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Surname: StemUp Model Solution | Other names:

Pearson Edexcel
Level 3 GCE

Centre Number | Candidate Number

Economics A

Advanced
Paper 2: The National and Global Economy

Tuesday 12 June 2018 – Afternoon
Time: 2 hours

Paper Reference
9EC0/02

You do not need any other materials.

Total Marks

Instructions

- Use **black** ink or ball-point pen.
- **Fill in the boxes** at the top of this page with your name, centre number and candidate number.
- There are three sections in this question paper. Answer **all** questions from Section A and Section B. Answer **one** question from Section C.
- Answer the questions in the spaces provided
  – *there may be more space than you need.*

Information

- The total mark for this paper is 100.
- The marks for **each** question are shown in brackets
  – *use this as a guide as to how much time to spend on each question.*
- Calculators may be used.

Advice

- Read each question carefully before you start to answer it.
- Check your answers if you have time at the end.

Turn over ▶

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SECTION A

Answer ALL questions. Write your answers in the spaces provided.

Some questions must be answered with a cross in a box ☒. If you change your mind about an answer, put a line through the box ☒ and then mark your new answer with a cross ☒.

You are advised to spend 30 minutes on this section.

Use the data to support your answers where relevant. You may annotate and include diagrams in your answers.

1 The trade deal known as the Comprehensive Economic and Trade Agreement (CETA) is designed to eliminate or reduce trade barriers between the European Union (EU) and Canada. It is estimated that it will increase trade by 20% and boost EU GDP by 12 billion euros.

(Source: http://www.theguardian.com/business/2016/oct/30/eu-canada-sign-ceta-free-trade-deal-trudeau-juncker)

(a) Which **one** of the following is most likely to decrease as a result of CETA?

(1)

☒ **A** Economic growth in EU countries

☒ **B** Exports from EU countries to Canada

☒ **C** Imports from Canada to EU countries

☒ **D** Tariffs on European exports to Canada

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(b) With reference to the theory of comparative advantage, explain how CETA may increase the GDP of both the EU and Canada.

(4)

Comparative advantage means a country can produce a good at a lower opportunity cost than another country. CETA eliminates or reduces trade barriers such as tariffs between the EU and Canada, moving them towards freer trade.

This allows each to specialise in the goods in which it has a comparative advantage, for example Canada in timber and natural resources and the EU in cars and machinery, and trade the surplus. For example, if Canada gives up 2 cars to produce 10 units of timber while the EU gives up 5 cars, Canada should specialise in timber and the EU in cars.

Because resources are used where they are most efficient, total world output rises, so both economies can produce and consume more than before. Trade is estimated to increase by 20%, and the higher exports and output mean an increase in GDP for both, such as the 12 billion euro boost to EU GDP.

(Total for Question 1 = 5 marks)

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2 (a) Which **one** of the following would be most likely to cause aggregate demand to increase?

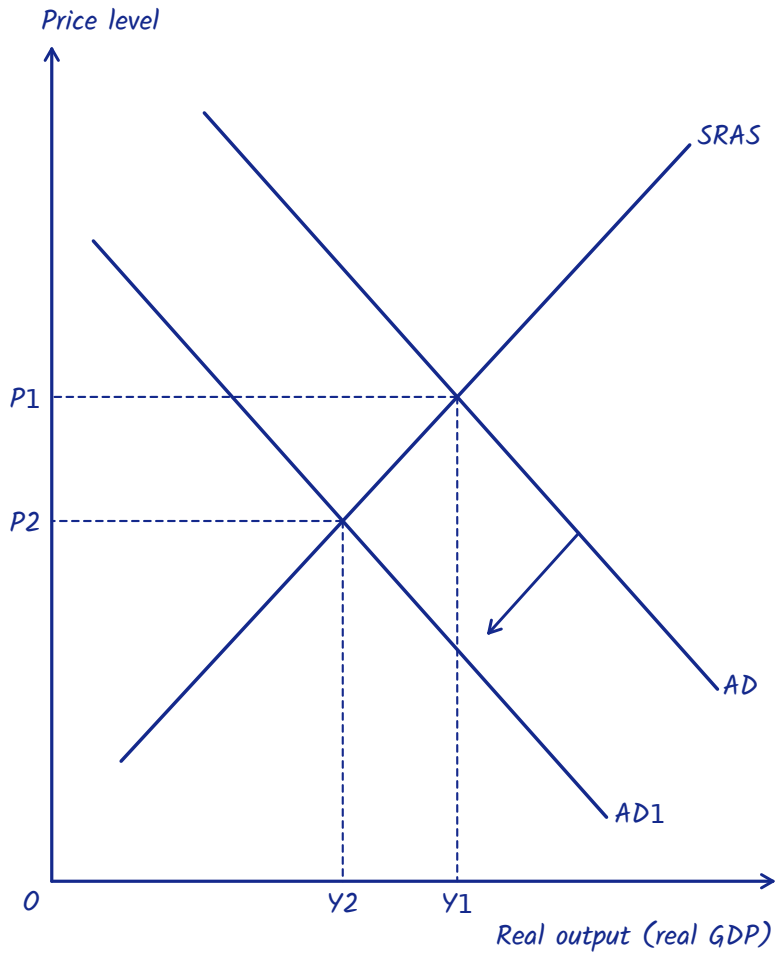
A fall in:

(1)

- ☒ **A** government spending
- ☒ **B** net trade (X–M)
- ☒ **C** the marginal propensity to consume
- ☒ **D** the marginal propensity to save

(b) Draw an aggregate demand and aggregate supply diagram illustrating the likely impact of a rise in interest rates on the price level and real output.

(4)



A rise in interest rates raises the cost of borrowing and the reward for saving, so consumption and investment fall and AD shifts left from AD to AD1: the price level falls from P1 to P2 and real output falls from Y1 to Y2.

(Total for Question 2 = 5 marks)

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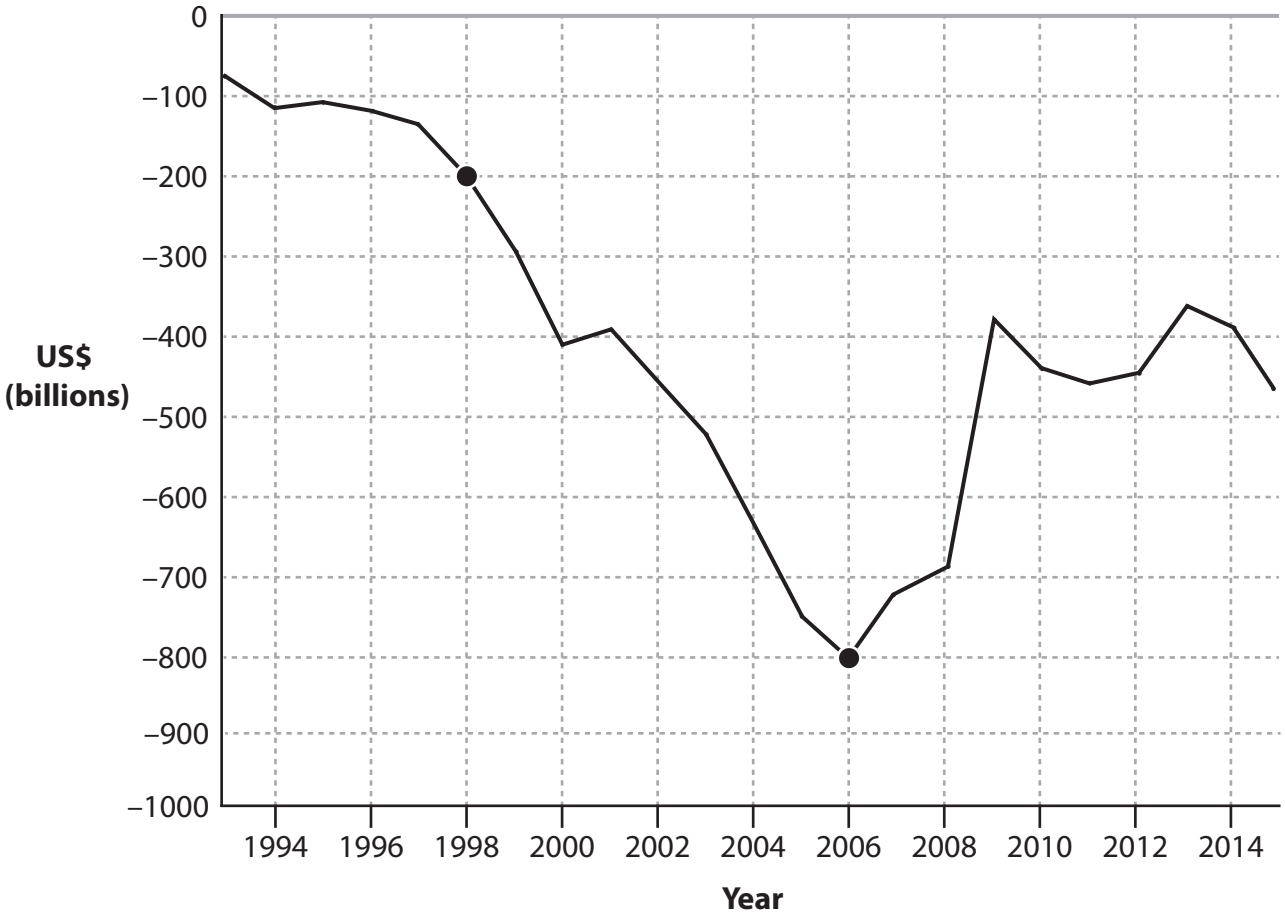
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QUESTION 3 BEGINS ON THE NEXT PAGE.

3 United States current account of the balance of payments, 1993–2015



(Source: http://data.worldbank.org/indicator/BN.CAB.XOKA.CD?end=2015&locations=US&start=1993)

(a) Calculate the percentage change in the United States current account deficit on the balance of payments between 1998 and 2006.

(2)

1998 deficit = US$200 billion; 2006 deficit = US$800 billion

% change = (change ÷ original) × 100

= (800 − 200) ÷ 200 × 100 = 600 ÷ 200 × 100

Answer: a 300% increase in the current account deficit

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(b) Explain the term 'current account of the balance of payments'.

(2)

The current account measures the total value of exports minus the total value of imports of goods and services, plus net income flows, so it shows money inflows minus outflows from trade and income.

It has four parts: trade in goods, trade in services, primary income (e.g. investment income and wages) and secondary income (current transfers, e.g. foreign aid).

(c) Using the chart on page 6, which **one** of the following may be inferred about the United States balance of payments?

(1)

- ☐ **A** The current account deficit decreased between 2001 and 2006
- ☐ **B** The current account surplus increased between 2001 and 2006
- ☒ **C** There was a current account deficit for the entire period shown
- ☐ **D** There was a current account surplus for the entire period shown

(Total for Question 3 = 5 marks)

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4 The UK has experienced a budget deficit since 2001. The government aimed to reach a budget surplus by 2019, but in 2016 this target was abandoned.

(Source: adapted from https://www.gov.uk/government/news/autumn-statement-2016-some-of-the-things-weve-announced)

(a) Explain **one** likely reason why the 2019 budget surplus target was abandoned.

(2)

One likely reason is a fall in expected UK economic growth, for example after the 2016 vote to leave the EU, with a reduction in business confidence.

Slower growth reduces tax revenue and raises spending on benefits, and lower business confidence means less private sector investment, so the government may need to support the economy for longer to ensure stable growth, making a surplus by 2019 unrealistic.

(b) Explain the likely impact of abandoning the budget surplus target on the UK national debt.

(2)

The UK national debt will continue to increase.

Abandoning the target means the government keeps running a budget deficit, where government expenditure is greater than tax revenue. Each year's deficit must be financed by borrowing money, for example by selling gilts, and this borrowing adds to the accumulated national debt, along with higher debt interest payments.

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(c) If a government takes decisions to target a budget surplus, this is an example of:

(1)

- ☐ **A** contractionary monetary policy
- ☒ **B** discretionary fiscal policy
- ☐ **C** expansionary fiscal policy
- ☐ **D** expansionary monetary policy

(Total for Question 4 = 5 marks)

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5 UK total bank lending to individuals, percentage change on previous year

2014	2.5%
2015	3.2%
2016	4.0%

(Source: Bank of England 2017)

(a) Explain **one** likely reason why consumer demand for bank loans has increased.

(2)

One likely reason is lower interest rates: the Bank of England cut Bank Rate to a record low (0.25% in 2016).

Lower interest rates make loans cheaper and more affordable, as monthly repayments are lower, so consumers are more willing to borrow to buy goods such as cars and houses. Higher consumer confidence also encourages consumers to borrow, believing they can repay in the future.

(b) Which **one** of the following is most likely to result from an increase in bank lending to individuals?

(1)

☒ **A** An improvement in net trade (X–M)

☒ **B** An increase in consumption

☒ **C** An increase in unemployment

☒ **D** Deflation

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(c) Calculate the index number for the total value of bank lending in 2016 using 2015 as a base year.

(2)

Base year 2015 = 100

Bank lending rose by 4.0% in 2016 compared with 2015

Index for 2016 = 100 × (1 + 4.0 ÷ 100) = 100 × 1.04

Answer: index number = 104

(Total for Question 5 = 5 marks)

TOTAL FOR SECTION A = 25 MARKS

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SECTION B

Read Figure 1 and the following extracts (A and B) before answering Question 6.

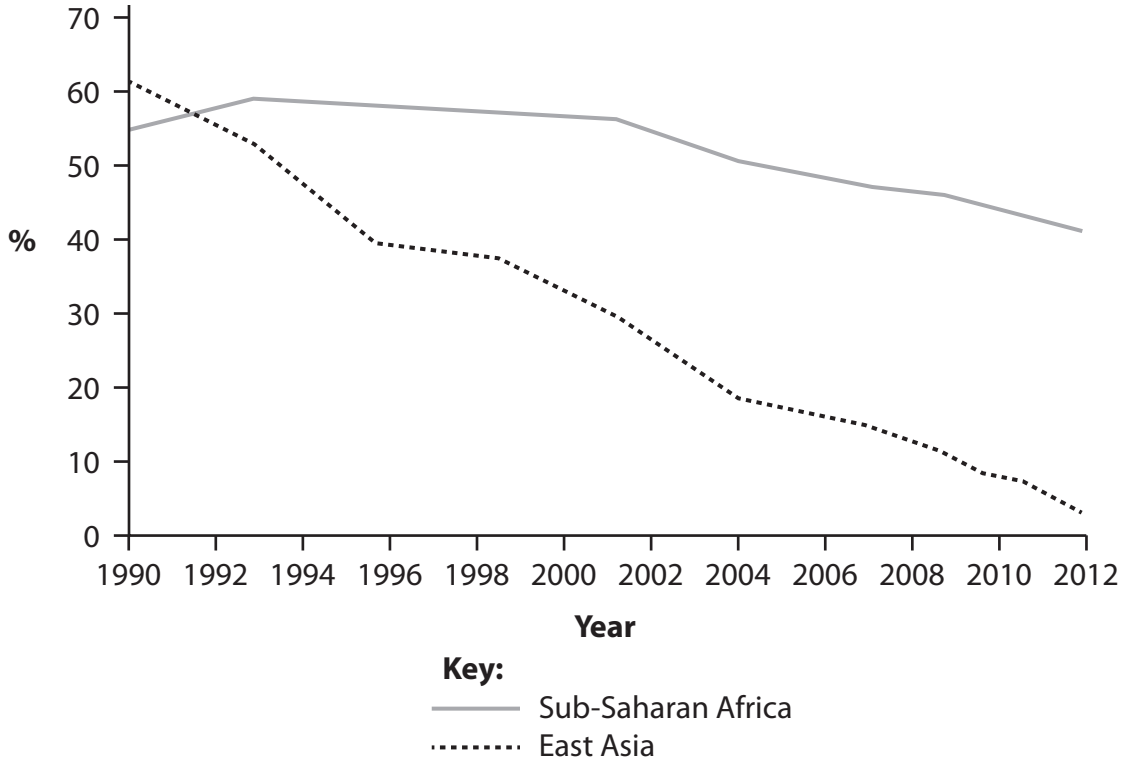
Write your answers in the spaces provided.

You are advised to spend 1 hour on this section.

Question 6

Globalisation and Inequality

Figure 1: Proportion of population in absolute poverty (US$1.90-a-day 2011 PPP)



(Source: https://openknowledge.worldbank.org/bitstream/handle/10986/25078/9781464809583.pdf)

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Extract A

Lessons from globalisation

The past 25 years have seen a freeing up of trade. Capital has been free to move around the world. Formerly closed economies in Asia have been opened up and tariffs cut. In emerging economies, a billion people have been taken out of absolute poverty, but relative poverty remains a problem.

In many advanced economies globalisation has come to mean, according to the Governor of the Bank of England, "low wages, insecure employment, stateless corporations and striking inequalities". His solution to these problems is threefold: an acceptance by economists that not everybody has gained from trade and technology; a better mix of monetary policy, fiscal policy and structural reform to boost growth; and more inclusive growth. In essence, this is the same conclusion that was reached in the past when there was a fear that market forces had to be moderated to prevent capitalism from destroying itself.

The good news is that this moderation of capitalism included real policy changes: an extension of the right to vote, the growth of trade unions, the creation of welfare states, a move to more progressive tax policies, nationalisation of key sectors of the economy, and more activist demand management.

The bad news is that this process took about 100 years and was not completed until the end of the Second World War. What's more, protectionism seems to be on the increase as countries seek to protect themselves from inequalities caused by rapid globalisation.

(Source: adapted from https://www.theguardian.com/business/2016/dec/05/mark-carney-globalisation-bank-of-england-capitalism)

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Extract B

Tackling inequality

Despite decades of substantial progress in boosting prosperity and reducing absolute poverty, the world continues to suffer from substantial inequalities. For example, the poorest children are four times less likely than the richest children to be enrolled in primary education across developing countries. Among the estimated 780 million illiterate adults worldwide, nearly two-thirds are women. Poor people face higher risks of malnutrition and death in childhood and lower chances of receiving key healthcare. Such inequalities result in high financial costs, limit economic growth, and generate social and political burdens and barriers.

These consequences highlight the importance of directing attention to the problem of inequality. There are other reasons to tackle inequality. Most economies are struggling to recover from the global financial crisis that started in 2008 and the subsequent slowdown in global growth. The goal of eliminating absolute poverty by 2030 might not be achieved without accelerated economic growth or reductions in inequalities within countries, especially in those with large numbers of poor. Generally speaking, poverty can be reduced through higher average growth, a narrowing in inequality, or a combination of the two. Achieving the same poverty reduction during a slowdown in growth therefore requires a more equal income distribution.

Some level of inequality is desirable to maintain an appropriate incentive structure in the economy or simply because inequality also reflects different levels of talent and effort among individuals. However, the substantial inequality observed in the world today offers great scope for reducing the gap between rich and poor. Policies to redistribute income from higher-income and wealthy households to those on lower incomes can be achieved without compromising growth, if done effectively. A trade-off between efficiency and fairness is not inevitable.

(Source: adapted from https://openknowledge.worldbank.org/bitstream/handle/10986/25078/9781464809583.pdf)

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6 (a) With reference to the information provided, explain the distinction between absolute poverty and relative poverty.

(5)

(b) With reference to the information provided and your own knowledge, examine **two** factors that might explain the differing rates of decline in absolute poverty in East Asia and Sub-Saharan Africa.

(8)

(c) With reference to Extract A, discuss **two** macroeconomic policies, apart from protectionism, that a government could use to reduce the negative effects of globalisation.

(12)

(d) Assess the view that 'some level of inequality is desirable to maintain an appropriate incentive structure in the economy' (Extract B, lines 19 and 20).

(10)

(e) Discuss the role of the financial sector in the growth and development of developing countries.

(15)

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(a) With reference to the information provided, explain the distinction between absolute poverty and relative poverty.

(5)

Absolute poverty is when people lack the basic necessities needed to survive, such as food, clean water, shelter and healthcare. The World Bank defines it as living on less than US$1.90 a day, measured at 2011 PPP (purchasing power parity) values so it can be compared across countries.

Relative poverty is when people are poor compared with others in their own country, usually defined as having a household income below 60% of the median household income. It depends on the general standard of living in that country.

Figure 1 shows absolute poverty in East Asia fell from around 60% of the population in 1990 to under 5% in 2012, and Extract A states a billion people in emerging economies have been taken out of absolute poverty, but 'relative poverty remains a problem'.

So absolute poverty can decline at the same time as relative poverty is increasing, if the incomes of the rich grow faster than those of the poor. A country such as the UK may have relative poverty but very little absolute poverty.

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(b) With reference to the information provided and your own knowledge, examine **two** factors that might explain the differing rates of decline in absolute poverty in East Asia and Sub-Saharan Africa.

(8)

Figure 1 shows absolute poverty fell far more rapidly in East Asia, from about 60% in 1990 to under 5% in 2012, than in Sub-Saharan Africa, where it only fell from about 55% to about 42%.

One factor is the level of education. East Asian economies such as China and South Korea invested heavily in schooling, while in Sub-Saharan Africa many children are not enrolled in primary education; Extract B notes the poorest children are four times less likely to be enrolled, and nearly two-thirds of 780 million illiterate adults are women. A relative lack of education means a less skilled and therefore less productive workforce, so wages stay low, fewer people can move into higher-paid manufacturing jobs and incomes fail to rise above US$1.90 a day.

A second factor is the level of trade and capital flows. Extract A explains that formerly closed economies in Asia opened up, cut tariffs and attracted free-moving capital. East Asia specialised in export-led manufacturing, attracting FDI, which created millions of jobs and increased incomes. Sub-Saharan Africa has relied more on primary commodity exports with volatile prices, has poorer infrastructure, making it more expensive to move goods to markets, and has faced civil war and poor governance, deterring investment.

However, the significance of each factor differs between countries: Botswana has grown strongly, so governance and stability may matter more than education alone. Also, improvements in education and infrastructure only raise incomes in the long term, so Sub-Saharan Africa's slower progress partly reflects a later start, and factors like drought and disease (healthcare) also play a role.

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(c) With reference to Extract A, discuss **two** macroeconomic policies, apart from protectionism, that a government could use to reduce the negative effects of globalisation.

(12)

Extract A says that in advanced economies globalisation has meant 'low wages, insecure employment, stateless corporations and striking inequalities', and the Governor of the Bank of England suggests a better mix of monetary policy, fiscal policy and structural reform.

The first policy is fiscal policy, the use of government spending and taxation. A more redistributive, progressive tax and welfare system, such as higher tax rates on top incomes and more generous benefits or tax credits for low earners, would raise the disposable income of workers whose wages have been held down by foreign competition. This directly reduces inequality and relative poverty caused by globalisation. Expansionary fiscal policy, such as higher government spending, also increases aggregate demand, creating jobs for workers made unemployed when firms moved production abroad, giving more 'inclusive growth'.

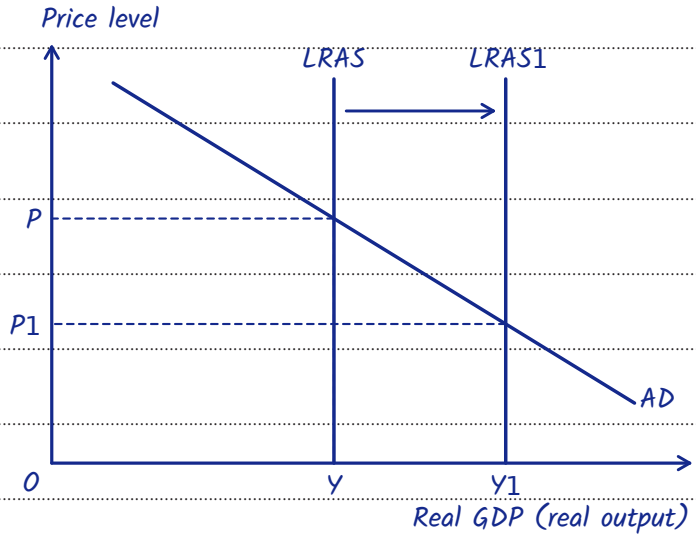
The second policy is supply-side policy, or 'structural reform'. Government spending on improved education, training, healthcare and infrastructure increases the skills and productivity of the workforce. Retraining workers who lost jobs in declining manufacturing industries reduces structural unemployment and occupational immobility. Higher productivity shifts LRAS right from LRAS to LRAS1 in my diagram, raising real output from Y to Y1 with a lower price level, P to P1. More productive workers can be paid higher wages, and firms can compete with foreign competition through lower prices and better quality, reducing insecure, low-wage employment.

Expansionary monetary policy, such as a cut in interest rates, could also help by raising the availability of credit so firms can borrow for investment to combat foreign competition.

However, expansionary fiscal policy will worsen the budget deficit and national debt, which is a problem for the UK after years of deficits, and higher taxes on the rich may lead 'stateless corporations' and entrepreneurs to relocate abroad, reducing tax revenue. Its effectiveness also

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depends on consumer confidence: if households save extra income, the multiplier is small. Supply-side policies may not be effective in the short run, as education and infrastructure take years to raise productivity, and they have large public sector cost implications and an opportunity cost. Extract A notes the earlier moderation of capitalism took about 100 years. Overall, a combination of redistributive fiscal policy in the short run and supply-side policy in the long run is likely to be most effective, but success depends on the size of the spending and on the government's ability to finance it.



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(d) Assess the view that 'some level of inequality is desirable to maintain an appropriate incentive structure in the economy' (Extract B, lines 19 and 20).

(10)

Inequality is the uneven distribution of income and wealth between individuals and households, which can be measured by the Gini coefficient or Lorenz curve. Extract B argues that some inequality is desirable to maintain incentives, and because it reflects 'different levels of talent and effort among individuals'.

Firstly, if people can earn a higher reward through higher wages, promotions or bonuses, they have an incentive to work hard, gain skills and train for productive jobs such as doctors or engineers. This increases labour productivity and economic growth, which raises average incomes and can result in reduced absolute poverty through a 'trickle-down' effect.

Secondly, the profit motive encourages entrepreneurs, firms and inventors to take risks and innovate. The prospect of high profits leads to more innovation and more competitive industry, giving faster economic growth. If income was fully equalised, there would be little reward for risk-taking.

Thirdly, lower taxes and less redistribution may encourage entrepreneurs and highly skilled workers to relocate to the country, bringing investment and jobs. Largely market-based economies, such as the UK and US, have seen rising living standards over time despite relatively high inequality.

However, the view refers to 'some level' of inequality, and Extract B says the substantial inequality in the world today offers great scope for reducing the gap. Excessive inequality can reduce consumer confidence: the poor have a higher marginal propensity to consume, so transferring income to the rich increases saving, and aggregate demand may fall as a result.

Excessive inequality can also lead to more crime, poorer health and lower educational attainment among the poor, so talent is wasted and growth is limited; Extract B notes inequalities 'result in high financial costs, limit economic growth' and generate social and political burdens. Very low pay can act as a disincentive to seek employment if it is little

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more than benefits, so economic growth suffers as a result.

Furthermore, Extract B argues redistribution can be achieved without compromising growth if done effectively, so 'a trade-off between efficiency and fairness is not inevitable'. Nordic economies such as Denmark combine low inequality with high living standards.

In conclusion, some inequality is desirable to maintain incentives, but beyond a certain level the costs outweigh the benefits. The appropriate level depends on whether inequality reflects effort and talent or unequal opportunities such as access to education, and on how effectively redistribution is designed.

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(e) Discuss the role of the financial sector in the growth and development of developing countries.

(15)

The financial sector includes commercial banks, central banks, insurance companies, stock markets and microfinance institutions. It channels funds from savers to borrowers, which is essential for growth (increases in real GDP) and development (improvements in living standards such as health, education and income).

Firstly, the financial sector facilitates saving. The Harrod-Domar model states that growth depends on the level of savings and the productivity of capital (the capital-output ratio). In many developing countries, such as those in Sub-Saharan Africa, savings are low because incomes are low and many people are 'unbanked'. Banks provide a safe place to save, so they have more funds available for lending, which finances investment, increases the capital stock and therefore raises growth.

Secondly, the financial sector promotes lending to enable more investment in the economy. Firms can borrow to buy machinery or build factories, and households can borrow to start small businesses. Microfinance, such as the Grameen Bank in Bangladesh, provides small loans to poor people, often women, who lack collateral and cannot access conventional banks. This allows them to set up businesses, earn an income and escape absolute poverty, contributing to development as well as growth.

Thirdly, the financial sector exchanges currencies, enabling firms to import parts and raw materials, often more cheaply, and also enabling them to export, helping to increase the size of their market. This links developing countries to global markets and attracts FDI. Stock markets provide a market for equities so large firms can raise finance for expansion, and insurance allows farmers and firms to take risks.

Central banks and international organisations also play a role. A central bank can keep inflation low and stable, and act as lender of last resort, providing the confidence needed for saving and investment. The World Bank and IMF lend to developing countries to fund

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infrastructure projects and stabilise economies.

However, for the financial sector to develop there needs to be a clear rule of law and property rights; without them, banks will not lend as contracts cannot be enforced and collateral cannot be seized. There is also a risk of corruption, where loans are given to politically connected firms rather than the most productive projects, so funds are misallocated.

There is a risk of market failure in financial markets, such as asymmetric information, speculation and moral hazard, which can lead to financial crises, as seen in the 1997 Asian financial crisis. Microfinance can also lead to over-indebtedness if borrowers take on loans they cannot repay at high interest rates.

Moreover, a lack of financial literacy in developing countries may limit the potential of the financial sector, as many people do not trust banks or understand how to use them. However, mobile banking such as M-Pesa in Kenya has greatly increased access to financial services at low cost.

Finally, other factors may play a larger role in growth and development, such as healthcare, infrastructure, education, political stability and access to markets. Even with savings available, the Harrod-Domar model assumes investment is productive, which requires skilled labour and good infrastructure. Savings may also flow abroad through capital flight.

In conclusion, the financial sector plays an important role in mobilising savings and enabling investment, which is key to growth and development in developing countries. However, its impact depends on strong institutions, effective regulation and complementary improvements in human capital and infrastructure, so it is necessary but not sufficient on its own.

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(Total for Question 6 = 50 marks)

TOTAL FOR SECTION B = 50 MARKS

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SECTION C BEGINS ON THE NEXT PAGE.

SECTION C

Answer ONE question from this section.

Write your answer in the spaces provided.

You are advised to spend 30 minutes on this section.

EITHER

7 In 2016 the UK Chancellor of the Exchequer announced that the government would spend an extra £23 billion on innovation and infrastructure over the following five years.

Evaluate the likely economic effects of this planned increase in government expenditure.

(Total for Question 7 = 25 marks)

OR

8 The British pound fell by over 10% to a 30-year low against the US dollar after the UK voted to leave the European Union.

To what extent will this depreciation impact on future economic growth in the UK?

(Total for Question 8 = 25 marks)

Indicate which question you are answering by marking a cross in the box ☒. If you change your mind, put a line through the box ☒ and then indicate your new question with a cross ☒.

Chosen question number: **Question 7** ☒ **Question 8** ☒

Write your answer here:

Question 7

Government expenditure is spending by the public sector on goods, services and investment, and is a component of aggregate demand (AD = C + I + G + (X − M)). An extra £23 billion on innovation and infrastructure over five years is a form of expansionary fiscal policy and of supply-side policy.

In the short run, the increase in government spending is an injection into the circular flow of income, so AD increases, shifting right from AD to AD1 in my diagram. Firms building roads, railways, broadband or research facilities hire more workers and buy more materials, so real output and employment rise. Through the multiplier effect, workers' incomes are spent in other

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parts of the economy, so the final increase in real GDP is greater than the initial £23 billion injection. This could reduce cyclical unemployment and help maintain growth after the uncertainty of the 2016 EU referendum.

In the long run, infrastructure spending increases the productive capacity of the economy. Better transport means less time spent in traffic jams and fewer delayed trains, so firms' costs fall and workers can commute further, improving geographical mobility of labour. Faster broadband raises productivity across many industries. This shifts LRAS right from LRAS to LRAS1, so real output rises from Y to Y1 without the price level rising as much as from an AD increase alone, giving sustainable, non-inflationary economic growth.

Spending on innovation, such as research and development, can lead to the development of new, more efficient ways of working, which boosts productivity, growth and living standards. Innovation means the UK may have more new goods and services that can be exported to other countries, such as in technology, pharmaceuticals and green energy. This improves international competitiveness and the current account, while higher net exports further increase AD.

Higher growth also raises tax revenue and reduces spending on benefits, so in the long run the spending may partly pay for itself and improve the government's budget position.

However, £23 billion is not really a very large amount of money, especially when spread over five years for the whole of the UK economy. At under £5 billion a year, it is less than 0.3% of UK GDP of around £2 trillion, so the impact on AD and LRAS is likely to be small.

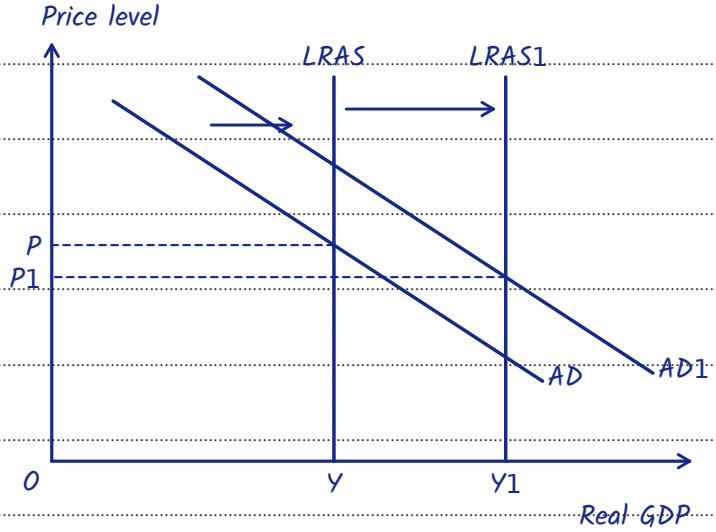
Also, there are many significant issues with poor quality infrastructure that will need a lot more money to solve, for example average speeds falling on roads in London and ageing rail infrastructure causing lots of delays. Projects such as HS2 alone cost far more than £23 billion. UK productivity has lagged behind other countries such as Germany and the US for some time, so it will need a significant boost just to catch up with the rest of the world.

There is no guarantee that innovation will boost growth, as research may not lead to

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commercially successful products, and the benefits may take many years to appear.

Infrastructure projects have long time lags for planning and construction, so the supply-side benefits may not be felt within five years.



The effect also depends on the effectiveness of the government at allocating resources. Government failure may occur if money is spent on politically popular projects rather than those with the highest returns, or if projects overrun on cost. The extra spending must be financed by borrowing, adding to the national debt, and it may crowd out private sector investment if it raises interest rates. If the economy is close to full capacity, the increase in AD may be inflationary.

The size of the multiplier also matters. With a high marginal propensity to import in the UK, much of the extra income may leak abroad, reducing the impact on UK GDP.

In conclusion, the planned increase in government expenditure is likely to have positive effects, raising AD in the short run and productive capacity in the long run. However, given its relatively small size, the time lags and the risk of government failure, the overall effect on the UK economy is likely to be modest, and it depends on how well the projects are chosen and managed.

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Question 8

A depreciation is a fall in the value of a currency in a floating exchange rate system, caused by market forces. After the 2016 vote, the pound fell by over 10% to a 30-year low against the US dollar. Economic growth is an increase in real GDP.

Firstly, UK exports are now cheaper when priced in dollars. For example, a £10,000 UK good that cost $14,500 at £1 = $1.45 would cost only about $13,000 at £1 = $1.30. This improves UK price competitiveness, leading to increased demand for UK exports from the US, the UK's largest single-country trade partner.

Secondly, UK imports from the US are now more expensive in pounds, so UK consumers and firms are likely to switch to domestic alternatives, reducing demand for US imports. Both effects improve net trade (X – M), so AD increases, shifting right from AD to AD1 in my diagram. Through the multiplier effect, higher demand for exports raises incomes and output further, increasing real GDP and employment in export industries such as manufacturing and tourism.

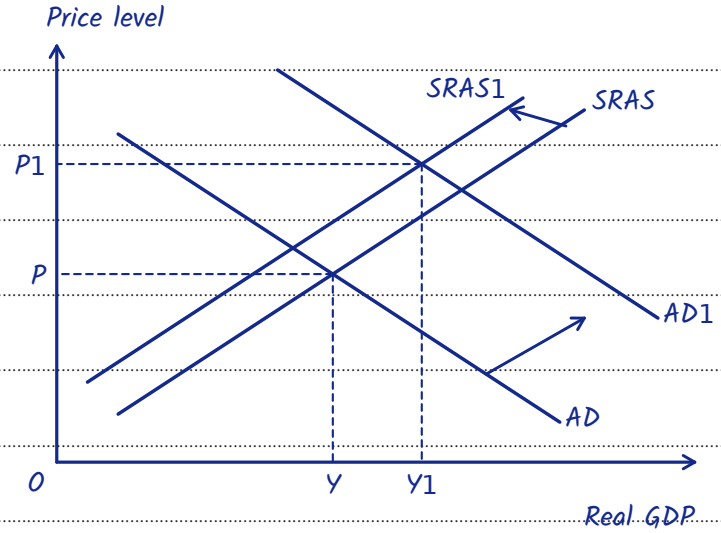
Thirdly, a lower exchange rate might attract inward investment, as UK assets, land and labour become cheaper for foreign firms, and FDI has multiplier effects on AD. Investment also increases the capital stock and productive capacity, supporting long-run growth.

However, there is a risk of imported inflation. As the price of imports rises, particularly of necessities such as food and fuel and of imported raw materials and components, firms' costs increase, shifting SRAS left to SRAS1 in my diagram. This raises the price level from P to P1 and reduces the increase in real output. Imported inflation will be a particular problem if wages do not increase in line with inflation, as real incomes fall and consumption, the largest component of AD, falls, reducing growth.

The impact depends on the price elasticity of demand for exports and imports. According to the Marshall-Lerner condition, a depreciation will only improve the current account if the sum of the PEDs for exports and imports is greater than 1. In the short run demand is often

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inelastic, as contracts are fixed and buyers take time to switch, so the current account may first worsen before improving, the J curve effect. The growth benefit may therefore only



appear in the long run.

It also depends on the quality of UK exports and whether US firms and consumers demand what the UK is producing. Non-price factors such as quality, design and reliability matter, and many UK exports are services such as finance, which may be less price sensitive. If there are no domestic alternatives to US imports, UK firms and consumers will simply pay higher prices. The impact depends on whether this is a temporary fall or a permanent adjustment to the exchange rate. If the pound recovers, firms will not change their plans. It also depends on the UK exchange rate with other currencies as well, especially the euro, as the EU is a very significant trading partner for the UK, taking around 45% of UK exports, so the impact is likely to be significant. As the US is also a significant trade partner, the impact of the fall against the dollar is likely to be significant too.

Finally, other factors which cause growth may be more important. The vote to leave the EU created uncertainty, reducing business confidence and investment, which may offset the benefits of the depreciation. Growth also depends on the state of the world economy, on productivity and on government policy, such as the Bank of England's interest rate decisions.

In conclusion, the depreciation is likely to boost UK growth in the short to medium run by increasing net exports and AD, but the effect is reduced by imported inflation and falling real

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wages, and depends on the Marshall-Lerner condition, the J curve and how long the low pound lasts. Given Brexit uncertainty, the overall effect on future UK growth is likely to be positive but limited.

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TOTAL FOR PAPER = 100 MARKS

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