

A-level ECONOMICS

Paper 2 National and International Economy

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 cover of your answer book.
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**.

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

Investment in Africa

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

Extract A

Figure 1: Real GDP (US\$ bn), selected African nations, 2015–2018

Country	2015	2016	2017	2018
Egypt	250.0	260.9	271.8	286.3
Kenya	52.3	55.4	58.1	61.7
Liberia	2.6	2.6	2.5	2.6
Morocco	113.4	114.6	119.5	123.2
Nigeria	461.8	454.4	458.0	466.9

Source: World Bank, 2020

Figure 2: Foreign direct investment (FDI) net inflows (US\$ bn), selected African nations, 2015–2018

Country	2015	2016	2017	2018
Egypt	6.9	8.1	7.4	8.1
Kenya	0.6	0.7	1.3	1.6
Liberia	0.2	0.3	0.2	0.1
Morocco	3.3	2.2	2.7	3.5
Nigeria	3.0	4.5	3.5	2.0

Source: World Bank, 2020

Extract B: Foreign direct investment in Africa

In 2018, foreign direct investment (FDI) in Africa rose to \$46 billion, an 11% increase on the previous year. Morocco and Kenya saw some of the biggest rises in FDI, although many nations in Sub-Saharan and Central Africa experienced falls. Nations with high and stable growth seem better able to attract FDI inflows.

It was expected that increased rates of economic growth in Africa, along with progress towards the African Continental Free Trade Area (AfCFTA) agreement and key improvements in infrastructure, would boost FDI. Multinational corporations (MNCs) from developing countries have been expanding their activities in Africa but investors from developed countries remain key. French companies are currently the largest investors in Africa, followed by the Netherlands, the United States and the UK. Africa is a key producer of commodities and with higher demand and rising commodity prices, FDI inflows are expected to increase even further.

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The growing number of special economic zones (SEZs) are also likely to help Africa attract more FDI. SEZs are areas with relaxed trade rules, little regulation and little or no tax on firms that invest in the zone. This makes locating in a SEZ very appealing to foreign firms. The creation of these zones has helped to promote development in several Asian economies and many African nations hope to make their economies more business-friendly. There are an estimated 237 SEZs in the African continent already.

15

FDI can have many benefits. It should create employment, boost long-run economic growth and increase exports. SEZs and improving competitiveness should contribute to the achievement of key macroeconomic objectives and the development of a country's economy.

20

Source: News reports, 2020

Extract C: Problems for Africa

It has been said that 'investing in Africa is only for the brave'. Some of the issues faced by firms include lack of infrastructure such as poor electricity and transport networks, bureaucracy, political instability and corruption. African nations' current share of global trade is only around 3%.

Since African governments began to use SEZs in the early 1970s, they have failed to attract significant investment, to promote exports, or to create sustainable industrial development. SEZs create distortions in markets, with too much focus on short-term gains. Often, conflicts of interest occur between host governments and investors. Many MNCs, that have been attracted to Africa by the SEZs, have been accused of doing little to improve the living standards of the African people. It has been said that they do not create many jobs, they exploit workers and damage the environment. Too often, profits are not reinvested in Africa but distributed to shareholders or invested elsewhere. 5

Some argue that African governments should be doing more to improve the living standards of their citizens, rather than relying on foreign firms. However, high debts, high unemployment rates and low tax revenues often make it difficult for the governments of African nations to develop their economies without investment from abroad. 10

Source: News reports, 2020

0 1 Using the data in **Extract A (Figure 1)**, if 2015 is the base year, calculate the index of Egypt's real GDP in 2018.

Give your answer to **one** decimal place.

[2 marks]

0 2 Explain how the data in **Extract A (Figures 1 and 2)** show that nations with high and stable economic growth attract rising foreign direct investment (FDI) inflows.

[4 marks]

0 3 **Extract B** (lines 18–19) states: 'FDI can have many benefits. It should create employment, boost long-run economic growth and increase exports.'

With the help of a suitable diagram, explain how a rise in inward foreign direct investment (FDI) may lead to increased exports.

[9 marks]

0 4 **Extract C** (lines 13–14) states: 'Some argue that African governments should be doing more to improve the living standards of their citizens, rather than relying on foreign firms.'

Using the data in the extracts and your knowledge of economics, assess the view that to improve the living standards of their citizens, African nations should pursue policies to attract foreign direct investment (FDI).

[25 marks]

Turn over ►

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

OR

Context 2

Total for this context: 40 marks

Is inflation a problem?

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

Extract D

Figure 3 and Figure 4 not reproduced here due to third-party copyright restrictions

Extract E: Argentina's economic woes

In 2019, Argentina's inflation rate hit 53.8%, climbing to its highest level in thirty years. This confirmed Argentina's place among the five countries with the highest inflation rates in the world, just behind Venezuela, Zimbabwe, South Sudan and Sudan. However, inflation isn't the only problem faced by Argentina. The country has just suffered three years of recession and the government has often struggled to meet its debt repayments.

5

Despite one of the tightest monetary policies in Argentina's history, implemented in 2018 after a currency crisis, inflation continued to rise and the recession deepened. It was hoped that policy measures, including a reduction in tariffs and strict currency controls, would help to reduce inflation, but so far this has not happened.

In 2020, Argentina's central bank cut its base interest rate to support the recovery of the economy. However, it has been argued that lower interest rates would be likely to cause further inflation. "Loosening monetary policy without having a clear fiscal plan or winning over the confidence of businesses and consumers is a mistake", said an Argentine economist.

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Some argue that Argentina should prioritise eliminating inflation over other objectives of economic policy. In the 1970s and 1980s, the UK experienced high inflation. Policies were put in place to reduce the money supply and reduce government spending. The control of inflation became the main target of UK government macroeconomic policy. However, reducing inflation often comes at the expense of growth and jobs, at least in the short term.

15

Source: News reports, 2020

Extract F: Is the problem of high inflation in the past?

These days, most advanced economies no longer suffer from rapidly rising prices. Despite over a decade of low interest rates, increases in the money supply and record employment levels, inflation rates in most advanced economies remain low.

Since the 1990s, many governments have set inflation targets which their central banks are required to achieve. This has contributed to a reduction in inflation. In some countries, the risk of deflation has been greater than the risk of inflation. In the 2000s and the early 2010s, rising commodity prices added to inflationary pressures. However, since oil and some other commodity prices crashed in 2014, in many advanced economies inflation above 3% has been rare. In emerging markets, inflation tends to be higher, but the direction of change is the same. For nearly two decades, economists have talked about an era of 'global disinflation'.

Low inflation can be self-reinforcing as expectations change. Also, as inflation falls, the real rate of interest is likely to increase, weakening demand and further reducing inflation. This would not be a problem if central banks could cut nominal interest rates sufficiently to offset the risk of deflation, but many have little room to do so. Nominal rates are near zero in the UK, and only a little higher in the USA.

Before the pandemic, two-thirds of countries in the Organisation for Economic Co-operation and Development (OECD) had low inflation and a record proportion of their population of working age in employment. This has led some to claim that the Phillips curve is outdated and no longer a relevant model. Low inflation and low unemployment can be achieved simultaneously.

Source: News reports, 2020

0 5 Using the data in **Extract D (Figure 3)**, calculate the difference between the UK's and Argentina's mean unemployment rates over the period 2015 to 2018.

Give your answer to **two** decimal places.

[2 marks]

0 6 Explain how the data in **Extract D (Figures 3 and 4)** show that there may be a short-run trade-off between unemployment and inflation.

[4 marks]

0 7 **Extract E** (lines 7–9) states: 'It was hoped that policy measures, including a reduction in tariffs... would help to reduce inflation'.

With the help of a diagram, explain how a reduction in tariffs could help to reduce inflation.

[9 marks]

0 8 **Extract E** (lines 15–17) states: 'Policies were put in place to reduce the money supply and reduce government spending. The control of inflation became the main target of UK government macroeconomic policy.'

Using the data in the extracts and your knowledge of economics, evaluate the view that achieving a low and stable rate of inflation should be the main economic objective of governments.

[25 marks]

Turn over ►

Section B

Answer **one** essay from this section.

Each essay carries 40 marks.

EITHER**Essay 1**

The UK has been running a deficit on its balance of trade in goods and services since 1998. Expenditure-reducing and expenditure-switching policies can both be used to correct a trade deficit. However, the UK government has focused on other objectives rather than achieving a trade balance.

0	9
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Explain how expenditure-switching policies can be used to reduce a deficit on a country's balance of trade in goods and services.

[15 marks]

1	0
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Assess the view that floating exchange rates are always better than fixed exchange rates.

[25 marks]

OR**Essay 2**

In 2018, the European Commission estimated that Bulgaria and Romania were both experiencing positive output gaps whilst the UK was experiencing a negative output gap. Persistent output gaps can cause problems for economies which may be addressed by supply-side improvements.

1	1
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Explain the main problems for an economy of having a large positive output gap.

[15 marks]

1	2
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Evaluate the view that supply-side improvements in the UK economy can best be achieved through the use of interventionist policies.

[25 marks]

OR

Essay 3

Over the past 20 years, the growth of world trade has averaged 6% per year, twice as fast as the growth in world output. As countries become ever more interconnected, they experience both economic opportunities and threats.

1	3
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 Explain reasons for changes in the value of exports from the UK to the rest of the world. **[15 marks]**

1	4
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 Evaluate the view that international trade always benefits nations. **[25 marks]**

END OF QUESTIONS

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Question
number

0 1

$$\text{Index} = (\text{real GDP in 2018} \div \text{real GDP in 2015}) \times 100$$

$$= (286.3 \div 250.0) \times 100 = 114.52$$

Index of Egypt's real GDP in 2018 = 114.5 (to one decimal place)

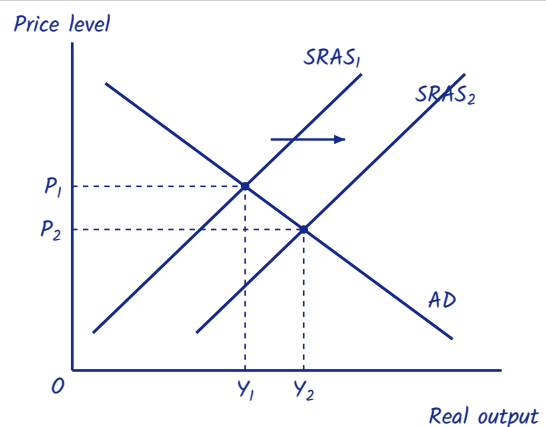
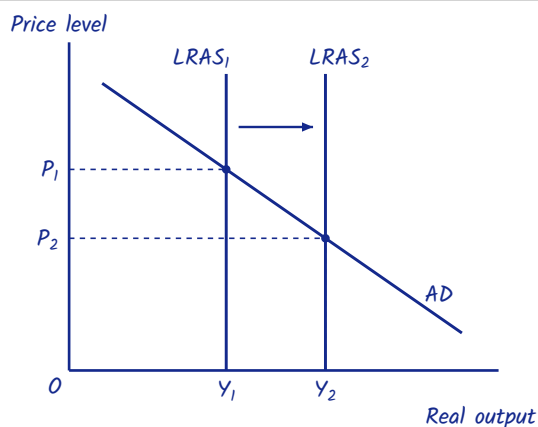
0 2

High and stable economic growth means real GDP rising quickly and consistently every year; rising FDI inflows means foreign firms investing more each year in productive assets in the country. Kenya had the highest real GDP growth between 2015 and 2018 (from \$52.3bn to \$61.7bn, about 18.0%) and grew steadily every year (about 5.9%, 4.9% and 6.2%). It was also the only country whose FDI inflow rose every year, from \$0.6bn to \$1.6bn, a rise of about 166.7%. Egypt had the second highest and steady growth (about 14.5%) and its FDI rose from \$6.9bn to \$8.1bn (+17.4%), the largest absolute rise.

In contrast, Nigeria (growth of only 1.1%, with real GDP falling in 2016) and Liberia (zero growth overall, with a fall in 2017) both saw FDI fall, from \$3.0bn to \$2.0bn (−33.3%) and from \$0.2bn to \$0.1bn (−50%). This suggests that strong, stable growth raises investors' confidence and the expected profits from a growing market, so it attracts rising FDI.

0 3

Foreign direct investment (FDI) is investment by a firm based in one country in productive assets, such as factories or machinery, in another country, giving it a lasting controlling interest. Exports are goods and services produced domestically and sold to buyers abroad. Inward FDI, for example by MNCs attracted to Africa's special economic zones by low taxes and little regulation (Extract B), can raise exports in several ways.



Firstly, FDI increases the productive capacity of the economy. New factories, machinery and infrastructure increase the quantity of capital, and MNCs bring new technology, management techniques and training that raise labour productivity. As shown in the left-hand diagram, LRAS shifts right from $LRAS_1$ to $LRAS_2$, so potential real output rises from Y_1 to Y_2 and the price level falls from P_1 to P_2 . With more output than domestic demand can absorb, firms sell the surplus abroad, and because prices are lower relative to trading partners, the country's goods become more price competitive, so the volume of exports rises.

Secondly, FDI can lower firms' costs of production. MNCs exploit economies of scale, and the extra competition forces domestic firms to become more efficient and reduce X-inefficiency. Lower unit costs shift SRAS right from $SRAS_1$ to $SRAS_2$ (right-hand diagram), reducing the price level from P_1 to P_2 . Lower inflation than in trading partners improves international competitiveness, so foreign demand for the nation's exports rises, especially if demand for them is price elastic.

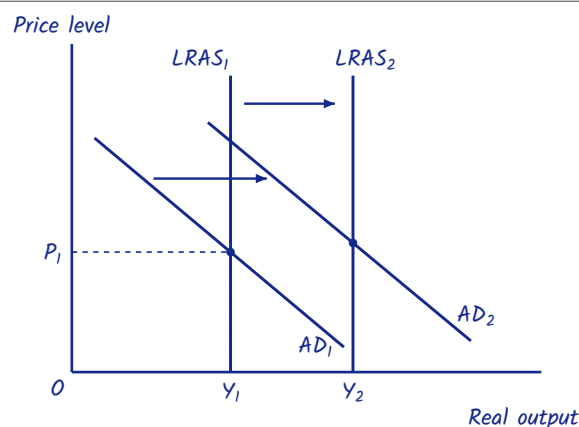
Thirdly, many MNCs locate in Africa precisely in order to export. A firm setting up in a SEZ to supply European or Asian markets, or to extract and process the commodities that Africa produces (Extract B), directly adds to exports, since MNCs already have global distribution networks. Goods that were previously imported may now be produced domestically and even exported to neighbouring countries, especially as the AfCFTA reduces trade barriers. However, the size of the rise in exports depends on whether the extra output is sold at home and on world demand for the products.

04

Foreign direct investment (FDI) is long-term investment by a firm based in one country in productive assets in another, such as a factory, mine or office, over which it has a controlling interest. Living standards refer to the economic and social well-being of citizens. They are often measured by real GDP per capita, but broader measures such as the Human Development Index (HDI) also include life expectancy and education, and inequality, the environment and working conditions matter too.

Policies to attract FDI, such as creating special economic zones (SEZs) with low taxes and little regulation (Extract B), can raise living standards in several ways.

Firstly, FDI is an injection into the circular flow. When an MNC builds a plant, investment rises, so aggregate demand shifts right from AD_1 to AD_2 in the diagram. Through the multiplier process, the wages paid to local workers are spent in local businesses, generating further rounds of income and employment. Real GDP rises and unemployment falls, which matters in economies where, as Extract C notes, unemployment rates are high. Higher incomes allow households to consume more goods and services, raising material living standards.



Secondly, FDI increases productive potential. New capital, technology and management expertise raise productivity, and MNCs often train workers, improving human capital. This shifts LRAS right from $LRAS_1$ to $LRAS_2$, so real output can rise from Y_1 to Y_2 without inflationary pressure, allowing sustained growth in real GDP per capita. MNCs may also build or demand better infrastructure such as roads, ports and electricity, which Extract C identifies as a key weakness in Africa, and this benefits domestic firms too. The data support the link: Kenya, whose FDI inflows rose from \$0.6bn to \$1.6bn between 2015 and 2018, had the fastest real GDP growth in Figure 1 at about 18%, while Egypt's FDI rose to \$8.1bn as its real GDP grew by 14.5%. FDI to Africa as a whole rose by 11% to \$46bn in 2018.

Thirdly, FDI can relieve the constraints faced by African governments. Extract C states that high debts and low tax revenues make it difficult for governments to develop their economies themselves. Profitable MNCs and their employees pay taxes, which can be spent on merit goods such as healthcare and education

without increasing debt, improving HDI. FDI also raises exports (Extract B), earning foreign currency to pay for imports of capital goods and to service debt. However, the benefits of FDI for living standards are far from guaranteed. Extract C states that SEZs in Africa have 'failed to attract significant investment' since the 1970s and that MNCs have been accused of creating few jobs, exploiting workers and damaging the environment. If MNCs use capital-intensive methods and bring skilled managers from abroad, the employment multiplier is small, and low wages and poor conditions may raise GDP without improving the well-being of workers. Pollution from mining or manufacturing harms health and quality of life, so HDI and sustainability may not improve even if GDP rises. Moreover, profits are often 'distributed to shareholders or invested elsewhere' (Extract C). Repatriated profits are a leakage from the circular flow and an outflow on the primary income account, so national income rises by much less than GDP. In addition, the very policies used to attract FDI can undermine the gains. SEZs offer 'little or no tax', so governments may gain little revenue, and competition between the 237 SEZs and between nations can become a race to the bottom on tax and regulation that transfers the gains to foreign shareholders. MNCs can be footloose, leaving when costs rise or when global shocks such as the pandemic occur, causing structural unemployment. The benefits may also be concentrated in a few regions or among an elite, especially where corruption is a problem, widening inequality. Finally, FDI depends on factors governments cannot easily control: Extract C notes that 'investing in Africa is only for the brave' because of political instability and corruption, and the data show that Nigeria and Liberia, with weak and unstable growth, saw FDI fall by 33.3% and 50%. Attracting FDI may simply not work for the poorest nations.

There are alternatives. Governments could invest directly in education, health and infrastructure, but with high debts this may require borrowing, raising interest costs and risking a debt crisis. Foreign aid could fund these projects, although it may be tied to purchases from donor countries and create dependency. Freer trade through the AfCFTA could raise living standards by allowing specialisation according to comparative advantage and access to larger markets, raising Africa's

tiny 3% share of world trade. Strengthening institutions, property rights and anti-corruption measures would improve living standards directly and also make FDI more attractive, which suggests these approaches are complements rather than substitutes.

In conclusion, policies to attract FDI can improve living standards, particularly in the long run by raising productive capacity, employment and tax revenue, and the experience of Kenya and Egypt suggests that FDI is associated with faster growth. However, the extent of the benefit depends on the type of FDI and the terms on which it is attracted. Labour-intensive manufacturing with links to local suppliers and training is likely to raise living standards much more than capital-intensive extraction of commodities with profits sent abroad. Since African governments lack the funds to develop without investment from abroad, FDI should be pursued, but not by offering unlimited tax breaks and weak regulation. The best approach is to attract FDI alongside government spending on infrastructure, education and institutions, with minimum environmental and labour standards, so that the gains are widely shared and sustainable.

Question number

0 5

Argentina's mean = $(6.5 + 8.5 + 8.4 + 9.2) \div 4 = 32.6 \div 4 = 8.15\%$

UK's mean = $(5.4 + 4.9 + 4.4 + 4.1) \div 4 = 18.8 \div 4 = 4.70\%$

Difference = $8.15 - 4.70 = 3.45$ percentage points

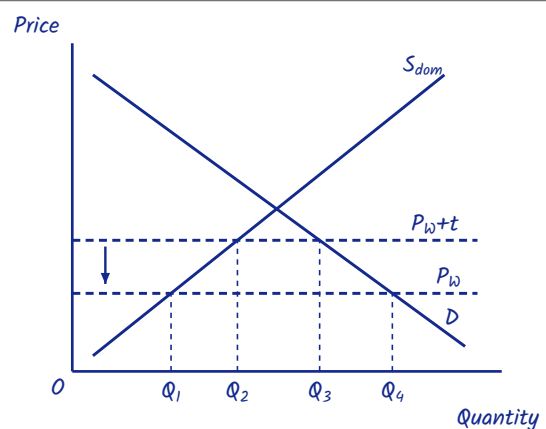
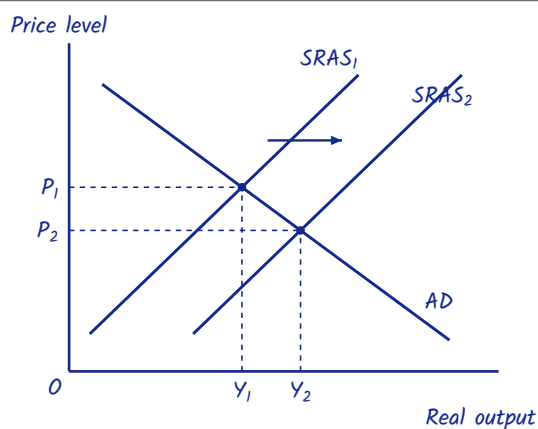
0 6

A short-run trade-off means that lower unemployment is achieved at the cost of higher inflation, an inverse relationship shown by the short-run Phillips curve. As unemployment falls, labour shortages push up wages and excess demand pulls up prices. The data show this for most of the countries. In the USA, unemployment fell from 5.3% in 2015 to 3.9% in 2018 while inflation rose from 0.1% to 2.4%; in France, unemployment fell from 10.4% to 9.0% as inflation rose from 0.1% to 2.1%; and in the UK, unemployment fell from 5.4% to 4.1% while inflation rose from 0.0% to 2.5%. In Brazil the opposite happened: unemployment rose from 8.3% to 12.3% while inflation fell from 9.0% to 3.7%.

However, Argentina does not fit the pattern, as unemployment rose from 6.5% to 9.2% while inflation also rose, from 10.0% to 34.3%, so the trade-off may only exist in some economies.

0 7

A tariff is a tax on imported goods, which raises their price in the domestic market. Inflation is a sustained rise in the general price level, measured by the annual percentage change in a consumer price index. A reduction in tariffs can reduce inflation through several channels.



Firstly, a cut in tariffs directly lowers the prices of imported consumer goods. As shown in the right-hand diagram, with the tariff the domestic price is the world price plus the tariff ($P_W + t$) and imports are only Q_2 to Q_3 . Removing the

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tariff lowers the price to P_w , so consumers pay less and imports rise to Q_1 to Q_4 .

Imported goods form part of the weighted basket used to measure the CPI, so

lower import prices reduce the measured rate of inflation.

Secondly, firms import raw materials, components and machinery. Lower tariffs

reduce firms' costs of production, so SRAS shifts right from $SRAS_1$ to $SRAS_2$ in

the left-hand diagram. With AD unchanged, the price level falls from P_1 to P_2 (or

rises by less than it otherwise would) and real output rises from Y_1 to Y_2 . This

reduces cost-push inflationary pressure, which matters in Argentina, where a

currency crisis has made imports more expensive (Extract E).

Thirdly, cheaper imports increase competition for domestic firms. To avoid losing

market share, domestic producers must hold down their prices and cut costs, for

example by reducing X-inefficiency, which reduces inflation further. Also, as

spending switches from domestic goods to imports, there is a larger leakage from

the circular flow, reducing AD and therefore demand-pull inflationary pressure.

However, the effect may be small if imports are only a small share of the

basket, if the currency keeps depreciating so that import prices rise anyway, or if

inflation is mainly driven by monetary growth and expectations, as may be the

case in Argentina.

08

Inflation is a sustained rise in the general price level, measured in the UK by the

annual percentage change in the CPI. A low and stable rate of inflation means

inflation close to a target, such as the UK's 2% CPI target, with little

fluctuation. Governments also have other macroeconomic objectives: strong and

sustainable economic growth, low unemployment and a satisfactory current account

position, as well as objectives such as a fairer distribution of income and

protecting the environment.

There are strong arguments for making low, stable inflation the main objective.

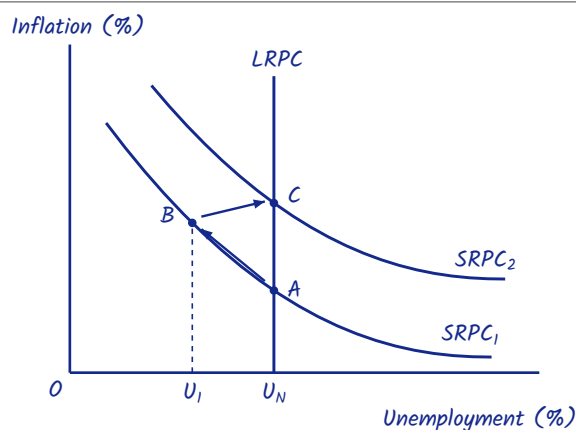
High and volatile inflation, as in Argentina where it reached 53.8% in 2019

(Extract E), creates uncertainty. Firms cannot predict future costs and prices, so

investment falls, damaging long-run growth. Inflation erodes the real value of

savings and fixed incomes, redistributing income arbitrarily from savers and

pensioners to borrowers, and it imposes menu and shoe-leather costs. If a country's inflation is higher than its trading partners', its exports become less price competitive, worsening the current account. Once expectations of high inflation become embedded, workers demand higher money wages, firms raise prices to cover costs, and a wage-price spiral develops that is very costly to stop.



Low, stable inflation may also be a precondition for achieving the other objectives.

According to the expectations-augmented Phillips curve, shown in the diagram, there is only a short-run trade-off between inflation and unemployment along $SRPC_1$. If the government tries to keep unemployment below the natural rate, U_N , to U_1 by stimulating demand, the economy moves from A to B and inflation rises. Expectations then adjust and $SRPC$ shifts up to $SRPC_2$, so in the long run the economy returns to U_N at C on the vertical $LRPC$, but with higher inflation.

Argentina shows the costs of failing to control inflation: its inflation rose from 10.0% in 2015 to 34.3% in 2018 while unemployment also rose, from 6.5% to 9.2% (Extract D), and it suffered three years of recession. This supports the view that controlling inflation should come first, as the UK concluded in the 1970s and 1980s (Extract E).

In practice, giving priority to inflation has been successful. Since the 1990s, many governments have set inflation targets for independent central banks (Extract F), such as the Bank of England's Monetary Policy Committee, which uses Bank Rate and forward guidance to anchor expectations. The extract says this has contributed to lower inflation, and the UK combined low inflation with falling unemployment, from 5.4% in 2015 to 4.1% in 2018 (Extract D), so low and stable inflation seems compatible with the other objectives.

However, there are good reasons why low inflation should not always be the main objective. Firstly, reducing inflation often has a cost in growth and jobs, at least in the short term (Extract E). Tight monetary and fiscal policies reduce AD, and in the UK in the early 1980s unemployment rose above three million. Argentina's very tight monetary policy in 2018 deepened the recession without reducing inflation, partly because its inflation was driven by currency depreciation and a lack of confidence rather than excess demand. If inflation is caused by a supply shock, such as rising commodity prices (Extract F), fighting it by reducing AD lowers output further, so a government may prefer to accept temporarily higher inflation.

Secondly, Extract F suggests that high inflation in advanced economies may be a problem of the past. In an era of 'global disinflation', the greater risk may be deflation. Falling prices can cause consumers to delay purchases and raise the real value of debt, and as inflation falls the real interest rate rises, weakening demand further. With nominal rates near zero in the UK, central banks have little room to respond, so supporting demand, growth and employment may matter more.

Furthermore, Extract F notes that two-thirds of OECD countries had low inflation and record employment before the pandemic, suggesting the short-run trade-off has weakened. If low inflation and low unemployment can be achieved together, there is less need to prioritise one over the other.

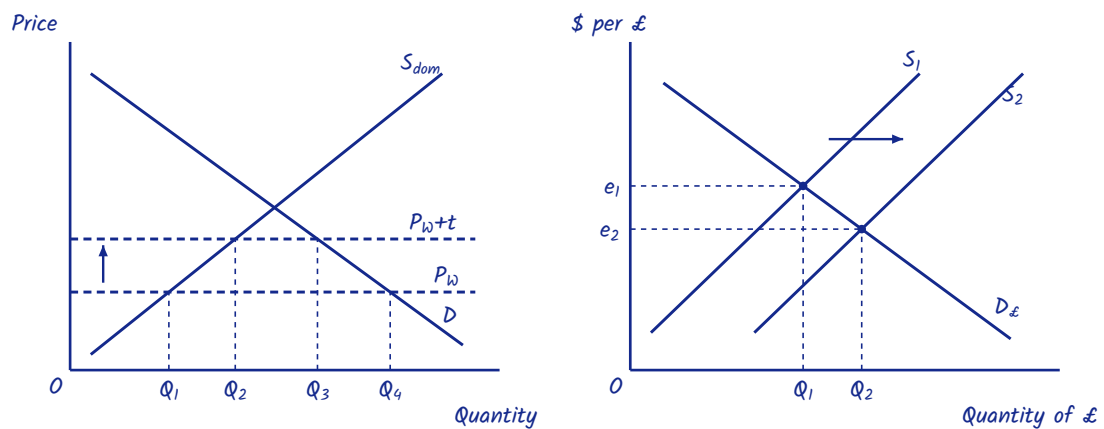
Thirdly, other objectives may matter more for living standards. Inflation of 2% or 3% does little damage, whereas long-term unemployment causes lost output, hysteresis and social problems, and inequality and climate change may matter more to citizens. Priorities also depend on the stage of the economic cycle: during the pandemic, governments rightly prioritised protecting jobs and incomes, and in a deep recession, stimulating growth should come first.

In conclusion, low and stable inflation should be a key objective because it creates the confidence needed for investment and long-run growth, and the experiences of Argentina and the UK in the 1970s show that high inflation makes the other objectives harder to achieve. However, it should not always be the main objective. When inflation is already low and stable, as in most advanced

economies according to Extract F, or when the economy faces a recession or a supply shock, governments should give more weight to growth and employment. The best approach is probably the UK model: an independent central bank targets low inflation with a symmetrical target that also guards against deflation, while the government uses fiscal and supply-side policies to pursue growth, employment and a fairer society. For a country like Argentina, where inflation is extremely high, reducing it must be the priority, but this needs a credible fiscal plan and business and consumer confidence, not just tight monetary policy.

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The balance of trade in goods and services is the value of exports of goods and services minus the value of imports. A deficit occurs when the value of imports exceeds the value of exports, as in the UK since 1998. Expenditure-switching policies aim to reduce a deficit by changing relative prices, so that domestic and foreign residents switch spending away from imports and towards domestically produced goods and services, including exports. They differ from expenditure-reducing policies, such as higher taxes or interest rates, which cut total spending and therefore spending on imports, but at the cost of lower output and employment.



One expenditure-switching policy is protectionism. A tariff, a tax on imports, raises the domestic price of imported goods from P_W to $P_W + t$, as shown in the left-hand diagram. Domestic consumers buy less (demand contracts from Q_4 to Q_3) and domestic producers supply more (from Q_1 to Q_2), so imports fall from Q_1Q_4 to Q_2Q_3 . If demand for imports is price elastic, the value of imports falls significantly. Quotas, which limit the physical quantity of imports, and non-tariff barriers, such as strict product standards or complex customs procedures, have similar effects. Export subsidies lower the price of exports in foreign markets, increasing export volumes and, if foreign demand is price elastic, export values. A second expenditure-switching policy is to lower the exchange rate. Under a floating system, the central bank can cut interest rates, reducing hot money inflows and so the demand for the currency, or it can sell its own currency on the foreign exchange market. As shown in the right-hand diagram, the supply of pounds shifts right from S_1 to S_2 and the exchange rate depreciates from e_1 to e_2 . Under a fixed system, the government could devalue. A lower exchange rate

makes UK exports cheaper in foreign currency and imports more expensive in pounds. For example, at \$1.40 per pound a £10 UK good costs \$14 abroad, but at \$1.20 it costs only \$12.

Whether a depreciation reduces the deficit depends on the price elasticities of demand for exports and imports. According to the Marshall-Lerner condition, the trade balance improves only if the sum of the PEDs for exports and imports is greater than one. In the short run, demand is inelastic because contracts are fixed and buyers take time to find alternatives, so the deficit may at first worsen before improving, as shown by the J-curve.

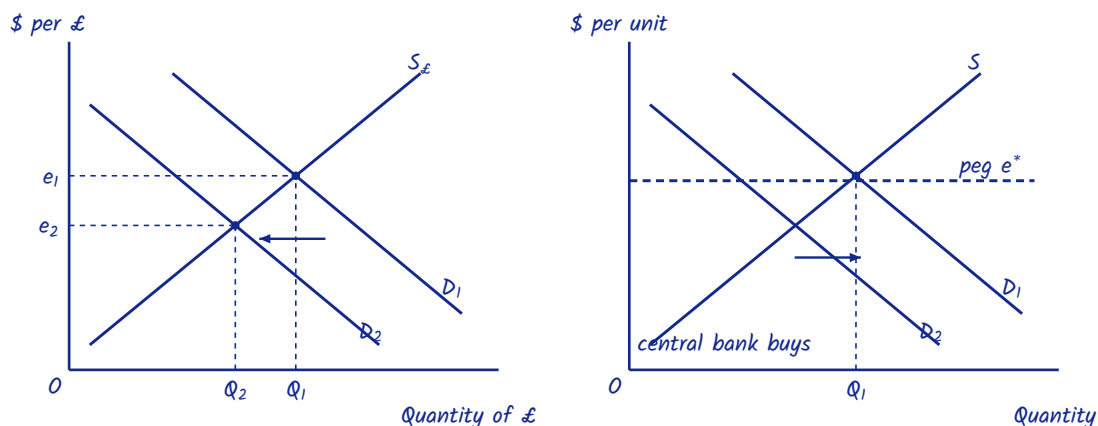
A third approach is supply-side policies, such as spending on education, training and research and development, which reduce costs and raise productivity and quality. Domestic goods become more competitive in both price and non-price terms, so both home and foreign consumers switch towards them. This works more slowly but can bring a lasting improvement.

Overall, the effect on net trade depends on the elasticities, on the risk of retaliation by other countries, which would reduce exports, and on time lags.

Nonetheless, by changing relative prices, expenditure-switching policies can reduce a trade deficit without the large fall in output that expenditure-reducing policies cause.

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An exchange rate is the price of one currency in terms of another. In a floating exchange rate system, the rate is determined purely by the demand for and supply of the currency on the foreign exchange market, without government intervention. In a fixed system, the government or central bank sets the value of the currency against another currency, such as the US dollar, or a basket of currencies, and maintains it by buying and selling currency and by changing interest rates. Whether one system is 'better' should be judged by its effects on the macroeconomic objectives: growth, employment, low inflation and a sustainable current account.



Floating exchange rates have several advantages. Firstly, they may automatically correct a current account deficit. If the UK has a deficit, the supply of pounds (to buy imports) exceeds the demand for pounds (to buy exports). As shown in the left-hand diagram, a fall in demand for pounds from D_1 to D_2 causes the pound to depreciate from e_1 to e_2 . This makes exports cheaper and imports dearer, so, provided the Marshall-Lerner condition holds, the deficit narrows, and the depreciation also boosts AD, growth and employment. Under a fixed system this cannot happen, and the deficit must be corrected by deflationary policies that reduce output and jobs.

Secondly, a floating rate frees monetary policy to pursue domestic objectives. The Bank of England can set Bank Rate to meet its 2% inflation target rather than to defend a currency value. In 1992, the UK had to keep interest rates high to stay in the Exchange Rate Mechanism (ERM) during a recession, and leaving the ERM allowed rates to be cut. Thirdly, a floating system does not require large reserves of foreign currency, which have an opportunity cost, and it reduces the chance of a speculative attack: when a fixed rate is clearly overvalued, speculators have a one-way bet and can force a devaluation, as happened to the UK on Black Wednesday.

However, fixed exchange rates also have significant advantages. Floating rates can be volatile, and large fluctuations create uncertainty for firms that trade internationally. An exporter does not know how many pounds it will receive for a contract priced in euros, which discourages trade and investment, although firms can hedge on forward markets at a cost. A fixed rate gives certainty, encouraging trade, FDI and confidence. As shown in the right-hand diagram, if demand for a

pegged currency falls to D_2 , the central bank buys its own currency with its reserves, shifting demand back to D_1 and maintaining the peg at e^* . Denmark has kept the krone fixed against the euro for decades, and several African nations peg to the euro or US dollar to gain credibility.

Furthermore, a fixed rate imposes discipline. A country cannot rely on depreciation to restore competitiveness, so firms must control costs and governments must avoid excessive inflation. A floating rate can instead allow an inflationary cycle: depreciation raises import prices, causing cost-push inflation, which leads to higher wage demands and further depreciation. Pegging to a low-inflation currency can therefore help bring inflation down. Moreover, depreciation may not improve the trade balance if demand for exports and imports is price inelastic, or if competitiveness depends more on quality and other non-price factors.

The word 'always' is too strong. Which system is better depends on the characteristics of the economy. A large, diversified economy with a credible independent central bank, such as the UK, benefits from the flexibility of floating, because shocks that affect it differently from its trading partners can be absorbed by exchange rate changes. A small, very open economy that trades mainly with one partner, or a developing country with a history of high inflation, may gain more from the stability and credibility of a fixed rate. It also depends on whether the fixed rate is set at the right level: an overvalued peg damages exports and growth, while an undervalued one causes inflation. Fixed systems also depend on adequate reserves; when they run out, the peg collapses, often causing a crisis, as with the end of the Bretton Woods system and the ERM.

In practice, few countries operate a pure free float or a rigid fixed system. Many use a managed float, allowing market forces to determine the rate but intervening to reduce excessive volatility, and even the value of the pound is influenced by the Bank of England's interest rate decisions.

In conclusion, floating exchange rates are generally better for large economies like the UK because they allow independent monetary policy and automatic adjustment, and avoid speculative crises. However, they are not always better: their volatility can damage trade and investment, and for small open economies or

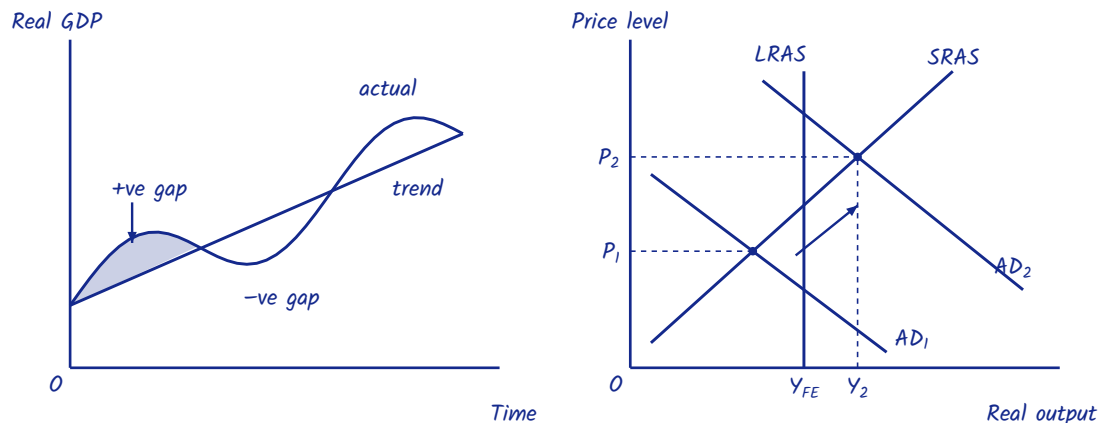
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those with poor inflation records, the stability of a fixed rate may lead to better macroeconomic performance. The key factor is whether an economy needs flexibility to respond to its own shocks more than it needs certainty and credibility, so for many countries a managed float may offer the best compromise.

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Output is the total value of goods and services produced in an economy, measured by real GDP. An output gap is the difference between the actual level of real output and the economy's potential (trend) output. A positive output gap occurs when actual output is above potential output, as in Bulgaria and Romania in 2018. It usually occurs during a boom in the economic cycle, when AD grows faster than productive capacity, for example due to rapid credit growth, rising consumer confidence, a fiscal stimulus or booming exports. As shown in the left-hand diagram, actual GDP rises above the trend growth line, and the shaded area is the positive output gap. The economy can only produce above its potential temporarily, by using factors of production more intensively than is sustainable, for example through overtime and running machinery without maintenance.



The main problem is demand-pull inflation. As shown in the right-hand diagram, AD rises from AD_1 to AD_2 , taking the economy beyond its full-capacity output Y_{FE} to Y_2 , where there is excess demand. Because firms are already near capacity, the increase in demand mainly raises prices, so the price level rises from P_1 to P_2 : too much money is chasing too few goods. Inflation reduces the real value of savings and fixed incomes, creates uncertainty and discourages investment. Secondly, a large positive output gap creates cost-push inflation. Unemployment falls below the natural rate, labour shortages emerge and firms compete for workers by raising wages. Raw materials and components also become scarce and their prices rise. Higher costs shift SRAS to the left, raising prices further. If workers then expect higher inflation they demand higher wages, starting a wage-price spiral that is difficult to stop without a painful recession. Thirdly, there are problems for the balance of payments. With domestic firms

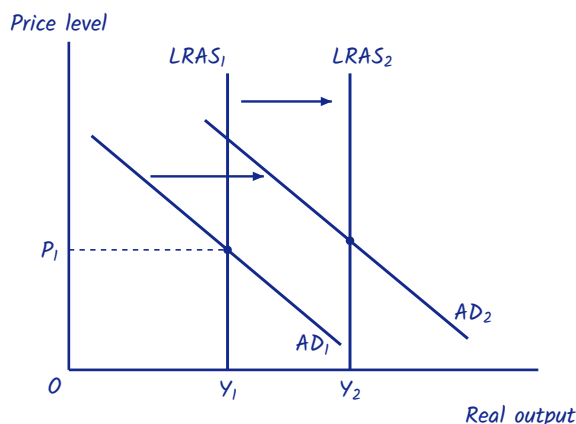
unable to meet demand, consumers and firms buy more imports, while rising domestic prices make exports less price competitive and some output is diverted from exports to the home market. The current account deficit therefore widens. If inflation is higher than in trading partners, the exchange rate may come under downward pressure, or in a fixed system the currency becomes overvalued.

Fourthly, positive output gaps can create asset price bubbles. Easy credit and optimism push house and share prices up to unsustainable levels, encouraging further borrowing. When the bubble bursts, as in 2008, households and banks face large losses and the economy can fall into a deep recession.

Finally, a positive output gap cannot be sustained. To reduce inflation, the central bank will raise interest rates and the government may tighten fiscal policy, which can cause a sharp slowdown, so the boom is followed by a bust, increasing the volatility of the economic cycle and causing unemployment. A positive output gap is especially likely, and problematic, if productivity growth is low, which keeps potential output low, so even moderate demand growth overheats the economy. Overall, the larger and more persistent the gap, the more severe the inflationary and balance of payments problems become.

1 2

Supply-side improvements increase the productive capacity of the economy, shifting the long-run aggregate supply (LRAS) curve to the right, and improve the efficiency of markets. They can be achieved by free-market policies, which aim to make markets work better by reducing government involvement, or by interventionist policies, where the government acts directly to correct market failures, for example by spending on education, training and infrastructure. The UK needs supply-side improvements because of its weak productivity growth since 2008, skills shortages and large regional inequalities.



Interventionist policies can be very effective. Education and training are merit goods which the free market under-provides, because individuals underestimate the benefits and there are positive externalities: firms are reluctant to train workers who may leave for rivals. Government spending on schools, apprenticeships and further education raises human capital and labour productivity, so LRAS shifts right from $LRAS_1$ to $LRAS_2$ in the diagram, raising potential output from Y_1 to Y_2 and reducing inflationary pressure. Infrastructure, such as transport networks and broadband, has large external benefits, reducing costs for all firms; investment in projects such as full-fibre broadband and better transport links aims to raise productivity outside London. Government funding of research and development overcomes the reluctance of private firms to fund risky basic research, and spending on healthcare raises the size and productivity of the workforce.

Interventionist policies also increase AD in the short run, as government spending is an injection, shifting AD right from AD_1 to AD_2 . This helps reduce unemployment during a recession, whereas many free-market policies do nothing to boost demand. By targeting particular regions or groups, interventionist policies can also reduce inequality and structural unemployment.

However, free-market policies can also achieve supply-side improvements. Cutting income tax and corporation tax increases incentives to work, take risks and invest; the UK cut corporation tax from 28% in 2010 to 19% by 2017, which may have encouraged investment and FDI. Reforming welfare benefits increases the incentive to take work, and reducing trade union power and making labour markets more flexible lowers firms' costs and helps reduce the natural rate of unemployment. The UK's flexible labour market is often credited with its relatively low

unemployment. Privatisation and deregulation introduce the profit motive and competition, reducing X-inefficiency, as in telecommunications after BT was privatised. Free trade increases competition and allows specialisation. These policies also cost the government less.

Interventionist policies have limitations. They are expensive and have an opportunity cost: with UK government debt around 100% of GDP, extra spending may require higher taxes or borrowing, which may crowd out private investment.

They suffer from long time lags: better early-years education may take 15 to 20 years to raise productivity. There is also a risk of government failure, as governments lack the information to pick winners, projects may be poorly managed and costs can escalate, as with HS2. Training schemes may not match the skills employers need.

Equally, free-market policies have weaknesses. Tax cuts mainly benefit higher earners and may widen inequality, and the evidence that lower income tax raises labour supply is mixed, because the income effect may offset the substitution effect. Flexible labour markets can create insecure, low-paid jobs, such as zero-hours contracts, which may reduce workers' incentive to train and firms' incentive to invest in labour-saving capital. Privatisation has had mixed results: the railways have been criticised for high fares and poor service, and regulation is still needed. Indeed, many free-market policies, such as trade union legislation, themselves require government intervention.

In conclusion, whether supply-side improvements are best achieved by interventionist policies depends on the causes of the UK's supply-side weakness.

The UK already has relatively flexible labour markets, low corporation tax and few state-owned industries, so the scope for further gains from free-market policies is probably limited. The UK's main problems, low investment, poor infrastructure outside London and skills gaps, are market failures that the free market is unlikely to solve. Interventionist policies are therefore likely to be the most effective way to achieve lasting supply-side improvements, provided they are well targeted, carefully evaluated and sustainably funded. However, the best approach is a combination: intervention to provide education, infrastructure and research,

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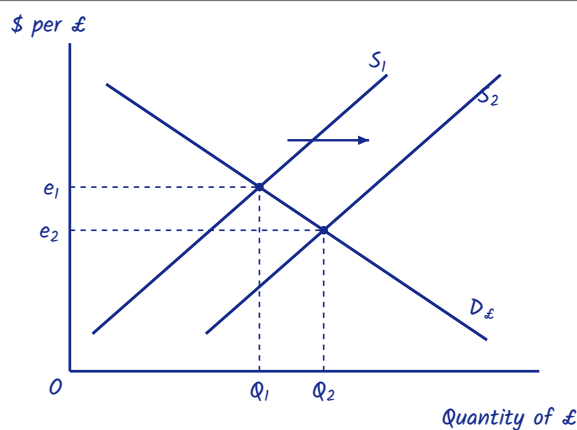
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together with market-based incentives that encourage firms to invest and workers to train.

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Exports are goods and services produced in the UK and sold to buyers in other countries. The value of exports equals the volume (quantity) of exports multiplied by their price, so a change in either can change the value of UK exports, which are around 30% of GDP, with services such as finance and business services making up almost half.

In the long run, the pattern and value of exports depend on comparative advantage. A country has a comparative advantage in a good if it can produce it at a lower opportunity cost than other countries. For example, if a UK worker can produce either 10 units of financial services or 5 cars, and a Chinese worker either 2 units of financial services or 4 cars, the opportunity cost of a car is 2 units of financial services in the UK but only 0.5 in China, so the UK should specialise in and export financial services. Over time, the UK has lost comparative advantage in many manufactured goods to lower-cost economies, leading to deindustrialisation and a fall in manufactured exports, while the value of service exports has grown.



In the short run, changes in the exchange rate affect the value of exports. After the 2016 EU referendum, the pound depreciated. As shown in the diagram, the supply of pounds increased from S_1 to S_2 and the value of the pound fell from e_1 to e_2 . This made UK exports cheaper in foreign currencies, so the volume of exports demanded increased. Since exports are priced in pounds, the sterling value of exports rises, by more if foreign demand is price elastic. An appreciation has the opposite effect, making exports less price competitive.

The value of UK exports also depends on incomes in the rest of the world. When the EU and the USA, the UK's largest trading partners, experience economic

growth, their consumers and firms buy more UK goods and services, so exports rise. A global recession or external shock, such as the 2008 financial crisis or the pandemic, reduces world demand and UK exports fall. Growth in emerging economies such as China and India creates new markets for UK services and luxury goods.

Trade policy also affects the value of exports. Leaving the EU's single market and customs union in 2021 introduced non-tariff barriers, such as customs checks and rules of origin, making it more costly to export to the EU and reducing exports to it. New trade deals with other countries may lead to trade creation with them, while protectionist measures by other countries, such as tariffs, reduce UK exports.

Relative costs and inflation matter too. If UK inflation or unit labour costs rise faster than in other countries, UK exports become less price competitive.

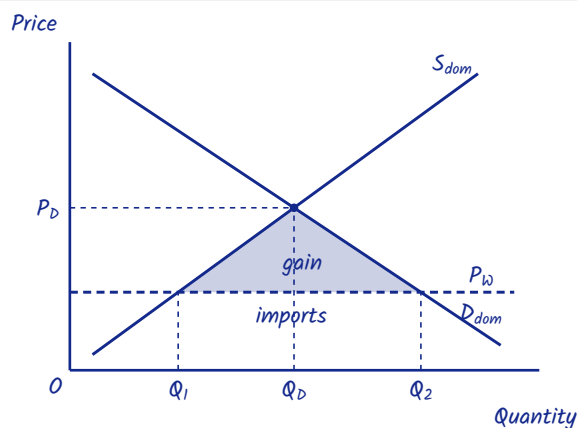
Non-price factors, such as quality, reputation, design and innovation, also affect demand: UK cars, pharmaceuticals and higher education sell well abroad because of their reputation. Product and process innovation, and improvements in transport and communications technology, have reduced the cost of trading, allowing more services to be exported digitally. Finally, changes in world commodity prices affect the value of exports such as North Sea oil and gas.

1 4

International trade is the exchange of goods and services between countries. The alternative is protectionism, such as tariffs and quotas, or, in the extreme, a closed economy. Whether trade benefits a nation can be judged by its effects on consumers, producers, workers, the government and the environment, and on macroeconomic objectives such as growth and employment.

The main argument for trade is comparative advantage. If each country specialises in the goods it can produce at the lowest opportunity cost and trades, world output increases and all countries can consume beyond their production possibility frontiers. For example, if the UK has a comparative advantage in financial services and Vietnam in clothing, both gain when they specialise and trade at terms of trade between their opportunity cost ratios. World trade growing at 6% a year,

twice as fast as world output, reflects these gains.



Trade also benefits consumers through lower prices and greater choice. As shown in the diagram, without trade a country produces and consumes at the domestic equilibrium, P_D and Q_D . With free trade, the price falls to the world price, P_W . Domestic consumption rises to Q_2 , domestic production falls to Q_1 , and Q_1Q_2 is imported. Consumer surplus rises by more than producer surplus falls, so there is a net welfare gain shown by the shaded triangle. Competition from imports also forces domestic firms to become more efficient and innovative, and access to larger export markets allows firms to exploit economies of scale, lowering average costs.

At the macroeconomic level, exports are an injection into the circular flow, so trade can lead to export-led growth and employment, as experienced by China and other East Asian economies. Trade also attracts FDI, spreads technology and knowledge, and may improve international relations and reduce conflict.

However, trade does not always benefit every nation, or every group within a nation. Firstly, there are losers as well as winners. As the diagram shows, domestic producers lose producer surplus and their output falls from Q_D to Q_1 . Workers in industries that cannot compete with imports may become structurally unemployed: in the UK, the decline of steel, textiles and shipbuilding caused long-term unemployment in regions such as the North East. The gains to consumers are widely spread, while the losses are concentrated, and workers may lack the skills or mobility to move to expanding industries.

Secondly, developing countries may benefit much less. Many specialise in primary products, whose prices are volatile and whose terms of trade have often

deteriorated relative to manufactured goods, so they must export ever more to buy the same imports, and primary product dependency leaves them vulnerable to falls in commodity prices. Infant industries may never become established if they are exposed to competition from established foreign firms, which is why many now-developed countries, including the USA and South Korea, used protection in the early stages of development. MNCs may also exploit low-paid workers and weak environmental regulation.

Thirdly, the theory of comparative advantage rests on assumptions, such as constant costs, perfect factor mobility and no transport costs, which do not hold in reality. Trade also has external costs: transporting goods around the world adds to carbon emissions, which are not reflected in prices. As countries become more interconnected they also import shocks, as the 2008 financial crisis and the disruption to supply chains during the pandemic showed. A country with a persistent trade deficit, like the UK, faces a leakage from the circular flow, which may reduce AD and employment, and it may become dependent on others for strategic goods such as energy and medical supplies.

In conclusion, international trade benefits nations overall in most cases, because the gains from specialisation, lower prices, competition and economies of scale outweigh the losses, and open economies tend to grow faster than closed ones.

However, it is wrong to say that trade always benefits nations. The size of the gains depends on what a nation exports, its terms of trade, its stage of development and how well the government supports those who lose out. Trade benefits nations most when it is accompanied by policies to retrain workers, regulation to protect workers and the environment, and, for developing countries, policies to diversify their economies. The benefits are therefore likely but not guaranteed, and they are not shared equally by everyone within a nation.