Cambridge Assessment International Education

Cambridge International AS & A Level

ECONOMICS **9708/42**

Paper 4 Data Response and Essays **February/March 2021**

2 hours 15 minutes

4118171327

You must answer on the enclosed answer booklet.

You will need: Answer booklet (enclosed)

INSTRUCTIONS

- Answer **three** questions in total:
  - Section A: answer Question 1.
  - Section B: answer **two** questions.
- Follow the instructions on the front cover of the answer booklet. If you need additional answer paper, ask the invigilator for a continuation booklet.
- You may use a calculator.
- You may answer with reference to any economy you have studied where relevant to the question.

INFORMATION

- The total mark for this paper is 70.
- The number of marks for each question or part question is shown in brackets [ ].

This document has **4** pages.

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Section A

Answer this question.

1 Equality in markets and economic performance

Adam Smith's proposition that free markets organise economic resources for the benefit of everyone rests upon the even distribution of power between the market participants. Without that even distribution, the proposition fails.

The reality of markets today is that the distribution of power is uneven and the markets are exploited by the powerful for their own gain. Markets are imperfect.

These imperfections hinder economic equality. Economic equality is linked to economic power and requires ownership and control over economic resources. Concentration of economic power, particularly in the hands of large global companies can adversely affect local economies. For example, local business owners have to work longer hours to compete with giant corporations.

The growth in the power of large companies is a cause of inequality in the distribution of income and wealth. The companies have an ability to make high profits, to practise price discrimination and exploit consumers. This sometimes leads to regulation by governments. Consumer protection is usually the aim. Take-overs are monitored. Progressive taxes on high incomes are used. Social welfare, inheritance taxes and greater workers' rights all attempt to deal with excessive inequality.

However, it is also said that large companies contribute disproportionately more to a country's economic growth than smaller ones. Such companies are more productive, pay higher wages, enjoy higher profits and are more successful in international markets.

Therefore, differences in economic growth between countries, it is argued, could be linked to the difference in the number of large firms.

In Spain and Italy, firms are on average 40% smaller than those in Germany. Increasing the size of firms in Spain and Italy, it is said, is the key to improving their comparative economic growth.

Firms with more than 250 employees are only 5% of manufacturing firms in Spain and Italy. This compares with a much higher 11% of firms in Germany. The average firm size in Spain is 49.3 employees, and in Italy it is 42.7 employees. Both are lower than the average of 76.4 employees per firm in Germany.

Sources: adapted from www.euractiv.com and www.destatis.de

Table 1.1 shows GDP and inflation rates for Germany, Italy and Spain in 2017.

Table 1.1

	GDP growth rate (% p.a.)	Inflation (% p.a.)
Germany	2.2	1.7
Italy	1.5	1.3
Spain	3.1	2.0

Source: RSA Journal, Issue 1 2018

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(a) Explain what is meant by 'a free market organises economic resources for the benefit of everyone'. [4]

(b) Analyse why the article says that some markets are 'imperfect'. [4]

(c) Distinguish between equality and equity and use the information to give **two** examples of policy measures that might promote equality in the distribution of income. [4]

(d) Some argue that large firms are beneficial. Consider whether the evidence in the information supports their opinion. [8]

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Section B

Answer **two** questions.

2 'Smoking cigarettes causes negative externalities and negative externalities cause market failure, which can only be solved by government intervention.'

To what extent do you agree with this statement? [25]

3 **(a)** 'A firm in a perfectly competitive market can make either a supernormal profit or a loss in the short run but will only make normal profit in the long run.'

Assess whether this statement is true. [12]

(b) Discuss the view that a firm operating in a perfectly competitive market will achieve economic efficiency but a monopoly firm will not. [13]

4 **(a)** Distinguish between transfer earnings and economic rent. With the help of diagrams, consider the links between transfer earnings, economic rent, the elasticity of supply of labour and an individual worker's wage rate. [12]

(b) 'Trade unions can gain an increase in wage levels only at the expense of higher levels of unemployment.'

To what extent do you agree with this statement? [13]

5 **(a)** Distinguish between productivity and the level of production and discuss why productivity is likely to be lower in a developing economy than in a developed economy. [12]

(b) 'Rising population levels in a developing economy create many problems while falling population levels in a developed economy cause even greater problems.'

To what extent do you think this is a true statement? [13]

6 Explain why an economy might be in equilibrium at less than a full employment level of output and critically evaluate alternative policy measures which might be used to move the economy to a full employment level of output. [25]

7 **(a)** 'Economic growth should be the most important macroeconomic aim.'

Discuss this view. [12]

(b) To what extent do you agree that it is not possible to solve a persistent balance of payments deficit without sacrificing other key macroeconomic aims? [13]

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

Question number

1(a) A free market is one in which the factors of production (land, labour, capital and enterprise) are organised by the price mechanism, without government intervention. Prices are determined by unrestricted competition between many buyers and sellers through the forces of supply and demand, and there are no imperfections, so no participant has the power to influence the price. Prices act as signals and incentives, so resources move to producing the goods consumers value most. This gives allocative efficiency (P = MC), which maximises society's welfare, so all participants, consumers and producers, benefit from the working of the market.

1(b) The article says markets are imperfect because power is not evenly distributed between the participants. There is a concentration of market power and control in the hands of very large global companies, so they become price makers rather than price takers. This allows them to make high (supernormal) profits, to practise price discrimination and to exploit consumers by charging prices above marginal cost. As a result rewards are unequal, which causes inequality in the distribution of income and wealth, and production and distribution are inefficient. Local economies also suffer: local business owners have to work longer hours to compete with the giant corporations. So the outcome does not benefit everyone.

1(c) Equality means everyone receives the same: an identical (or similar) distribution of income or wealth. Equity means fairness, a fair distribution of income or of opportunity. It is a normative concept, based on value judgements about what is fair, so it is harder to measure, and an equitable distribution need not be an equal one.

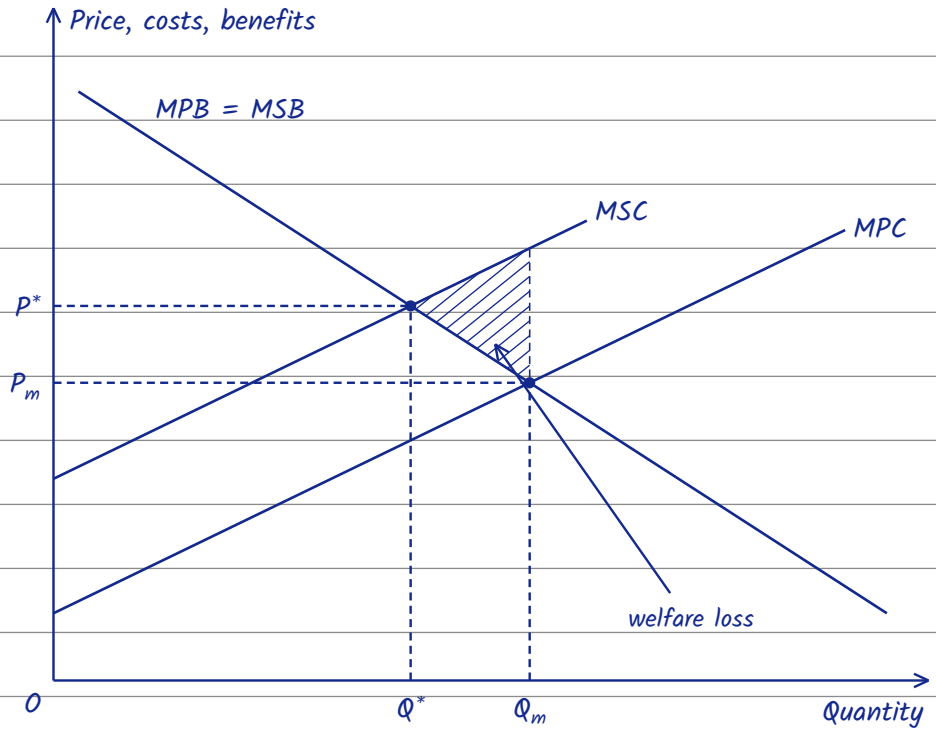
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	Two policy measures from the information: (1) progressive taxes on high incomes, where the average rate of tax rises as income rises, so the post-tax income of the rich falls by more; (2) social welfare payments (benefits) to low income households, which raise their disposable income. Inheritance taxes and greater workers' rights are also mentioned.
1(d)	The opinion is that large firms are beneficial because they are more productive, pay higher wages, enjoy higher profits and are more successful in international markets, so they contribute disproportionately to a country's economic growth. Higher productivity lowers average costs, and higher profits can fund investment and research, raising growth. Some evidence supports this. In Germany 11% of manufacturing firms have more than 250 employees, compared with only 5% in Spain and Italy, and the average German firm has 76.4 employees against 42.7 in Italy. Table 1.1 shows Italy had the smallest firms and the lowest GDP growth, 1.5%, below Germany's 2.2%. However, Spain contradicts it. Spain's firms are also about 40% smaller than Germany's (49.3 employees on average), yet Spain had the highest growth, 3.1% in 2017, though also the highest inflation, 2.0%. So firm size does not explain the growth differences. The evidence is also weak: only three countries and one year are given, correlation does not prove causation, and phrases such as 'it is said' and 'it is argued' show these are opinions rather than facts. The article also gives evidence that large firms are not beneficial: their concentrated power lets them practise price discrimination and exploit consumers, it adversely affects local economies, forces local businesses to work longer hours to compete, and is a cause of inequality of income and wealth. Overall, the evidence only partly supports the opinion: large firms may raise productivity and wages, but the data do not show a clear link with growth, and their market power has significant costs.

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2

An externality is a cost or benefit arising from production or consumption that affects a third party who is not directly involved in the transaction, and which is not reflected in the market price. A negative externality is an external cost, so the marginal social cost (MSC) is greater than the marginal private cost (MPC): MSC = MPC + marginal external cost.

Smoking cigarettes creates external costs. Non-smokers suffer from passive smoking, which damages their health; the state health service must treat smoking-related illnesses such as lung cancer and heart disease, paid for by all taxpayers; there is litter and a risk of fires; and firms lose output through sick days. Smokers ignore these costs when they decide how much to smoke, because they consider only the private cost (the price) and the private benefit. There is also information failure: smokers may underestimate the harm to themselves because the effects are long-term and nicotine is addictive, so cigarettes are a demerit good, and the private benefit as judged by the smoker is greater than the true benefit.



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The diagram shows why this causes market failure. The free market is in equilibrium where MPB = MPC, at output Q_m and price P_m. The socially optimum output is where MSB = MSC, at Q^*. At Q_m, for each unit between Q^* and Q_m the marginal social cost exceeds the marginal social benefit, so too many cigarettes are consumed and too many resources are allocated to producing them. The market is allocatively inefficient, because $P \neq MSC$, and society suffers the welfare loss shown by the shaded triangle. So the first two parts of the statement are true: smoking does cause negative externalities, and these do cause market failure.

The government can correct this failure in several ways. An indirect (Pigouvian) tax equal to the marginal external cost shifts the MPC curve up to MSC, so the external cost is internalised: the price rises, quantity falls towards Q^* and the polluter pays. The revenue can fund health care for smoking-related illness. Regulation can ban smoking in public places, restaurants and workplaces, which directly removes most passive smoking, and can ban advertising and sales to under-18s. Information policies, such as graphic health warnings and education campaigns, correct the information failure and shift the private benefit curve to the left.

However, intervention does not always work. Demand for cigarettes is price inelastic because they are addictive and have few substitutes, so a tax raises revenue but cuts consumption only slightly. It is very hard to put a money value on the external cost, so the tax may be set at the wrong level, leading to government failure. High taxes encourage smuggling and illegal markets, where cigarettes are untaxed and unregulated. Taxes on cigarettes are regressive, taking a larger share of the income of poorer households, who are more likely to smoke. Bans need enforcement, which has an opportunity cost.

Government intervention is also not the only possible solution. The Coase theorem suggests that if property rights are clearly defined and transaction costs are low, private bargaining can reach the optimum: for example the owner of a restaurant,

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office or rented flat can ban smoking on their property, or non-smokers could pay smokers not to smoke. Private health insurers can charge smokers higher premiums, which makes smokers bear more of the cost. Social pressure and changing attitudes, and campaigns by charities, have reduced smoking in many countries. These solutions work best when few people are involved, but with millions of smokers and victims, bargaining is impractical, so they are limited.

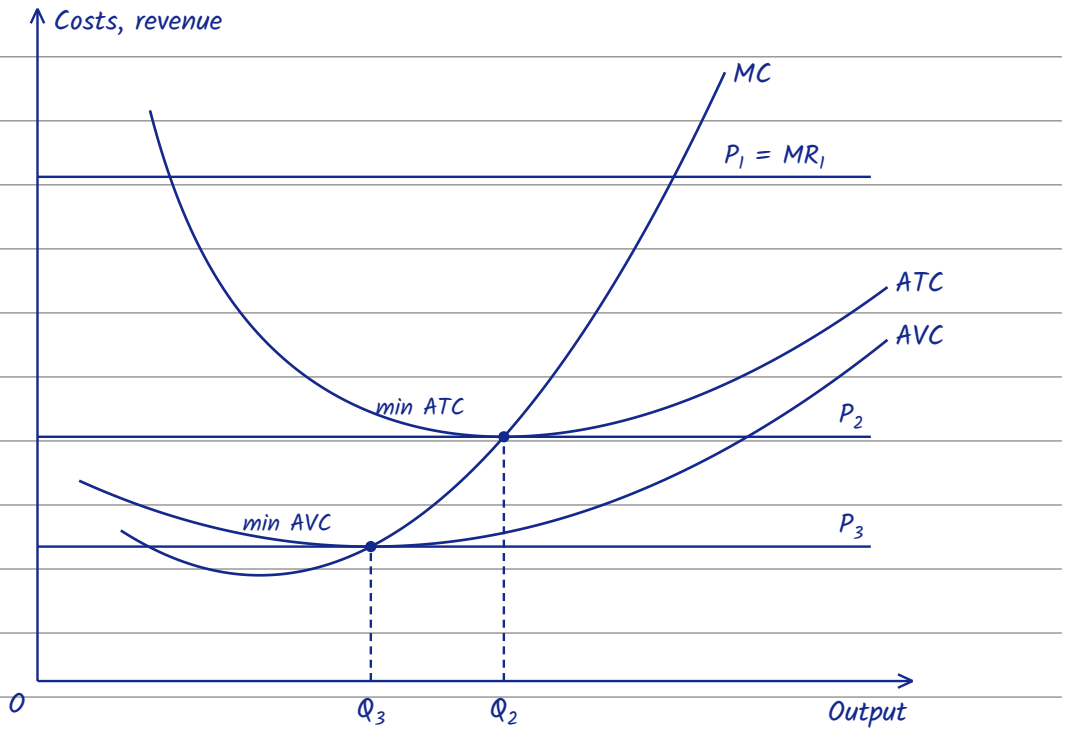
The statement can also be challenged. Smoking alone at home creates mainly private costs, so not all smoking causes significant externalities. Some argue that smokers already pay more in tobacco tax than they cost the health service, so the external cost is largely internalised. And if the external cost is small, the cost of intervention may be greater than the welfare loss it removes.

In conclusion, I largely agree that smoking causes negative externalities and that these cause market failure through over-consumption. However, the claim that it can only be solved by government intervention is too strong; private solutions and social norms can help. Yet with so many third parties and serious information failure, government intervention, ideally a combination of tax, regulation and information rather than one measure, is the most effective, though even it cannot fully reach the social optimum.

3(a) In perfect competition there are many buyers and sellers, a homogeneous product, perfect information and no barriers to entry or exit. Each firm is a price taker: the price is set by market demand and supply, and the firm can sell any amount at that price, so it faces a perfectly elastic demand curve where P = AR = MR. Every firm maximises profit where MC = MR.

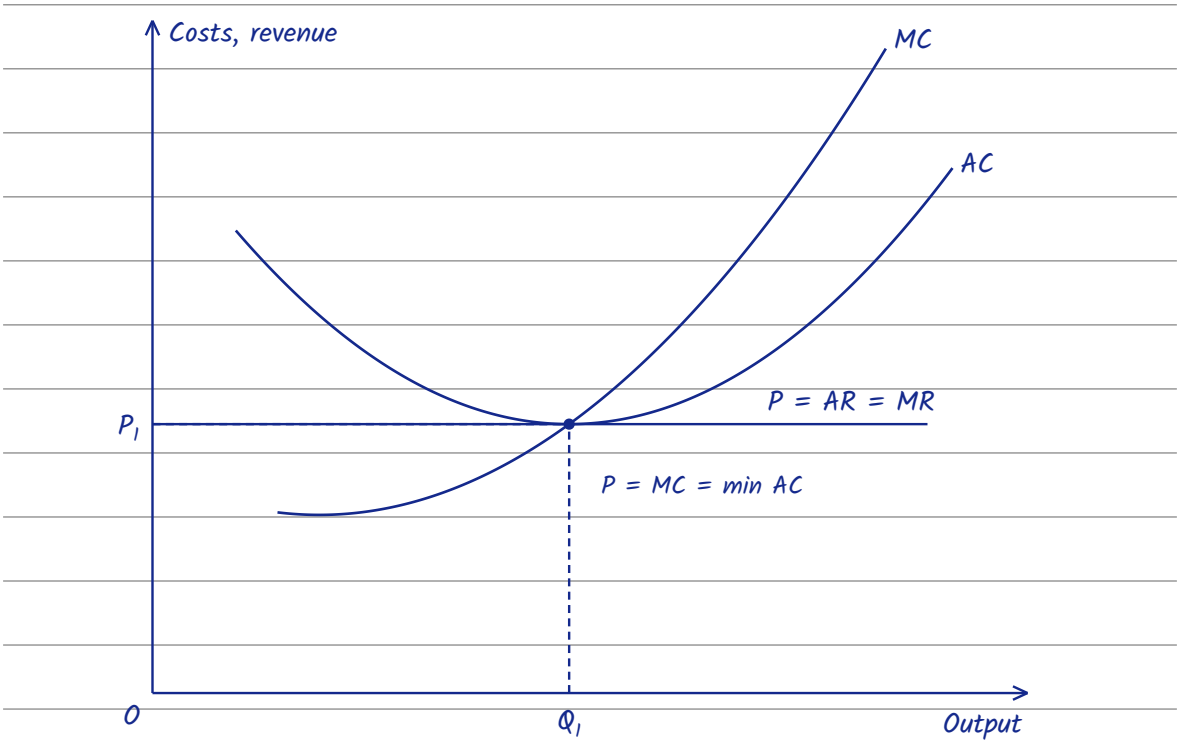
Normal profit is the minimum profit needed to keep the firm in the industry, when total revenue equals total cost including opportunity cost (AR = AC). Supernormal profit is profit above this (AR > AC); a loss occurs when AR < AC.

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In the short run the firm may make any of these, depending on the market price. If the market price is P_1, the firm produces where MC = MR, above ATC, and makes supernormal profit. At P_2, equal to minimum ATC, it makes normal profit. At any price between P_2 and P_3 it makes a loss but continues to produce, because it covers its variable costs and makes some contribution to fixed costs. Below P_3, the minimum of AVC, it shuts down. So in the short run the firm can make a supernormal profit or a loss, but it can also make only normal profit, so the first part of the statement is incomplete.

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In the long run all factors are variable and firms can enter or leave. If firms make supernormal profit, perfect information and no barriers mean new firms enter, so market supply shifts to the right and the market price falls until it equals minimum AC. If firms make losses, some leave, market supply shifts left and the price rises. Equilibrium is reached only when P = MC = minimum AC, as in the diagram, so every firm makes normal profit.

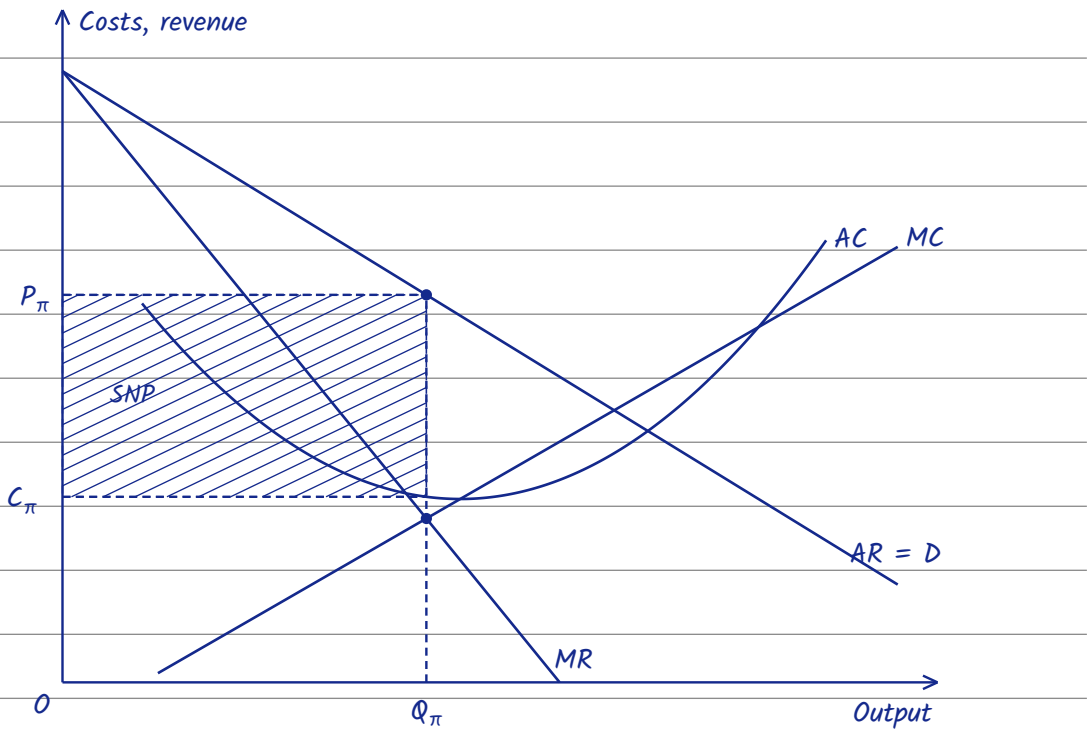
The statement is therefore true in theory, but it depends on the assumptions. The long run is a tendency: if market demand keeps changing, firms may keep earning short-run supernormal profits or losses. Any firm with a unique advantage, such as a better location, would earn extra profit, though this is usually counted as rent and included in cost. In the real world very few markets meet all the assumptions. So the statement is broadly true for the model, with the qualification that normal profit is also possible in the short run.

3(b) Economic efficiency includes three types. Productive efficiency is producing at the lowest point of the average cost curve, so the fewest resources are used per unit.

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Allocative efficiency is where P = MC, so the value consumers place on the last unit equals the cost of the resources used to make it. Dynamic efficiency is improvement in efficiency over time, through investment, innovation and new technology.

In long-run equilibrium a perfectly competitive firm produces where P = MC = minimum AC (see the diagram in 3(a)). So it is both allocatively and productively efficient. Competition also removes X-inefficiency, since a firm with higher costs makes a loss and leaves. However, it is unlikely to be dynamically efficient: it makes only normal profit, so it has no supernormal profit to fund research and development, and perfect information means any innovation is copied immediately, so there is no incentive to innovate.



A profit-maximising monopoly produces Q_π, where MC = MR, and charges P_π from the AR curve. Price is above marginal cost, so it is allocatively inefficient: output is restricted and there is a deadweight welfare loss. Output is not at the lowest point of AC, so it is productively inefficient too. With barriers to entry and no competition, managers may let costs rise, causing X-inefficiency. So on static

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efficiency the view is correct.

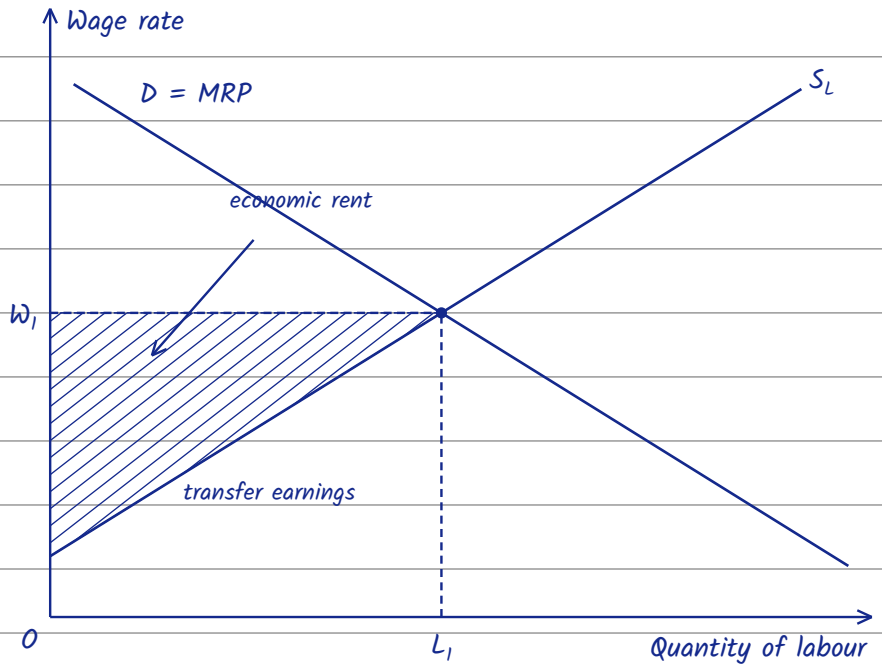
However, the view can be challenged. A monopoly may gain large economies of scale, so its costs, and even its price, can be lower than the price in a competitive industry made up of many small firms. In a natural monopoly, such as water supply, one firm is more productively efficient than many. Most importantly, supernormal profits protected by barriers to entry and patents give a monopoly the funds and the incentive to invest in research and development, so it may be dynamically efficient, as Schumpeter argued, producing new products and lower costs over time. If the market is contestable, the threat of entry may force the monopoly to keep prices and costs low, and governments can regulate monopolies, for example with price caps.

In conclusion, the view is true for static efficiency in the long run, but perfect competition is a theoretical model with strict assumptions, and in terms of dynamic efficiency a monopoly may well be more efficient. Which is more efficient overall depends on economies of scale, contestability and whether the monopoly reinvests its profits.

4(a) Transfer earnings are the minimum payment needed to keep a factor of production, such as a worker, in its present use: it equals what the worker could earn in the next best alternative job. Economic rent is any payment to a factor above its transfer earnings. So a worker's wage = transfer earnings + economic rent.

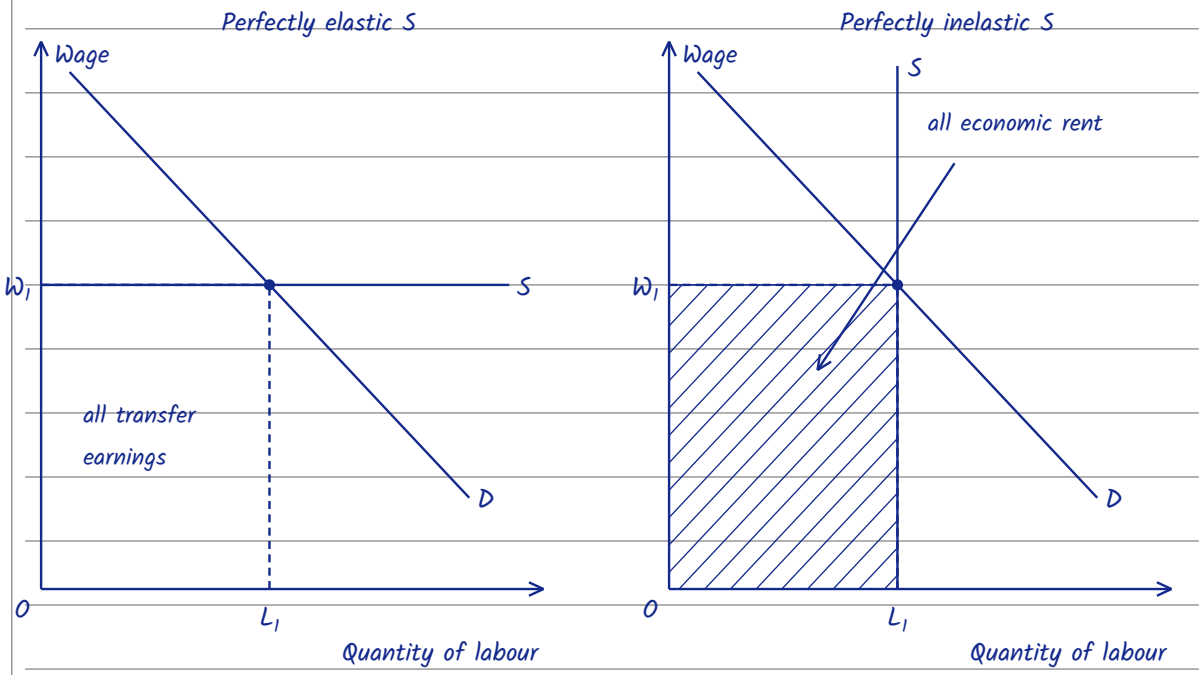
A worker's wage rate is determined by the demand for labour (the marginal revenue product, MRP) and the supply of labour. In the diagram the equilibrium wage is W_1 and L_1 workers are employed. Every worker receives W_1, but the supply curve shows the minimum wage needed to attract each worker, so the area under the supply curve is transfer earnings and the shaded area above it, below W_1, is economic rent.

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The elasticity of supply of labour measures the responsiveness of the quantity of labour supplied to a change in the wage rate. The proportion of the wage that is economic rent depends on this elasticity, as the second diagram shows. If supply is perfectly elastic, every worker would leave if the wage fell at all, so the whole wage is transfer earnings. If supply is perfectly inelastic, the same number would work at any wage, so the whole wage is economic rent. The more inelastic supply is, the larger the share of economic rent.

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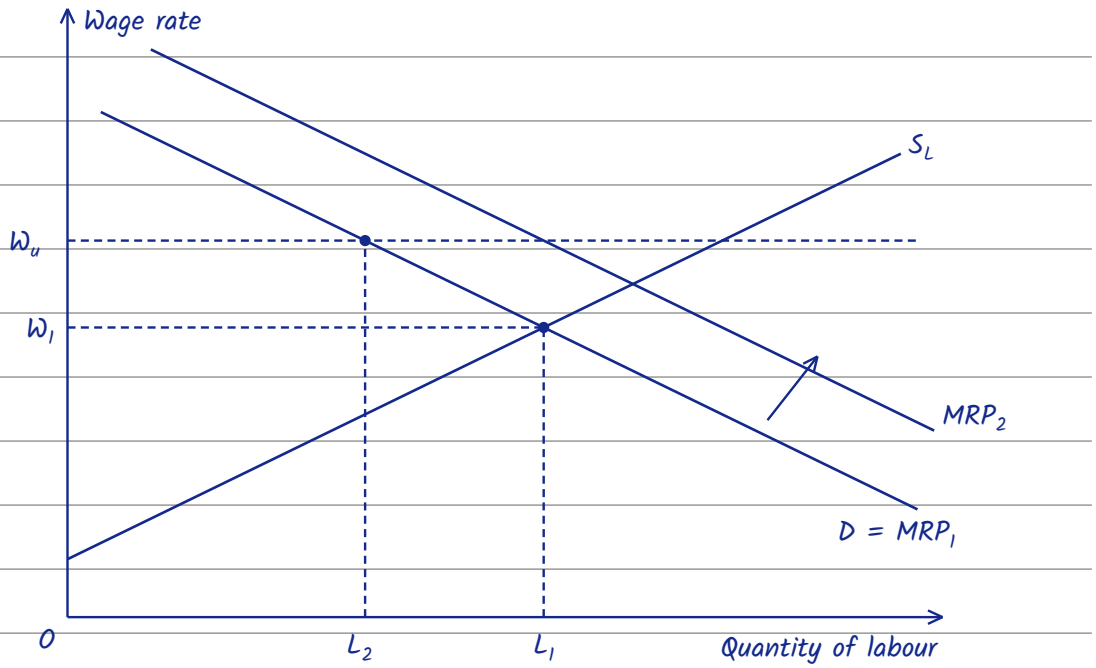
This explains individual wage rates. A top footballer or surgeon has rare skills that take years to develop, so supply is very inelastic; when demand (MRP) is high the wage is very high and most of it is economic rent, since their next best job pays far less. An unskilled worker has many close substitutes, so supply is elastic, the wage is low and mostly transfer earnings. An increase in demand for inelastically supplied workers raises the wage mainly as extra rent rather than attracting more workers.

However, the links are not complete. The wage also depends on demand: inelastic supply gives high rent only if MRP is high. Trade unions, minimum wages, monopsony employers, discrimination and non-monetary factors such as job satisfaction can all change the wage independently of elasticity. The time period matters: in the long run more people can train, supply becomes more elastic and the rent element falls, so much rent is quasi-rent. In conclusion, elasticity of supply strongly influences how a worker's wage is split between transfer earnings and economic rent, but the level of the wage depends on both demand and supply and on institutional factors.

Question number

4(b)

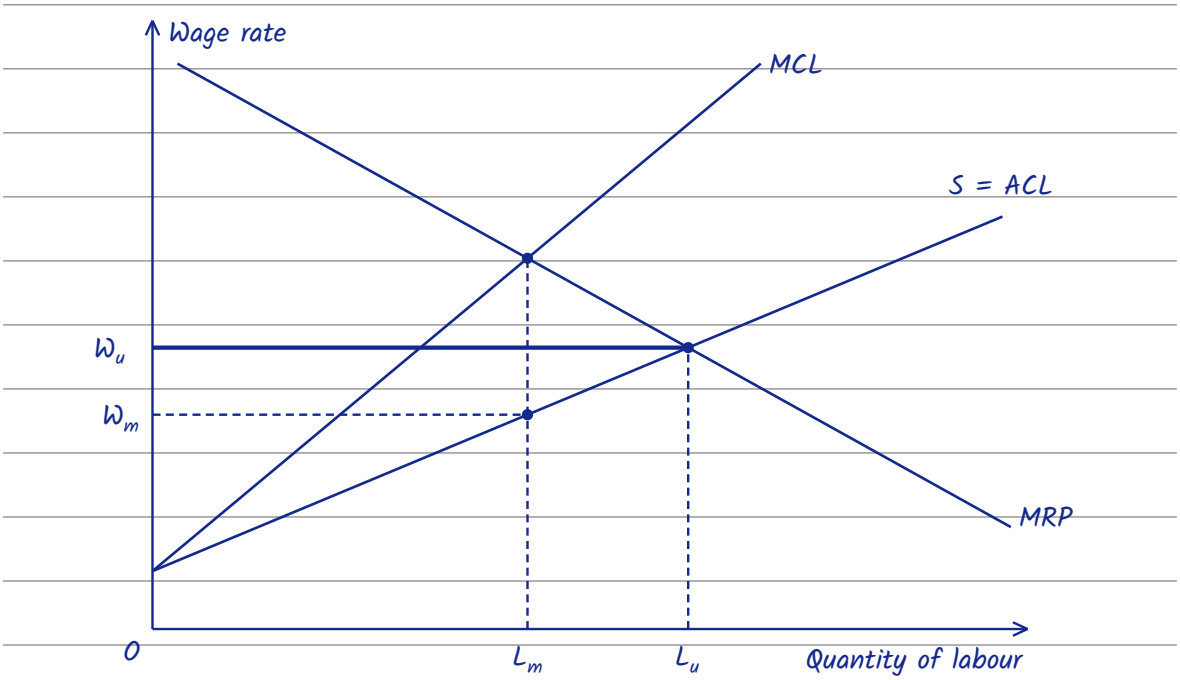
A trade union is an organisation of workers that bargains collectively with employers over wages and conditions. In a competitive labour market the wage is set where the demand for labour (MRP) equals the supply of labour, at W_1 and L_1 in the diagram.



If the union negotiates a wage above equilibrium, W_u, and demand stays at MRP_1, firms employ only L_2. More workers want jobs at the higher wage, so there is excess supply of labour, unemployment. In this case the statement is true. The size of the fall in employment depends on the wage elasticity of demand for labour, which is greater when the product's demand is price elastic, labour is a large share of total cost and capital can easily replace labour, especially in the long run.

However, there are situations where unions can raise wages without causing unemployment. First, unions can agree productivity deals: in return for higher wages, workers accept training, new technology or more flexible working. This raises MRP and shifts the demand for labour to MRP_2, so at W_u employment stays at L_1. Also, if demand for the product is rising, the derived demand for labour rises, so wages can rise with no job losses.

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Second, where the employer is a monopsony, it employs where MCL = MRP, at L_m, and pays only W_m, below MRP. If a union bargains (bilateral monopoly) for a wage of W_u, the supply curve becomes horizontal at W_u up to the supply curve, so MCL equals W_u and the firm employs L_u. Both the wage and employment rise.

Efficiency wage theory also suggests higher wages can raise motivation and reduce labour turnover, raising productivity.

On the other hand, even in these cases there are limits. If the union pushes the wage above the competitive level, employment falls again. In the long run firms may substitute capital for labour or relocate abroad. Higher wages for union members (insiders) may reduce jobs for outsiders, and if higher wage costs raise prices, cost-push inflation can reduce demand and employment elsewhere.

In conclusion, I only partly agree. In a competitive market with unchanged productivity, higher union wages do cause unemployment, but where unions face a monopsony employer, agree productivity deals or demand for labour is rising, wages can rise without higher unemployment. The outcome depends on the type of labour market and on elasticity of demand for labour.

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5(a)

The level of production is the total output of goods and services produced in a given time period, for example measured by real GDP. Productivity is the efficiency of production: output per unit of input in a given time period, for example labour productivity is output per worker per hour. A country can have a high level of production but low productivity if it has a very large labour force, as in India, whereas a small economy such as Singapore can have low total production but very high productivity.

Productivity is likely to be lower in developing economies for several reasons. First, there is little capital per worker. Low incomes mean low savings, so there is little investment in machinery and technology, which keeps productivity and incomes low: a vicious circle of poverty. Workers using basic hand tools produce far less than workers with modern machinery.

Second, human capital is low. Limited access to education and training, and poor health and nutrition, mean workers are less skilled and less able to use modern technology. There is also a shortage of skilled managers and entrepreneurs to organise production efficiently.

Third, infrastructure is inadequate: unreliable electricity, poor roads and ports and weak communications raise costs and waste working time. Fourth, a large share of the labour force works in the primary sector, often in subsistence agriculture on small plots, where productivity is low and there is disguised unemployment. Weak institutions and corruption also discourage investment.

These factors are linked, but the most important are probably low capital investment and low human capital, because without them new technology cannot be used and infrastructure cannot be built. Their importance varies: some developing economies have highly productive sectors, such as India's IT services, and some regions of developed economies have low productivity. In conclusion, productivity is likely to be lower in developing economies mainly because of a lack of physical and human capital, made worse by poor infrastructure and dependence

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on primary production.

5(b) Population changes depend on the birth rate, death rate and net migration. Many developing economies have rising populations, because death rates have fallen with better health care while birth rates remain high, giving a young population. Many developed economies have falling or stable populations with low birth rates and long life expectancy, giving an ageing population. In both cases the key link is the dependency ratio: the number of dependants (under 15 and over 65) relative to the working population who create income and wealth.

In a developing economy a rising population creates many problems. A high youth dependency ratio means government must spend more on schools, health care and housing, often financed by a narrow tax base. If population grows faster than real GDP, GDP per head falls, so living standards fall. More income is spent on consumption, so savings and investment are low. Rapid growth of the labour force can exceed the number of jobs, causing unemployment and underemployment, rural-urban migration and slums, and pressure on land, water and the environment, as Malthus warned.

However, a rising population is not only a problem. Once the young reach working age, a large workforce can give a demographic dividend, as in East Asia, and a larger population creates a bigger market and economies of scale. Whether the problems arise depends on whether the economy can provide education and jobs.

In a developed economy a falling, ageing population raises the old-age dependency ratio. A smaller workforce must support more pensioners, so taxes on workers must rise or pensions and health care must be cut, as in Japan. Labour shortages can cause wage inflation, lower AD and investment can slow economic growth, and an older population may be less innovative and less geographically and occupationally mobile.

Yet these problems can be managed. Developed economies can raise the retirement

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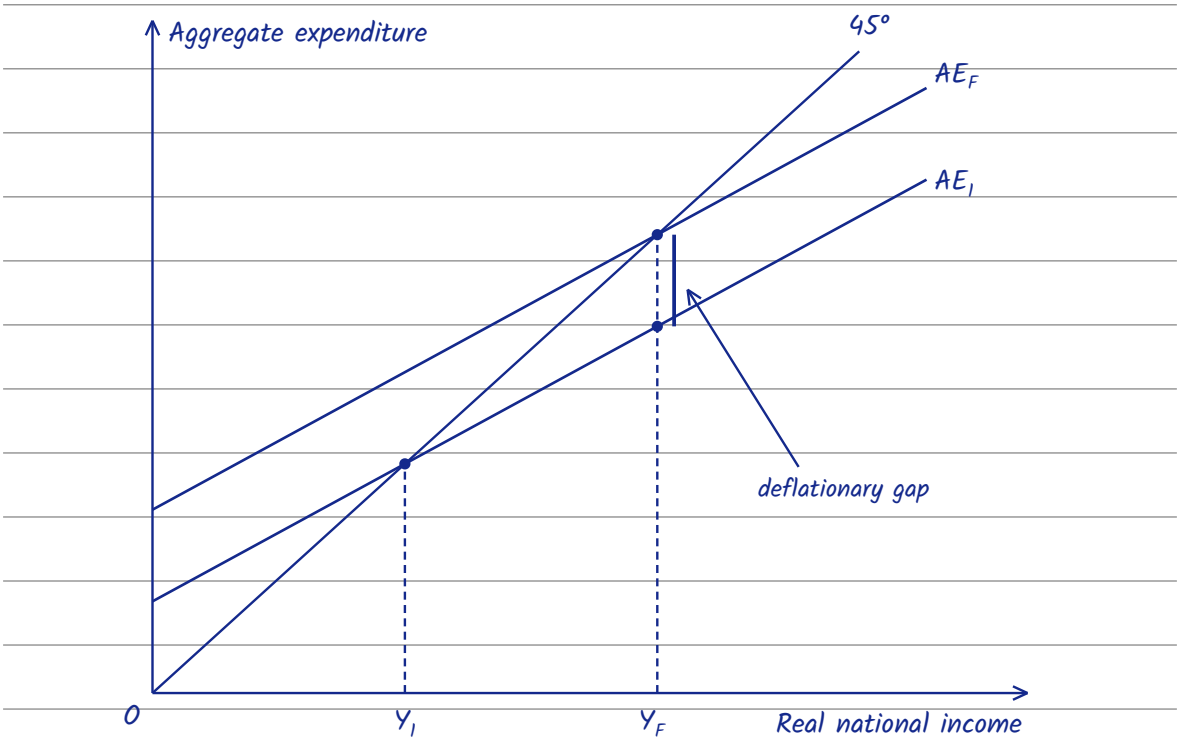
age, encourage more women and older people to work, allow immigration of young workers and invest in automation to raise productivity, so real GDP per head can still rise. They also have the wealth, tax revenue and institutions to adapt, and the change is usually gradual.

In conclusion, both trends create problems because they raise the dependency ratio and reduce the income created per person. But I do not agree that falling populations in developed economies cause even greater problems. Rising populations in developing economies can deepen absolute poverty in countries with few resources to respond, whereas developed economies have more policy options. The statement is only true where a developed economy's population falls rapidly and it does not adapt.

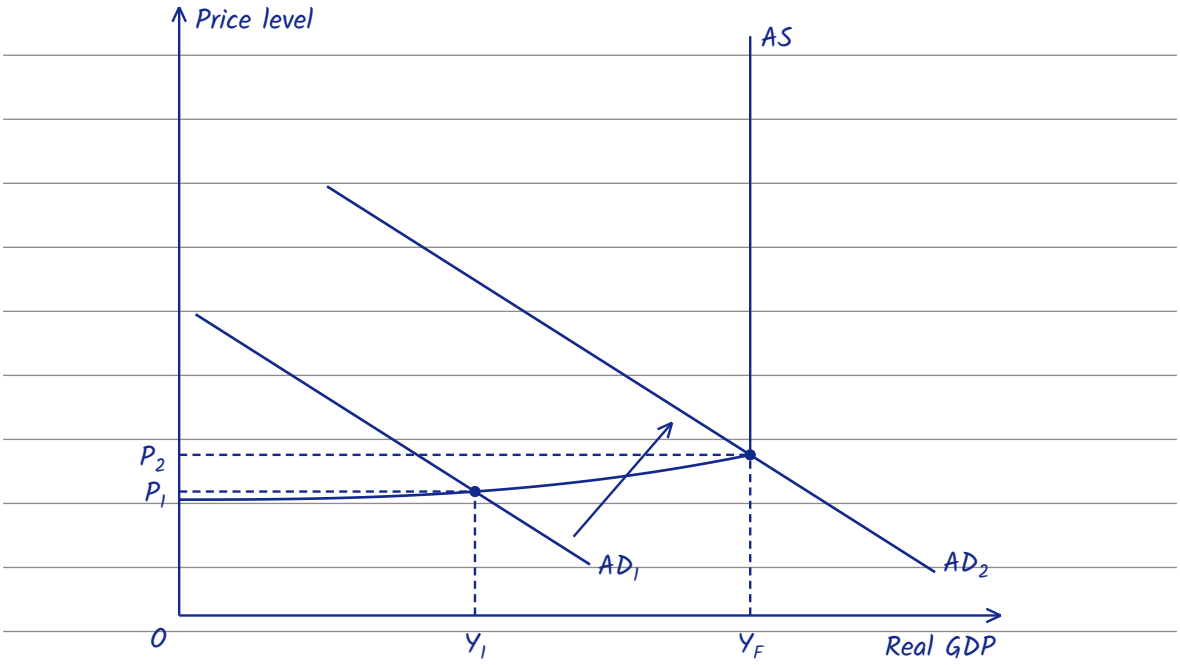
6 An economy is in equilibrium when there is no tendency for national income to change: planned injections (investment, government spending and exports) equal planned withdrawals (saving, taxation and imports), or aggregate expenditure equals national output. Full employment is the level of output at which all those willing and able to work at the going wage have jobs, apart from frictional unemployment.

Keynes argued that this equilibrium need not be at full employment. If aggregate demand is too low, for example because business confidence falls so investment falls, or households save more (the paradox of thrift), national income falls through the multiplier until withdrawals again equal injections, but at a lower level. Wages and prices are sticky downwards, so there is no automatic return to full employment, and the economy can stay in equilibrium with demand-deficient (cyclical) unemployment.

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In the diagram, equilibrium is at Y_1, where AE_1 crosses the 45° line, below full employment Y_F. The deflationary gap is the amount by which aggregate expenditure would have to rise at Y_F to bring equilibrium to full employment. The same idea is shown with AD and AS: AD_1 meets the AS curve at Y_1, where there is spare capacity.



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Monetarists and new classical economists take a different view. They argue the economy settles at the natural rate of unemployment, where the labour market clears and LRAS is vertical. The remaining unemployment is frictional and structural, caused by imperfect information, lack of skills and immobility of labour. In this view the economy is below 'full employment' because of supply-side problems, not a lack of demand.

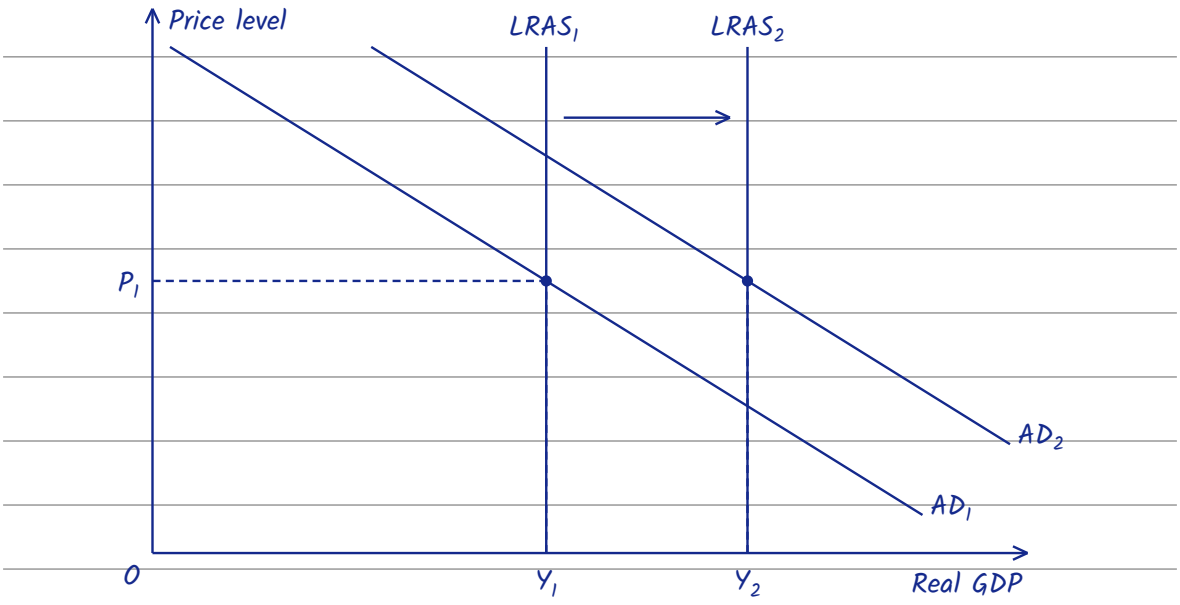
The first policy is expansionary fiscal policy: increasing government spending or cutting taxes, which means a budget deficit. This raises injections, and through the multiplier, $k = 1 \div (1 - MPC)$ or $1 \div MPW$, national income rises by more than the original injection. For example, if $MPW = 0.25$, $k = 4$, so a deflationary gap of \$100bn needs only \$25bn of extra spending, shifting AD_1 to AD_2 in the diagram. However, fiscal policy has drawbacks. There are time lags in recognising the problem and in spending, so the policy may take effect when the economy has already recovered. The multiplier is hard to estimate, so the government may overshoot and cause demand-pull inflation as output nears Y_F. Government borrowing may raise interest rates and crowd out private investment, and it increases the national debt. Some of the extra spending leaks into imports, worsening the current account of the balance of payments.

The second policy is expansionary monetary policy: cutting interest rates or quantitative easing. Lower interest rates reduce the cost of borrowing, so investment and consumption on credit rise, and the exchange rate falls, raising net exports. But if business confidence is very low, investment may be interest inelastic, and if interest rates are already near zero the economy may be in a liquidity trap, where extra money is simply held. It may also cause asset price inflation.

The third approach is supply-side policies, which shift LRAS to the right and lower the natural rate of unemployment. These include education and training to increase occupational mobility, better job information and job centres to reduce frictional

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unemployment, subsidies to firms that hire workers, lower income tax and reforms to benefits to raise the incentive to work, and labour market deregulation.



Supply-side policies have long time lags, since training takes years, and involve a large opportunity cost, for example subsidies and training use money that could be spent elsewhere. Cutting benefits may increase inequality and poverty, and if the real cause is a lack of demand, more skilled workers will not find jobs that do not exist.

In conclusion, the right policy depends on why the economy is below full employment. If unemployment is cyclical, caused by deficient demand, expansionary fiscal and monetary policy are the most effective in the short run, though they risk inflation and debt. If it is structural and frictional, supply-side policies are needed, though they work only in the long run. In practice most economies need a combination: demand-side policies to close the deflationary gap quickly, and supply-side policies to raise full employment output and allow non-inflationary growth.

7(a) Economic growth is an increase in real GDP over time (actual growth), or an increase in the productive potential of the economy (potential growth), shown by

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an outward shift of the PPC or of LRAS. The main macroeconomic aims are economic growth, low unemployment, low and stable inflation and a satisfactory balance of payments position, with others such as a fair distribution of income and protecting the environment.

There is a strong case that growth should be the most important aim. Sustained growth raises real GDP per head and so material living standards, and reduces absolute poverty. Higher output requires more workers, so growth reduces unemployment. It raises tax revenue without higher tax rates, allowing more spending on health and education, and it makes the national debt easier to manage. For a developing economy, growth is essential to escape the vicious circle of poverty.

However, the aims are linked and growth can conflict with them. If AD grows faster than productive capacity, there will be demand-pull inflation, which reduces real incomes and international competitiveness. Faster growth increases incomes and so imports, causing a current account deficit. Growth may also increase inequality and cause pollution and depletion of resources, so it may not be sustainable and may not raise well-being.

Other aims may sometimes be more important. Low and stable inflation can be seen as a precondition for growth, because high or unpredictable inflation creates uncertainty and discourages investment; with very high inflation, controlling it must come first. In a deep recession reducing unemployment may be the main priority because of the human cost. It is also difficult to isolate aims: achieving low unemployment usually requires growth, so the aims cannot easily be ranked separately.

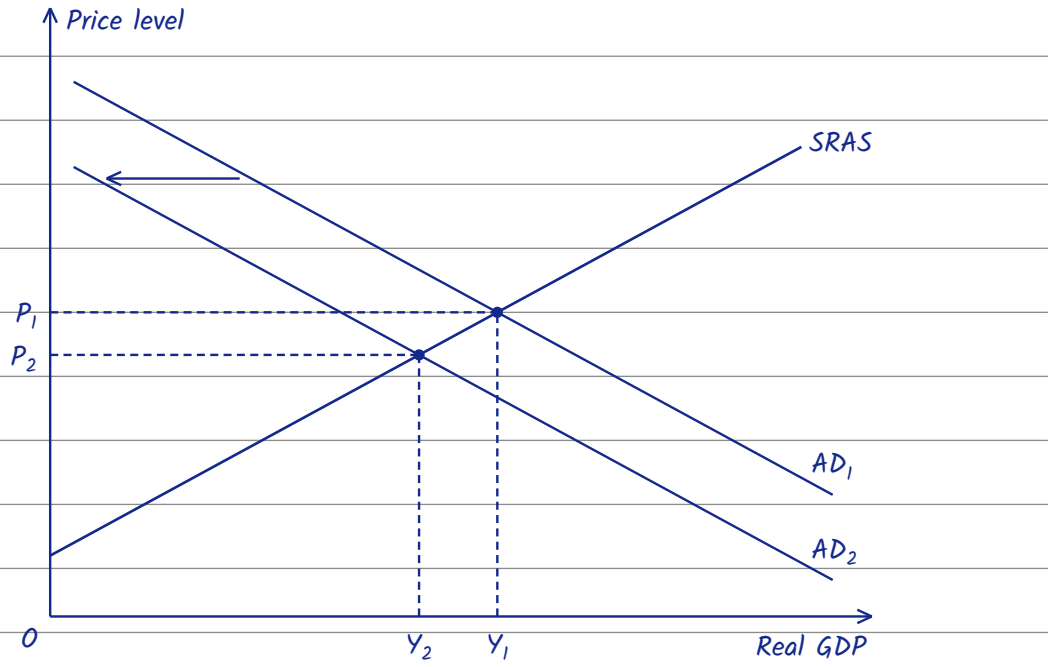
In conclusion, economic growth is perhaps the most important long-run aim, because it raises living standards and helps achieve low unemployment, but only if it is sustainable and non-inflationary. Which aim is most important depends on the economy's situation at the time, so the view is only partly correct.

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7(b)

A balance of payments deficit on the current account occurs when the value of imports of goods and services, plus outflows of primary and secondary income, exceeds the corresponding inflows. A persistent deficit lasts for many years, so it is likely to be structural, due to a lack of international competitiveness, rather than a temporary result of a boom. It must be financed by borrowing, selling assets or running down foreign currency reserves, and can lead to a falling exchange rate, foreign debt and loss of confidence.

One approach is expenditure-reducing policy: contractionary fiscal policy (higher taxes, lower government spending) or higher interest rates. These reduce aggregate demand and real incomes, so spending on imports falls, depending on the marginal propensity to import. Lower inflation also improves price competitiveness. But, as the diagram shows, AD shifts left from AD_1 to AD_2, so real GDP falls from Y_1 to Y_2: economic growth and employment are sacrificed, although inflation falls. Higher interest rates also reduce investment and may cause hot money inflows that raise the exchange rate, worsening the deficit.



A second approach is expenditure-switching policy, which switches spending from

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imports to domestic goods. A devaluation or depreciation makes exports cheaper abroad and imports dearer at home. If the Marshall-Lerner condition holds (the sum of the price elasticities of demand for exports and imports is greater than 1), the current account improves, though by the J-curve effect it may first worsen. Higher net exports raise AD, so growth and employment may improve. But dearer imported raw materials cause cost-push inflation, and the extra AD can add demand-pull inflation, so low inflation is sacrificed. Tariffs and quotas also switch expenditure, but they raise prices, protect inefficient firms and risk retaliation, which can reduce exports and growth.

A third approach is supply-side policy, such as investment in education, training, infrastructure and research, to raise productivity and improve the quality and price competitiveness of exports. This tackles the structural cause of a persistent deficit and shifts LRAS to the right, so it can reduce the deficit while also raising growth, increasing employment and reducing inflationary pressure. No other aim need be sacrificed. However, it takes many years to work, its success is uncertain and it involves government spending with an opportunity cost.

In conclusion, I largely agree in the short run: expenditure-reducing policies sacrifice growth and employment, and expenditure-switching policies risk inflation. However, a persistent deficit is a long-run problem, and supply-side policies can reduce it without sacrificing other aims, though slowly. So it is possible in the long run, but in practice governments usually accept some short-term trade-off.