2017 H2 Prelims EQ4 Suggested Answer

The Federal Reserve raised interest rates on Wednesday, ending an extraordinary period of seven years of government intervention in the financial markets that started at the height of the recession. However, some have expressed concern about the move, urging the Fed to "avoid making a mistake" by raising interest rates.

Source: adapted from The Guardian, 16 December 2015

Discuss the factors that the Federal Reserve could have considered when deciding to raise interest rates. [25]

Question Dissection

To judge and determine the importance of something

US central bank → conducts nation's monetary policy

Faced with 2 options: continue to keep interest rates low or raise it

Discuss the **factors** that the Federal Reserve could have **considered when deciding** to **raise interest rates**. [25]

Issues that need to be thought about when making a decision

Ending of the expansionary monetary policy meant to stimulate the economy

Schematic Plan

Contextual background: State what the government intervention is and what has changed

Policy: Explain what the policy is and how the change in approach may affect the US economy

Considerations: Identify and explain factors that the US Federal Reserve may have considered when deciding to raise interest rates. For each factor, there is a need to show how the Fed might have used the relevant information to conclude that interest rates should be raised.

State of the US economy

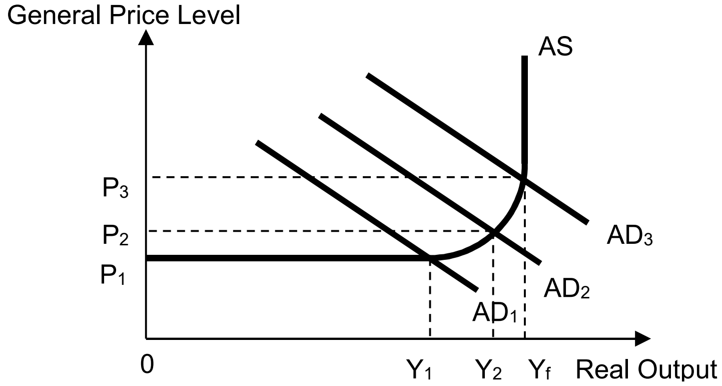
Economic outlook of consumers and businesses

Unintended consequences on US and other economies

Evaluative conclusion

- Explain which of the considerations likely played the greatest role in influencing the Fed's decision and justify why
- Consider if the most important/relevant decision to be made is whether to raise interest rates or rather the pace or extent to which interest rates are raised

Suggested Answer	Comments
Introduction The subprime mortgage crisis that happened in 2008 led the US Federal Reserve to engage in expansionary monetary policy in an attempt to stimulate economic growth. The policy aims to increase money supply and lower interest rates in order to increase growth. In deciding to raise interest rates, there are several factors that the central bank could have considered. This essay will analyse the considerations that the central bank might have made when deciding to raise interest rates, and assess the relative importance of them in influencing the Federal Reserve's decision.	Set the context and give an overview of the essay in the introduction
Explanation of Expansionary Monetary Policy Expansionary monetary policy aims to increase aggregate demand (AD) and hence economic growth in US in the wake of the financial crisis. The reduction in interest rates lowers the cost of borrowing and increases the ability and willingness of households to borrow to purchase big-ticket items, thus increasing consumption. Firms are also encouraged to borrow due to higher expected profitability, which increases their willingness and ability to expand scale of production, thereby increasing investment expenditure. This increase in consumption and investment increases AD and triggers the multiplier effect, where subsequent rounds of increase in income-induced consumption results in a multiplied increase in national income and employment. Raising the interest rates from near-zero levels signals the end of expansionary monetary policy by the central bank. Doing so, would however slow down the increase in AD and hence the growth rate of US.	Explain the aim and effects of the Federal Reserve's policy of low interest rates State what the change in policy approach entails
Considerations of US Federal Reserve One of the considerations in deciding to raise interest rates could be the current state of the US economy, specifically its growth rate, inflation rate and employment rate. Since the aim of low interest rates was to stimulate economic growth, interest rates may be raised as the economy showed signs of recovery and growth. This coupled with an increase in jobs creation and employment rates would indicate that the economy is on the upswing, and that there is an increase in material living standards. By continuing to keep interest rates at very low levels, it is possible that inflationary pressures result, which could depress living standards. As shown in Figure 1, AD was initially at a low level represented by AD1 in the wake of the financial crisis. Low levels of interest rates would increase consumption and investment, causing AD to increase to AD2, bringing about a rise in real output and employment. However, in a persistent low interest rates environment, the continual increase in AD would cause the economy to approach the full employment output level as shown by	State the first factor – state of the US economy Explain how the factor may influence the Fed to raise interest rates Analyse using AD/AS model why state of the US economy may influence the Fed's decision

Yf, giving rise to overheating. The rise in inflationary pressures is shown by a continual rise in general price level from P1 to P2, and then from P2 to P3. The resultant demand-pull inflation caused by the easy availability of cheap money would lead to falling purchasing power of consumers. They are able to consume less goods and services than before, and hence material standard of living may worsen.  Figure 1: Inflationary pressures in US	
On the other hand, if the growth in the economy remains sluggish, or if the upswing in growth is only temporary, it would not be wise for the central bank to raise interest rates. Raising interest rates would dampen spending and investment, which jeopardises any economic recovery brought about by the low interest rates. Hence, the Federal Reserve would probably have considered the growth rate and inflation rate of the economy when deciding to raise interest rates, in order to prevent a worsening of economic performance and living standards.	Explain how the factor may influence the Fed not to raise interest rates
A second consideration that the Federal Reserve probably had, is the economic outlook of consumers and businesses, and how it may be affected by a rise in interest rates. An increase in interest rates by the central bank could indicate improved economic sentiments and confidence by the Federal Reserve that economic recovery is on track. Such a move is therefore likely to boost the confidence of consumers and firms, encouraging spending and investment. The increase in consumption and investment would increase AD and further strengthen the growth of the US economy. In addition, the increased business and investor confidence arising from the raising of the interest rates would also likely attract foreign direct investment (FDI) into US, further increasing AD and national income.	State the second factor – economic outlook Explain how the factor may influence the Fed to raise interest rates
However, if consumers and businesses are pessimistic about the economic prospects, raising the interest rates may not do much to boost their confidence in the long-term recovery of the economy. For instance, US exports and investments could be hampered by the slowdown in China's growth, as well as the uncertainty surrounding the eurozone and the economic future of Europe and the global economy. This could have resulted in weaker consumer and business confidence in their future incomes and profits respectively. In this case, instead of boosting spending and investment, the rise in interest rates could be untimely, and cause a	Explain how the factor may influence the Fed not to raise interest rates

drag in the economy's growth instead. Hence, the Federal Reserve would likely have considered firms' and household's expectations of future economic growth and concluded that sentiment was optimistic enough such that interest rates can be raised without dragging down the economy. Another key factor that the Federal Reserve would probably have considered is the possible unintended consequences arising from the raising of interest rates that could adversely affect US economic growth. A rise in interest rates would increase the rate of returns to deposits, which attracts inflow of short-term capital. This causes an increase in demand for US dollar in the foreign exchange market, causing an appreciation of the currency. A stronger US dollar would increase the price of US exports in terms of foreign currency and lower the price of imports in terms of domestic currency. This reduces quantity demanded for US exports and increases that for imports, thus causing a fall in net exports. This may result in a fall in AD unless improved consumer and business sentiments bring about a much larger increase in consumption and investment, offsetting the fall in net exports. In deciding to raise interest rates, the Federal Reserve would likely have concluded that the fall in net exports is not a significant threat to the economy's growth, as the increase in consumption and investment would be sufficient to boost the economy. In addition, raising of US interest rates can have unintended consequences on the economies of emerging markets. The relatively higher interest rates in US results in significant short-term capital outflows from emerging countries such as parts of Latin America and Asia. The subsequent depreciation of their currencies would not only lead to imported inflation and a slowdown of their growth, but also increase their debt burden in terms of US dollars. The weakening of their currencies and higher interest rates would make it more difficult for these countries to finance foreign debt, which could trigger a debt crisis. This could put a dampener on US economic recovery as emerging markets cut back on trade and global investments, as they struggle to service their debts.	State the third factor – unintended consequences on US and other economies Explain the unintended consequences of a rise in interest rates on the US economy Explain the unintended consequences of a rise in US interest rates on the other economies
<u>Evaluative conclusion</u> One of the main reasons for the US Federal Reserve to raise interest rates, was the fear of the economy overheating due to a prolonged period of near-zero interest rates. Inflationary pressures could dampen consumption and investment, which reduces growth at a time when US begins to show signs of economic recovery. Hence, in my opinion, I believe that the main consideration that influenced the Federal Reserve's decision to raise interest rates is the state of the US economy, which would also affect the economic outlook of households and businesses. Economic indicators in 2015 show a steady growth rate of about 2.4 per cent and a drop in unemployment rate to 5 per cent. Keeping interest rates at extremely low levels will eventually trigger inflationary pressures, which threaten growth, running counter to the policy's initial aim of stimulating growth.	Establish the Fed's reason for deciding whether to raise interest rates Based on the objective of the change in policy approach, explain what is likely the key consideration of the Fed

Given that the US is a large economy where domestic consumption and investment are large components of its AD, it is unlikely that the fall in price competitiveness of its exports would significantly dampen its growth. In addition, the Federal Reserve may also not factor in the impact on the emerging markets when making the decision to raise interest rates. However, given the increasing interconnectedness of the global economy, it may be necessary to give greater consideration to the impact on other economies arising from the Federal Reserve's monetary policies.	Explain which may be the least relevant or significant consideration of the Fed
Perhaps the decision to be made by the central bank was not a binary one where it simply decides whether to raise interest rates or not. Rather, what was more relevant as a consideration, is the extent and pace to which interest rates are raised. Given that interest rates have broad macroeconomic implications not just for the US economy but also for other economies, it would be wise for the Federal Reserve to adopt a cautious 'wait-and-see' approach where interest rates are raised gradually in response to signs of a robust US economic recovery, which would also bode well for the rest of the world economies.	Provide additional insight on what is the more relevant or important decision to be made here (challenge the implicit assumption in the question)

Mark Scheme

	Knowledge, Application / Understanding and Analysis	
L3	For an answer that **thoroughly analyses** how raising of interest rates may affect the US economy, as well as the factors that may influence the Federal Reserve's decision. Answer demonstrates **rigour and scope in analysis**. At least 3 factors are provided in the analysis.	15 – 20 (18)
L2	For an answer that has **good knowledge** of how raising of interest rates may affect the US economy, as well as the factors that may influence the Federal reserve's decision. However, analysis is undermined by **insufficient rigour and scope**. Answer may provide robust explanations of how raising interest rates may affect the US economy but **lack analysis of the factors that affect the Federal Reserve's decision.** Answers that provide analysis of 2 or fewer factors will be capped at L2.	9 – 14 (12)
L1	Answer may have some knowledge of how raising of interest rates may affect the US economy, and the factors to be considered. However, the answer has **significant conceptual errors or is very descriptive**.	1 – 8 (5)
	Evaluation/Synthesis	
E3	**Insightful conclusion/judgement** on the relative importance of the factors in determining the Federal Reserve's decision to raise interest rate. Synthesis makes it clear that one or more of the factors are more important than the others in the central bank's decision of whether to raise interest rate. Evaluative comments are provided based on the US economy's specific set of circumstances, with reference made to the factors.	4 – 5

E2	Attempted synthesis on the relative importance of the factors in determining the Federal Reserve's decision to raise interest rate. However, there are **some logical flaws and/or inaccuracies** in the synthesising process.	2 – 3
E1	For an answer that gives an **unsupported statement** on the relative importance of the factors in determining the Federal Reserve's decision to raise interest rate.	1