UNIVERSITY OF CAMBRIDGE

ECONOMICS 9708/42 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 Income, Spending and Prices in the US

Table 1 Some economic indicators for the US economy

	personal income	consumer spending	consumer prices
Nov 2008	fell 0.4%	fell 0.8%	fell 2.1%
Dec 2008	fell 0.2%	fell 1.0%	fell 1.0%
Jan 2009	rose 0.2%	rose 1.0%	rose 0.3%
Feb 2009	fell 0.2%	rose 0.2%	rose 0.4%

Consumer spending in the US fell by 0.8% in November 2008 and by a further 1% in December. December 2008 was the sixth consecutive month in which consumers cut back on their spending. Between October and December 2008 spending fell by a record 8.9%. Consumers were in a mood to increase their savings but not to go out and spend. Generally, that's a good thing, but not when everyone does it at the same time. By January 2009, the savings rate in the US had reached the highest it had been for 14 years. This increase in savings was caused by low consumer confidence and the fear of higher unemployment.

Declining consumer spending is a particularly troubling sign for the US economy, because spending accounts for more than two-thirds of GDP. GDP fell by 3.9% between October and December 2008, the sharpest decline in 26 years.

This decline in spending resulted in

– a proposed $888 billion stimulus plan from the government, including about $278 billion in tax cuts,

– companies reducing their workforce to cut costs because of falling revenue, – the expectation that business investment, which accounts for about one-tenth of US GDP, would decline during 2009.

(a) What evidence is there in the data that the economic situation in the US improved after December 2008? [3]

(b) How far is there any consistent link in the data between

(i) changes in personal income and consumer spending and

(ii) changes in overall prices and consumer spending? [5] **(c)** Explain why a fall in spending might be expected to lead to a fall in business investment. [4]

(d) Do you agree that a rise in savings is generally ‘a good thing, but not when everyone does it at the same time’ (line 5)? [8]

(a) Government announcement to provide tax holidays is expected to boost local spending. Substantial decrease in direct taxation will encourage consumers to spend more. The overall increase in national income is expected to be greater than consumers’ spending due to more elastic spending. Given the information provided in table 1 fall in incomes result in more than proportionate fall in spending and vice versa. Now $ 278 billion reduction in taxation will cause more than $ 278 billion increase in national income.

Increased consumer spending is expected to boost national investment. According to accelerator theory increase in investment will be greater than increase in national income hence further increasing national income. Furthermore, higher government spending will increase aggregate demand and as result is expected to further promote local growth.

(b) (i) According to the information provided in the table above shows positive relationship between US consumers’ spending and consumers’ income levels. This is because higher income levels allow for increased spending. Consumer spending is expected to increase more than proportionately than increase in income levels. Except for February 2009 when consumers’ spending should have fallen following decrease in income levels, for all other periods the two variables were observed having direct relationship.

(c) (ii) Products' prices are observed increasing following higher consumer spending. Data for each of the four months show positive relationship between consumers' spending and price levels. However strength of relationship cannot be estimated from the available data. Since aggregate consumption levels are not the only determinant of products' prices therefore following certain change in consumers' spending changes in price levels is ambiguous. For some data points prices are found reacting more to given change in consumers' spending and in some period prices have been seen undergoing negligible changes.

© According to Keynesian's accelerator theory changes in national income result in more than proportionate similar direction changes in economy's investment levels. Falling consumer spending mean lower demand for firms' products and so businesses are expected to reduce their production capacity if fall in consumer spending is expected to persist. Similarly increase in consumer spending is often expected to encourage firms' investment in production capacity.

Economies accelerator coefficient is expected to be greater than one meaning one dollar increase in consumer spending is expected to increase investment in production capacity by more than one dollar. Therefore certain increase in national income due to higher aggregate consumption levels is expected to increase national income by higher levels in future due to more than proportionate change in aggregate investment levels.

(d) Higher aggregate savings convert into higher investment when channelized through economy's financial institutions. These increased aggregate savings are expected to improve economy's production potential. Enhanced production potential will allow for higher economic growth and will limit inflationary pressures. Lower inflation rates will put lower pressure on citizens' purchasing power hence ensuring higher purchasing power. Therefore to some extent higher savings are utmost necessary for countries' achievement of higher growth rates which later translate into improved development.

Higher savings might at times prove disastrous because of more withdrawals from economy's circular flow of income. Higher the withdrawals lower is multiplier effect that shows changes in national income following changes in economy's injection levels. Hence too high of savings especially when it is saved at home without being made available for other market participants to use for potential investment projects will prove harmful for economy’s growth. Therefore firstly too high of savings and by most of citizens might prove to be too harmful for economy’s growth and moreover if these savings are not even channelized into investment then savings are not even expected to enhance countries’ production potential.