may not lead to conflict of goals.
L1 (1 – 5)	• Serious conceptual errors. • Answer is largely out of point (e.g. answer is about how fiscal debt leads to economic problems or only about microeconomic problems). • For a descriptive answer that is poor in or lack economic analysis.
E2 (3 – 4)	• Relevant stand taken but with appropriate or adequate justification.
E1 (1 – 2)	• Relevant stand taken with inappropriate and inadequate justification.