

372/01

ECONOMICS – EC2

P.M. FRIDAY, 8 June 2007

(1 hour)

ADDITIONAL MATERIALS

In addition to this examination paper, you will need an 8 page answer book.

INSTRUCTIONS TO CANDIDATES

This paper contains **one** compulsory question.

INFORMATION FOR CANDIDATES

The number of marks is given in brackets at the end of each question.

You are reminded of the necessity for good written communication and orderly presentation in your answers.

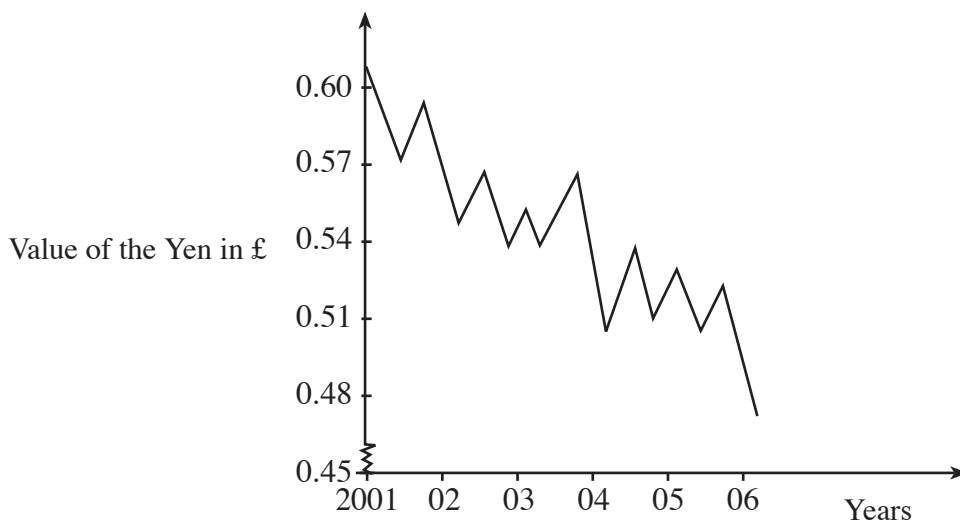
Study the information below and then answer the questions that follow.

JAPAN PUTS INTEREST UP BY 0.25%

In July 2006 the Bank of Japan (BoJ) raised interest rates by one quarter of one per cent (0.25%). This was the first *monetary tightening* for some years, but Toshihiko Fukui, the BoJ's Governor, told a news conference that the Bank had no intention of raising interest rates again in the near future. The BoJ described the Japanese economy as 'expanding' for the first time in fourteen years, but the Governor said that the Bank was not going to raise interest rates at consecutive BoJ meetings and would adjust rates only slowly and steadily.

After years of stagnation the Japanese economy has grown on the back of strong consumer spending growth and increased investment expenditure, which was up 8.9% on last year. In each of the past five quarters unemployment has fallen, and is now at an eight year low of 4%. The Japanese government has upgraded its annual economic growth forecast to 2% for 2006. Economists believe that this growth may well continue into 2007. Despite the small rise in interest rates the yen hit a near eight-year low against the UK pound and also fell against the dollar and the euro.

Figure 1 – Yen falls against the pound



Anatole Kaletsky, writing in *The Times*, believes that interest rates in Japan would stay below 0.5% until 2007. He had two arguments to support this view. Firstly, Japan needs to undertake a huge *fiscal tightening* over the next few years to bring its budget deficit under control. In order to be able to raise taxes substantially without pushing the economy back into recession interest rates will have to be kept very low. Secondly, while the Japanese economy is clearly growing after years of stagnation and very low interest rates, most prices in the economy are still falling.

Adapted from The Times, 15 July 2006

- (a) Using Figure 1, comment on how the change in the value of the yen, between 2001 and 2006, may affect Japanese export prices and import prices. [4]
- (b) (i) Explain what is meant by monetary policy and fiscal policy. [4]
- (ii) Using the data explain what is meant by *monetary tightening* and *fiscal tightening*. (Lines 3, 15 and 16.) [4]
- (c) With the aid of the data and using an aggregate demand and aggregate supply diagram, explain how the changes in consumer and investment spending have increased economic growth in Japan. [8]
- (d) Using economic analysis, explain why Anatole Kaletsky believes that Japanese interest rates will have to remain low for the foreseeable future. [4]
- (e) Using the data, discuss the view that low interest rates are needed to stimulate consumer spending and investment. [8]
- (f) With the aid of the data, discuss the possible effects of continued economic growth on the Japanese economy. [8]