UNIVERSITY OF CAMBRIDGE

ECONOMICS 9708/41 Paper 4 Data Response and Essay (Supplement) **May/June 2010 2 hours 15 minutes**

Additional Materials: Answer Booklet/Paper

READ THESE INSTRUCTIONS FIRST

If you have been given an Answer Booklet, follow the instructions on the front cover of the

Booklet. Write your Centre number, candidate number and name on all the work you hand in.

Write in dark blue or black pen.

You may use a soft pencil for any diagrams, graphs or rough working.

Do not use staples, paper clips, highlighters, glue or correction fluid.

Section A
Answer **Question 1**.
Section B
Answer any **two** questions.

You may answer with reference to your own economy or other economies that you have studied where relevant to the question.

At the end of the examination, fasten all your work securely together.
The number of marks is given in brackets [ ] at the end of each question or part question.

Section A

Answer this question.

1 Interest rates, inflation and growth

Between 1 July and 1 October 2007, the GDP of the US rose at an annual equivalent rate of 4.0%. This was faster than the forecast rate of 3.1%. The rise was caused by an increase in consumer spending and by rising exports.

By November 2007, however, there were increased signs of a housing market slump, a rise in oil prices and a fall in the value of the US dollar. These changes presented the Federal Reserve (the US central bank) with a problem about interest rates.

The Federal Reserve had already cut interest rates in October 2007 and it reduced the interest rate again in November in order to help defend the US economy against the worsening housing market.

Further interest rate cuts were thought unlikely, as there was anxiety over the rising price of oil, which by November 2007 had reached a record level. The Federal Reserve said 'recent increases in energy and commodity prices may result in further inflation'.

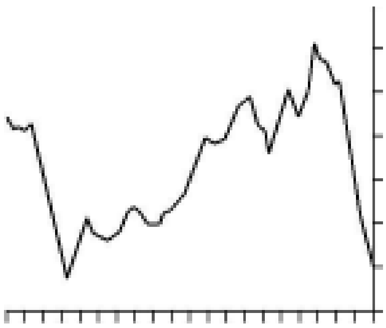
A difficult balance: conflicting policy objectives

20

10 00 01 02 03 04 05 06 07

year

America's housing market
is slumping . . .



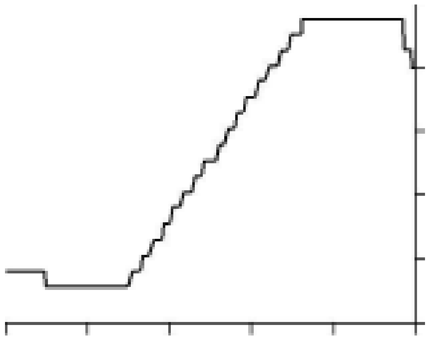
25
20
15 annual
10 %
change
5
0
–5
–10

88 00 07

year

Fig. 1: House price index

. . . so the Federal Reserve acted to cut borrowing costs



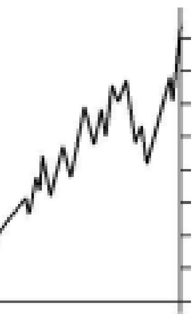
5.5
4.5
3.5
%
2.5
1.5
0.5

03 04 05 06 07

US interest rate

Fig. 2: US interest rate

but soaring oil prices pose
an inflation threat . . . 100 90 80
70
60 $ per
50
40 barrel
30



. . . and so does the falling dollar 1.5

1.

1.0

4

0.9

1.3

1.2 00 01 02 03 04 05 06 07 0.8

$ dollars to the euro

1.1

Fig. 3: US crude oil price Fig. 4: Dollars to the Euro

3

(a) Name **two** components of aggregate demand **not** mentioned in the first paragraph of the extract. [2]

(b) Calculate the percentage increase in the GDP of the US between 1 July and 1 October 2007. [2]

(c) Why does Fig. 4 refer to a 'falling dollar' when the trend of the line is upward? [2]

(d) Discuss the likely effectiveness of a reduction in interest rates as a solution to a housing market slump. [6]

(e) To what extent does the data support the view that the US economy was facing 'conflicting policy objectives'? [8]

(a) Aggregate demand refers to total spending in an economy. It is function of economy's general price level. Aggregate demand is inversely related to general price level. Investment, government spending, consumption and net exports collectively determine country's level of aggregate demand.

(b) 1.75 percent (4/12*4). If economy is expected to grow by 4 percent during the year of 2007 then for a quarter the expected growth rate should be 1.75 percent.

(c) Since the vertical axis is calculating the quantity of US dollars that can be afforded by each Euro therefore higher the quantity of US dollars afforded by Euros lower will be US dollars' exchange rate against Euros.

(d) Housing market slump refers to falling product prices which in this case are houses. After 1990 till 2005 house prices constantly increased with rising growth rates but after 2005 the rate of increase in house prices significantly fell from 20 percent to negative 5 percent within two years till 2007.

Various reasons can explain this market slump. Firstly reduced consumer confidence might have discouraged them to invest more in housing market. Moreover rising interest rates during 2004 to 2006 would have made borrowing expensive hence discouraging potential investment in the market.

Federal Reserve strategy of lower interest rates is expected to be effective in eliminating slump of US house market. Lower borrowing costs for US citizens will encourage them to invest in housing which will positively affect their prices by increasing domestic demand. Moreover lower borrowing costs for businesses will encourage firms to expand which as the result will recover low domestic demand for housing. However constantly rising fuel prices might discourage higher business investment and therefore might limit businesses' demand for housing and therefore this proposed strategy of interest rates deduction might not prove to be very effective. Therefore unless consumers' and businesses' expectations about economy's future economic prospects do not improve there is expected to be limited benefit from government's reduction of country's interest rates in eliminating its housing market slump.

(e) Countries wish to pursue certain macroeconomic objectives to ensure smooth functioning of their economies. High and sustainable economic growth, low and stable inflation rates, balance of payments equilibrium and avoiding exchange rate fluctuations are some common objectives that countries pursue almost all times.

According to the information provided in the case study, US economy has experienced weakening exchange rate even during periods of higher interest rates. High interest rates encourage foreign investment which in turn increase demand for local currency which in turn positively affects domestic exchange rate. Moreover though economies generally face higher inflationary pressures during periods of high economic activity but US economy was seen experiencing both low economic growth and rising cost push inflation. Higher cost inflation is expected to adversely affect economy's production potential which in future is expected to have severe negative effects on country's economic growth rates.

If US is depending upon imported oil then it should take serious action against its depreciating exchange rate. However artificial improvement would mean pressure on economy's foreign currency reserves.

At the moment, US economy should be most concerned about constant increase in oil prices. Better control of cost push inflation through minor increase in oil and other raw material prices will improve citizens' expectations about economy's future growth prospects and hence will encourage more consumption and investment. Moreover increased foreign investment due to lower domestic inflation rates is expected to positively affect economy's exchange rate due to higher demand for local currency.