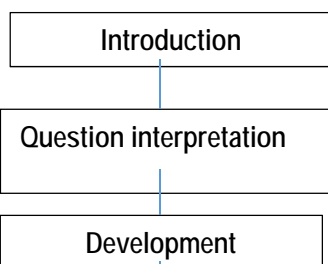


### Question 5

During 2009 the Bank of England engaged in what is known as 'quantitative easing' by pumping more than £200 billion into the economy. Record low levels of interest rates have also been maintained within the UK economy. Quantitative easing and low interest rates were also adopted by the US.

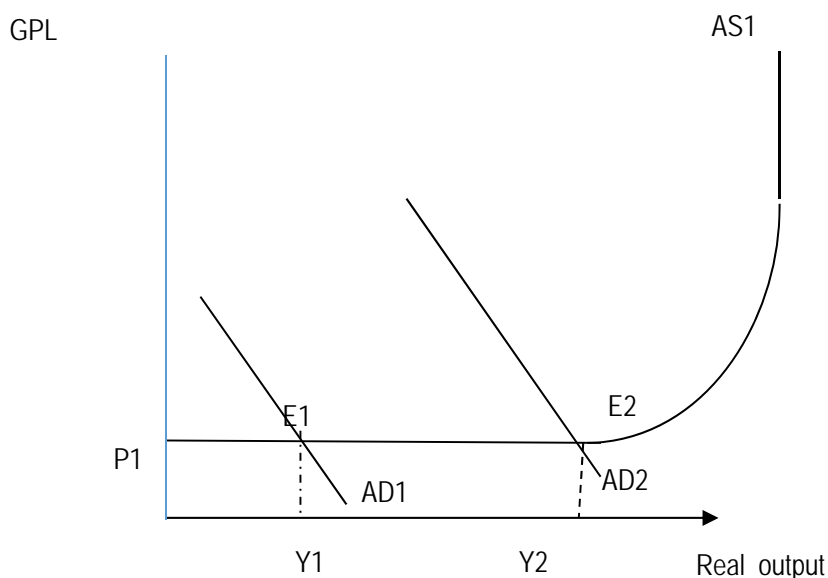
Discuss the potential impact of quantitative easing and low interest rates on an economy and its trading partners. [25]



**Development 1 : Explain how quantitative easing and low interest rates in USA and UK might lead to economic growth in USA and UK.**

Using AD/AS analysis, explain how a quantitative easing and decrease in interest rates brings about actual growth in the USA/UK economy

- Explain QE
- Assume excess capacity in economy
- Analyse the links between quantitative easing and low interest rates and the components of AD in USA/UK
- Illustrate using AD-AS diagram how AD shifts outwards.
- Explain the adjustment process towards the new equilibrium
- Summarise:  $\downarrow i/r \rightarrow AD \uparrow \rightarrow \uparrow NI, \text{ output by a MULTIPLIED amount}$



**EV:** While an economy with high unemployment may see increased borrowing due to QE & low interest rate, and a move out of recession, the potential drawback is that QE & lower interest rate may lead to inflation if US and UK are operating close to full employment. (Analyse)

**Explain impacts the balance of trade.**

**Explain impact on the balance of trade**

**Decrease in export revenue (X):** When inflation in US is relatively high, US produced goods will become more expensive and less competitive internationally. Exports will be relatively more expensive, thus foreigners will reduce the quantity demanded of exports. If  $PED_x > 1$ , the rise in price of exports will lead to a more than proportionate fall in quantity demanded → Total export revenue (X) will fall because the rise in total revenue due to the increase in price is smaller than the fall in total revenue due to more than proportionate fall in quantity demanded.

**Increase in import revenue (M):** When US goods become more expensive, US residents will buy more imports assuming imports and US produced goods are substitutes. Demand for imports increases and import expenditure increases.

Assuming that initially there is a balance in the current account position, as receipts from exports falls while payments for imports increases, the trade balance and hence the current account worsens for USA.

Low interest rate may also cause capital flight and hence a depreciation of pound and USD.

**Development 2: Explain how quantitative easing and low interest rates in USA and UK impact their trading partners such as Singapore.**

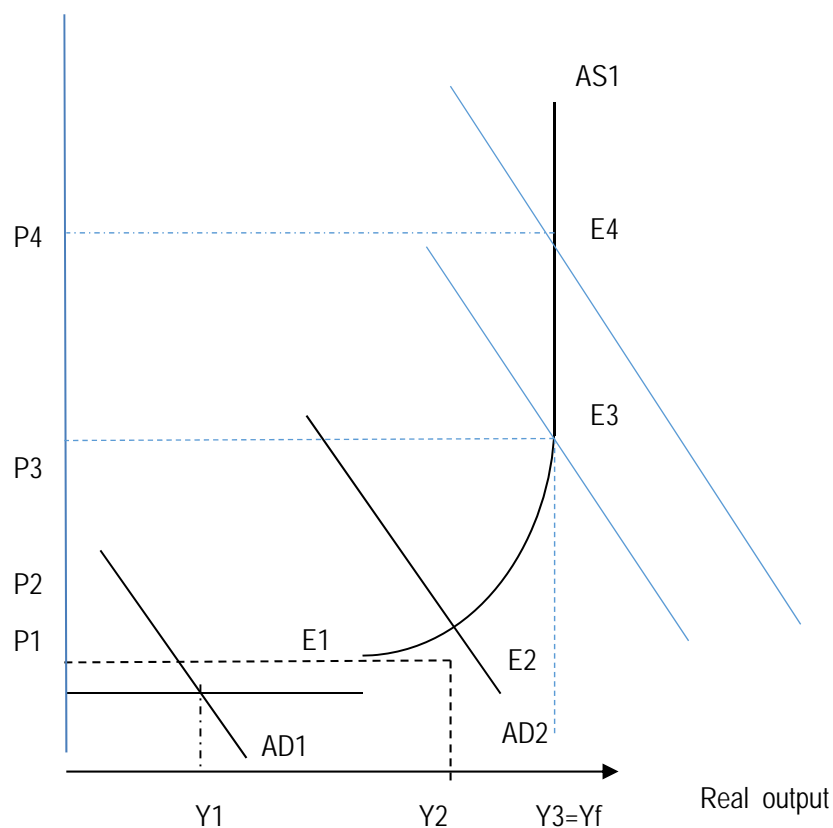
Quantitative easing and fall in interest rates in USA and UK might lead to economic growth in USA and UK, hence increased imports by USA/UK which will benefit Singapore as some of this increase will be for exported goods from Singapore.

Economic growth, higher disposable income in USA/UK will cause Americans/British to increase their demand for Singapore's exports, leading to an increase in Singapore's export revenue. The increase in exports increases AD. The impact on the SG economy depends on the state of the economy. Assuming that the SG economy is operating very near to capacity i.e. on the upward sloping part of the AS curve. The increase in AD promotes AG in Singapore increasing real output from  $Y_1$  to  $Y_2$  but GPL to increase from  $P_1$  to  $P_2$ . Persistent increases in AD due to continued QE and lower interest rates in USA/UK may create demand pull inflation in SG.

Assuming ceteris paribus condition, AD increases beyond the level of AD ( $AD_3$ ) that brings about full employment then further increases in AD (to  $AD_4$ ) will cause no change in real output but will instead raise GPL and creates demand pull inflation. E.g. increase in AD from  $AD_2$  to  $AD_3$  and to  $AD_4$ , real output in SG economy remains at  $Y_f$  but GPL rises from  $P_2$  to  $P_3$  and to  $P_4$ .

GPL

Singapore economy



Development 3: Consider the impact of a fall in interest rate on hot money flows or exchange rates and explain the impact of these 'indirect' changes on Singapore.

Conclusion :

Make judgement on extent of the impact and compare the effect caused by US's and UK's policy

### Knowledge, Application, Understanding and Analysis

#### Suggested Mark Scheme 5 :

L3	For an answer using analysis to explain the impact on both an economy and its trading partners	15-21
L2	For an answer that gives a descriptive explanation of the impact on an economy and/or its trading partners	9-14
L1	For an answer that shows some basic but largely unexplained knowledge of the impact on an economy and/or its trading partners	1-8

### Allow up to 4 additional marks for Evaluation

E2	For an evaluative assessment based on economic analysis.	3-4
E1	For an unexplained assessment, or one that is not supported by analysis.	1-2