2.26 The National Debt: Fiscal Sustainability and Fiscal Rules: 30-minute Pack

Total Marks

AQA 7136 · Calculators not allowed · about 30 minutes

Name: _____ Date: ____ / ____ / _____

Answer all questions. Full sentences are required for questions worth 4 marks or more. No calculator is allowed. The final question is worth 25 marks; plan your time accordingly.

1 Explain, in the context of government borrowing and sustainability, why the trend in the debt-to-GDP ratio matters for assessing fiscal sustainability in a country such as Albion.

(Total for Question 1 is 4 marks)

2 Explain how the relationship between the government interest rate on public debt (r) and the economy's trend real growth rate (g) affects whether a given level of debt is sustainable, using the debt dynamics intuition for a country like Albion.

(Total for Question 2 is 4 marks)

3 Explain why the maturity structure of government debt matters for fiscal sustainability and the risk of a rollover crisis in a country that finances itself with short-dated gilts versus long-dated gilts.

(Total for Question 3 is 4 marks)

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4 Explain one advantage and one disadvantage of self-imposed fiscal rules, such as a legislated ceiling for the debt-to-GDP ratio, for the fiscal sustainability of a country like Albion.

(Total for Question 4 is 4 marks)

5 Explain how the choice between rapid consolidation (austerity) and slower consolidation with continued borrowing can have different short-term and long-term effects on the debt-to-GDP ratio in a country experiencing weak growth.

(Total for Question 5 is 4 marks)

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Mark scheme · 2.26 The National Debt: Fiscal Sustainability and Fiscal Rules: 30-minute Pack

Question 1

identifies that the trend shows whether debt is rising faster than the economy, e.g. debt-to-GDP rising means debt is growing faster than GDP **M1**

explains that a rising ratio may be unsustainable because interest payments can grow relative to revenue, crowding out other spending **A1**

identifies that a stable or falling debt-to-GDP ratio is more sustainable as GDP growth can outpace debt accumulation **M1**

explains that the trend matters to markets and credit ratings, affecting gilt yields and the government's ability to refinance at low cost **A1**

Answer: A rising debt-to-GDP ratio suggests debt is growing faster than the economy and may be unsustainable due to rising interest costs and market concern; a stable or falling ratio is more sustainable as growth outpaces debt accumulation.

Question 2

states the key comparison: if r < g, debt can be stabilised without primary surpluses; if r > g, debt tends to grow unless offset by primary surpluses **M1**

explains that when g exceeds r, nominal GDP grows faster than interest obligations, making it easier to stabilise or reduce the debt-to-GDP ratio **A1**

states that when r exceeds g, the cost of servicing debt grows faster than GDP, requiring larger primary balances to prevent a rising debt ratio **M1**

links this to policy: if r > g, the government may need fiscal consolidation or structural reforms to avoid unsustainable debt dynamics **A1**

Answer: If r < g the debt-to-GDP ratio can be stable or decline without large surpluses; if r > g interest costs push debt up relative to GDP, requiring primary surpluses to stabilise debt.

Question 3

identifies that short maturity means frequent refinancing, so the government is exposed to changes in market yields and liquidity **M1**

explains that if markets lose confidence, yields can spike and the government may face high costs or difficulty rolling over maturing debt, causing a rollover crisis **A1**

identifies that long maturity spreads refinancing risk over time and locks in borrowing costs **M1**

explains that a portfolio with longer maturities reduces vulnerability to short-term market swings, improving perceived sustainability even at the same debt-to-GDP ratio **A1**

Answer: Short maturities increase rollover risk and exposure to yield spikes, making debt less sustainable in bad markets; long maturities reduce refinancing frequency and stabilise financing costs, enhancing sustainability.

Question 4

advantage identified: rules can bind policymakers, increase credibility, and lower risk premia **M1**

development: greater credibility can reduce gilt yields and financing costs, helping sustainability **A1**

disadvantage identified: rules can be inflexible and may force procyclical policy **M1**

development: in a recession a strict rule could force spending cuts or tax rises that deepen the downturn and reduce the denominator GDP, paradoxically worsening debt ratios **A1**

Answer: Advantage: rules improve credibility and may reduce yields; disadvantage: they can be procyclical and force damaging cuts in downturns, harming both growth and sustainability.

Question 5

identifies that rapid consolidation reduces the primary deficit quickly and lowers borrowing needs **M1**

explains that in the short term rapid consolidation may reduce GDP growth, lowering nominal GDP and possibly keeping the debt-to-GDP ratio higher than expected **A1**

identifies that slower consolidation supports demand and growth in the short term **M1**

explains that higher growth can raise the denominator GDP, helping to reduce the debt-to-GDP ratio over time even with ongoing borrowing, especially if r < g **A1**

Answer: Austerity cuts borrowing fast but can depress GDP so debt ratio may not fall as expected short term; slower consolidation may support growth and reduce the ratio via a larger GDP denominator, particularly when r < g.

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