INSTITUTE AND FACULTY OF ACTUARIES

EXAMINATION

19 April 2024 (am)

Subject CB2 – Business Economics
Core Principles

Time allowed: Three hours and twenty minutes

In addition to this paper you should have available the 2002 edition of the Formulae and Tables and your own electronic calculator.

If you encounter any issues during the examination please contact the Assessment Team on T. 0044 (0) 1865 268 873.

1 Which changes are most relevant to macroeconomics?

Changes in:

A real gross domestic product.
B the wage rate paid to workers at a car manufacturing plant.
C the price of computers purchased.
D the quantity of ships produced in a country.

[1.5]

2 If Good X is a Giffen good then a rise in the price of Good X will result in:

A an increase in the consumer's utility.
B a rightward shift in the consumer's budget line.
C a decrease in the quantity demanded.
D an increase in the quantity demanded.

[1.5]

3 Good X is a normal good. Assuming no other changes to the factors that affect the supply and demand for Good X, which statement is true if there is a general fall in income?

A The price of Good X will rise.
B The quantity supplied of Good X will rise.
C The quantity supplied of Good X will remain unchanged.
D The price of Good X will fall.

[1.5]

4 What is the minimum information necessary to determine a company's short run shut down point?

A Total revenue; total fixed costs; total variable costs
B Average revenue; average variable costs
C Total revenue; average total costs
D Average revenue; average total costs; average variable costs.

[1.5]

5 Company A is a manufacturer of high-quality men's suits. To boost revenues, it is considering third-degree price discrimination.

Which statement best explains why such a strategy may not be possible to implement?

A Company A is unable to place its customers in different age groups.
B Company A is unable to offer customers different pricing options for the purchase of suits.
C Company A is unable to put potential customers into different categories based on their occupation.
D Company A is unable to keep its prices low if it were to increase production of its suits.

[1.5]

6 You are given the following data:

Price (£)	*Quantity demanded*
90	200
80	300
70	400
60	500
50	600

For which price change is the price elasticity of demand equal to −1.0 using the arc (average) method?

A From £80 to £90
B From £70 to £80
C From £60 to £70
D From £50 to £60.

[1.5]

7 An indifference set is a:

A set of indifference curves that give the same utility.
B table of alternative combinations of goods that give the same utility.
C set that shows how much a consumer likes different goods.
D combination of two different goods on which the consumer can spend their budget.

[1.5]

8 Constant returns to scale means:

A short run average total costs are unchanged as output rises.
B long run average total costs are unchanged as output rises.
C short run total costs are unchanged as output rises.
D long run total costs are unchanged as output rises.

[1.5]

9 A firm decides to increase sales from 10 units to 11 units by reducing its price from £10 to £9 while its marginal cost of production of the 11th unit is £1. This implies that the firm:

A is profit maximising.
B is sales maximising.
C is not following the profit maximisation rule.
D has positive marginal revenue from the 11th unit.

[1.5]

10 According to the law of diminishing returns, as the input of the variable factor of production is increased, total product will:

A increase in a linear fashion.
B initially increase at a diminishing rate and then increase at an increasing rate.
C initially increase at an increasing rate then increase at a decreasing rate.
D diminish as the input of the variable factor of production increases.

[1.5]

11 Under the Cournot model of duopoly, equilibrium will occur when the:

A price set by the two firms are equal.
B marginal costs of the two firms are equal.
C reaction functions of the two firms intersect.
D total quantity produced by the two firms is equal to the monopoly output.

[1.5]

12 Consider the following table:

Units of labour	*Units of capital*	*Output*
1	1	100
2	2	180
3	3	250
4	4	300
5	5	340

The price of labour is £50 per unit and the price of capital is £100 per unit.

The table illustrates which of the following?

A The law of diminishing marginal returns
B Decreasing returns to scale
C Constant returns to scale
D Increasing returns to scale.

[1.5]

13 Bigfirm is a monopolist in the market for household gas.

As part of a limit pricing strategy, Bigfirm is currently producing quantity Q and charging price P. However, NewCo has decided to enter the market.

What is the most likely reason for NewCo's decision?

A NewCo has lower marginal costs than Bigfirm.
B Bigfirm's marginal costs are above Bigfirm's marginal revenues.
C NewCo's average costs are below price P.
D Bigfirm's average costs are higher than price P.

[1.5]

14 Which of the following is added to the gross domestic product to arrive at gross national income?

A Net income from abroad
B Increases in stocks of unsold goods
C Government expenditure on social security payments
D Depreciation of the capital stock.

[1.5]

15 In an open economy with a high degree of unemployment, which one of the following will result in a fall in stocks of goods and a rise in output?

You are given: S = planned savings, I = planned investment, T = taxation, G = government expenditure, M = import expenditure, X = export receipts.

A $S + T + I < M + G + X$
B $S + T + M < I + G + X$
C $S + T + I > M + G + X$
D $S + T + M > I + G + X$.

[1.5]

16 If the money supply decreases due to a contractionary open market operation by the central bank, then the short-term rate of interest will:

A rise as the price of treasury securities falls.
B rise as the price of treasury securities rises.
C fall as the price of treasury securities falls.
D fall as the price of treasury securities rises.

[1.5]

17 In a closed economy the following information is given:

- The tax rate is 25% of the national income.
- Consumption expenditure (C) is related to current disposable income (Yd) by the formula C = £20 million + 0.8 Yd.
- Investment expenditure is £100 million.
- Government expenditure is £120 million.

Which of the following statements is FALSE?

A If national income is £800 million then consumption expenditure is £500 million.
B The equilibrium national income is £600 million.
C The tax revenue at the equilibrium level of national income is £150 million.
D The multiplier effect of an increase of investment is 5.

[1.5]

18 Which of the following is NOT one of the main macroeconomic objectives of a government?

A A balanced fiscal budget
B A high level of employment
C A high and stable economic growth rate
D A low and stable inflation rate.

[1.5]

19 When countries engage in international trade, one of the advantages of specialisation is that it will enable a country to:

A improve its terms of trade.
B export goods in which it has a lower opportunity cost of production.
C import cheaper labour to use in its production processes.
D attract foreign direct investment into the import competing sector of its economy.

[1.5]

20 Which of the following will always result in an increase in the national debt?

A A fall in the rate of interest payable on government bonds
B A rise in borrowing from the rest of the world
C A fiscal deficit
D A trade account deficit.

[1.5]

21 Which of the following will increase the domestic national income if an open economy is at less than full employment?

A A fall in the marginal propensity to save
B A fall in foreign income
C A rise in the marginal propensity to import
D A rise in the marginal rate of taxation.

[1.5]

22 Which of the following is likely to raise the natural rate of unemployment?

A Improved information flows on job availability
B A rise in unemployment benefits
C A fall in government expenditure
D A decrease in the money supply.

[1.5]

23 Which of the following are the correct responses for the missing words (i), (ii) and (iii) in the following statement?

'An appreciation of the domestic currency will likely act to ___(i)___ the volume of imports and ___(ii)___ the volume of exports and ___(iii)___ the recorded inflation rate.'

A (i) increase, (ii) decrease, (iii) increase
B (i) increase, (ii) decrease, (iii) decrease
C (i) decrease, (ii) increase, (iii) increase
D (i) decrease, (ii) decrease, (iii) decrease.

[1.5]

24 Which of the following items will be recorded as a plus in the balance of payments accounts?

A Lending by domestic banks to foreign citizens
B A fall in the country's holdings of foreign exchange reserves
C Outward foreign direct investment
D Import expenditure.

[1.5]

25 The government of Country A announces two new macroeconomic plans:

1. The central bank will increase its purchases of Country A's government securities.
2. It is going to increase taxes for every income bracket in Country A.

Which macroeconomic policies relate to these two new plans?

A Contractionary monetary policy and expansionary fiscal policy
B Expansionary monetary policy and expansionary fiscal policy
C Expansionary monetary policy and contractionary fiscal policy
D Contractionary monetary policy and contractionary fiscal policy.

[1.5]

26 Which of the following is NOT a crowding out effect after an increase in government expenditure financed by increased government borrowing?

A A rise in the domestic interest rate
B Consumers increase savings as they expect higher future taxes
C Private investment increases due to greater government expenditure
D Exports decrease because of an exchange rate appreciation due to a higher domestic interest rate.

[1.5]

27 A firm has the following data:

Number of units sold	*Total revenue (£)*
10	200
20	360
30	480
40	560
50	600
60	600
70	560

Variable costs are constant at £6 per unit produced. Fixed costs are £200.

(i) Construct a table showing the price associated with each of the above number of units sold. [1]

(ii) Calculate the profit maximising output of the firm. [1]

(iii) Calculate the profits at the profit maximising output. [1]

(iv) Calculate the average variable cost at the profit maximising output. [1]

(v) Determine the short run level of output (or outputs) at which profits are £100. [1]

[Total 5]

28 Outline the long run relationship between the marginal cost and price and between the average cost and price, for each of the following market structures. Assume that under a monopoly the firm is able to earn excess profits.

(i) Perfect competition. [2]

(ii) Monopolistic competition. [2]

(iii) Monopoly. [2]

[Total 6]

29 State, for each of the following cases concerning Good X, the substitution effect, income effect and overall effect on the demand for Good X of a fall in the price of Good X.

(i) Good X is an inferior good. [1]

(ii) Good X is a Giffen good. [1]

(iii) Good X is a normal good. [1]

State whether the following goods are substitutes or complements and also state the sign of the cross elasticity of demand.

(iv) Petrol and cars. [1]

(v) Buses and cars. [1]
[Total 5]

30 (i) Explain in words the impact of an indirect tax on the industry level of output and price. [1]

(ii) Comment on how such a tax will affect the amount of consumer and producer surplus. [2]

(iii) Discuss what is meant by a reaction function in the Cournot model of duopoly and how one firm will react to a perceived increase in the output of the other firm. [2]
[Total 5]

31 Explain with the aid of a numerical example, how game theory can result in two firms, Firm X and Firm Y, setting prices that are not in their mutual interests and how agreeing to higher prices can lead to higher joint profits. [5]

32 (i) Explain whether gross national income is greater or less than gross domestic product if a country has a negative net property income from abroad. [1]

(ii) Explain why an increase in nominal gross domestic product can be associated with a fall in the real gross domestic product. [1]

(iii) Explain how the gross domestic product deflator differs from the consumer price index. [1]

(iv) Explain why real gross domestic product per capita can decrease even if the population of a country falls. [1]

(v) Explain why the value of imports is entered as a negative value when calculating the gross domestic product. [1]
[Total 5]

33 (i) A new coffee shop chain called Superior enters the retail coffee market that is a monopolistically competitive market. It aims to charge significantly above the industry average per cup of coffee consumed in its shops. Explain how it may differentiate its product to make excess profits in the short run. [3]

(ii) Assume that the coffee chain Superior succeeds in making excess profits in the short run. Discuss what is likely to happen to its demand, price and output over the longer term. [2]

[Total 5]

34 The monetarist school argues that money supply increases can result in a short-run trade-off between inflation and unemployment but that such a trade-off does not exist in the long run.

Explain the economic reasoning that monetarists use to justify this argument. [5]

35 (i) Discuss how a country and its consumers can benefit from international trade. [4]

(ii) Discuss how a multinational insurance business can benefit from globalisation and the different ways that it can expand its business internationally. [4]

(iii) Identify the factors that may affect how a multinational expands its international business. [2]

[Total 10]

36 (i) Explain how, in an open economy with perfect capital mobility, an expansionary monetary policy has differing effects on output and employment depending on whether there is a fixed or floating exchange rate regime. [5]

(ii) Explain how, in an open economy with perfect capital mobility, an expansionary fiscal policy has differing effects on output and employment depending on whether there is a fixed or floating exchange rate regime. [5]

[Total 10]

END OF PAPER

Institute
and Faculty
of Actuaries

EXAMINERS' REPORT

CB2 – Business Economics

Core Principles

April 2024

Introduction

The Examiners' Report is written by the Chief Examiner with the aim of helping candidates, both those who are sitting the examination for the first time and using past papers as a revision aid and also those who have previously failed the subject.

The Examiners are charged by Council with examining the published syllabus. The Examiners have access to the Core Reading, which is designed to interpret the syllabus, and will generally base questions around it but are not required to examine the content of Core Reading specifically or exclusively.

For numerical questions the Examiners' preferred approach to the solution is reproduced in this report; other valid approaches are given appropriate credit. For essay-style questions, particularly the open-ended questions in the later subjects, the report may contain more points than the Examiners will expect from a solution that scores full marks.

For some candidates, this may be their first attempt at answering an examination using open books and online. The Examiners expect all candidates to have a good level of knowledge and understanding of the topics and therefore candidates should not be overly dependent on open book materials. In our experience, candidates that spend too long researching answers in their materials will not be successful either because of time management issues or because they do not properly answer the questions.

Many candidates rely on past exam papers and examiner reports. Great caution must be exercised in doing so because each exam question is unique. As with all professional examinations, it is insufficient to repeat points of principle, formula or other text book works. The examinations are designed to test "higher order" thinking including candidates' ability to apply their knowledge to the facts presented in detail, synthesise and analyse their findings, and present conclusions or advice. Successful candidates concentrate on answering the questions asked rather than repeating their knowledge without application.

The report is written based on the legislative and regulatory context pertaining to the date that the examination was set. Candidates should take into account the possibility that circumstances may have changed if using these reports for revision.

Sarah Hutchinson
Chair of the Board of Examiners
June 2024

A. General comments on the *aims of this subject and how it is marked*

The aim of the Business Economics subject is to introduce students to the core economic principles and their relevance to the business environment.

The subject provides a grounding in the fundamental concepts of micro- and macro-economics as they affect the operation of insurance and other financial systems, both for individuals and their requirements for financial security, and for financial institutions and their ability to provide products that meet individual and institutional clients' needs.

The examination paper is designed to assess candidates' knowledge and understanding as well as application of economic concepts and exploration of the linkages within the wider economy, and the marking scheme duly reflects this aim.

B. Comments on *candidate performance in this diet of the examination.*

The performance in this session was generally strong both for multiple choice questions and the short answer questions.

The answers to the theoretical parts of questions were generally stronger.

Where explanation of economic concepts or definitions were required, a concise definition was needed.

For application type questions, where the context was familiar and standard, there were some reasonably good attempts.

Long answer questions that involved a discussion of the impact of policies proved more challenging. Many candidates provided short sentences without linkages to discuss of the impact of policies, whereas for a full and clear answer, a step-by step explanation of the effect of the policy on the relevant parts of the economy, together with the linkages between each step and the next was rewarded.

C. Pass Mark

The Pass Mark for this exam was 60
1089 presented themselves and 817 passed.

Solutions for Subject CB2 – April 2024

Q1	A	[1½]
Q2	D	[1½]
Q3	D	[1½]
Q4	B	[1½]
Q5	C	[1½]
Q6	D	[1½]
Q7	B	[1½]
Q8	B	[1½]
Q9	C	[1½]
Q10	C	[1½]
Q11	C	[1½]
Q12	B	[1½]
Q13	C	[1½]
Q14	A	[1½]
Q15	B	[1½]
Q16	A	[1½]
Q17	D	[1½]
Q18	A	[1½]
Q19	B	[1½]
Q20	C	[1½]
Q21	A	[1½]
Q22	B	[1½]
Q23	B	[1½]
Q24	B	[1½]
Q25	C	[1½]
Q26	C	[1½]
		[Total 39]

Commentary:
The multiple-choice questions were generally answered well.

Q27

(i)

Price	Quantity Sold
20	10
18	20
16	30
14	40
12	50
10	60
8	70

[1]

(ii)

40 Units [1]

(iii)

£120 [1]

(iv)

£6 [1]

(v)

30 units and 50 units [1]

[Total 5]

Commentary:
Most candidates made a good attempt in answering this question, gaining the marks. Some candidates provided only one level of output corresponding to profits of £100 and gained half of the marks for this part.

Q28

(i)

Under perfect competition price equals marginal cost and price equals average cost in the long run [2]

(ii)

Under monopolistic competition price is greater than marginal cost and price equals average cost in the long run. [2]

(iii)

Under a monopoly price is greater than the marginal cost and price is greater than average cost in the long run [2]

[Total 6]

Commentary:
The answers to part (iii) of this question were generally correct. Quite a few candidates offered partially correct answers to parts (i) and (ii). *Very few candidates gained the full mark for part (ii) of this question omitting to comment adequately on the reasons for the fall in consumer/producer surplus. Most candidates made a reasonable attempt on parts (i) and (iii) of the question.*

Q29

(a) (i)
For an inferior good the substitution effect of a price fall will increase demand, the income effect will decrease demand and the net effect on demand is positive. [1]

(a) (ii)
For a Giffen good the substitution effect of a price fall will increase demand, the income effect will decrease demand and the net effect on demand is negative. [1]

(a) (iii)
For a normal good the substitution effect of a price fall will increase demand, the income effect will increase demand and the net effect on demand is positive. [1]

(b) (i)
Since petrol and cars are complementary goods their cross elasticity of demand is negative. [1]

(b) (ii)
Since buses and cars are substitutes their cross elasticity of demand is positive [1]

[Total 5]

Commentary:
In answering parts (i) and (ii), many candidates stated that the substitution effect of a price fall is negative and that of income effect is positive. Since here substitution effect is the effect of a price fall on the quantity demanded and the result is an increase in demand, there is a positive effect on demand and the substitution effect of a price fall is positive. Similarly, income effect is positive. This follows from the definitions of the income and substitution effects. *Quite a few candidates mis-interpreted the substitution and income effects as the direction of the effect on demand vis-s-vis the direction of the price/income change and did not gain the full mark for pats (i) and (ii).* *Answers to parts (iii)-(v) were generally correct and the great majority of candidates gained the marks for these parts.*

Q30

(i)
The effect of a sales tax is to shift the supply curve up to the left and this will lead to a rise in price and a fall in output [1]

(ii)
The effect will be to reduce both consumer and producer surplus. Consumer surplus falls because of the rise in price and fall in demand, while producer surplus falls because the price received by producers falls and the quantity sold falls. [2]

(iii)
A reaction function for a firm (firm A) shows how much it will produce for a given output of the other firm (firm B). In the Cournot model as Firm B increases its output firm A will react by producing less output [2]

[Total 5]

Commentary:
Very few candidates gained the full mark for part (ii) of this question omitting to comment adequately on the reasons for the fall in consumer/producer surplus. Most candidates made a reasonable attempt on parts (i) and (iii) of the question.

Q31

		Firm X Price	
		High	**Low**
Firm Y Price	**High**	£10million each	£5 million for Y £12 million for X
	Low	£12 million for Y £5 million for X	£8 million each

Note: the value in the cells refers to the profits of each firm

In the above Firm, X will choose to set the low price as this is its dominant strategy. Likewise, Firm Y will choose to set the low price as this is its dominant strategy. The result is they both make profits of £8 million each. If they were both to collude to set high prices (a cooperation scenario) then the result would be higher profits of £10 million each. [5]

[Total 5]

Commentary:
Many candidates offered a table without clearly defining the price/profit combinations for the two firms and lost some marks. Also, explanations of how the firms' dominant strategies are arrived at, were often inadequate. To gain the marks, a clear and full explanation was needed on the dominant strategies of the two firms and the resulting profits from each strategy.

Q32

(i)

If the country has a negative net property income from abroad then the gross national income will be less than the gross domestic product a income payments to foreign citizens exceed income receipts from foreign citizens. [1]

(ii)

An increase in nominal gross domestic product can be associated with a fall in the real national income if the rise in the GDP deflator is greater than the rise in the nominal gross domestic product. This means real income must have fallen. [1]

(iii)

The Gross Domestic Product deflator measures price changes in all components of the GDP such as consumption, Investment, government expenditure, exports and imports whereas the consumer price index is more clearly focussed on measuring inflation only in consumption expenditure. [1]

(iv)

If the fall in Real GDP is larger than the decrease in the population then real GDP per capita will fall. [1]

(v)

Since consumption expenditure, investment expenditure and government expenditure and exports will include some elements of import expenditure then we need to deduct imports values to get the domestic value of output required when calculating the gross domestic product. This will deal with the possibility of double counting. [1]

[Total 5]

Commentary:
This question was generally well answered. A clear and precise definition/explanation was needed to gain the mark for each part.

Q33

(i)

There are several ways that Superior can differentiate its product offering from its rivals enable it to charge a higher price:

It can offer a higher premium coffee with different types of flavours for consumers and from different countries of the world with well qualified baristas making the coffee.

Another way is to make the consumer experience superior through high quality furnishing including tables, seating and use of superior coffee cups.

Another way is to have a high focus on customer service perhaps with coffee being brought to table accompanied by a side chocolate or a biscuit.

Another way of distinguishing itself from its competitors is to offer a different range of high-quality accompaniments to the coffee such a cakes, sandwiches and croissants. [3]

(ii)

Over the long term due to the lack of barriers to entry, other coffee retailers are likely to upgrade their products and services and also new entrants will enter the market due to the observed excess profits. This means that Superior will begin to lose demand and it will find its demand curve becoming more elastic due to increased competition. The result will be that its market demand will begin to fall and it will have to reduce its price to remain competitive and so it will only be able to make normal profits in the long term. [2]

[Total 5]

Commentary:
Most candidates made a reasonably good attempt at this question. In part (i) distinct ways for the firm to differentiate its product together with stating the relevant theoretical concept was needed to gain the marks. Reasonable attempts were made in answering part (ii).

Q34

Monetarists argue that there may be a short-run trade-off between inflation and unemployment as wages are sticky and hence a monetary expansion will increase the inflation rate and reduce real wages making it more profitable for firms to take on extra workers in the short run so reducing the reported unemployment rate. However, they do not believe that there is a long-term trade-off between inflation and unemployment. since any increase in the money supply that attempts to reduce unemployment by raising prices relative to wages will be doomed to failure as workers demand wage rises in line with the inflation rate such that real wages are restored to their original level. From a policy perspective monetarists believe that in the long run there is no trade-off between inflation and unemployment. They believe that the economy will settle at the natural rate of unemployment and the only thing that the authorities can affect is the inflation rate.

[5]
[Total 5]

Commentary:
Many answers were a general discussion of monetary policy whereas an explanation of the Monetarists' view of the relationship between unemployment and inflation specifically was required. Other answers considered the short run only. A full and clear discussion of the impact of a monetary expansion on the relationship between unemployment and inflation in the short-and long run was required to gain the marks.

Q35

(i)

The existence of international trade enables countries to specialise in the production of the goods which they can produce relatively more efficiently than other countries and can raise economic output.

Another advantage of international trade is that it increases the scope for benefits from economies of scale by increasing the size of the available markets and helps to spread high research and development costs across possibly millions or even billions of worldwide consumers.

For consumers international trade increases the range of goods and services which consumers can buy and enables them to get more variety.

International trade can also benefit consumers by undermining the power of domestic monopolies and oligopolies as they have to compete with imported goods.

Another benefit of international trade is that competition from foreign producers forces domestic firms to become more efficient so they can compete with imports. This will mean there should be a downward shift in their long run average costs and resulting lower prices for domestic consumers. [4]

Q35 (ii)
A multinational insurance company can benefit from operating in a variety of countries:
By insuring risks in many countries the insurance company is able to spread its risks and take advantage of lower costs of labour and capital especially in lower income countries.
Operating in many countries will also enable the insurance company to outsource specific functions such as servicing policies and its administrative costs to international offices or to other international businesses that benefit from economies of scale and have specialist skills.
A multinational insurance company can expand its international presence by setting up local subsidiaries or partnering with local businesses to sell its products on the international markets. Another way of gaining a presence in different countries is to conduct purchases/takeovers of mergers with of overseas companies. [4]
(iii)
The particular approach a multinational business will take will depend upon the relative costs, efficiency (for example better labour productivity or lower labour costs) and effectiveness of international business partners as well as the culture, regulatory regime and legal and regulatory framework in countries in which the insurance company operates. [2]

[Total 10]

Commentary:
Part (i) of this question was generally answered well. In part (ii) only a few candidates offered the many ways that an insurance company could benefit from expansion abroad but most mentioned the many ways that the expansion could be achieved as well as the factors that are influential in such expansion in part (iii).

Q36
(i)
In an open economy with perfect capital mobility the domestic interest rate is constrained to be the same as the world interest rate. With an expansionary monetary policy the central bank increases the money supply and attempts to lower the domestic interest rate. Under a floating exchange rate there will be capital outflows, and this will lead to a depreciation of the domestic currency which will boost exports and reduce imports and so increase economic output and employment if the economy is operating at less than full employment. By contrast under a fixed exchange the fall in the domestic interest will mean that there are large capital outflows, and this will mean the central bank will have to intervene in the foreign exchange market to buy the domestic currency using its foreign exchange reserves. This will mean all of the initial expansion of the domestic currency is brought back to its original level leaving the domestic interest rate and economic output unaffected. As such, an expansionary monetary policy is-useful at raising economic output under a floating exchange rate regime with perfect capital mobility but ineffective under a fixed exchange rate regime. [5]

Q36 (ii)
In an open economy with perfect capital mobility the domestic interest rate is constrained to be the same as the world interest rate. With an expansionary fiscal policy, the authorities borrow money to finance increased fiscal expenditure, and this puts upward pressure on the domestic interest rate. Under a floating exchange rate there will be huge capital inflows, and this will lead to an appreciation of the domestic currency which will reduce exports and increase imports and so prevent any increases in economic output and employment with the domestic interest rate remaining unchanged. By contrast under a fixed exchange the rise in the domestic interest will mean that there are large capital inflows, and this will mean the central bank will have to intervene in the foreign exchange market to sell the domestic currency and buy the foreign currency so increasing its foreign exchange reserves and the domestic money supply. Overall, the expansionary fiscal policy results in an expansion of domestic output and employment. As such, an expansionary fiscal policy is unable to raise economic output under a floating exchange rate regime with perfect capital mobility but effective at increasing output and employment under a fixed exchange rate regime. [5]

[Total 10]

Commentary:
Very few answers to this question gained a high mark. The question was generally not answered fully by many candidates; many provided short sentences in bullet points without reasoning the impact of the monetary or fiscal policy step-by-step and the linkages between various stages of the impact. In part (i) the marks were equally divided between the impact of monetary policy with a floating/fixed exchange rate. Similarly, in part (ii) half of the mark was allocated to the impact of fiscal policy with a floating/fixed exchange rate. At the end of the discussion for each part, a conclusion was required as to the effectiveness or otherwise of the two policies but the conclusion was not offered by many.

[Paper Total 100]

END OF EXAMINERS' REPORT

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