

A-level ECONOMICS

Paper 2 National and international economy

Tuesday 12 June 2018

Afternoon

Time allowed: 2 hours

Materials

For this paper you must have:

- an AQA 12-page answer book
- a calculator.

Instructions

- Use black ink or black ball-point pen. Pencil should only be used for drawing.
- Write the information required on the front of your answer book. The **Examining Body** for this paper is AQA. The **Paper Reference** is 7136/2.
- In **Section A**, answer **EITHER** Context 1 **OR** Context 2.
- In **Section B**, answer **one** essay.

Information

- The marks for questions are shown in brackets.
- The maximum mark for this paper is 80.
- There are 40 marks for **Section A** and 40 marks for **Section B**.
- You will be marked on your ability to:
 - use good English
 - organise information clearly
 - use specialist vocabulary where appropriate.

Advice

- You are advised to spend 1 hour on **Section A** and 1 hour on **Section B**.

Section A

Answer **EITHER** Context 1 **OR** Context 2.

EITHER

Context 1

Total for this context: 40 marks

The UK's trade balance

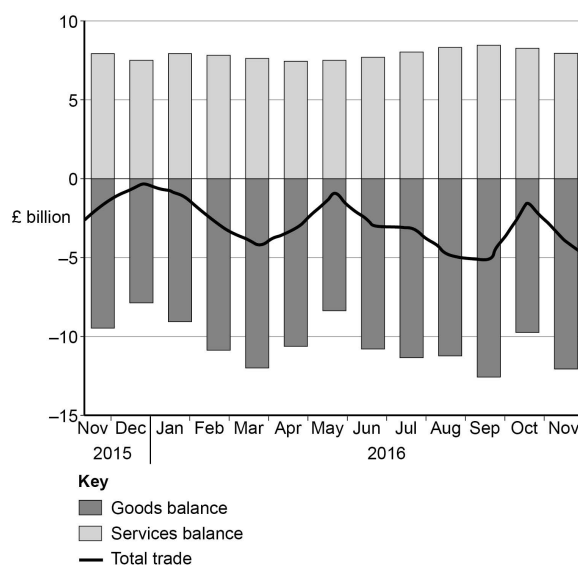
Study **Extracts A, B and C** and then answer **all** parts of Context 1 which follow.

Extract A

Figure 1: Sterling effective exchange rate index, November 2015 to November 2016



Figure 2: Balance of UK trade, November 2015 to November 2016



Source: ONS

Extract B: The UK's trade deficit

In September 2016, the UK's trade deficit with the rest of the world widened unexpectedly. Exports fell, despite a sharp fall in the value of the pound. The trade deficit in goods alone rose to £12.7bn. The value of imports increased by £1.3bn to £38.8bn, while exports fell by £0.2bn to £26.1bn. The rebalancing of the UK economy to achieve export-led growth has not happened yet.

5

The disappointing trade figures suggest that the 16% fall in the value of the pound since the EU referendum in June 2016 has failed to lift exports significantly. An economist at Scotiabank, said "If we are lucky, the weak pound may boost exports, but export growth tends to be driven more by the strength of overseas demand, rather than the exchange rate." Others point to a lack of competitiveness and low productivity as being central to the UK's poor export performance.

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In Quarter 3 of 2016, the UK economy grew much faster than many economists had initially expected, with signs that the growth had been supported by rising consumer spending. This may be one of the reasons why imports of goods have increased. A statistician at the ONS, said that "In this first full quarter since the EU referendum, there is little evidence of the lower pound feeding through into trade volumes or prices."

15

In recent years, the UK's earnings on assets overseas have fallen relative to the earnings of foreign investors in the UK. This contributed to the deterioration in the

current account balance, leading to a record deficit of 5.4% of GDP in 2015. Although some argue that a current account deficit is not a problem, others point to the worryingly large and persistent nature of the deficit. The effects on employment, the need to attract inward investment and the possible negative effects on growth and living standards are among the causes for concern. 20

Source: News reports, 2016

Extract C: Germany's trade surplus

Germany's surplus on the current account of its balance of payments surged to a record level in 2015, at 8.5% of GDP. It has now overtaken the Chinese surplus as the largest imbalance in the world. This imbalance is clearly causing problems inside the eurozone and globally. If the German current account is in surplus, it implies that other nations are in deficit. 5

Although the German government views the surplus as evidence of economic success, there is growing pressure from other countries and the European Commission for Germany to take steps to reduce the surplus. Trade deficits and surpluses may be self-correcting in a floating exchange rate system, but as Germany is part of the eurozone, its currency does not fluctuate against those of other member countries, since they all use the euro. 10

Germany's surplus has been increased by low oil prices and the relatively low value of the euro. Healthy growth in other European nations has also contributed to strong demand for German exports. Whatever the reason for Germany's surplus, the UK may only look on in envy. 15

Source: News reports, 2016

0 1 Using the data in **Extract A (Figure 1)**, calculate the change in the effective exchange rate index, as a percentage, between November 2015 (point A) and November 2016 (point B). Give your answer to **two** decimal places. [2 marks]

0 2 **Extract B** describes the trade figures as 'disappointing'. Explain how the data in **Extract A (Figure 2)** show that the UK's trade performance has been 'disappointing' given the fall in the value of the pound since November 2015. [4 marks]

0 3 **Extract C** (lines 8–9) states 'Trade deficits and surpluses may be self-correcting in a floating exchange rate system.' With the help of a diagram showing the supply of and demand for a currency, explain how a floating exchange rate may help to correct a trade surplus. [9 marks]

0 4 **Extract B** (lines 19–21) states 'Although some argue that a current account deficit is not a problem, others point to the worryingly large and persistent nature of the deficit.' Using the data in the extracts and your knowledge of economics, assess the impact of a persistent current account deficit on the macroeconomic performance of the UK economy. [25 marks]

Turn over ►

Do **not** answer Context 2 if you have answered Context 1.

OR

Context 2

Total for this context: 40 marks

Monetary policy and stability

Study **Extracts D, E and F** and then answer **all** parts of Context 2 which follow.

Extract D

Figure 3: UK household gross debt to income, 2006 to 2020

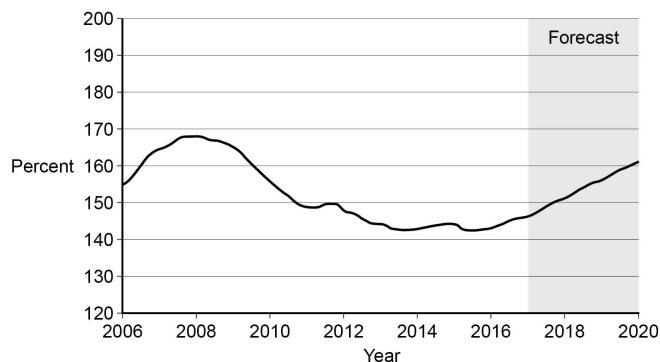


Figure 4: Household saving ratio, 2006 to 2016

Year	Saving ratio (%)
2006	7.6
2008	7.5
2010	11.2
2012	9.3
2014	8.4
2016	7.1

Source: ONS

Extract E: Financial regulation and monetary policy

In response to the lessons learned from the global financial crisis of 2007/08, the government of the UK has introduced major reforms to financial markets. The government recognised that systemic risk, moral hazard and imperfect information had all contributed to the credit crunch and subsequent recession in the UK. As a result, changes have been made to try to avoid a recurrence of failing banks and expensive state-backed bailouts.

5

The Prudential Regulation Authority (PRA) was established to ensure the stability of firms offering financial services and the Financial Conduct Authority (FCA) was set up to regulate the industry. Also, the Bank of England is responsible for supervising the whole financial system through the Financial Policy Committee (FPC). The FPC identifies and attempts to reduce risks in the system. The new framework is seen as the biggest change for the Bank of England since it was given operational independence for the conduct of monetary policy in 1997.

10

Since 2013, the Treasury has required the Bank of England to place more emphasis on helping the government to achieve its objectives for growth and employment, in addition to its central objective of maintaining price stability. However, some argue that trying to maintain stable prices and low unemployment could create trade-offs.

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The Monetary Policy Committee's decision to lower Bank Rate to 0.5% in 2009, and the subsequent decision to lower it to 0.25% in 2016, have been instrumental in the UK's sustained recovery and return to low levels of unemployment. The Bank of England has also used quantitative easing (QE) to boost consumption and investment. Maintaining low interest rates is considered by many to be vital for both consumer and business confidence.

20

Source: News reports, 2016

Extract F: A new financial crisis?

Has increased regulation worked or could the UK be on the verge of another financial crisis? The Bank of England is keeping a close watch on consumer spending amid signs that households are reducing their savings and building up debts. The Governor of the Bank, Mark Carney, said that consumption has been high in recent times, helping the economy, but he repeated the warning that living costs were likely to rise on the back of a weak pound and put a strain on households' real incomes. He also stated: "The saving ratio has fallen towards its pre-crisis lows, and consumer borrowing has accelerated noticeably." 5

It can be argued that rising borrowing has been caused by Bank Rate being kept too low for too long. The Austrian economist, Friedrich Hayek, highlighted artificially low interest rates and excessive credit creation as being the main causes of cyclical instability, damaging both investment and confidence. Asset price bubbles occur, including unsustainable rises in house prices, and eventually boom turns to bust. A major cause of the financial crisis in 2007/08 was arguably the unsustainably high level of debt that had been accumulated, but total world debt is now far in excess of the 2008 level. 10 15

Some form of financial crisis appears to occur every 7 to 10 years. As inflation rises, there will come a time when the Monetary Policy Committee decides to increase Bank Rate. This will affect many people who have become accustomed to cheap credit and who are tied into mortgages where the monthly repayments vary with interest rates. 20

Source: News reports, 2016

0 5 Using the data in **Extract D (Figure 4)**, calculate the average amount saved per household in 2016 if average household income was £26 300. Give your answer to the nearest pound. [2 marks]

0 6 Explain how the data in **Extract D (Figures 3 and 4)** show that consumer confidence may have risen since 2014. [4 marks]

0 7 **Extract E** (lines 16–17) states 'However, some argue that trying to maintain stable prices and low unemployment could create trade-offs.' With the help of a diagram, explain why a trade-off between price stability and low unemployment might occur. [9 marks]

0 8 **Extract F** (lines 10–12) states 'The Austrian economist, Friedrich Hayek, highlighted artificially low interest rates and excessive credit creation as being the main causes of cyclical instability.' Using the data in the extracts and your knowledge of economics, evaluate the view that maintaining low interest rates for a sustained period of time may be damaging to the UK's macroeconomic stability. [25 marks]

Turn over ►

Section B

Answer **one** essay from this section.

Each essay carries 40 marks.

EITHER**Essay 1**

An African Development Bank report showed that Angola received more direct foreign investment than any other African country in 2015. Angola is a less economically developed country (LEDC) that has had fluctuating economic growth in the past. Despite having suffered from a long civil war which ended in 2002, many multinational corporations (MNCs) are now investing heavily in Angola's growing economy.

0	9
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Explain the main barriers that LEDCs face when attempting to achieve stable, long-term economic growth.

[15 marks]

1	0
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Evaluate the view that MNCs play a positive role in the development of LEDCs.

[25 marks]

OR**Essay 2**

In the 2016 Autumn statement, the UK Chancellor of the Exchequer, Philip Hammond, officially abandoned the government's policy of trying to achieve a budget surplus by 2020. While some criticise the government for failing to achieve its fiscal target, others argue that the government should be doing more to help the supply side of the economy.

1	1
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Explain how fiscal policy can be used to try to improve the supply side of an economy.

[15 marks]

1	2
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Evaluate whether achieving a budget surplus is a desirable objective of economic policy.

[25 marks]

OR

Essay 3

In July 2017, more people were employed in the UK than ever before. At the same time, the UK unemployment rate fell to 4.3%, the lowest rate for 40 years. Whilst this suggests that the government's policies for employment are working, some claim that zero-hours contracts, low real wages and temporary jobs have made many people worse off.

1	3
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Explain the causes of cyclical **and** structural unemployment.

[15 marks]

1	4
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Assess the view that falling unemployment will inevitably lead to an improvement in the standard of living for people in the UK.

[25 marks]

END OF QUESTIONS

There are no questions printed on this page

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Question
number

0 1

Percentage change = (new value – original value) ÷ original value × 100
 = (74.10 – 93.13) ÷ 93.13 × 100 = -19.03 ÷ 93.13 × 100 = -20.4338...
 = -20.43% (a fall, or depreciation, of 20.43% in the effective exchange rate index)

0 2

A fall in the value of the pound (the effective exchange rate index fell by about 20%) makes UK exports cheaper in foreign currency and imports dearer in pounds. We would therefore expect export volumes to rise, import volumes to fall and the trade deficit to narrow.

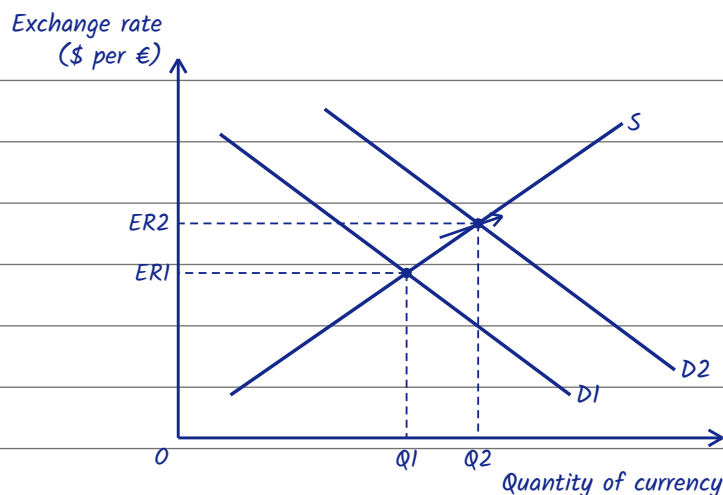
Figure 2 shows the opposite. Total trade was in deficit in every month, and the deficit ended larger than it started: about £2.5bn in November 2015 but about £4.8bn in November 2016, peaking at about £5.3bn in September 2016. The goods deficit widened from about £9.5bn to about £12.1bn, while the services surplus did not improve, staying at about £8bn. So despite the depreciation, imports still exceed exports by more than before, which is why the figures are "disappointing", perhaps because of a J-curve effect or price inelastic demand.

0 3

An exchange rate is the price of one currency in terms of another. In a floating system it is set by the market forces of supply and demand for the currency, with no government or central bank intervention. A trade surplus means the value of exports of goods and services is greater than the value of imports, as in Germany's current account surplus of 8.5% of GDP in 2015.

Foreign buyers of exports must buy the exporting country's currency to pay for them, so exports create demand for the currency, while importers sell the currency to buy foreign currency, so imports create supply. If there is a trade surplus, the demand for the currency is greater than its supply at the original exchange rate. Using the euro against the dollar as an example, this excess demand is shown in the diagram as demand shifting from D1 to D2, so the exchange rate rises (appreciates) from ER1 to ER2.

Do not write outside the box



As the diagram shows, the appreciation means each euro buys more dollars. This raises the foreign currency price of the country's exports and lowers the domestic price of imports (a strong currency means exports are dearer and imports cheaper). Foreign consumers buy fewer exports and domestic consumers switch towards imports, so export volumes fall and import volumes rise. The value of exports falls and the value of imports rises, which reduces the trade surplus. As the surplus shrinks, the extra demand for the currency disappears, so the market moves towards a new equilibrium where the currency flows balance: the surplus is "self-correcting".

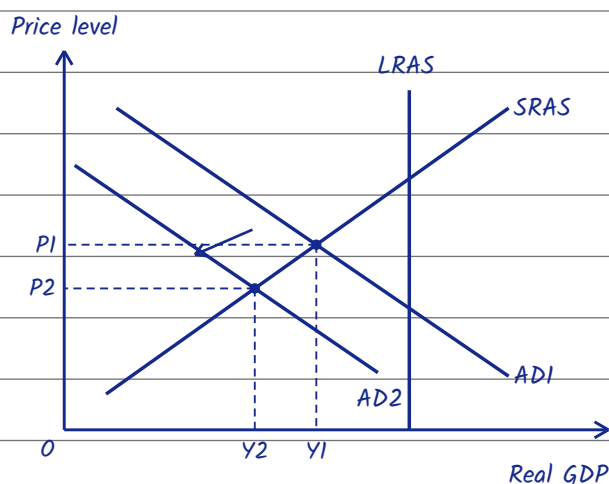
However, this depends on the price elasticity of demand for exports and imports. The Marshall-Lerner condition states that the appreciation only reduces the surplus if the sum of the PEDs for exports and imports is greater than 1. In the short run demand is often price inelastic because of contracts and habits, so the value of exports may initially rise and the surplus may widen before it narrows, an inverse J-curve effect. Also, Germany cannot benefit from this mechanism against other eurozone members, because it shares the euro with them, which helps to explain why its surplus has persisted.

0 4

The current account of the balance of payments records trade in goods and services, primary income (such as profits, interest and dividends on investments) and secondary income (transfers such as foreign aid and remittances). A current account deficit means that more money flows out of the UK on these items than flows in. Macroeconomic performance is judged by economic growth,

unemployment, inflation and the balance of payments itself. Extract B shows the UK deficit reached a record 5.4% of GDP in 2015 and the UK has had a deficit every year since the mid-1980s, so it is clearly persistent.

Firstly, a deficit on trade may reduce economic growth. Net exports ($X - M$) are a component of aggregate demand, $AD = C + I + G + (X - M)$. Imports are a withdrawal from the circular flow, so a widening trade deficit, such as the September 2016 rise in imports to £38.8bn while exports fell to £26.1bn (Extract B), lowers AD. As shown in the diagram, AD shifts left from AD1 to AD2, so real GDP falls from Y_1 to Y_2 , and the negative multiplier effect magnifies the initial fall, because lower spending on UK output reduces incomes and therefore consumption further.



Because labour is a derived demand, lower output in export and import-competing industries leads to job losses, so unemployment rises. These job losses tend to be concentrated in manufacturing, where the UK goods deficit (about £12bn a month in Figure 2) is largest, so the deficit may cause structural and regional unemployment, which is one of the "effects on employment" mentioned in Extract B. Lower AD also reduces demand-pull inflationary pressure, which may help the UK keep inflation near its 2% target.

However, the impact depends on the cause of the deficit. Extract B states that in Quarter 3 of 2016 the UK grew faster than expected, supported by rising consumer spending, and that this may explain the rise in imports. Here the deficit is a symptom of strong growth and rising real incomes rather than a cause of weak performance: UK consumers enjoy a wider range of cheaper goods,

which raises living standards. If the imports are capital goods and raw materials, they may even increase the UK's productive capacity in the long run. In this case the deficit does little harm to growth or unemployment.

Secondly, a current account deficit must be financed by a surplus on the capital and financial accounts, through inflows of foreign direct investment (FDI), portfolio investment, borrowing and sales of UK assets. FDI, such as car plants built by foreign manufacturers, brings jobs, technology and higher productivity, so it can improve long-run growth, which is why Extract B mentions "the need to attract inward investment". However, selling assets to foreigners means that profits and dividends flow abroad in future. Extract B shows that the UK's earnings on assets overseas have fallen relative to the earnings of foreign investors in the UK, so the primary income balance has worsened, which makes the current account deficit even larger and harder to correct. The deficit then becomes self-reinforcing.

A persistent deficit also makes the UK dependent on continued capital inflows, which may be "hot money" attracted by interest rates. If investors lose confidence, for example after the EU referendum, inflows may suddenly stop and the pound may fall sharply. Figure 1 shows the effective exchange rate falling by 20.43% between November 2015 and November 2016. A depreciation raises import prices, causing cost-push inflation that squeezes real incomes, and the Bank of England may then have to raise interest rates, which would reduce consumption, investment and growth.

On the other hand, the UK has a floating exchange rate, so the deficit should be partly self-correcting. A depreciation makes exports more price competitive and imports less competitive, so net exports should rise and the deficit narrow. Unlike Germany in the eurozone (Extract C), the UK can adjust its exchange rate. Also, the UK borrows mainly in its own currency, has deep and trusted financial markets and has never had difficulty financing its deficit, so the risk of a financing crisis is much lower than for an emerging economy.

Yet Figure 2 shows that, so far, the self-correction has not worked: the total trade deficit widened from about £2.5bn to about £4.8bn despite the 20% fall

in the pound. This may be a J-curve effect, as demand for imports and exports is price inelastic in the short run, so the Marshall-Lerner condition is not yet met. More worryingly, Extract B suggests that UK exports depend more on the strength of overseas demand than on the exchange rate, and that the real problem is a "lack of competitiveness and low productivity". This means the persistent deficit is a symptom of deep structural, supply-side weaknesses, such as low investment and a narrow manufacturing base. These weaknesses limit long-run growth and mean a depreciation alone will not fix the deficit; supply-side policies to raise productivity are needed.

Finally, the government might respond to a large deficit with deflationary, expenditure-reducing policies, such as higher taxes or interest rates, which reduce imports but also reduce growth and raise unemployment, or with protectionism, which risks retaliation and is not possible while the UK is in the EU. Here the policy response may damage macroeconomic performance more than the deficit itself.

In conclusion, the impact of a persistent current account deficit depends on its cause, size and how it is financed. In the short run it has had a limited effect: in 2016 the UK grew strongly with low unemployment despite a record deficit, which shows that the current account is often less important than the other macroeconomic objectives. However, in the long run a deficit of over 5% of GDP that persists for decades is a concern, because the falling primary income balance makes it self-reinforcing and it reflects low productivity and competitiveness. The most significant impact is therefore not the deficit itself but the structural weaknesses it reveals, which threaten long-run growth and living standards unless productivity improves.

Question
number

0 5

Saving = saving ratio $\times$ household income

= 7.1% $\times$ £26 300 = 0.071 $\times$ £26 300 = £1867.30

= £1867 (to the nearest pound)

0 6

Consumer confidence is how optimistic households feel about their future incomes, jobs and the economy. The saving ratio is the percentage of household disposable income that is saved. When households are confident they save less of their income and are more willing to borrow, so a falling saving ratio and a rising debt to income ratio suggest rising confidence.

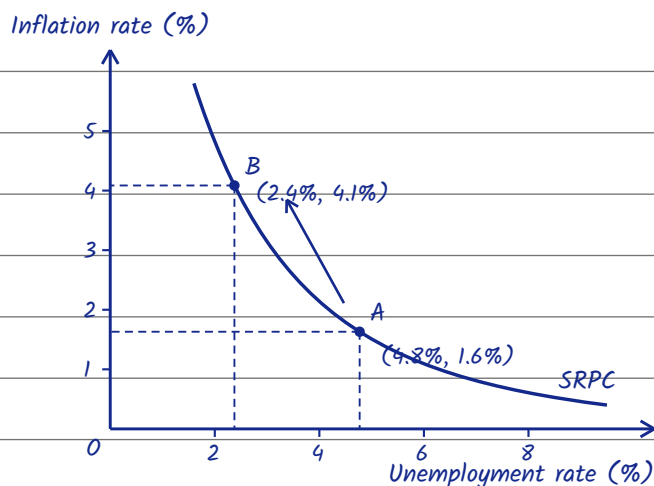
Figure 4 shows the saving ratio fell from 8.4% in 2014 to 7.1% in 2016, a fall of 1.3 percentage points and the lowest figure in the table, compared with a peak of 11.2% in 2010 when households were pessimistic. Figure 3 shows household gross debt to income fell from about 168% in 2008 to about 140% to 142% in 2013 to 2015 as households paid off debt, but it has since started to rise and is forecast to reach about 162% by 2020. Households are spending a larger share of their income and are willing to take on more debt, which suggests they are more confident about their future incomes and job security.

0 7

Price stability means a low and stable rate of inflation; in the UK the government sets a target of 2% CPI inflation. Unemployment is the number of people of working age who are willing and able to work but cannot find a job. A trade-off means that achieving one objective makes it harder to achieve another, in this case low unemployment may only be achieved at the cost of higher inflation.

The short-run Phillips curve (SRPC) shows this inverse relationship between unemployment and inflation. Suppose the Bank of England keeps Bank Rate low to meet its objectives for growth and employment (Extract E). Lower interest rates increase consumption and investment, so aggregate demand rises. Because labour is a derived demand, firms employ more workers to produce the extra output, so unemployment falls.

Do not write outside the box



As unemployment falls, more people have earned incomes, so disposable incomes and consumption rise further. As the economy approaches full capacity, firms cannot increase output fast enough to meet demand, so prices are bid up: demand-pull inflation. At the same time the pool of unemployed labour shrinks, so firms face labour shortages and must offer higher wages to recruit and keep workers. Workers with more bargaining power demand higher wages, which raises firms' costs, and firms pass these on as higher prices: cost-push inflation. Higher prices then lead workers to demand still higher wages to protect their real incomes, so a wage-price spiral can develop.

In the diagram, as unemployment falls from about 4.8% to about 2.4%, the economy moves along the SRPC from point A to point B and inflation rises from about 1.6% to about 4.1%, above the 2% target. The trade-off also works in reverse: to bring inflation back to target the MPC would have to raise interest rates, reducing AD and moving the economy back towards A with higher unemployment. However, monetarists argue the trade-off only exists in the short run: once workers expect higher inflation, the SRPC shifts up and in the long run the Phillips curve is vertical at the natural rate of unemployment.

08

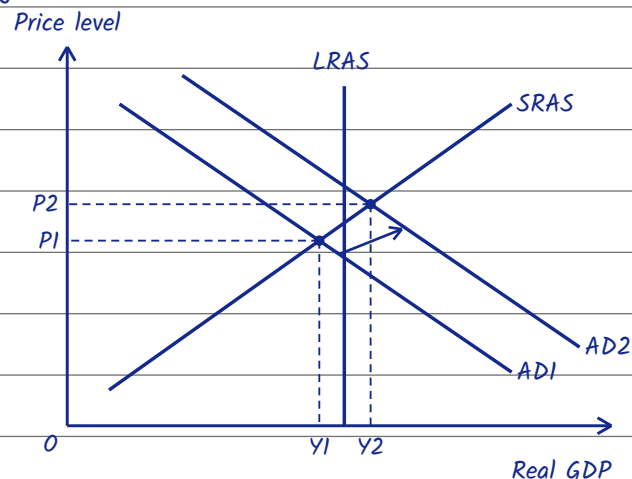
Interest rates are the cost of borrowing and the reward for saving. In the UK, Bank Rate is set by the Bank of England's Monetary Policy Committee (MPC) to meet the 2% inflation target. Macroeconomic stability means steady, sustainable growth without large booms and busts, low and stable inflation, low unemployment and a stable financial system. Bank Rate has been at historically

low levels for a sustained period: it was cut to 0.5% in 2009 and to 0.25% in 2016, supported by quantitative easing (Extract E).

Through the monetary transmission mechanism, low interest rates reduce the incentive to save and make borrowing cheaper, so households borrow more for consumption and mortgages, and firms borrow to invest. Mortgage repayments fall, raising disposable income, and asset prices such as houses and shares rise, creating a positive wealth effect. Low rates also make sterling less attractive to hot money, so the pound depreciates, boosting net exports. All of these increase aggregate demand.

There are strong arguments that sustained low rates are damaging to stability. Firstly, they encourage excessive credit creation and debt. Extract D shows the saving ratio fell from 11.2% in 2010 to 7.1% in 2016, and household debt to income is rising again, forecast to reach about 162% by 2020. Mark Carney warned that "consumer borrowing has accelerated noticeably" (Extract F). Growth based on borrowing rather than rising real incomes is unsustainable. Extract F notes that a major cause of the 2007/08 crisis was unsustainable debt and that world debt is now far above its 2008 level.

Secondly, if AD keeps rising when the economy is close to full capacity, a positive output gap opens. As shown in the diagram, AD shifts from AD1 to AD2 beyond the full employment level of output on the LRAS, so the price level rises from P1 to P2 and the economy overheats. Combined with the weak pound raising living costs (Extract F), inflation may rise well above 2%.



Thirdly, as Hayek argued, artificially low interest rates create asset price bubbles, such as unsustainable rises in house prices, and malinvestment: firms invest in projects that are only profitable at very low interest rates, and unproductive "zombie" firms survive because they can afford to service their debts, which holds back productivity growth. When inflation rises, the MPC must raise Bank Rate (Extract F). Households with variable rate mortgages face higher repayments, so consumption falls sharply; some default, house prices fall, banks make losses and cut lending, and confidence collapses. Boom then turns to bust, so low rates are a cause of cyclical instability, damaging both investment and confidence.

Finally, keeping rates near zero leaves the MPC little room to cut them in the next recession, reducing its ability to stabilise the economy, and it reduces the incomes of savers and pensioners, which may itself reduce their spending.

However, there are strong counter-arguments. Interest rates were cut because the UK faced a deep recession after the financial crisis, a large negative output gap and a risk of deflation. Without low rates, unemployment would have been much higher and the recession longer, which would have been far more destabilising. Extract E states that low rates have been "instrumental in the UK's sustained recovery and return to low levels of unemployment" and are vital for consumer and business confidence. The danger also depends on how far the economy is from full capacity: while there is spare capacity, rising AD increases real output with little inflation, and inflation remained low for most of this period, suggesting no overheating.

It is also arguable that rates are not "artificially" low. If global saving is high and the demand for investment is weak, the equilibrium (natural) rate of interest is itself low, and keeping Bank Rate low simply reflects this. Keynesian economists would argue that raising rates too early would be more damaging than keeping them low.

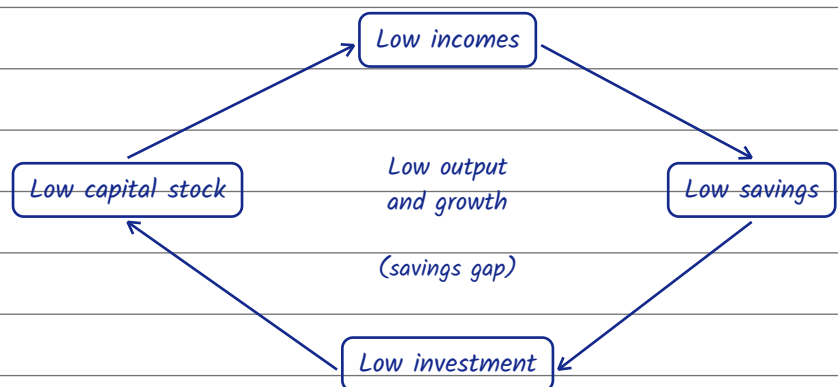
Furthermore, the financial system is now more tightly regulated than before 2008. Extract E explains that the PRA, FCA and the Financial Policy Committee were set up to reduce systemic risk. The FPC can use macroprudential tools, such as limits on high loan-to-value mortgages and higher capital requirements for banks,

to restrict excessive credit creation without raising Bank Rate. This means low interest rates are less likely to cause a credit bubble than they were before the crisis. Also, household debt to income at about 142% to 150% is still well below its 2008 peak of about 168% (Figure 3).

In conclusion, low interest rates for a sustained period carry real risks to stability: they encourage debt, asset price bubbles and malinvestment, and make the economy vulnerable when rates eventually rise. However, whether they are damaging depends on the state of the economy, why rates are low and the strength of regulation. After 2009, low rates were necessary to avoid a deeper recession, so in the short run they improved stability. The danger grows the longer they persist after the output gap closes. On balance, provided the MPC raises rates gradually with clear forward guidance and the FPC limits risky lending, low rates need not be damaging, but Hayek's warning is most valid if rates are kept low once the economy is close to full capacity.

Economic growth is an increase in real GDP. Stable, long-term growth means a sustained increase in the productive potential of the economy (trend growth), shown by the LRAS shifting right, without large fluctuations between booms and recessions. LEDCs are countries with low GDP per capita and a low Human Development Index (HDI) score, with lower life expectancy, education and incomes than more developed countries.

One major barrier is a lack of savings and investment. The Harrod-Domar model states that growth depends on the level of saving and the productivity of capital (the capital-output ratio). In LEDCs, incomes are so low that most income is spent on essentials, so savings are low. This means there are few funds for investment, so the capital stock stays small, output and incomes stay low and the cycle repeats, as shown in the diagram. This savings gap is often made worse by capital flight and by weak banking systems that fail to channel savings into investment.



A second barrier is primary product dependency. Many LEDCs rely on exporting one or two commodities, such as oil in Angola. Because the supply and demand for commodities are price inelastic, prices are very volatile, so export earnings, government revenue and GDP fluctuate. This explains Angola's fluctuating growth: when oil prices fell sharply after 2014, its growth collapsed. In the long run, the Prebisch-Singer hypothesis suggests the terms of trade of primary producers tend to worsen, as demand for primary products is income inelastic. Resource wealth may also cause "Dutch disease", where the currency appreciates and other export industries become uncompetitive.

A third barrier is poor human capital. Low levels of education, training and healthcare mean workers have low productivity, and diseases reduce the size and productivity of the labour force. Skilled workers may emigrate (the brain drain). Low productivity limits the growth of LRAS and makes it hard to attract high value industries.

A fourth barrier is poor infrastructure, such as unreliable electricity, poor roads, ports and communications. This raises firms' costs, makes it hard to get goods to market and discourages both domestic and foreign investment.

A fifth barrier is weak institutions. Corruption diverts resources away from productive uses and raises the cost of doing business. A lack of enforceable property rights means people cannot use land as collateral to borrow, and firms will not invest if their assets or ideas may be taken. Political instability and conflict, such as Angola's civil war until 2002, destroy capital and deter investment, causing unstable growth.

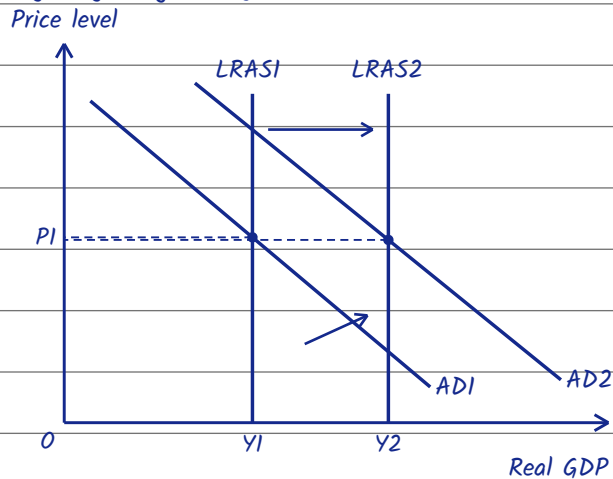
Finally, a large informal economy and low incomes mean the government collects little tax revenue, so it cannot afford to invest in education, healthcare and infrastructure. Many LEDCs also have high foreign debt, so a large share of revenue goes on debt interest rather than investment. Rapid population growth means GDP must grow quickly just to raise GDP per capita. These barriers reinforce each other, which is why stable, long-term growth is so difficult for LEDCs to achieve.

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A multinational corporation (MNC) is a firm that owns or controls production in more than one country. MNCs invest in LEDCs through foreign direct investment (FDI), such as building factories or developing oil fields. Economic development is a broader concept than growth: it means an improvement in living standards and welfare, including reductions in poverty, better health and education, and greater freedom and choice, often measured by the HDI. Angola received more FDI than any other African country in 2015.

MNCs can play a positive role. Firstly, FDI fills the savings gap. As LEDCs have low savings, they lack funds for investment; MNCs bring capital, so investment

risers. As shown in the diagram, investment is a component of AD, so AD shifts from AD1 to AD2, and the multiplier effect increases incomes further as local suppliers and workers spend their earnings. Investment also increases the capital stock, so the LRAS shifts from LRAS1 to LRAS2. Real GDP rises from Y1 to Y2 while the price level stays at P1, giving long-run growth without inflation.



Secondly, MNCs create jobs, often paying higher wages than local firms, which reduces poverty and raises living standards. They bring new technology and management techniques and train workers, improving human capital. This knowledge spreads to local firms when workers move jobs and when local suppliers must meet MNC standards, which raises productivity across the economy.

Thirdly, MNCs often export much of their output, earning foreign currency and improving the current account, which allows the LEDC to import capital goods. They also pay taxes, which governments can spend on schools, healthcare and infrastructure, and MNCs sometimes build infrastructure themselves, such as roads, ports and power supplies, which benefits other firms. These effects directly improve the HDI.

However, MNCs may also play a negative role. Profits are often repatriated to the MNC's home country, so although GDP rises, GNI rises by much less, and the benefit to the local population is limited. MNCs may also use transfer pricing to declare profits in low tax countries, so the LEDC government gains little tax revenue. Many governments offer tax holidays to attract MNCs, reducing revenue further.

Job creation may be limited, especially in extractive industries such as oil in

Angola, which are highly capital intensive, and senior management jobs are often filled by expatriates, so little human capital is developed locally. The MNC may operate as an "enclave", importing its inputs and having few links with the local economy, so the multiplier effect is small.

MNCs may exploit weak labour laws, paying low wages for long hours in poor or unsafe conditions, and may cause environmental damage, such as oil spills, deforestation and pollution, which harm health and the livelihoods of farmers and fishermen. These are negative externalities that reduce development even if GDP rises. Large MNCs may also have more economic power than the host government, allowing them to influence policy, bargain for low taxes and weak regulation, and sometimes encourage corruption. Local firms may be unable to compete and close, and MNCs are footloose, so they may leave once costs rise, causing sudden unemployment.

Whether MNCs play a positive role depends on several factors. The first is the type of investment: manufacturing FDI, which uses lots of labour and builds supply chains, is more likely to promote development than resource extraction, which may worsen the "resource curse" and corruption. In Angola, much of the FDI is in oil, so despite large inflows much of the population remains in poverty, suggesting growth has not led to development.

The second, and most important, factor is the quality of government and institutions. A government that can negotiate a fair share of revenue, enforce environmental and labour regulations, require local content and training, and spend tax revenue on education and health can ensure MNCs benefit development, as Botswana did with its diamond partnership. Where governments are weak or corrupt, the benefits are captured by the MNC and a small elite.

It also depends on the time period: initial benefits such as construction jobs may fade, while long-run benefits like technology transfer take time to appear. Finally, we must consider the counterfactual: without the MNC, would domestic firms have invested? In many LEDCs they lack the capital and technology, so the alternative may be no investment at all.

In conclusion, MNCs can play a positive role in development by providing capital,

jobs, technology and tax revenue that LEDCs cannot generate themselves.

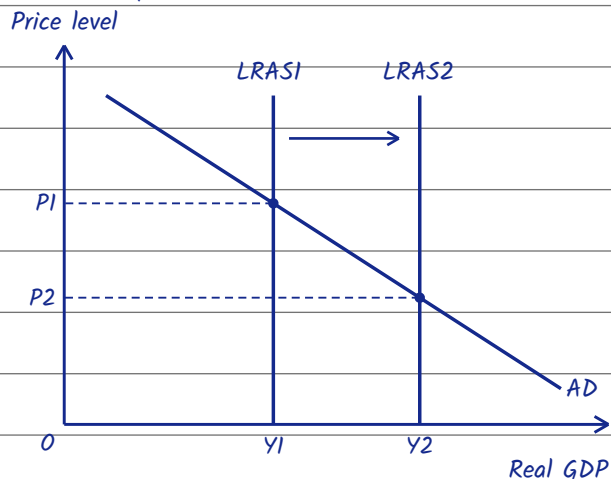
However, the benefits are not automatic. They are greatest where the investment is labour intensive and linked to local firms, and where the host government has strong institutions to regulate MNCs and use the revenue well. On balance, MNCs are a positive force when well managed, but in resource-dependent economies with weak governance, such as Angola, their effect on development is likely to be limited.

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Fiscal policy is the use of government spending, taxation and borrowing to influence the economy. The supply side of the economy is its productive capacity, shown by the long-run aggregate supply (LRAS) curve, which depends on the quantity and quality of the factors of production. Fiscal policy can improve the supply side if it increases the quantity or productivity of labour and capital, shifting LRAS to the right as shown in the diagram, from LRAS1 to LRAS2, so real output rises from Y_1 to Y_2 and the price level falls from P_1 to P_2 .



Government spending can be used in several ways. Spending on education and training improves human capital, so workers become more productive and more occupationally mobile, which reduces structural unemployment and skills shortages. Spending on healthcare creates a healthier workforce, reducing absence and increasing the effective labour supply. Spending on infrastructure, such as roads, railways and broadband, reduces firms' transport and communication costs, increasing productivity, and improved transport and housing increase the geographical mobility of labour. Government can also give grants and subsidies for research and development and investment, increasing the capital stock and encouraging innovation, and can use regional policy, such as enterprise zones, to attract firms to areas of high unemployment. These are interventionist supply-side policies.

Taxation can also be used. Cutting income tax increases the reward for working, so through the substitution effect people are encouraged to work more hours, enter the labour force or take on extra responsibility, increasing the supply of labour. Raising the personal allowance takes low earners out of tax, making work

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more attractive than benefits. Cutting corporation tax, as the UK did from 28% to 19%, raises post-tax profits, so firms have more retained profit to invest and the UK becomes more attractive for FDI. Capital allowances and R&D tax credits reduce the cost of investment, and lower business rates reduce firms' costs, especially in deprived regions. These are market-based policies, as they work by improving incentives.

Welfare spending can also be changed. Reducing out-of-work benefits, or capping them, lowers the replacement ratio, so the incentive to find work rises, reducing voluntary unemployment. In-work benefits and tax credits, such as Universal Credit, make sure people are better off in work, reducing the unemployment trap and increasing labour market participation.

By increasing the quantity and quality of labour and capital, these policies increase productivity and productive potential, allowing long-run, non-inflationary growth and improving international competitiveness. However, the effects take time and depend on how people respond; for example, if the income effect of a tax cut outweighs the substitution effect, people may choose to work fewer hours. Many of these measures also increase AD in the short run, because government spending is a component of AD, so they must be designed carefully to avoid demand-pull inflation.

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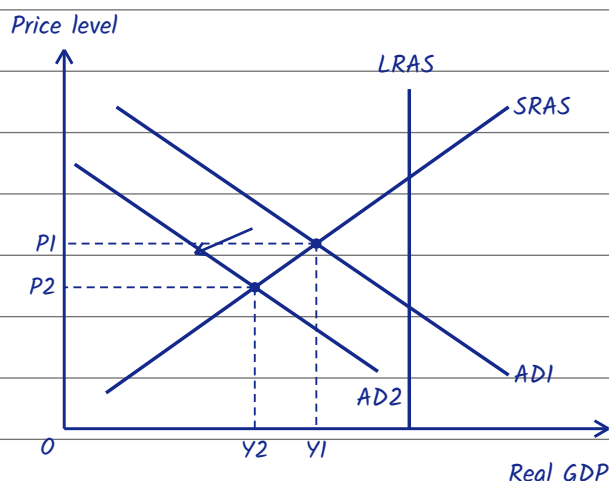
The budget is the balance between government spending and tax revenue in a year. A budget surplus occurs when tax revenue exceeds government spending, while a deficit occurs when spending exceeds revenue and must be financed by borrowing, adding to the national debt. A deficit can be cyclical, caused by a downturn as tax revenue falls and benefit spending rises, or structural, which persists even when the economy is at full capacity. In 2016 the Chancellor abandoned the target of a surplus by 2020.

There are several arguments that a surplus is desirable. Firstly, it allows the national debt to be reduced. UK national debt is around 85% of GDP and debt interest costs around £40bn a year, which has a large opportunity cost, as this money could be spent on health or education. Persistent deficits shift the burden

onto future generations, who must pay higher taxes to service the debt. Secondly, reducing borrowing may improve the government's credit rating and lower the yields (coupon rates) on government bonds, reducing debt interest and keeping interest rates low across the economy. It also reduces crowding out: when the government borrows less, more funds are available to the private sector, and interest rates are lower, so private investment increases, improving long-run growth.

Thirdly, a surplus in good times creates "fiscal space": with lower debt, the government can afford to run a large deficit in the next recession, using expansionary fiscal policy without worrying about debt levels. Finally, as a surplus means lower spending or higher taxes, it reduces aggregate demand, which can reduce demand-pull inflation if the economy is overheating, and may increase business confidence that public finances are sustainable.

However, there are strong arguments against making a surplus an objective. To achieve a surplus the government must cut spending or raise taxes. As shown in the diagram, this reduces AD from AD1 to AD2, so real GDP falls from Y1 to Y2, and the negative multiplier effect means the fall in national income is larger than the initial cut. Unemployment rises, and if the economy has spare capacity this can cause a recession.



Ironically, this may make the surplus harder to reach: as incomes fall, tax revenue falls and spending on benefits rises through the automatic stabilisers, so the deficit may not shrink at all. Higher taxes, such as VAT or income tax, also reduce disposable income and consumption, while higher corporation tax reduces

investment and may make UK firms less competitive internationally.

Cutting spending can also damage the supply side. Cuts often fall on capital spending, such as infrastructure, and on merit goods like education and healthcare, and public goods, which reduces productivity and long-run growth. This may reduce future tax revenue, so the debt to GDP ratio may not improve. Keynesian economists argue that the government should run a deficit in a recession to boost AD, so a fixed surplus target can make fiscal policy pro-cyclical.

Furthermore, when government bond yields are very low, as they were in 2016, borrowing is cheap. If the government borrows to invest in projects whose return exceeds the interest rate, such as transport or housing, the investment more than pays for itself. This is why many economists support a "golden rule": balance the current budget, but borrow for capital investment.

Whether a surplus is desirable depends on several factors. The first is the stage of the economic cycle. At the peak of a boom, a surplus is sensible and may even happen automatically as tax revenue rises with growth. In a recession, or at a time of uncertainty such as after the 2016 EU referendum, forcing a surplus would deepen the downturn, which is why the Chancellor abandoned the target. The second is whether the deficit is cyclical or structural: a cyclical deficit will disappear as the economy recovers, so it does not need to be cut, whereas a structural deficit does need action.

It also depends on what is cut or taxed. Cutting wasteful current spending while protecting investment is less harmful than cutting infrastructure. Finally, the debt to GDP ratio matters more than the deficit: if nominal GDP grows faster than the debt, the debt ratio falls even with a small deficit, so a surplus is not needed for sustainable public finances.

In conclusion, achieving a budget surplus is not desirable as an objective in itself, but as a means to the real objectives of sustainable growth, low unemployment and price stability. A surplus is beneficial over the cycle, especially on the current budget, as it reduces debt and creates fiscal space for future recessions. However, a rigid target for a fixed date ignores the state of the economy and risks

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recession and damage to the supply side. The best approach is to aim for a falling debt to GDP ratio and a balanced current budget over the cycle, while borrowing to invest when interest rates are low.

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Unemployment refers to people of working age who are willing and able to work, and actively seeking work, but cannot find a job. Cyclical (demand-deficient) unemployment is caused by a lack of aggregate demand in the economy, usually in a downturn or recession. Structural unemployment is caused by long-term changes in the structure of the economy, which create a mismatch between the skills or location of workers and the jobs available.

Cyclical unemployment occurs when aggregate demand falls. This may be caused by a fall in consumption, for example if consumer confidence falls, interest rates rise or house prices fall, reducing wealth. It may be caused by a fall in investment, as firms' "animal spirits" and expectations of future profits fall, and the accelerator effect means investment falls sharply when growth slows. Because economies are interdependent, a global downturn reduces demand for UK exports.

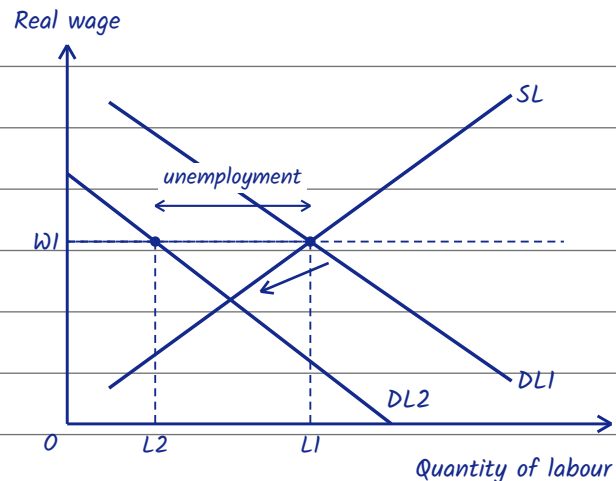
Problems in financial markets also affect the real economy: in the 2008 financial crisis, the credit crunch meant banks cut lending, so consumption and investment fell and the UK went into recession.

The fall in AD is magnified by the negative multiplier effect, as falling incomes cause further falls in spending. As output falls, a negative output gap opens.

Because labour is a derived demand, firms need fewer workers, so the demand for labour shifts left from DL_1 to DL_2 , as shown in the diagram. If wages are "sticky" downwards, because of contracts, minimum wages, trade unions or workers resisting pay cuts, the real wage stays at W_1 . At W_1 firms only demand L_2 workers, while L_1 want to work, so L_1 to L_2 workers are involuntarily unemployed.

UK unemployment rose to over 8% after the 2008 recession for this reason.

Cyclical unemployment is usually temporary and falls when AD recovers.



Structural unemployment is caused by changes in the pattern of demand and production. As an economy develops, demand shifts from manufactured goods towards services, and globalisation means that emerging economies such as China, with lower labour costs, gain a comparative advantage in manufacturing. Industries such as coal mining, steel, shipbuilding and textiles in the UK have declined, so workers in those industries lost their jobs. Technological change also causes structural unemployment, as automation and computers replace workers in some jobs, for example in factories, banking and retail.

Structural unemployment persists because workers are occupationally immobile: their skills are specific to a declining industry and they lack the skills needed for new jobs, such as in digital or financial services, so there is a skills mismatch. Workers may also be geographically immobile, due to high house prices in areas with jobs, such as London, family ties and a lack of information, so they cannot move to where the jobs are. As declining industries were often concentrated in particular areas, such as the North East and South Wales, structural unemployment tends to be regional.

Structural unemployment is therefore a supply-side problem: it can exist even when AD is strong. It can also be linked to cyclical unemployment through hysteresis, where workers who are unemployed for a long time during a recession lose skills and motivation, so cyclical unemployment becomes long-term structural unemployment.

Unemployment is the number of people of working age who are willing and able to work but cannot find a job. The standard of living refers to people's economic welfare, usually measured by real income per head, but it also includes wider quality of life factors such as health, education, leisure, security and the environment, which are partly captured by the Human Development Index (HDI). In July 2017 UK unemployment fell to 4.3%, the lowest rate for 40 years.

There are good reasons why falling unemployment should improve living standards. When people move from unemployment into work, their incomes usually rise well above benefit levels, so they can afford more goods and services, including leisure activities. As they spend their incomes, the multiplier effect creates further jobs and incomes. Employment also brings non-material benefits: work gives people self-esteem, social interaction and routine, and long-term unemployment is linked to poor mental and physical health, family breakdown and crime. Falling unemployment therefore improves quality of life as well as material living standards.

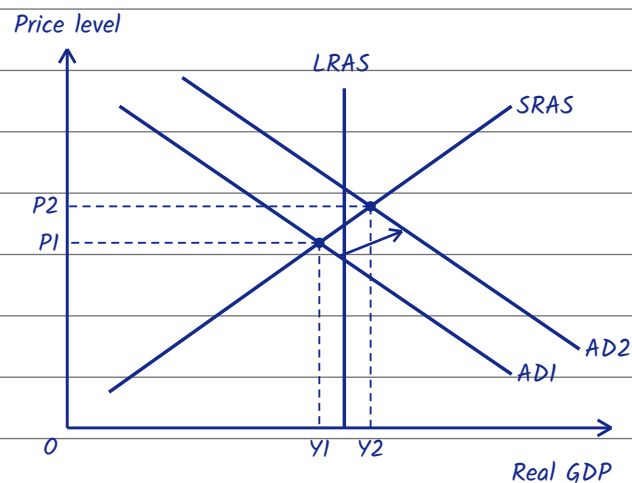
Falling unemployment also improves the government's finances: tax revenue from income tax, National Insurance and VAT rises, and spending on Jobseeker's Allowance and other benefits falls. This allows more spending on public services such as health and education, or lower taxes, without adding to the national debt, which further improves living standards and the HDI. Inequality and poverty also tend to fall, since unemployment is one of the main causes of relative poverty.

However, falling unemployment will not "inevitably" improve living standards. Firstly, the quality of the jobs matters. Much of the recent rise in UK employment has been in zero-hours contracts (around 900 000 people), temporary jobs and self-employment in the "gig economy". These workers have insecure and unpredictable incomes, few employment rights, no sick pay and find it hard to get a mortgage or credit. Many are underemployed, wanting more hours than they can get. A person counted as employed may therefore not have a higher standard of living, and in-work poverty has risen.

Secondly, standards of living depend on real wages, not just employment. After the 2008 recession, UK real wages fell and were still below their 2008 level in

2017, because nominal wage growth was weak and inflation rose. The main reason is low productivity growth (the "productivity puzzle"): if output per worker does not rise, firms cannot afford to pay higher real wages. Unemployment may have fallen precisely because labour was cheap, so firms hired workers rather than investing in capital.

Thirdly, falling unemployment may cause inflation. As the labour market tightens, firms compete for scarce workers and wages are bid up, raising costs, and higher incomes increase consumption. As shown in the diagram, if AD rises from AD1 to AD2 as the economy approaches full capacity, output rises from Y_1 to Y_2 but the price level also rises from P_1 to P_2 . Inflation reduces real incomes, especially for those on fixed incomes such as pensioners and benefit claimants, and for workers with little bargaining power, whose wages do not keep up with prices. The cost of living rises, so living standards for some groups fall.



Fourthly, falling unemployment may increase inequality. Most of the gains may go to skilled workers with bargaining power, while those who remain unemployed or on benefits fall further behind, especially if benefits are frozen. There are also regional differences: unemployment may fall in London and the South East while staying high in some northern towns.

Finally, more employment means more output, which may cause negative externalities such as pollution and congestion, and people may work longer hours with more stress and less leisure, which reduces quality of life even if incomes rise. The fall in the unemployment rate may also partly reflect people leaving the

labour force, for example because they are discouraged or long-term sick, rather than finding jobs.

The impact depends on several factors. The most important is why unemployment is falling. If it falls because of rising productivity, investment and growth, real wages rise and living standards improve. If it is due to low-paid, insecure jobs replacing better ones, the benefit is small. It also depends on the rate of inflation, the distribution of the gains and what happens to public services. For an individual moving from long-term unemployment to secure work, the improvement is likely to be large; for the average worker, the effect depends mainly on real wage growth.

In conclusion, falling unemployment is likely to improve the standard of living for many people, as it raises incomes, improves government finances and brings important social and health benefits. However, it does not inevitably do so. The UK experience since 2010 shows record employment combined with falling real wages, low productivity and insecure work, so living standards for many have barely improved. Falling unemployment is a necessary but not sufficient condition: living standards only rise significantly if the jobs created are secure, productive and well paid, and if inflation is kept under control.