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Centre number

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Candidate number

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StemUp Model Solution

Forename(s)

Candidate signature

I declare this is my own work.

AS ECONOMICS

Paper 2 The National Economy in a Global Context

Monday 22 May 2023

Morning

Time allowed: 1 hour 30 minutes

Materials

For this paper you must have:

- the Insert
- a calculator.

Instructions

- Use black ink or black ball-point pen. Pencil should only be used for drawing.
- Fill in the boxes at the top of this page.
- Answer **all** questions in **Section A**.
- Answer **either** Context 1 **or** Context 2 in **Section B**.
- You will need to refer to the Insert provided to answer **Section B**.
- You must answer the questions in the spaces provided. Do not write outside the box around each page or on blank pages.
- If you need extra space for your answer(s), use the lined pages at the end of this book. Write the question number against your answer(s).
- Do all rough work in this book. Cross through any work you do not want to be marked.

Information

- The maximum mark for this paper is 70.
- The marks for questions are shown in brackets.
- No deductions will be made for wrong answers.

For Examiner's Use	
Section	Mark
A	
B	
TOTAL	



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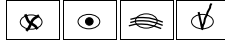
Section AAnswer **all** questions in this section.Only **one** answer per question is allowed.

For each question completely fill in the circle alongside the appropriate answer.

CORRECT METHOD



WRONG METHODS



If you want to change your answer you must cross out your original answer as shown.



If you wish to return to an answer previously crossed out, ring the answer you now wish to select as shown.

**0 1**

Which one of the following is an injection into the circular flow of income?

[1 mark]**A** Consumer expenditure**B** Exports**C** Imports**D** Wages**0 2**

In which one of the following situations is an increase in aggregate demand most likely to result in higher inflation?

[1 mark]**A** Household savings are increasing**B** Mortgage interest rates are high**C** Resources are fully employed**D** Unemployment is rising

0 3

Table 1 shows the Consumer Price Index (CPI) for an economy over a period of time.

Table 1

Year	CPI
2008	110
2011	108
2014	116
2017	124
2020	130

Which one of the following can be concluded from **Table 1**?

[1 mark]

- A** The price of a representative basket of goods rose throughout the period. ☐
- B** The rate of inflation from 2011 to 2014 was the same as from 2014 to 2017. ☐
- C** The standard of living reached its highest level in 2020. ☐
- D** The value of money rose between 2008 and 2011. ☒

Turn over for the next question

Turn over ►

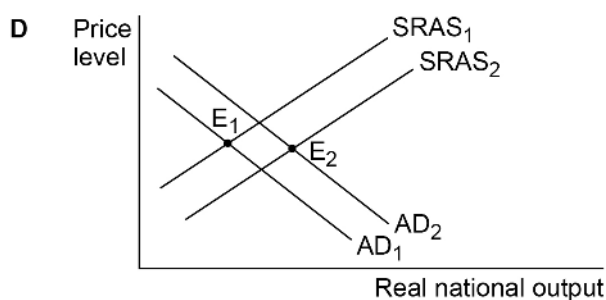
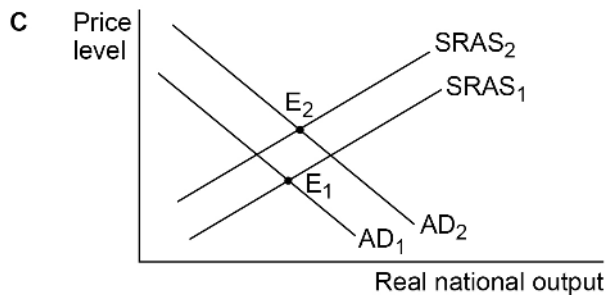
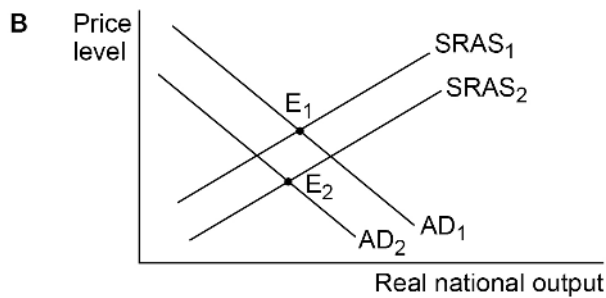
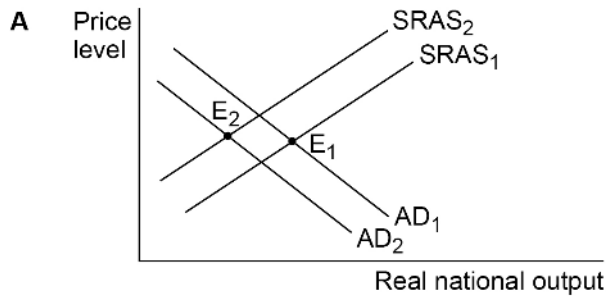


0 4

A government decides to increase the minimum wage at a time when the rest of the world is coming out of recession. These events cause short-run aggregate supply (**SRAS**) to shift from **SRAS₁** to **SRAS₂** and aggregate demand (**AD**) to shift from **AD₁** to **AD₂**.

If the initial macroeconomic equilibrium is **E₁**, which one of the following diagrams shows the correct new equilibrium **E₂**?

[1 mark]



0 5

Which one of the following is a direct tax?

[1 mark]**A** Corporation tax☒**B** Fuel tax☐**C** Import tax☐**D** Vehicle tax☐**0 6****Table 2** shows the components of a country's national income in 2021.**Table 2**

	£bn
Consumer expenditure	22
Investment	10
Government expenditure	8
Exports	11
Imports	9

It can be concluded from the data in **Table 2** that aggregate supply in 2021 must have been**[1 mark]****A** £21bn.☐**B** £40bn.☐**C** £42bn.☒**D** £60bn.☐**Turn over ►**

0 7

Which one of the following is most likely to be used to identify a phase of the economic cycle?

[1 mark]**A** Firms' capacity utilisation☒**B** Structural unemployment☐**C** The economy's productive potential☐**D** The exchange rate☐**0 8**

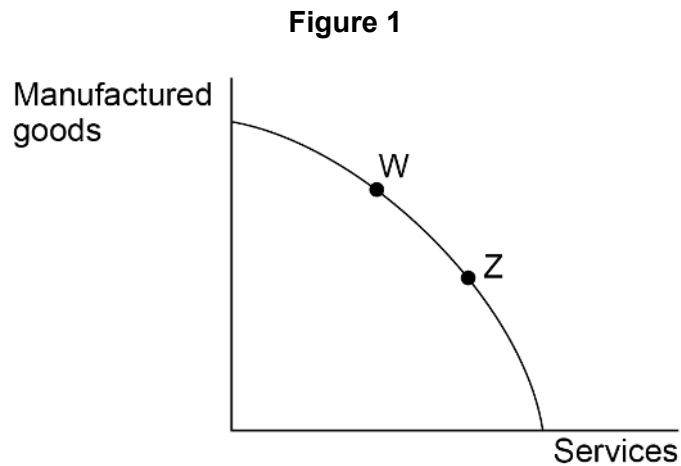
An economy has a low rate of economic growth and high unemployment.

Which one of the following sets of policies would be most likely to increase growth and reduce unemployment whilst avoiding a rise in inflation?

[1 mark]**A** A cut in income tax and lower interest rates☐**B** Higher interest rates and an appreciation in the exchange rate☐**C** Higher welfare benefits and an increase in the money supply☐**D** Increased expenditure on training and an investment subsidy☒

0 9

Figure 1 shows the production possibility curve for an economy producing services and manufactured goods.



The economy moves from point **W** to point **Z**. It can be concluded that

[1 mark]

- A** imports of manufactured goods have risen.
- B** the international competitiveness of services has increased.
- C** the pattern of economic activity has changed.
- D** unemployment in manufacturing has increased.

☐
☐
☒
☐

Turn over for the next question

Turn over ►



1 0

Table 3 shows the planned change in government spending, the size of the output gap and the size of the multiplier in four economies, W, X, Y and Z.

Table 3

	Change in government spending (£bn)	Output gap (£bn)	Multiplier
W	–80	+100	1.25
X	–150	–225	1.5
Y	+200	+350	1.75
Z	–300	+150	2

All other things being equal, in which one of the economies, W, X, Y or Z, will the planned change in government spending eliminate the economy's output gap?

[1 mark]**A** W☒**B** X☐**C** Y☐**D** Z☐**1 1**

A government wishing to reduce inflation through the use of fiscal policy could

[1 mark]**A** cut government borrowing.☒**B** decrease income tax.☐**C** raise interest rates.☐**D** reduce the budget surplus.☐

1 2

Table 4 shows the percentage change in real GDP in an economy in the four years 2016 to 2019.

Table 4

Year	Change in real GDP (%)
2016	4.2
2017	3.1
2018	2.6
2019	1.1

Over the period 2016 to 2019, which one of the following can be concluded from **Table 4**?
[1 mark]

- A** Aggregate demand decreased ☐
- B** Real national income increased ☒
- C** Structural unemployment increased ☐
- D** The inflation rate decreased ☐

1 3

The national debt is the sum of all past and current borrowing, less repayments, undertaken by

[1 mark]

- A** firms and government. ☐
- B** firms, government and households. ☐
- C** government. ☒
- D** households and firms. ☐

Turn over ►



1 4

Which one of the following is most likely to be an instrument of industrial policy?

[1 mark]**A** An increase in manufacturing productivity☐**B** Government grants for firms with growth potential☒**C** Higher investment by firms in research and development☐**D** Investment by firms in artificial intelligence☐**1 5**

An economy experiences a low trend rate of economic growth, no output gap and a fall in total hours worked. In these circumstances, which one of the following combinations of events is most likely to occur?

[1 mark]

	National output	Cyclical unemployment	Labour productivity
A	Falling	Absent	Increasing
B	Falling	Present	Decreasing
C	Rising	Absent	Increasing
D	Rising	Present	Decreasing

☐☐☒☐**1 6**

The UK economy experiences a change in its foreign exchange rate from £1 = \$1.60 to £1 = \$1.75.

Which one of the following is the most likely effect on the UK economy?

[1 mark]**A** A decrease in employment☒**B** A fall in the budget deficit☐**C** A reduction in productivity☐**D** Higher raw material prices☐

1 7

An economy is experiencing deflation and high employment.

The most likely cause of this situation is a

[1 mark]

A deficit on the balance of payments.

☐

B government budget surplus.

☐

C negative demand-side shock.

☐

D positive supply-side shock.

☒
1 8

Which one of the following is an example of a contractionary fiscal policy designed to reduce inflation while, at the same time, minimising the negative impact on the economy's potential for long-run economic growth?

[1 mark]

A A decrease in the budget deficit and replacement of a sugar tax with a tax on savings

☐

B An increase in interest rates and replacement of food subsidies with subsidies for innovation

☐

C An increase in the budget surplus and a switch from spending on pensions to spending on new airports

☒

D Restrictions on bank lending and a switch from spending on arts degrees to spending on apprenticeships

☐

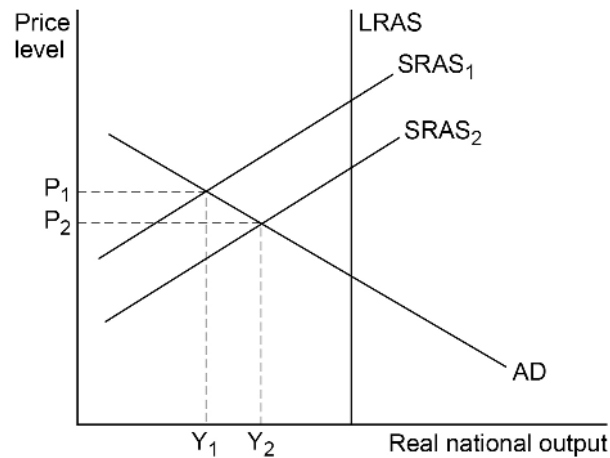
Turn over for the next question

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1 9

Figure 2 shows the aggregate demand curve (**AD**), short-run aggregate supply curves (**SRAS**) and long-run aggregate supply curve (**LRAS**) for an economy.

Figure 2

The short-run aggregate supply curve shifts from **SRAS₁** to **SRAS₂**. Which one of the following is the most likely cause of the resulting increase in real national output?

[1 mark]

- A** An increase in bank lending to households
- B** An increase in government expenditure
- C** Productivity rising faster than money wages
- D** The action of the multiplier

☐☐☒☐

2 0

Which one of the following is most likely to result in an increase in exports from the UK economy? An increase in

[1 mark]

- A** inflation in other countries.
- B** productivity in other countries.
- C** UK incomes.
- D** UK interest rates.

☒☐☐☐**END OF SECTION A**

Section B

Look at the Insert and choose to answer **EITHER** Context 1 **OR** Context 2.

Answer **EITHER** Questions 21 to 26 in the spaces below

OR

Questions 27 to 32 on pages 24 to 32 of this answer booklet.

There is a total of 50 marks for either context.

Shade the circle below to indicate which context you have answered.

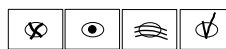
Context **0** **1** ☐

Context **0** **2** ☐

CORRECT METHOD



WRONG METHODS



EITHER

Context 1

Total for this context: 50 marks

INFLATION

Use the Insert provided to study **Questions 21 to 26** and **Extracts A, B and C**, and then answer the questions in the spaces which follow.

2 **1** Define 'deflation' **Extract C** (line 2).

[3 marks]

Deflation is a sustained fall in the general (average) price level in an economy over a period of time, so that the rate of inflation, measured for example by the CPI, becomes negative.

Turn over ►



2 2

The original price of an overnight stay in a hotel room is £180 including VAT. Calculate the new price of an overnight stay, following the reduction in VAT referred to in **Extract B** (line 15).

[4 marks]

$$\text{Price excluding VAT} = £180 \times 100/120 = £150$$

$$\text{Original VAT at 20\%} = £180 - £150 = £30$$

$$\text{New VAT at 5\%} = £150 \times 5/100 = £7.50$$

$$\text{New price} = £150 + £7.50 = £157.50$$

$$(\text{or } £180 \times 105/120 = £157.50)$$



2 3

Use **Extract A** to identify **two** significant features of the inflation rate over the period shown.

[4 marks]

Feature 1 *The inflation rate fell over the period as a whole, from its highest rate of 3% (CPI) in January 2018 to 0.6% in December 2020, well below the 2% target.*

Extra space

Feature 2 *The lowest rate of inflation was 0.2% in August 2020. Inflation stayed positive throughout, so prices still rose, and it fluctuated with a range of 2.8 percentage points.*

Extra space

Turn over for the next question

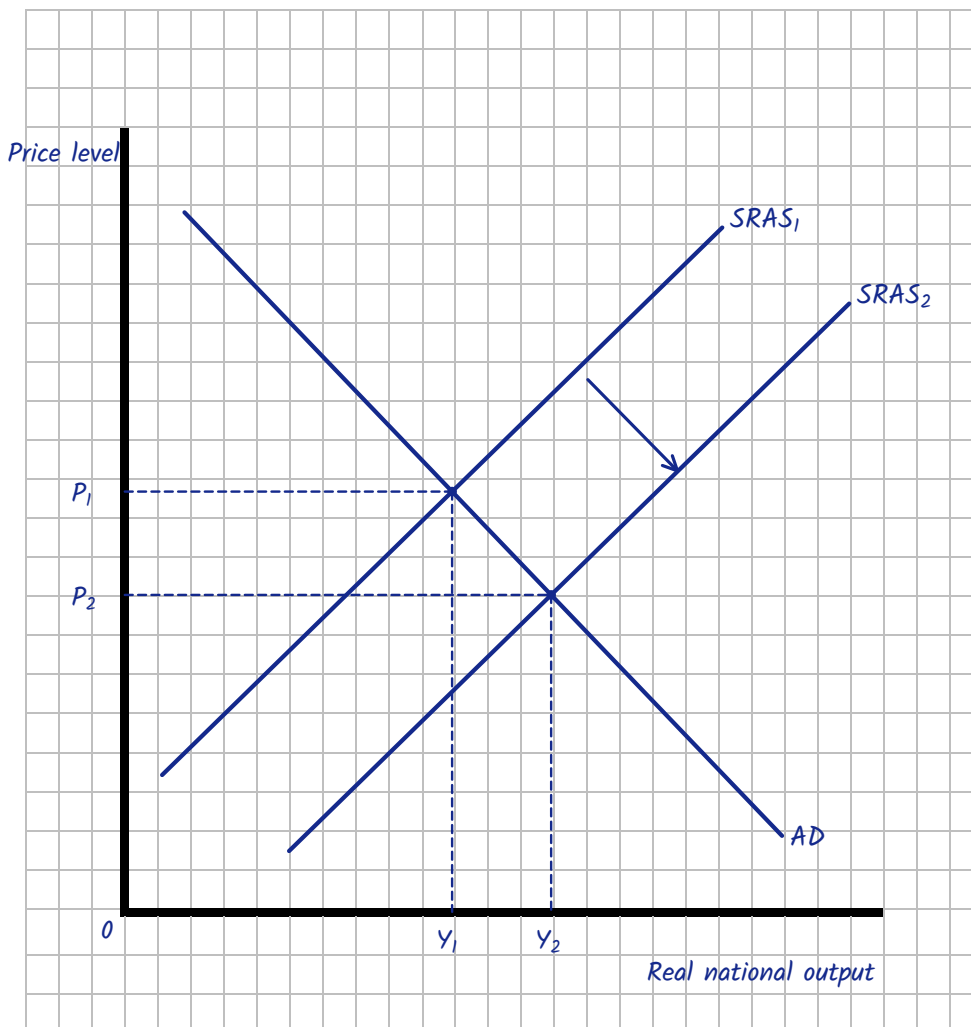
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2 4

Extract B (lines 14–15) states: ‘In the UK, government policy, such as the temporary reduction in VAT, an indirect tax, from 20% to 5%, also helped to reduce inflation.’

Draw an AD/AS diagram to show the impact of a reduction in indirect taxation on real national income and the price level in an economy.

[4 marks]

The cut in VAT lowers firms' costs of production, so SRAS shifts right from $SRAS_1$ to $SRAS_2$: the price level falls from P_1 to P_2 and real national income rises from Y_1 to Y_2 .



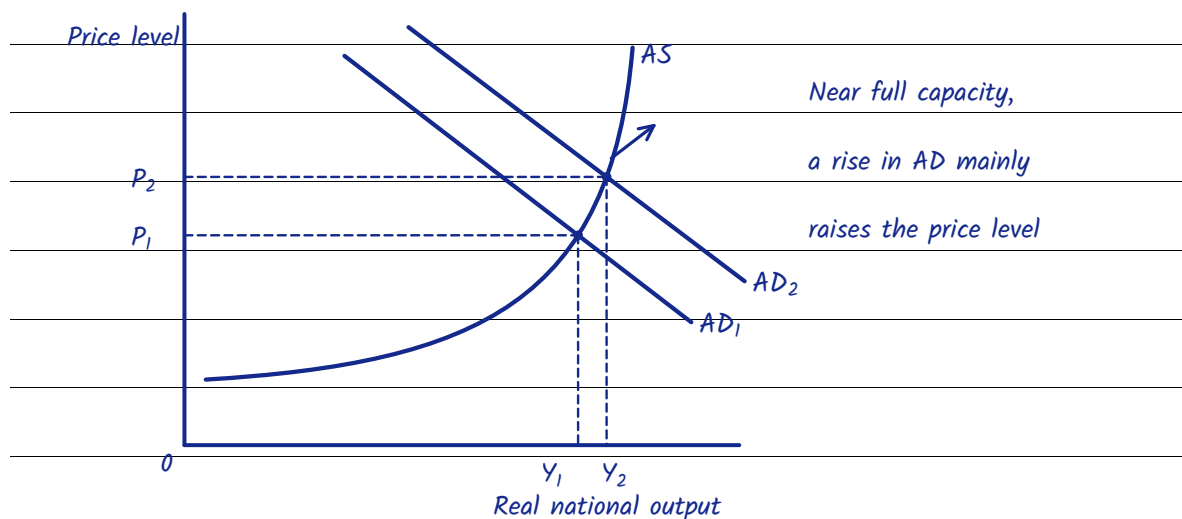
2 5

Extract B (lines 7–9) states: 'With this in mind, the government sets the target rate of inflation that the Bank of England's Monetary Policy Committee (MPC) has to achieve.'

Explain **two** factors considered by the Bank of England's MPC when setting Bank Rate.

[10 marks]

Bank Rate is the interest rate the Bank of England pays on commercial banks' reserves, and it influences all other interest rates in the economy. The MPC sets Bank Rate as its main tool of monetary policy so that CPI inflation meets the government's target of 2% (Extract B) while supporting growth and jobs. As changes take up to two years to have their full effect, the MPC looks at forecasts of future inflation, not just the current rate.



Factor 1: the state of the economy and demand-pull pressure. The MPC looks at the phase of the economic cycle: the growth of real GDP, consumer spending, unemployment, money wages, credit and house prices. If AD is growing faster than productive potential, spare capacity is used up and a positive output gap opens. As shown in the diagram above, when AD shifts from AD_1 to AD_2 near full capacity, most of the increase is in the price level (P_1 to P_2) rather than real output. A tight labour market also pushes up money wages, raising firms' costs. The MPC is then likely to raise Bank Rate: borrowing becomes dearer and saving more rewarding, so consumption and investment grow more slowly, curbing AD and bringing inflation back to 2%.

Turn over ►



Extra space *In 2020, by contrast, unemployment rose and inflation fell*

(Extract B), so Bank Rate stayed at 0.1%.

Factor 2: cost-push pressures from the world economy, such as commodity prices and the exchange rate. Extract B notes that the price level is affected by supply-side factors 'from all over the world'. In 2020 oil prices tumbled, cutting firms' costs and shifting SRAS right, which reduced inflation. A depreciation of sterling raises the price of imported raw materials and goods, increasing costs and CPI inflation, whereas the pound's rise to its highest level against the dollar since April 2018 (Extract C) is deflationary. If cheap commodities or a strong pound are expected to push inflation below target, the MPC can keep Bank Rate low; if import prices surge, it may raise it. However, the MPC may 'look through' a temporary supply shock, because raising rates would cut output and jobs further. It also watches inflation expectations: if people expect high inflation, workers ask for large wage rises (Extract B), so inflation becomes self-fulfilling and a rise in Bank Rate is more likely.



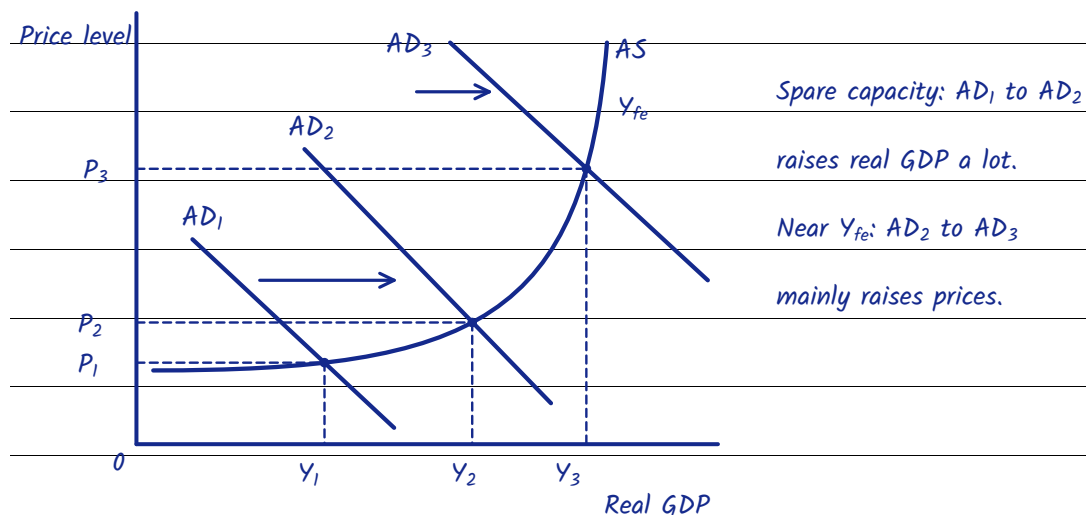
2 6

Extract C (lines 18–19) states: 'It remains to be seen whether very low interest rates are good for the economy.'

Use the extracts and your knowledge of economics to assess the view that very low interest rates are good for the UK economy.

[25 marks]

Interest rates are the cost of borrowing and the reward for saving. The Bank of England's MPC sets Bank Rate, which feeds through to mortgage, loan and savings rates. In 2020 rates were very low: Bank Rate was at an all-time low of 0.1%, alongside quantitative easing (Extract C). Whether this is good for the UK depends on how far it helps achieve the macroeconomic objectives of growth, low unemployment and price stability, and on the state of the economy.



Very low interest rates should increase aggregate demand. Cheaper borrowing reduces the cost of loans and credit, and lower returns make saving less attractive, so consumption rises. Households with variable-rate mortgages have more disposable income. Firms find more investment projects profitable because the cost of borrowing is below the expected return, so investment rises: Extract C says low rates 'should encourage consumption and much needed investment'. Low rates may also weaken the pound, making exports cheaper and imports dearer. As C , I and $(X - M)$ are components of AD , AD

Turn over ►



shifts right from AD_1 to AD_2 . As shown in the diagram, in 2020 there was a large negative output gap, since output was not expected to recover to its previous peak until 2022 (Extract C), so real GDP rises from Y_1 to Y_2 with only a small rise in the price level. The initial injection is magnified by the multiplier, and rising output may raise investment further through the accelerator.

This helps achieve the macroeconomic objectives. Higher output means firms need more workers, so cyclical unemployment, which rose in 2020 (Extract B), falls. Low rates also help prevent deflation: Extract A shows CPI inflation falling to only 0.2% in August 2020, far below the 2% target. Deflation would be harmful, as consumers delay spending in the hope of lower prices and the real value of debt rises, so very low rates help the MPC meet its symmetric target.

A further benefit is that the cost of servicing government debt stays low, which Extract C calls 'crucial' when the budget deficit and national debt were increasing considerably. Lower debt interest frees money for public services and infrastructure, so fiscal and monetary policy can work together to support the recovery.

However, the effectiveness of very low rates depends on confidence. In a deep crisis such as the pandemic, households may save for precautionary reasons and firms may not invest however cheap borrowing is, because expected demand is weak. With Bank Rate at 0.1% there is little room to cut further, so monetary policy may be 'pushing on a string' and needs fiscal support. Time lags of up to two years also mean the stimulus may arrive after the economy has already recovered.

Very low rates also have significant costs. First, they can create inflationary pressure (Extract C). The average UK house price rose by 7.6% in the year to



Extra space *November 2020 and the FTSE 100 reached its highest value since March 2020, suggesting cheap credit inflates asset prices. If rates stay very low once spare capacity is used up, a further rise in AD from AD_2 to AD_3 close to full employment output (Y_{fe}) mainly raises the price level from P_2 to P_3 , as the diagram shows, causing demand-pull inflation above the 2% target. Second, savers lose out. Pensioners and others who rely on interest from their savings (Extract C) see their income fall, and if inflation exceeds the interest rate their real return is negative, reducing their spending and making the distribution of income less fair.*

Third, low rates encourage more consumer debt, which might lead to instability in the future (Extract C). When rates eventually rise, highly indebted households face much higher repayments and may cut spending sharply or default, as in the 2008 financial crisis.

Fourth, tempted by cheap borrowing, some firms may make poor investment decisions (Extract C), and unproductive 'zombie' firms may survive, causing a misallocation of resources that reduces productivity and long-run growth.

Overall, whether very low interest rates are good for the UK depends mainly on the amount of spare capacity and the time period. In the short run in 2020, with a large negative output gap, rising unemployment and inflation of only 0.6% in December 2020, very low rates were beneficial: they supported AD, jobs and government finances, and the risk of excessive inflation was small. The costs to savers and the risk of asset price bubbles were a price worth paying in a crisis. However, very low rates become less beneficial the longer they last: once the recovery is under way and spare capacity is used up, they risk inflation, unsustainable debt and misallocated resources. They also work best alongside fiscal and supply-side policies, as monetary policy alone cannot fix a collapse in confidence. Therefore very low interest rates are good

Turn over ►



for the UK economy as a temporary emergency measure, but not as a permanent policy, and the MPC should raise rates gradually as the economy recovers.



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outside the
box

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

OR

Context 2

Total for this context: 50 marks

INTERNATIONAL TRADE

Use the Insert provided to study **Questions 27 to 32** and **Extracts D, E and F**, and then answer the questions in the spaces which follow.

2 7 Define 'economic recovery' **Extract E** (line 17).

[3 marks]

Economic recovery is the phase of the economic cycle after a recession (the trough) when real GDP begins to grow again, so national output rises and unemployment begins to fall.

2 8 In the year to July 2020, the deficit in the balance of trade in goods was £105 billion. Calculate the value of imports of goods for the year to July 2020, using the information in **Extract E** (lines 12–15) to help you.

[4 marks]

Balance of trade in goods = exports of goods – imports of goods

–£105bn = £321.6bn – M

M = £321.6bn + £105bn

Imports of goods = £426.6bn



2 9

Use **Extract D** to identify **two** significant features of the balance of trade in goods and services over the period shown.

[4 marks]

Feature 1 *The largest trade deficit was £7900m in February 2019. Before June 2019 the balance was always in deficit, but after that it fluctuated between deficit and surplus, such as a surplus of £7100m in May 2020, the largest surplus.*

Extra space

Feature 2 *The sharpest improvement was between March and April 2020, when the balance moved from a deficit of £3300m to a surplus of £5700m, a change of £9000m.*

Extra space

Turn over for the next question

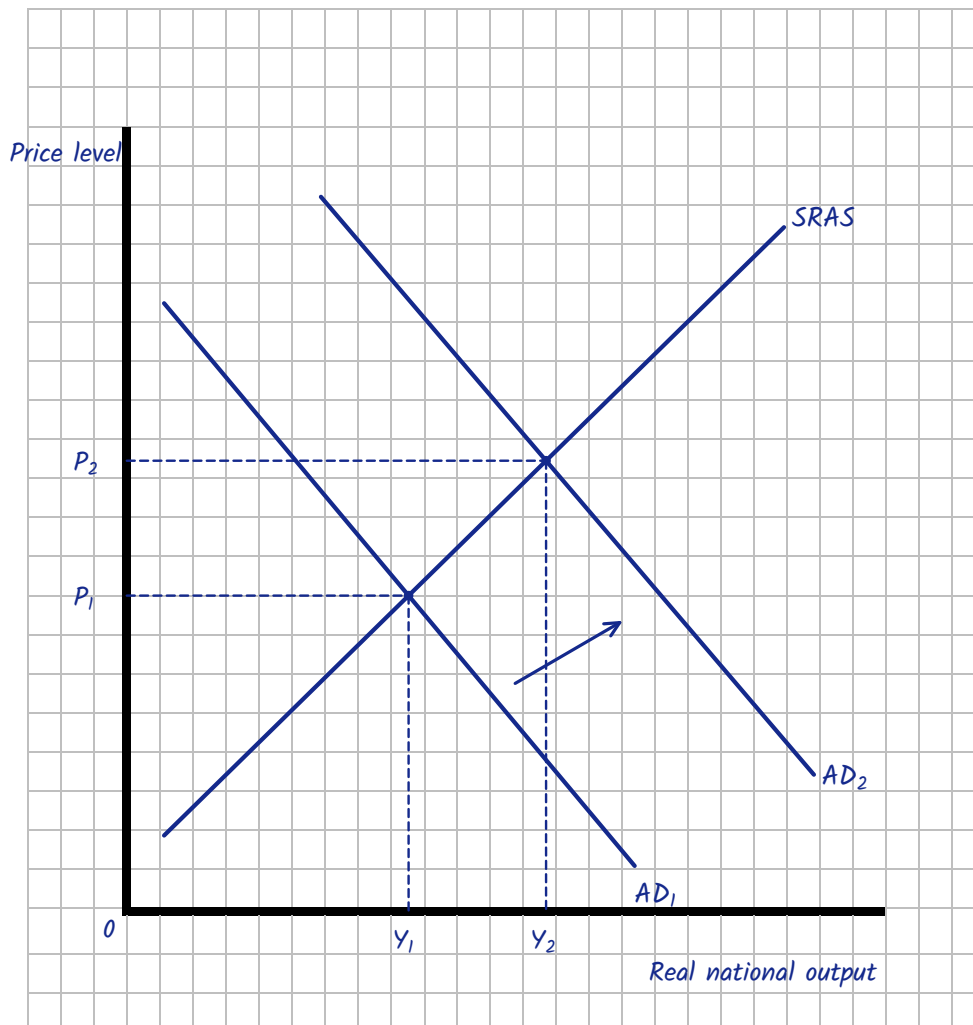
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3 0

Extract E (lines 4–6) states: ‘Recent favourable trade balances, such as the £8.2 billion surplus achieved in the 12 months to October 2020, have largely been overlooked.’

Draw an AD/AS diagram to show the effect of an improvement in the balance of trade in goods and services on real national income and the price level in an economy.

[4 marks]

Higher net exports ($X - M$) increase AD, so AD shifts right from AD_1 to AD_2 : real national income rises from Y_1 to Y_2 and the price level rises from P_1 to P_2 .



3 1

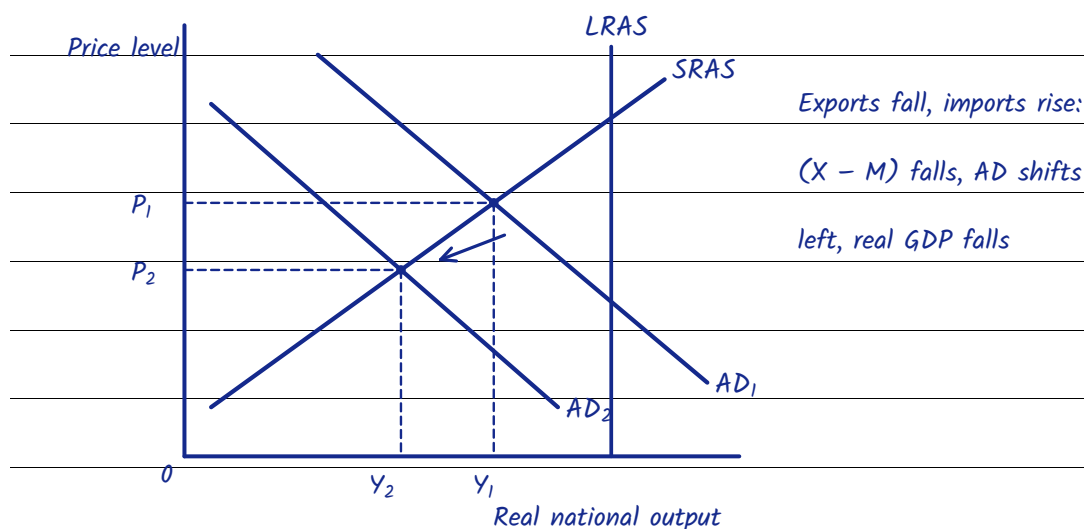
Extract F (lines 1–2) states: ‘Many economists believe that the trade balance reflects the strength or weakness of a country’s international competitiveness’.

Explain how a fall in a country’s international competitiveness may affect economic growth in the economy.

[10 marks]

International competitiveness is the ability of a country's firms to sell their goods and services at home and abroad, in terms of price and quality (Extract F). Economic growth is an increase in real GDP: short-run growth uses up spare capacity, while long-run growth is an increase in the economy's productive potential.

A fall in competitiveness, for example because UK inflation or unit labour costs rise faster than abroad, the pound appreciates, or product quality falls behind, makes UK exports relatively dearer or less attractive and imports relatively cheaper. Foreign demand for UK exports falls and UK consumers switch to imports, so net exports ($X - M$) fall and the trade balance worsens. Since $AD = C + I + G + (X - M)$, AD shifts left from AD_1 to AD_2 , as shown in the diagram, and real output falls from Y_1 to Y_2 , so short-run growth slows or becomes negative.



This fall is magnified by the multiplier. Exporting firms cut output and lay off workers, so incomes fall and these workers spend less, reducing demand for

Turn over ►



Extra space *other firms. Rising unemployment and falling confidence reduce consumption further, so the final fall in real GDP is larger than the initial fall in net exports. Extract E makes the reverse point, that rising exports bring a positive multiplier effect.*

Long-run growth may also suffer. With spare capacity and falling sales, firms are less confident and, through the accelerator, investment falls as output growth slows. Less investment in new capital, technology and research reduces productivity growth, so LRAS grows more slowly. Long-term unemployment also erodes workers' skills, reducing productive potential, which can create a vicious circle in which lower productivity reduces competitiveness further.

However, the size of the effect depends on how open the economy is and on the price elasticity of demand for exports and imports. If the trade deficit causes the pound to depreciate, export prices fall again, partly offsetting the effect, and strong growth in trading partners may keep demand for UK exports high.



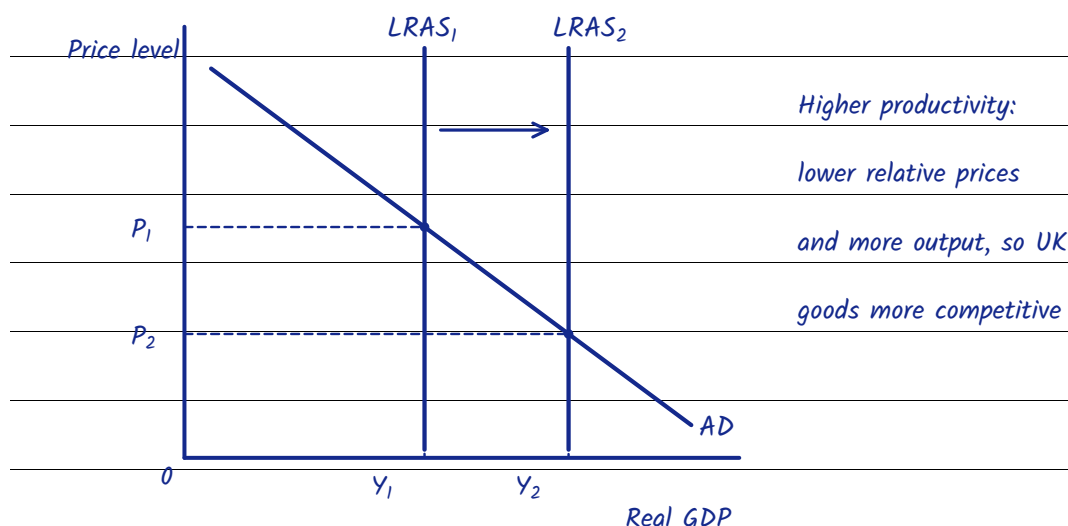
3 2

Extract F (lines 6–7) states: ‘However, there is a great deal that can be done to improve the balance of trade in goods and services.’

Use the extracts and your knowledge of economics to evaluate policies that may be used to achieve a sustained improvement in the UK’s balance of trade in goods and services.

[25 marks]

The balance of trade in goods and services is the value of exports minus the value of imports of goods and services, and it is the largest part of the current account of the balance of payments. The UK usually runs a trade deficit: Extract D shows it was always in deficit before June 2019, reaching £7900m in February 2019, though there was an £8.2bn surplus in the 12 months to October 2020 (Extract E). A sustained improvement is one that lasts, rather than a temporary change caused by the economic cycle.



Contractionary fiscal or monetary policy, such as higher income tax, lower government spending or higher interest rates, reduces AD and real incomes. As the UK has a high marginal propensity to import, spending on imports falls, and lower inflation makes UK goods more price competitive. However, this is a costly approach: lower AD reduces growth and raises unemployment. Extract E shows this: the goods deficit improved in the year to July 2020 not because exports rose, but because imports fell by more than exports as the pandemic cut demand. As the recovery gets underway, the balance may deteriorate again,

Turn over ►



so the improvement is not sustained.

A second approach is to lower the exchange rate, for example by cutting interest rates, which reduces hot money inflows so sterling depreciates. UK exports become cheaper in foreign currency and imports dearer in pounds, so if the Marshall-Lerner condition holds (the price elasticities of demand for exports and imports sum to more than one) the trade balance improves, though the J-curve means it may worsen at first. However, dearer imported raw materials and fuel cause cost-push inflation, which erodes the competitive gain over time, and the UK has limited control over a floating exchange rate. So depreciation tends to give only a temporary improvement.

A third option is protectionism, such as tariffs or quotas, which raise import prices and cut the quantity imported, improving the balance quickly. However, the UK is bound by trade agreements such as the UK-EU deal, and tariffs invite retaliation against UK exports. Protection also removes the pressure on domestic firms to become efficient and raises costs for consumers and for firms using imported components, so it does not improve competitiveness and is unlikely to give a sustained improvement.

The most likely route to a sustained improvement is supply-side policy that improves price and non-price competitiveness (Extract F). Cuts in corporation tax and industrial policy provide incentives for exporting firms to increase investment, raising productivity. Better-targeted spending on education and training improves human capital, so highly skilled workers produce 'cutting-edge, high-quality goods and services' sought after globally (Extract F). As shown in the diagram, LRAS shifts right from $LRAS_1$ to $LRAS_2$; the price level falls from P_1 to P_2 relative to other countries and real GDP rises from Y_1 to Y_2 . Exports rise and consumers buy fewer imports, so the trade balance improves without sacrificing growth or jobs. This matters for the UK,



Extra space *whose comparative advantage lies in high-value services such as finance, where quality matters more than price.*

However, supply-side policies have drawbacks. Time lags are long, as training takes years to raise productivity. They are costly: lower corporation tax and higher spending worsen the budget position when the deficit and national debt were already rising. Firms may use tax cuts to pay dividends rather than invest, and grants may back the wrong industries (government failure). Higher incomes from growth may also suck in more imports.

Any policy also depends on factors beyond the government's control (Extract F), such as exchange rate fluctuations and economic activity in other economies: if trading partners are in recession, export demand stays weak whatever the policy. Spare capacity matters too: cutting AD in a recession, as in 2020, would cause heavy job losses, while a depreciation near full capacity would mainly cause inflation.

The best policy also depends on whether the deficit is cyclical or structural: a cyclical deficit will correct itself as the economic cycle changes, but a structural deficit caused by weak competitiveness needs supply-side reform.

In conclusion, demand-side policies and depreciation can improve the trade balance in the short run, but the improvement is unlikely to last and costs growth, jobs or low inflation. The best policy for a sustained improvement is supply-side policy, because it tackles the root cause of the deficit, weak international competitiveness, and also supports long-run growth. Since it works slowly, it could be combined with a competitive exchange rate and low inflation in the short run, while firms play their part by being innovative and raising productivity (Extract F).

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