2017 RVHS Y6 H2 Prelims II Essay Question 4 Answer

The prospect that the US Federal Reserve will decide to start raising interest rates has raised fears about the effects it will have on the economies of emerging markets.

(a) Explain how the decision to raise interest rates in the US might affect the economic agents in the domestic sector and its economy. [10]

(b) Discuss whether the fears are justified. [15]

Suggested Answer for part (a)

The interest rate is defined as the cost of borrowing, typical expressed as an annual percentage of an outstanding loan. The decision to raise interest rates, a form of contractionary monetary policy, can be used to slowdown the increase in AD and thus dampen inflation. It also has wide-ranging effects on the different economic agents, consumers, firms and the government, and consequently the domestic economy itself.

The increase in interest rates will discourage consumers to spend. With an increase in interest rates, consumers are likely to decrease consumption and increase saving as the reward of saving increases. Consumers will also be discouraged from spending on big-ticket items such as cars, as the purchase of such goods are typically financed on loans which are affected by the increase in interest rates. Furthermore, consumers with outstanding mortgages would have to make higher payments, reducing disposable income for consumption.

The increase in interest rates will also discourage firms from investing. An increase in interest rates will increase the cost of borrowing for firms. As a result, projects that were initially viable due to lower interest rates are now unviable, leading to a decrease in investment.

The increase in interest rates will also affect the consumption and investment by the government. The increase in interest rates will increase debt payments on US government debt, which is incurred financing government fiscal policies, and such spending will become further constrained, such as by delaying public infrastructure projects.

The effects on the economic agents have consequent effects on the US domestic economy. Consumption, investment and government spending are all components of aggregate demand (AD). With a decrease in all three components, AD will fall from AD_0 to AD_1 as shown in Figure 1. This would lead to a fall in national income through the multiplier effect. More likely, the decrease in consumption and investment is coupled with the an increase in both due to strong economic conditions, leading to a dampening of actual economic growth.

With a fall in investment, potential economic growth will also be dampened. If firms and the government reduce investment, there will be a fall in capital growth. If the rate of capital growth falls below the replacement rate (due to depreciation and wearing out of capital), the productive capacity of the economy will be reduced. This leads to a fall in aggregate supply (AS) and potential economic growth.

At the same time, with a fall in AD, the general price level falls from P_0 to P_1 as shown in Figure 1. A fall in aggregate demand leads to firms reducing production and thus competing less for resources for production. This leads to a fall in prices of raw materials and consequently the general price level. This lowers the inflation rate and ensures price stability for the US domestic economy.

Finally, with a fall in AD, unemployment may increase. A fall in aggregate demand leads to firms reducing production which leads to firms reducing employment of labour for production. This may lead to a rise in unemployment in the US domestic economy.

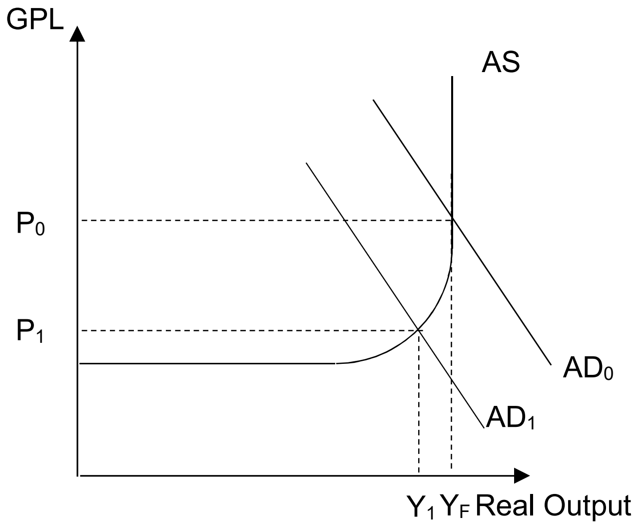

Figure 1: Increase in real GDP through increase in AD

Marking Scheme

Knowledge, Application, Understanding and Analysis		
L3	Consequences on **all three** economic agents as well as **at least two macroeconomic goals** well explained in the context of the **US domestic economy**.	**8-10**
L2	Consequences on **at least two** economic agents as well as **at least one** macroeconomic goal well explained. OR Consequences on **all three** economic agents as well as **at least two macroeconomic goals** explained but with errors or descriptively explained.	**5-7**
L1	Smattering of points	**1-4**

Suggested Answer for part (b)

Emerging economies, such as the BRICS economies (Brazil, Russia, India, China and South Africa), have significant economic links with the US. Globalization has led to greater exports to developed economies such as the US, leading to economic growth for the emerging market economies. For example, China holds a significant trade surplus against the US. Thus, the increase in interest rates in the US may have significant impact on these economies and their macroeconomic goals.

The rise in interest rates will cause hot money inflows into the US by investors seeking higher returns, leading to an increase in demand for the US dollar. This leads to an appreciation of the US dollar and thus a depreciation of the currencies of the emerging market economies. With an increase in the value of the US dollar vis-à-vis the currencies of the emerging economies, exports from the emerging economies become relatively cheaper compared to domestic goods in the US. This would lead to an increase in demand for exports from emerging economies by US consumers, increasing net exports for emerging economies. An increase in net exports would increase AD for emerging economies, leading to an increase in demand-pull inflation.

The increase in capital outflows would also worsen the balance of payments (BOP) for the emerging economies. The balance of payments records capital flows under the financial account. Thus, with an increase in capital outflows, the financial account and consequently the BOP would also worsen.

Fears of inflation may be dampened by the fact that the policy would have contractionary effects on the US economy. Over time, as interest rates continue to increase, there would be a moderation in the economic growth of the US, thus reducing the increase in demand of US consumers for exports from emerging economies.

However, there may also be benefits for emerging economies. The increase in demand for emerging market exports by US consumers would lead to an increase in AD and consequently an increase in national income through the multiplier effect. This would lead to actual economic growth for the emerging economies. Demand for coffee from Brazil would thus increase, increasing AD and economic growth in Brazil.

Similarly, the increase in AD would lead to an increase in employment in the emerging market economies. The increase in demand for emerging market exports would increase production by the export sectors in these countries, leading to firms in these sectors employing more labour for production. As these labour earn income, through the multiplier effect, production and thus employment in other sectors of the economy would also increase. This leads to an overall fall in unemployment for the emerging market economies.

The improvement in the BOP is dependent on the relative elasticities of the exports and imports of the emerging market economies. In this case, it is likely that the demand for emerging market exports is price elastic, as they have many substitutes. For example, Brazil exports only accounts for 15% of the world's coffee exports, signifying that there are many substitutes from other countries.

The increase in inflation can be weighed against the increase in economic growth and employment due to an increase in net exports. Both factors are dependent on the size of the export sector in these economies, which are significant as a proportion of national income at the moment, but may decrease over time as the economies mature. For example, the Chinese government has implemented policies to focus on domestic consumption and thus domestically driven economic growth in the future.

Marking Scheme

Knowledge, Application, Understanding and Analysis		
L3	Both thesis and anti-thesis addressed, covering **at least three** macroeconomic goals (BOP must be included), well explained and developed.	**8-10**
L2	Both thesis and anti-thesis addressed, covering **at least two** macroeconomic goals, well explained OR Both thesis and anti-thesis addressed, covering **at least three** macroeconomic goals, explained but with errors or descriptively explained. (One-sided argument – capped at 5 marks)	**5-7**
L1	Smattering of points	**1-4**
Allow up to 5 additional marks for Evaluation		
E3	For an evaluative assessment on the impacts on the emerging market economies, well justified based on economic analysis.	**4-5**
E2	For an evaluative assessment of various points that is based on economic analysis	**2-3**
E1	For an unexplained judgement, or one that is not supported by analysis	**1**