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Answers

Exam-style questions

Questions on interest rates and investment

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This resource provides answers to the questions posed in the Exam-Style Questions column, in the September 2024 issue of ECONOMIC REVIEW.

Question 1

Using only data from Table 1, calculate the percentage change in investment between 2018 and 2023 to one decimal place. (2 marks)

Answer

$$(\$315\text{bn} - \$200\text{bn})/\$200\text{bn} \times 100 = 57.5\%$$

Question 2

Using evidence from Table 1, to what extent do the data show that cuts in interest rates lead to increases in investment? (4 marks)

Answer

Relevant points include:

- Low interest rates increase the profitability of investment projects financed by borrowing.
- One would expect a fall in interest rates to increase investment.
- Smallest level of investment (\$200bn) is in 2017 when interest rate was highest (8.5%).
- Highest level of investment (\$335bn) is in 2022 when interest rates were low (4.25%) but not the lowest.
- Second highest level of investment (\$330bn) was in 2021 when interest rates were lowest.
- Biggest increase in deficit was in 2021 (from 1.2% to 2.5%). This coincided with lowest growth rate (-0.1% in 2021)
- This indicates that investment increases are linked to lower interest rates.

Question 3

With the help of a diagram, explain how increases in investment affect economic growth. (9 marks)

Answer

- Diagrams: AD/AS model with either:
 - increased AD (as a result of increased spending in investment)
 - increased LRAS (as a result of increased investment raising productive capacity).
- Economic growth should increase — as long as there is spare capacity in the short-term.
- Long-run growth can be increased if investment leads to increased capacity.
- Multiplier effects on growth possible.
- Accelerator effects on investment from economic growth — data in table may be used to support this.

Question 4

Evaluate the extent to which investment in infrastructure is always beneficial for an economy. (25 marks)

Answer

Short-term effects of increased investment:

- should increase economic growth via increased AD
- should lead to lower unemployment (cyclical)
- multiplier effects will lead to further increases in economic growth
- may be inflationary
- depends on current phase of economic cycle
- interaction of multiplier-accelerator may be mentioned

Long-term effects of increased investment:

- should increase productive capacity
- lower structural unemployment possibly
- non-inflationary economic growth
- improved business performance due to less pressure on capacity and prices
- dynamic efficiency
- crowding out may limit overall impact

Issues for evaluation

- will take time to become effective — years perhaps (e.g. HS2)
- no guarantee it will lead to any significant increase in productive capacity

- if public sector investment, then may lead to increased public borrowing and increased national debt
- crowding out may or may not occur
- should reduce natural rate of unemployment if successful