Exercise walk-through

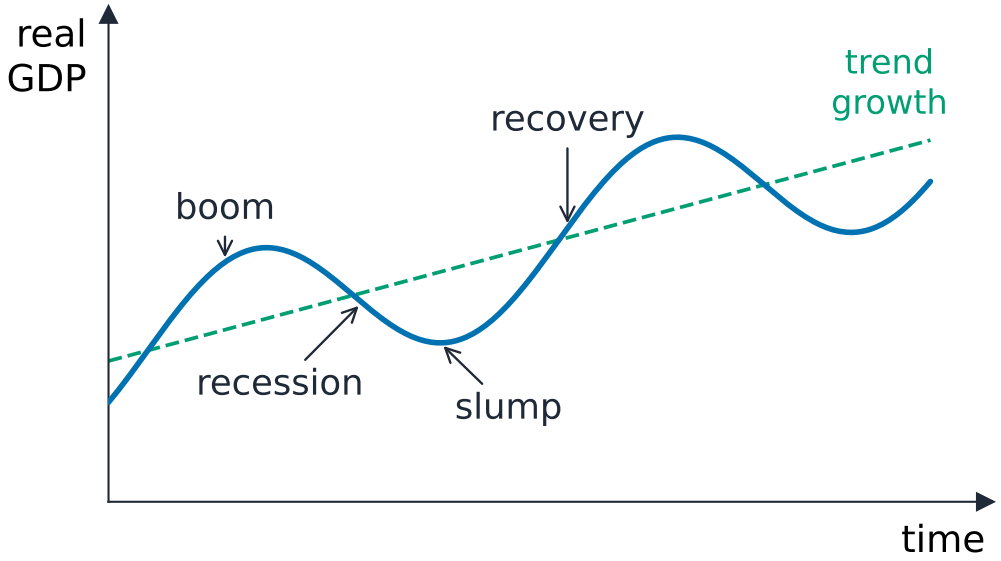
5.4
Economic growth and government debt

International Baccalaureate · IB Diploma · Economics · HL

Macroeconomic activity, objectives and policy

- measure economic activity with GDP and other indicators, and describe the **business cycle**;
- use **aggregate demand** and aggregate supply to explain output gaps, and the HL **multiplier**;
- explain the objectives of low unemployment, low and stable inflation, growth and sustainable debt;

Figure: Measuring economic activity



- **Real GDP** rises and falls around its long-term **trend**
- Match each part of the diagram to the text.

Monetary policy

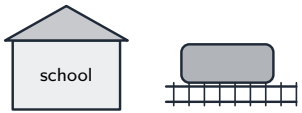
- the **policy interest rate** (the rate at which the **central bank** lends to commercial banks);
- **open market operations** : buying or selling government bonds to change the **money supply**;
- **minimum reserve requirements** : the share of deposits banks must keep and cannot lend. Lowering it lets banks lend more;
- **quantitative easing** (QE): large-scale bond buying with newly created money, used when interest rates are already near zero.

Exercises 2.1·2.2

2.1 Distinguish between a budget deficit and government debt. [2]



2.2 State **two** sources of long-term economic growth. [2]



Exercises 2.1·2.2

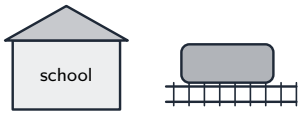
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2.1

budget deficit: government spending is greater than revenue in one year; government debt: the total amount owed, built up from past deficits

2.2 State **two** sources of long-term economic growth. [2]



2.2

any two: investment in physical capital / infrastructure; education and training (human capital); new technology; better institutions

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Exercise 2.3

2.3 Using a PPC diagram, distinguish between actual growth and potential growth. [4]



[[drawlines:4]]

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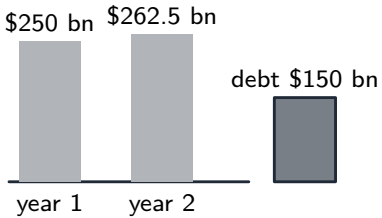
[[drawlines:4]]

2.3

actual growth: a movement from a point inside the PPC towards the curve, using unemployed resources; potential growth: an outward shift of the PPC, from more or better resources or technology; correctly labelled diagram showing both

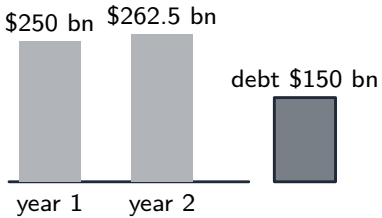
Exercise 2.4

2.4 A country's real GDP rises from \$250 billion to \$262.5 billion. Its government debt is \$150 billion at the start. Calculate the growth rate and the debt-to-GDP ratio at the start. [3]



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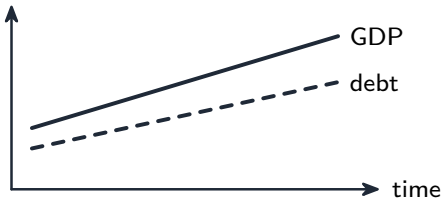


2.4

growth $= 12.5 \div 250 \times 100 = \mathbf{5}\%$; debt ratio $= 150 \div 250 \times 100 = \mathbf{60}\%$

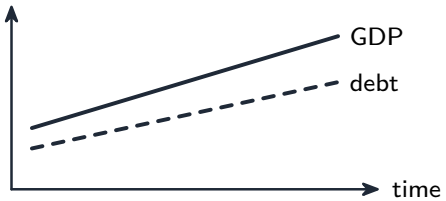
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2.5 The next year the government runs a deficit of \$6 billion and nominal GDP is \$262.5 billion. Calculate the new debt-to-GDP ratio, and explain why the ratio fell even though the government borrowed more. [3]



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2.5

new debt = 156 bn; ratio = $156 \div 262.5 \times 100 \approx \mathbf{59}.4\%$; GDP grew by 5% while debt grew by only 4%, so debt fell as a share of GDP

Exercise 3.1 (a)

3.1 A fast-growing economy has rising incomes but worsening air pollution and a widening gap between rich and poor.

(a) Define **economic growth**. [2]

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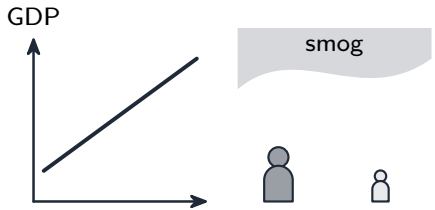
(a) Define **economic growth**. [2]

(a) an increase in real GDP; over a period of time, usually a year

Exercise 3.1 (b)

3.1 A fast-growing economy has rising incomes but worsening air pollution and a widening gap between rich and poor.

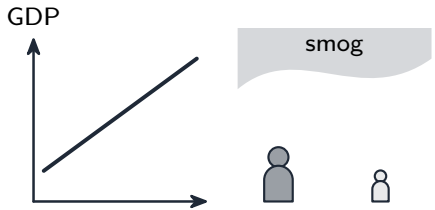
(b) Discuss the view that economic growth always raises living standards. [6]



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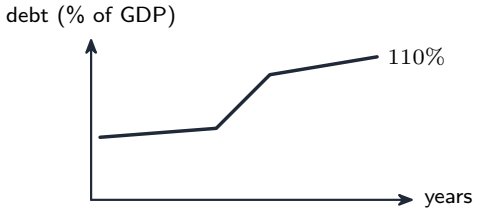


(b) growth raises incomes, jobs and tax revenue for schools and health care; but pollution harms health and quality of life; widening inequality means many people gain little; resources may be used up, harming future generations: not sustainable; judgement: growth is necessary but not enough; its quality and distribution matter

Exercise 3.2

3.2 After a recession, a government's debt has risen to 110% of GDP.

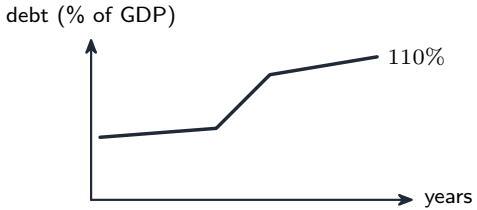
Evaluate whether the government should cut its spending quickly to reduce the debt. [8]



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3.2

award up to [8]: high debt means large interest payments: opportunity cost for public services; risk of lower credit ratings and higher borrowing costs; cutting the debt keeps room to act in the next crisis; but quick cuts reduce AD; with the multiplier, GDP falls further; lower GDP can raise the debt ratio and unemployment; better to cut slowly as the economy recovers and grows; growth faster than interest rates lowers the ratio without big cuts; judgement depends on the interest rate, who holds the debt, and the state of the recovery