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General Certificate of Education

2018

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# Economics

Assessment Unit A2 2

*assessing*

Managing the Economy in a Global World



AEC21

[AEC21]

**TUESDAY 12 JUNE, AFTERNOON**

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## TIME

2 hours.

## INSTRUCTIONS TO CANDIDATES

Write your Centre Number and Candidate Number on the Answer Booklet provided.  
Answer **all** questions in Section **A** and **B** and **one** question in Section **C**.

## INFORMATION FOR CANDIDATES

The total mark for this paper is 90.

- Section A: 20 marks
- Section B: 40 marks
- Section C: 30 marks

Figures in brackets printed down the right-hand side of pages indicate the marks awarded to each question or part question.

## ADVICE TO CANDIDATES

You are advised to take account of the marks for each part question in allocating the available examination time. In questions involving calculations, you are advised to show your workings. Quality of written communication will be assessed in Questions **3**, **4 (b)**, **(c)** and **(d)**, **5** and **6**. Quantitative skills will be assessed where appropriate.

## Section A

### Answer all questions (20 marks)

- 1 The table below shows outputs of computers and slaughtered beef cattle in two countries when each country allocates exactly half of its resources to each type of output.

A computer and a tonne of beef are of equal value in world markets.

| Country | Computers   | Beef (tonnes) |
|---------|-------------|---------------|
| Carniva | 200 million | 300 million   |
| Tronica | 400 million | 200 million   |

- (a) Using the information in the table above, explain what is meant by “absolute advantage”. [2]
- (b) Using the information in the table above, explain how both countries could benefit by specialisation and trade. [5]

- 2 Domestic demand and supply schedules for microwave ovens in a particular country are illustrated in the table below.

| Price (\$) | Quantity demanded domestically (000s) | Quantity supplied domestically (000s) |
|------------|---------------------------------------|---------------------------------------|
| 60         | 1500                                  | 100                                   |
| 100        | 1300                                  | 300                                   |
| 140        | 1100                                  | 500                                   |
| 180        | 900                                   | 700                                   |
| 220        | 700                                   | 900                                   |

There has been no government intervention in the market, so microwave ovens have been selling within the country at the world price of \$100. Domestic output accounted for less than 25% of total sales, prompting the government to introduce a specific tariff of \$40 per microwave oven.

- (a) Calculate the revenue which this tariff will raise for the country’s government. [2]
- (b) With the aid of a diagram, analyse the impact of this tariff on community surplus in the country. [5]

- 3 A country's government is worried about a long-term deficit on the balance of payments on the current account. A few months ago, it began implementing policies to try to reduce the exchange value of its currency. The value of the trade-weighted exchange rate index of the country's currency (base 2008 = 100) has reduced from 97.00 to 87.30. In the same time period, imports into the country have fallen by 4%, and the country's exports have risen by 4%.

Assume that there are no other changes.

With reference to the Marshall-Lerner condition, analyse whether the government's policy is achieving its objectives in the short term. [6]

## Section B

### Answer all questions (40 marks)

The case study which follows was compiled in August 2016.  
Read the articles carefully and answer the questions which follow.

#### Case study: “Interesting Times”

##### Source 1: Fears of deflation spark unprecedented measures

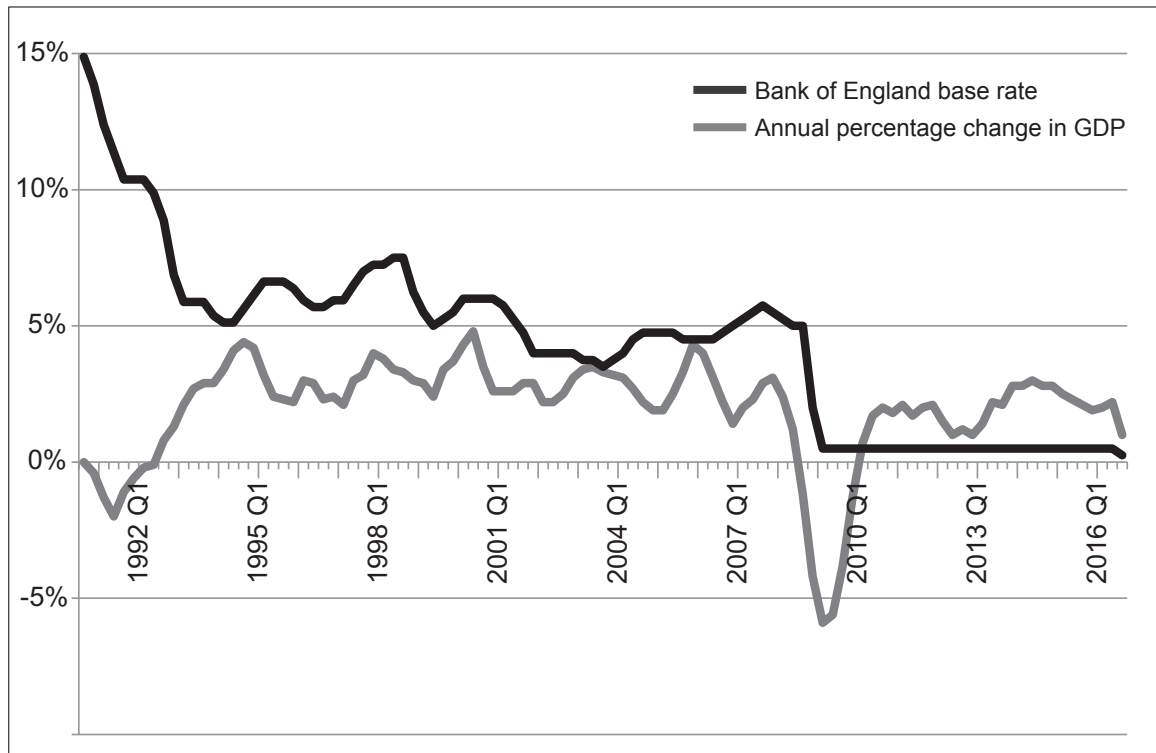


Fig. 1: Bank of England interest rate and annual change in GDP (1990–2016)

On 4 August 2016, the Bank of England reduced its base lending rate to a new record low level of 0.25%. Just over a quarter of a century earlier, that rate was 14.875%! Economic conditions and problems faced by policy-makers have changed considerably since the banking crisis of 2008–9. Mark Carney, Governor of the Bank of England, warned high-street lenders they must pass on cheaper borrowing costs to customers as part of a bigger-than-expected package of measures designed to prevent a post-Brexit recession. The Bank indicated that interest rates could be reduced further in coming months as the economic fallout from the vote to leave the EU becomes clearer. It had been forecasting slower growth in earnings and 250 000 job losses, even with these stimulus measures. Early economic indicators suggested that confidence among businesses and households slumped after the June referendum and that a slowdown in spending threatened to tip the UK into recession. Mr Carney rebuffed suggestions that the Bank was over-reacting to the Brexit vote. “There is a clear case for stimulus, and stimulus now, in order to have an effect when the economy really needs it,” he said.

## Source 2: HM Treasury ready to be more flexible

The Bank's intervention to shore up confidence was backed by the Chancellor of the Exchequer, Philip Hammond. He also responded to assertions from Mr Carney and others that monetary policy had limited power to solve Britain's economic problems. "Alongside the actions the Bank is taking," he stated, "I am prepared to take any necessary steps to support the economy and promote confidence."

Markets are notoriously fickle, and the "liquidity trap" identified by John Maynard Keynes may result in growth being less than these measures are aiming for. The Bank's Monetary Policy Committee (MPC), chaired by the Governor, would almost certainly support a further interest rate cut, potentially taking official borrowing costs to as low as 0.1%, although Mr Carney said he was strongly opposed to negative interest rates.

The European Central Bank's introduction of charges to commercial banks for holding their cash was not a solution for stagnation in the Eurozone, and the Bank of Japan's introduction of negative rates in early 2016 had consequences scarcely anyone would have predicted. Instead of speculators selling the yen and triggering a beneficial depreciation of the Japanese currency, global uncertainties encouraged investors in Japan and abroad to invest in safe Japanese government bonds, despite their negative yield. The value of the yen on international currency markets actually rose, and the stimulus the Japanese monetary authorities were counting on did not happen!

The MPC was not unanimous in endorsing all the measures, which also included:

- plans to pump an additional £60bn in electronic cash into the economy to buy government bonds, extending the existing quantitative easing (QE) programme to £435bn in total;
- another £10bn in electronic cash to buy corporate bonds from firms "making a material contribution to the UK economy";
- as much as £100bn of new funding to banks to help them pass on the base rate cut. Under this new "term funding scheme", the Bank will create new money to provide loans to banks at interest rates close to the base rate of 0.25%. Banks which do not re-lend would be penalised.

The pound fell sharply against the dollar and euro after the Bank's announcement but the FTSE 100 share index rallied. Matthew Whittaker, economist at the Resolution Foundation think-tank, commented: "On the severe near-term economic cooling associated with the post-referendum uncertainty, the Bank can help. Longer-term, our economic performance rests on the post-Brexit picture on trade, competition and – crucially – productivity. Influencing those outcomes largely rests with politicians, not central bankers."

### Source 3: Is the future dark – or just cloudy?

Philip Hammond's statement of intent was welcome to many who had argued that the policies of "austerity" followed by his predecessor, George Osborne, were unfair, divisive and inappropriate. The Treasury's reliance on monetary policy had been criticised as "obsessive". Mr Osborne's target of reaching a budget surplus by 2020 was dropped when Theresa May became Prime Minister.

David Farrow of the pressure group "Dikenomika" compared the national government to cautious companies in the private sector, which are afraid to borrow funds in difficult times, and end up with a more crippling ratio of debt to income than buoyant enterprises, which thrive by adopting bold strategies.

Doubts about expansionary monetary policy are not new. Economists generally agree that monetary policies can work to "pull down" the level of aggregate demand in an economy, but there is less agreement on their suitability for "pushing" aggregate demand upwards.

Ian MacParton, of the Pairat Investment Consultancy, told a conference of financial advisers: "We don't know how much worse things might be if the Bank of England had done nothing in 2009. We don't know if banks will find people who actually want to borrow, or if they might use their funds from sale of bonds to speculate outside the UK. It's even possible that quantitative easing might lead to a new asset price bubble, further increasing problems of inequality in the UK. The killer", he concluded, "is that we can't tell the future. If small firms and householders could be sure of markets and jobs, agonising about economic policy would be irrelevant!" Delegates at the conference upheld a motion declaring that the government's monetary policy was not working according to plan and needed to be replaced by a raft of tax cuts and subsidies for industrial investment.

- 4 (a) Compare the trends in the Bank of England's interest rate and rate of change in GDP between 1990 and 2016 shown in **Fig. 1**. [4]
- (b) Analyse the possible consequences to the UK economy of the cut in the Bank of England's base lending rate to 0.25% in August 2016. [9]
- (c) Examine why the result of the referendum on Britain's withdrawal from the European Union might have led monetary authorities to expect negative consequences for the UK economy. [12]
- (d) Evaluate the idea expressed in **Source 3** that expansionary monetary policy was not working and needed to be replaced by a package of fiscal measures. [15]

## Section C

### Answer one question (30 marks)

- 5** In 2015, the UK's deficit on the current account of the balance of payments was 5.4% of UK GDP, one of the highest figures on record. At the same time, figures published by the Office for National Statistics showed that 54% of the shares in British companies were in foreign ownership. Despite these figures, very few economists have been calling on the government to take action to reduce the current account deficit.

Critically examine the view that there is no need for concern about the UK's deficit on the current account of the balance of payments. [30]

- 6** Recent research suggests that there is little, if any, positive link between levels of foreign aid and economic growth in Less Developed Countries. Some of the fiercest critics of foreign aid programmes go as far as arguing that the main beneficiaries of foreign aid are the donor countries themselves. They argue that the only way to truly promote development is to change the rules regarding international trade.

Critically examine the opinion that financial aid is neither necessary nor sufficient to generate economic development in less prosperous countries. [30]

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**THIS IS THE END OF THE QUESTION PAPER**

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## Sources

Source 1.....© Guardian News & Media Ltd 2019

Fig. 1.....© Bank of England and © Office for National Statistics. All content is available under the Open Government Licence v3.0

Source 2.....© Guardian News & Media Ltd 2019

Source 3.....Source 1: Reference from: OECD calls for less austerity and more public investment by Larry Elliott, Economics Editor.  
Published by The Guardian, 18 February 2016.

<https://www.theguardian.com/business/2016/feb/18/oecd-calls-for-less-austerity-and-more-public-investment>

Source 2: Reference from: Osborne abandons 2020 budget surplus target. Published by BBC News, 01 July 2016

<https://www.bbc.co.uk/news/business-36684452>

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|                |                                                                                |
|----------------|--------------------------------------------------------------------------------|
| Surname        | <i>StemUp Model Solution</i>                                                   |
| Answer booklet | Write the question number in the left-hand margin at the start of each answer. |

Question  
number

1 (a)

*A country has an absolute advantage in a good when it can produce more of that good than another country using the same quantity of resources, i.e. it produces it more efficiently. With half their resources each, Carniva produces 300 million tonnes of beef compared with Tronica's 200 million, so Carniva has the absolute advantage in beef, while Tronica produces 400 million computers compared with 200 million, so Tronica has the absolute advantage in computers.*

1 (b)

*Opportunity costs: in Carniva 1 computer costs  $300/200 = 1.5$  tonnes of beef (1 tonne of beef costs  $\frac{2}{3}$  of a computer). In Tronica 1 computer costs  $200/400 = 0.5$  tonnes of beef (1 tonne of beef costs 2 computers). Carniva has the comparative advantage in beef and Tronica in computers.*

*If each country specialises fully, Carniva produces 600 million tonnes of beef and Tronica 800 million computers. Total output of computers rises from 600m to 800m and beef from 500m to 600m tonnes, so world output gains 200m computers and 100m tonnes of beef.*

*They then trade at the world rate of 1 computer = 1 tonne of beef, which lies between the two domestic opportunity cost ratios. Suppose Carniva exports 250m tonnes of beef in return for 250m computers. Carniva consumes 250m computers and 350m tonnes of beef (gains of +25.0% and +16.7%), and Tronica consumes 550m computers and 250m tonnes of beef (gains of +37.5% and +25.0%).*

*Carniva now obtains a computer for 1 tonne of beef instead of 1.5, and Tronica obtains a tonne of beef for 1 computer instead of 2. Both countries consume beyond their own production possibility frontiers, so both benefit from specialisation and trade.*

2 (a)

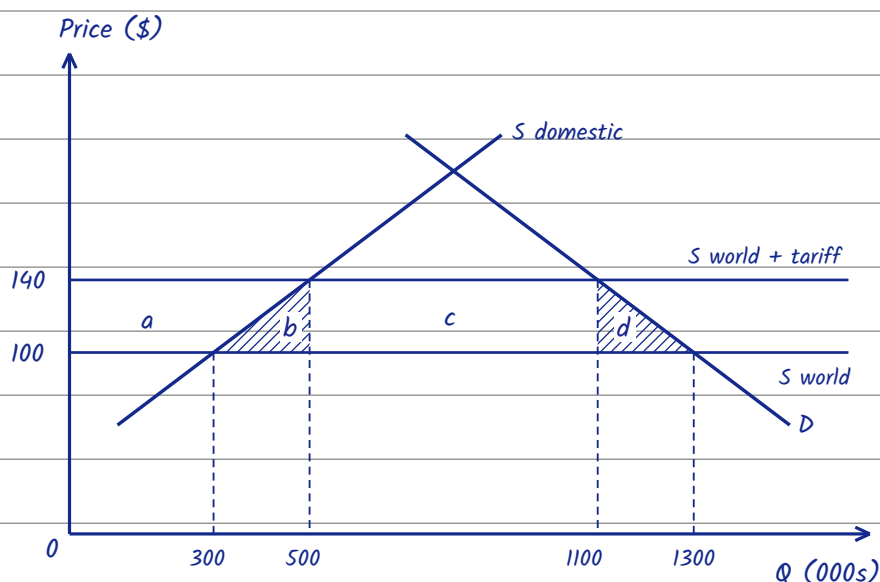
At the tariff-inclusive price of  $\$100 + \$40 = \$140$ : quantity demanded = 1100 000, domestic supply = 500 000

Imports =  $1100\ 000 - 500\ 000 = 600\ 000$  ovens

Tariff revenue =  $600\ 000 \times \$40 = \$24$  million

2 (b)

Community surplus is the sum of consumer surplus and producer surplus (plus any government revenue) in a market. Before the tariff, ovens sell at the world price of  $\$100$ : domestic demand is 1300 000, domestic firms supply 300 000 and 1000 000 are imported. The  $\$40$  specific tariff raises the domestic price to  $\$140$ .



$a$  = gain in PS,  $c$  = tariff revenue,  $b + d$  = net welfare loss

As the diagram shows, consumption contracts to 1100 000 and domestic output expands to 500 000, so imports fall to 600 000. Consumer surplus falls by  $a + b + c + d = 40 \times (1300\ 000 + 1100\ 000) \div 2 = \$48$ m. Domestic producers gain producer surplus  $a = 40 \times (300\ 000 + 500\ 000) \div 2 = \$16$ m, and the government gains tariff revenue  $c = \$24$ m.

The remaining areas  $b$  and  $d$  are a net welfare loss:  $b$  ( $\$4$ m) is the production inefficiency of less efficient domestic firms producing 200 000 ovens that could be imported more cheaply, and  $d$  ( $\$4$ m) is the consumption loss from 200 000 ovens no longer bought. Community surplus therefore falls by  $\$48$ m -  $\$16$ m -

$\$24m = \$8m$ , a deadweight loss, and part of the gain to producers is simply a transfer from consumers.

3

The Marshall-Lerner condition states that a depreciation (or devaluation) of a currency will only improve the balance of payments on current account if the sum of the price elasticities of demand for exports and imports is greater than 1 (ignoring the minus signs).

The trade-weighted index fell from 97.00 to 87.30, a fall of  $9.70 \div 97.00 \times 100 = 10\%$ . So, roughly, export prices in foreign currency fall by 10% and import prices in domestic currency rise by 10%.

PED for imports =  $-4\% \div +10\% = -0.4$ . PED for exports =  $+4\% \div -10\% = -0.4$ . Sum =  $0.4 + 0.4 = 0.8$ , which is less than 1, so the Marshall-Lerner condition is not met.

This means that demand for both imports and exports is price inelastic. Export volumes rise by only 4% while each unit earns 10% less foreign currency, so export earnings in foreign currency fall ( $1.04 \times 0.9 = 0.936$ , about  $-6.4\%$ ).

Import volumes fall by only 4% while each import costs 10% more, so import spending in domestic currency rises ( $0.96 \times 1.1 = 1.056$ , about  $+5.6\%$ ). Since the country already imports more than it exports, the gap widens and the current account deficit worsens.

So in the short term the policy is not achieving its objective. This is consistent with the J-curve: contracts are fixed, and consumers and firms take time to find substitutes, so elasticities are low at first. Over time elasticities usually rise and the condition may be met, so the deficit may improve later, but the weaker currency also raises import prices and so the risk of cost-push inflation in the meantime.

4 (a)

Both variables trend downwards over the period, but much more strongly for the base rate. The base rate falls from 14.875% in 1990 to about 6% by 1993, then fluctuates between about 3.5% and 7.5% until 2008. GDP growth is

negative at first (about -2% in 1991) but recovers as rates are cut, then fluctuates between about 2% and 4.5%.

From 1990 to 2007 there is a broadly inverse relationship with a time lag: cuts in the base rate are followed by faster growth and rises in the rate by slower growth. In 2008 to 2009 the rate was cut sharply from 5% to 0.5% while GDP fell to -5.9% in 2009 Q1. After 2009 there is no clear relationship: the rate is held at 0.5% (cut to 0.25% in 2016) while growth fluctuates around 2%, between about 1% and 2.8%.

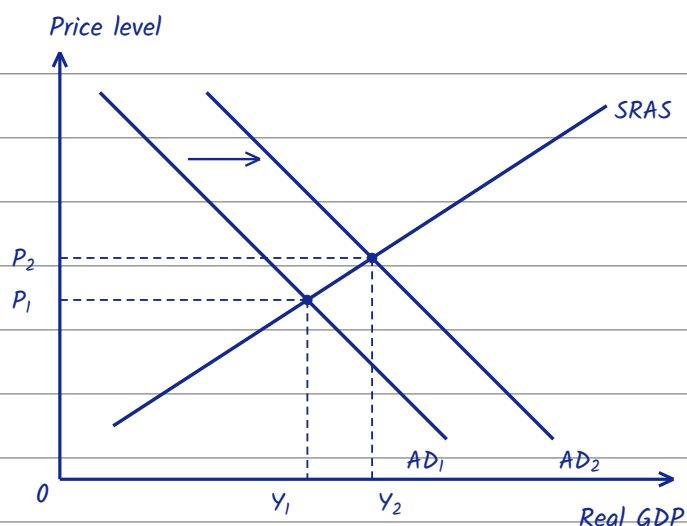
4 (b)

The base rate is the rate at which the Bank of England lends to commercial banks, and a cut to 0.25% has a knock-on effect on all other interest rates in the economy, such as mortgage, loan and savings rates. The Bank intends this expansionary monetary policy to raise aggregate demand ( $AD = C + I + G + X - M$ ) and prevent a post-Brexit recession.

Consumption: the reward for saving falls and the cost of borrowing falls, so households are less inclined to hold low-yielding savings and more inclined to borrow to fund consumption, especially of durables bought on credit. Households with variable-rate mortgages have lower monthly repayments and more disposable income, although most new mortgages are now fixed-rate, which weakens this effect. Lower rates also raise asset prices such as houses and shares (the FTSE 100 rallied), creating a positive wealth effect.

Investment: with a lower cost of borrowing, firms expect a better return relative to cost on investment projects, so investment rises. Commercial banks earn less on funds held at the Bank, so they should be more willing to lend, helped by the £100bn term funding scheme.

Exchange rate: speculators move hot money out of the UK to economies with higher returns, increasing the supply of pounds, so sterling depreciates, as it fell sharply against the dollar and euro. Exports become cheaper and imports, including foreign holidays, dearer, so net exports may rise and the current account may improve if the Marshall-Lerner condition holds.



As the diagram shows, higher  $C$ ,  $I$  and  $(X - M)$  shift AD right from  $AD_1$  to  $AD_2$ . Real GDP rises from  $Y_1$  to  $Y_2$ , boosted by the multiplier, so the 250 000 forecast job losses may be reduced.

However, the price level rises from  $P_1$  to  $P_2$ , and dearer imports add cost-push inflation. Savers and pensioners who rely on interest income lose out relative to borrowers. Lower bond yields increase pension fund deficits, so firms with pension schemes may cut costs elsewhere, possibly by laying off staff. Very cheap credit could also encourage excessive household debt and asset price bubbles. Finally, with rates already at 0.5%, a 0.25 point cut may have little effect if confidence is low (a liquidity trap), so the size of the impact is uncertain.

4 (c)

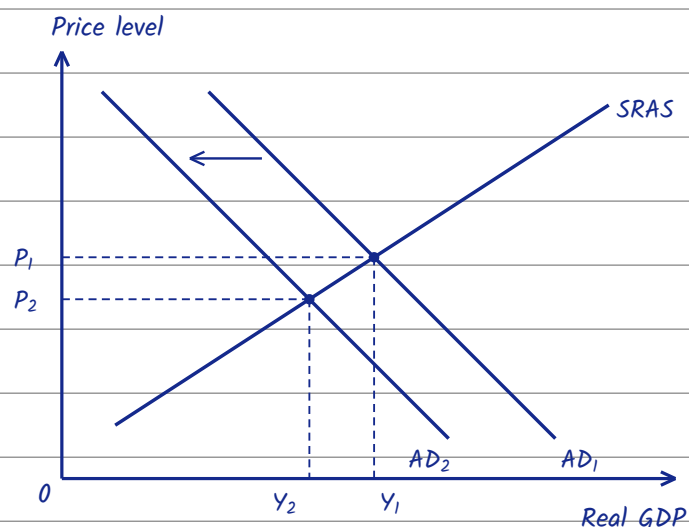
The monetary authorities expected the vote to leave the EU in June 2016 to reduce aggregate demand and growth, which is why the Bank forecast slower earnings growth and 250 000 job losses even with stimulus.

Uncertainty and confidence: many economic agents felt the government had not planned for a Brexit vote, and nobody knew what the future trading relationship with the EU would be. Source 1 states that confidence among businesses and households slumped after the referendum. Firms postpone investment when expected returns are uncertain, and households save more and delay big purchases, so  $C$  and  $I$  fall and, through the multiplier, AD falls by more than

the initial cut in spending.

Trade: the EU is the UK's largest export market. The possibility of tariffs and non-tariff barriers would reduce the exports component of AD, especially for manufacturing and financial services. Even if trade continued on favourable terms, slower growth in Europe could still reduce total trade volumes.

FDI and migration: there were fears, although disputed, that foreign firms would reduce investment in the UK or relocate branches to the EU to keep access to the single market, which would reduce investment, jobs and long-run productive capacity. Lower migration could cause labour shortages in sectors such as agriculture and health, shifting LRAS left.



As the diagram shows, falling  $C$ ,  $I$  and  $X$  shift AD left from  $AD_1$  to  $AD_2$ , so real GDP falls from  $Y_1$  to  $Y_2$ , risking recession and rising unemployment.

Sterling: the pound fell sharply, especially against the dollar and euro, the two most important currencies in the trade-weighted index. This raises the cost of imported raw materials and food, causing cost-push inflation that squeezes real incomes and further hits consumer confidence.

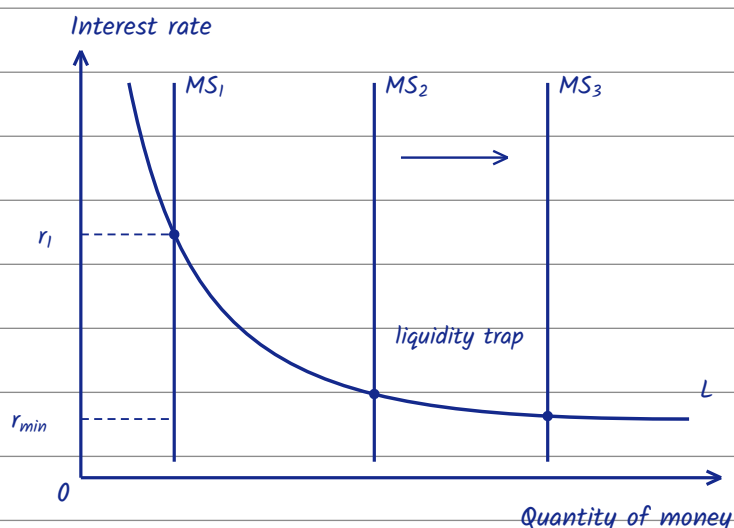
Context: UK growth had been slow since the banking crisis, at around 2% (Fig. 1), with the Eurozone stagnating, and the base rate had been at 0.5% since 2009, so there was little room to respond to a shock. Neo-classical economists see any shock as destabilising.

However, these were expectations rather than certainties. The initial fall in share prices was not catastrophic: the FTSE 100 rallied because many of its largest firms earn revenue abroad and gain from a weaker pound, which also made exports more competitive. The size of the negative effects depended on the eventual trade deal and how long uncertainty lasted, so the authorities were right to act cautiously but the long-term effects were genuinely unknown.

4 (d)

Expansionary monetary policy involves cutting interest rates and increasing the money supply, for example through quantitative easing (QE), where the Bank creates electronic money to buy bonds. Fiscal policy uses government spending and taxation, so the motion in Source 3 calls for tax cuts and subsidies for industrial investment, which would increase the budget deficit.

Arguments that monetary policy was not working. Keynes's liquidity trap (Source 2) suggests that when interest rates are already very low, further cuts have little effect because people expect rates to rise and simply hold extra money rather than spend it.



As the diagram shows, increasing the money supply from  $MS_2$  to  $MS_3$  leaves the interest rate at its floor, so spending does not rise. Expectations matter more than the interest rate: if households and firms cannot be sure of markets and jobs (MacParton), they will not borrow. The weight of expert opinion is

significant; even Mr Carney accepts that monetary policy has limited power, and Source 3 notes it can pull AD down more easily than push it up.

Evidence supports this. After 2009 the base rate stayed at 0.5% for seven years, yet growth was only about 2% (Fig. 1). The Bank of Japan's negative rates caused the yen to rise and the expected stimulus did not happen, and ECB charges did not end Eurozone stagnation. Banks have not significantly increased lending, and some question why the institutions that caused the crisis should be trusted to lead the recovery; they may use funds to speculate abroad. QE raises bond, share and house prices, so most of the gains go to wealthier households, who have a lower marginal propensity to consume, increasing inequality and risking asset price bubbles.

Arguments for fiscal measures. When monetary policy is least effective, interest rates are low, so it is cheap for the government to borrow and fiscal measures are less risky. Government spending enters AD directly, and investment subsidies could raise both AD and LRAS by improving the capital stock and productivity, which Whittaker says determine long-term performance. Farrow argues that bold borrowing in difficult times can lower the debt to income ratio if it generates growth, as austerity may have slowed recovery.

Counter-arguments. Fig. 1 shows that rate cuts from high levels in the early 1990s were followed by real growth, and holding the rate at 0.5% may have kept GDP growth stable and positive after 2009. We do not know how much worse things would have been without QE, so the claim that it 'was not working' cannot be verified. QE does not need to be funded by higher taxes or borrowing, whereas a larger deficit adds to the national debt, may reduce foreign confidence in the UK and raise borrowing costs, and interest payments may take a large share of GDP in future. Fiscal policy also has long time lags, tax cuts may be saved if confidence is low (Ricardian equivalence), and changes in the tax burden do not always work as Chancellors intend. The monetary package was also only introduced in August 2016, so it had not yet had time to work.

*Evaluation. Whether monetary policy should be replaced depends on the cause of the slowdown: if it is a confidence shock, neither policy may work quickly; if the real problem is weak productivity, supply-side policies are needed rather than demand management. It also depends on the size of the multiplier and the state of public finances, as UK debt was already about 80% of GDP.*

*On balance, the motion is right that monetary policy alone was losing effectiveness at near-zero rates, but wrong to say it should be replaced. The best approach is to use both: keep low rates and QE to support confidence and lending, while adding targeted fiscal stimulus, especially investment in infrastructure and skills, as Mr Hammond signalled. It is unwise for a government to restrict itself to only one kind of policy.*

6

*Financial aid is the voluntary transfer of resources, such as grants and concessional (soft) loans, from governments, multilateral bodies such as the World Bank, and NGOs to less developed countries (LDCs). It can be bilateral or multilateral, and tied (spent on the donor's goods or services) or untied.*

*Economic development is a broader concept than growth: it is an improvement in living standards and welfare, including health, education, life expectancy and freedom from poverty, measured for example by the HDI. Aid would be necessary if development could not happen without it, and sufficient if aid on its own guaranteed development.*

*The case for aid. Many LDCs are caught in a poverty cycle: low incomes mean low savings, low investment and so low growth. The Harrod-Domar model shows that  $\text{growth} = \text{savings ratio} \div \text{capital-output ratio}$ , so aid can fill the savings gap and the foreign exchange gap, funding investment in infrastructure, schools and clinics. Aid has helped to raise agricultural productivity through training, and has funded vaccination programmes that have greatly reduced child mortality.*

*Much aid channelled through NGOs funds beneficial, well-targeted projects.*

*Emergency aid after natural disasters or famine may be a humanitarian duty, and not all governments in LDCs are corrupt. Raising living standards in LDCs*

may also ease migration pressures in more developed countries (MDCs).

Why aid may not be sufficient. Recent research suggests little, if any, positive link between aid and growth. Africa has received over \$500 billion of aid, yet many nations remain mired in poverty. Aid may be stolen by corrupt officials, insurgents or paramilitary groups before it reaches those in need. Donors may misunderstand where need is greatest, or cultural and religious differences may stop aid programmes working as intended. Emergency aid can be wasted, for example perishable food may rot if there are no roads to distribute it. Aid can create dependency, reduce the incentive for governments to raise taxes and reform, and cause a Dutch disease effect, where large inflows raise the real exchange rate and make exports less competitive.

Aid may also mainly benefit donors, as the critics argue. Tied aid means contracts must go to firms in the donor country, so far less wealth is created in the recipient. Aid may carry a hidden military, ideological or commercial agenda, and conditions may force inappropriate policies or systems on LDCs which are even less efficient locally. Policies are often contradictory: projects fail because MDCs keep tariffs and subsidies, such as EU and US farm subsidies, which depress world prices for LDC exports.

Why aid may not be necessary: the case for trade. According to the theory of comparative advantage, if LDCs specialise in goods they produce at the lowest opportunity cost and trade freely, world output rises and they gain from trade. Export revenue provides foreign exchange, jobs and economies of scale without debt or dependency. The potential gains from genuine trade liberalisation, such as removing MDC tariffs and agricultural subsidies, far exceed the aid budgets of donors. China, India and Thailand developed rapidly through export-led growth, FDI and market reforms, with aid playing little or no part. This suggests that aid is not necessary: 'trade not aid'.

However, trade is not a perfect alternative. The poorest African countries may lack a comparative advantage in anything except primary products, which face volatile prices, low income elasticity of demand and declining terms of trade

(Prebisch-Singer). Formal trade deals on unequal terms may retard development, and removing protection may destroy infant industries before they can grow.

Landlocked countries with poor infrastructure, low skills and weak institutions cannot easily take advantage of trade without investment that may need aid.

Trade benefits may also go mainly to multinationals and elites, so growth may not reduce poverty or inequality.

Evaluation. Whether aid is necessary depends on the country. For middle-income economies with access to capital markets and FDI, such as China and India, aid is not necessary. For the least developed countries, conflict-affected states and those hit by disasters, aid may be necessary because domestic savings and private investment are too low. It also depends on the type of aid: untied, well-targeted aid for health, education and infrastructure delivered through NGOs is far more effective than tied loans that add to debt. Aid is clearly not sufficient on its own: its success depends on good governance, stable institutions, the absence of conflict and complementary policies such as fair trade rules and debt relief.

In conclusion, the opinion is partly correct. Aid is not sufficient to generate development, and it may not always lead to development, but that does not make it unnecessary, particularly for emergency relief and the poorest countries.

Changing the rules of international trade, so that LDCs have fair access to MDC markets, is probably the most powerful long-run route to development, but its drawbacks mean it should be combined with aid that is sensitively adapted to the real needs of the countries receiving it, rather than replacing aid altogether.