

# Answers to the macroeconomic practice questions

## Objective test questions

- |   |   |    |   |
|---|---|----|---|
| 1 | B | 6  | A |
| 2 | B | 7  | D |
| 3 | A | 8  | D |
| 4 | C | 9  | C |
| 5 | B | 10 | B |

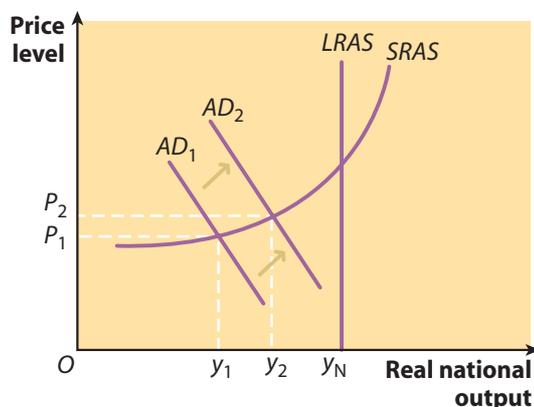
## AS context question

### Context 1

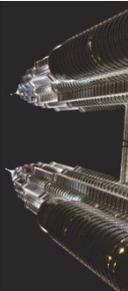
- 01** Exports are the goods produced in an economy which are sold to other countries or economies. Exports divide into exports of goods and exports of services.
- 02** Extract A indicates that the UK current account was in deficit to the tune of about £73bn in 2013. The stem of the question tells us that UK GDP was only £1.6bn, but this figure is surely wrong. I know from my recent studies that in 2013 UK GDP was close to £1620bn, so I shall use this figure in my calculation. Assuming I am right, the UK current account deficit as a percentage of GDP was 73 divided by 1620, which is approximately 4.5%. I know this percentage must be correct because it is similar to the percentage given in lines 34 and 35 in Extract B in the question. However, despite my ingenuity, I know I shall get no marks for this answer because the exam board will declare the question void!
- 03** My first significant point of comparison is that the current account was in deficit in all the years shown in Extract A, with the deficit rising from about £20bn to about £73bn between the first and last years, 2003 and 2013.

My second significant point of comparison is that the deficit was largest in the last two years in the data series — around £60bn in 2012 and £73bn in 2013. It was smallest, around £18bn, in 2005.

**04**

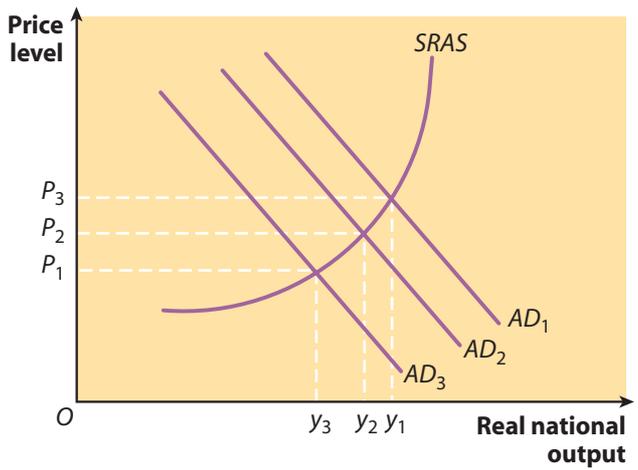


A fall in the exchange rate lowers the export prices of UK goods, which become more price competitive on world markets. Overseas demand for UK exports increases. Since exports



( $X$ ) are one of the components in aggregate demand in the  $AD$  equation,  $AD = C + I + G + (X - M)$ , the  $AD$  curve shifts to the right, from  $AD_1$  to  $AD_2$  in the diagram. Aided by an export multiplier effect, real output increases from  $y_1$  to  $y_2$ . However, the price level also rises and this may eventually wipe out the competitive advantage won by the falling exchange rate. Note also that if the  $AD$  curve were to shift and intersect the vertical  $LRAS$  curve, with output reaching 'normal capacity' output, there would be no further increase in output in the long run.

- 05 A collapse of aggregate demand, caused for example by a collapse of consumer confidence and/or business confidence, shifts the  $AD$  curve to the left. It will also trigger a contractionary multiplier effect. Both are shown in the diagram below.



Initially, the collapse of confidence causes the  $AD$  curve to shift leftward from  $AD_1$  to  $AD_2$ . Then the contractionary multiplier takes over and shifts the  $AD$  curve further to the left to  $AD_3$ . Real output eventually falls from  $y_1$  to  $y_3$ . The diagram illustrates a multiplier somewhat smaller than 2 in size.

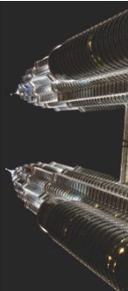
The fall in the level of real income from  $y_1$  to  $y_3$  means that firms now require less labour to produce the lower level of real output. Cyclical unemployment results.

- 06 An increase in any of the components of aggregate demand, consumption included, shifts the  $AD$  curve to the right and increases the level of real income — provided there is spare capacity in the economy. An increase in private sector investment in new capital goods or in government investment in infrastructure projects such as High Speed Rail, adds to productive capacity, thereby shifting outward the economy's production possibility frontier, which in turn can lead to sustainable economic growth. For this to happen in the short run, unless they are initially idle, resources must be diverted away from consumption and into investment.

By contrast, if more of the economy's resources are devoted to consumption, this is inevitably at the expense of saving. If savings were being used to finance investment in new capital goods, the growth of consumption must be at the expense of investment.

The moral of this is that consumption-led growth can occur and perform a useful task, if the economy is initially in recession, but its continuation becomes unsustainable once demand deficiency has been eliminated and the economy has reached its production possibility frontier.

The trouble in the long run with consumption-led growth is that it has to be fuelled by increased consumer debt. If there were no borrowing or debt, the maximum consumers could spend would be determined by their current levels of income. Increased consumption out of current income cannot fuel an ongoing domestic growth of income, especially as a



large part of income is spent on imports, which stimulates the output of other countries rather than domestic output in this country.

In relatively recent history, the ‘long boom’ in the UK which started in the 1990s and then extended in heady times to early 2007 was largely led by consumption. However, it all ended in tears, being one of the causes of the ‘great recession’ of 2008 and 2009. In the pre-recession years, people’s ability to borrow very cheaply financed a spending spree on housing. Housing being in inelastic supply, house prices took off in response to rapidly increased demand for property, financed by borrowing. Owner occupiers made huge capital gains from properties already bought, which they used to trade up to larger properties and/or to finance a spending spree on consumer goods and imports. Fuelled by further demand, a speculative house price ‘bubble’ emerged, which, when it burst, led to a rapid fall in house prices and the end of the consumer boom. Continuing growth led by consumption was not sustainable.

Commenting on the years 1993 to 2007, the Confederation of British Industry (CBI) stated that UK growth had been over-dependent on consumption, with the apparent stability of the pre-recession years masking growing imbalances underlying the UK economy. The financial position of UK households had become increasingly unstable. Domestic consumption was a bigger part of overall spending in the UK than in Germany, the country regularly cited as the model for international competitiveness. Given that the level of domestic consumption was achieved at the expense of domestic investment and a sound trading position, growth could not be maintained.

In 2014, in an article titled ‘The dangerous consequences of debt-led growth’, the New Economics Foundation commented, ‘What keeps growth going now is the same thing that has kept it going for more than a decade: consumer spending, fuelled by debt. This isn’t so much a recovery, as a relapse — straight back to the bad old ways of the early 2000s. We’re repeating exactly the same mistakes as before.’

In conclusion, therefore, I have to agree with the view expressed in the question. The current period of consumption-led growth is inherently unstable and is in danger of repeating the ‘boom and bust’ experience of the first decade of the twenty-first century. Sustained economic growth requires a balanced economy — balanced in the sense of relying more on exports and investment as the main engines of continuing economic growth. The trouble is that we are set in our consumer-spending ways. Changing this is rather like trying to turn round a super-tanker in a confined area of ocean — easier said than done.