Please check the examination details below before entering your candidate information

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**Pearson Edexcel Level 3 GCE**

| Centre Number | Candidate Number |
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| | |

# Thursday 23 May 2019

| Morning (Time: 2 hours) | Paper Reference **9EC0/02** |
|---|---|

# Economics A

## Advanced
## Paper 2: The National and Global Economy

| 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

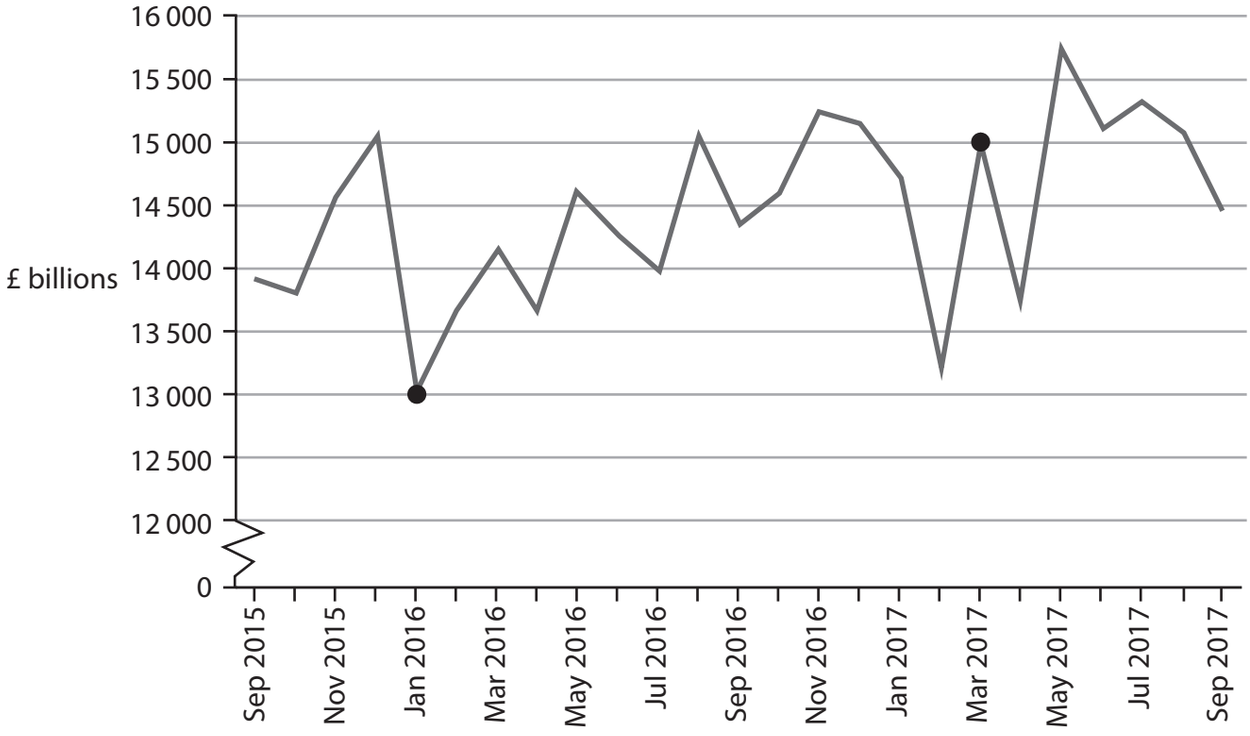
**Answer ALL questions. Write your answers in the spaces provided.**

**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 Monthly additions to UK credit card lending, £ billions, 2015 – 2017**




(Source: https://www.ukfinance.org.uk/statistics/cards/)

(a) Which **one** of the following would be **most** likely to cause an increase in credit card lending?

**(1)**

☒ **A** A fall in interest rates

☐ **B** A fall in investment

☐ **C** An increase in the deficit on the current account of the balance of payments

☐ **D** An increase in savings

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(b) Using the chart, calculate an index number for additions to credit card lending in March 2017, using January 2016 as the base. You are advised to show your working.

**(2)**

January 2016 (base year) = 13 000; March 2017 = 15 000 (£ billions)

Index = (value in March 2017 ÷ value in base period) × 100

= (15 000 ÷ 13 000) × 100 = 115.38

Index number for March 2017 = 115.4 (Jan 2016 = 100)

(c) Explain **one** possible link between an increase in credit card lending and the rate of inflation.

**(2)**

An increase in credit card lending is likely to cause a rise in inflation. Consumers use credit to spend more, so consumption, the largest component of aggregate demand, increases.

The rise in AD means demand grows faster than the economy's ability to supply goods and services, so firms raise prices, causing demand-pull inflation.

**(Total for Question 1 = 5 marks)**

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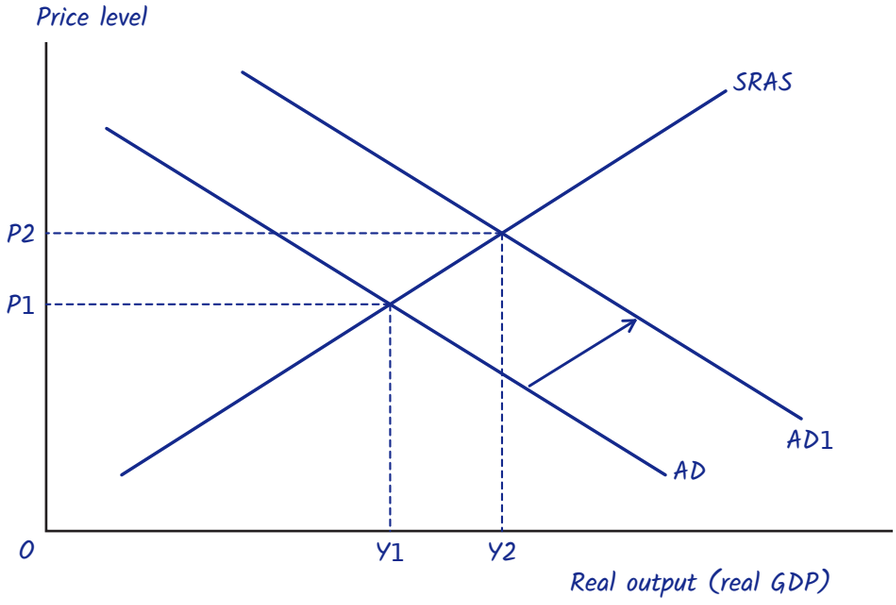
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**2** The International Monetary Fund has called on the G20 group of large industrialised countries to boost government spending on infrastructure.

(Source: https://www.theguardian.com/business/2016/jul/23/imf-calls-for-more-government-spending-as-rate-cuts-lose-their-impact)

(a) Draw an aggregate demand and aggregate supply diagram to show the likely impact of an increase in government spending on infrastructure on a country's price level and real output.

**(4)**




*Higher government spending on infrastructure (G) increases AD, shifting AD right to AD1: the price level rises from P1 to P2 and real output rises from Y1 to Y2. In the long run better infrastructure also raises productive capacity, shifting LRAS to the right.*

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(b) Which **one** of the following would be an example of government spending on infrastructure?

**(1)**

An increase in:

- ☒ **A** construction work on new railway lines
- ☐ **B** interest payments on the national debt
- ☐ **C** salaries for teachers
- ☐ **D** unemployment benefit payments

**(Total for Question 2 = 5 marks)**

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**3** Unit labour costs for selected European countries, 2017, base year 2010 = 100.

| Country | Unit labour costs |
|---|---|
| Austria | 113 |
| Hungary | 120 |
| Estonia | 129 |
| France | 107 |

(Source: http://www.oecd-ilibrary.org/economics/data/labour/unit-labour-cost-quarterly-indicators-early-estimates_data-00607-en)

(a) Explain **one** likely reason for Estonia's unit labour costs rising faster than in other European countries.

**(2)**

One likely reason is low unemployment and a shortage of labour in Estonia, as its economy grew faster than older EU economies such as France and Austria.

With labour in short supply, workers and trade unions can negotiate higher pay, and if wages rise faster than labour productivity, unit labour costs rise (to 129, a 29% rise since 2010).

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(b) Explain how Estonia's competitiveness could be affected by rising unit labour costs.

**(2)**

*Rising unit labour costs are likely to reduce Estonia's international competitiveness. Firms must pass on higher costs per unit through higher prices, so Estonia's exports become more expensive than those of countries such as France, where unit labour costs rose by only 7%, so demand for Estonian exports falls.*

(c) The increase in Austria's unit labour costs between 2010 and 2017 is:

**(1)**

- ☐ **A** 3%
- ☐ **B** 11.3%
- ☒ **C** 13%
- ☐ **D** 113%

**(Total for Question 3 = 5 marks)**

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**4** The UK Government is planning to cut the rate of corporation tax on all pre-tax profits of companies to 17% by 2020.

(Source: adapted from https://www.ft.com/content/7579f124-5742-11e7-9fed-c19e2700005f)

(a) This would be an example of:

**(1)**

- ☒ **A** a contractionary monetary policy
- ☒ **B** an exchange rate policy
- ☒ **C** an expansionary monetary policy
- ☒ **D** a supply-side policy

(b) If a company makes £500 000 pre-tax profit in 2020, calculate how much corporation tax it will pay. Assume that the government cuts the rate of corporation tax as planned.

**(2)**

*Corporation tax = pre-tax profit × tax rate*

*= £500 000 × 17% = £500 000 × 0.17*

*Corporation tax paid = £85 000*

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(c) Explain **one** possible reason why the revenue from corporation tax could increase if the government cuts the rate of tax.

**(2)**

*A lower rate of corporation tax may attract more firms, including multinationals, to choose to base themselves in the UK, and reduce tax avoidance such as shifting profits abroad. With more firms locating and declaring profits in the UK, there are more firms paying UK corporation tax, so the tax base widens and total revenue can rise even at a lower rate, as shown by the Laffer curve.*

**(Total for Question 4 = 5 marks)**

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**5** According to the charity Oxfam, the combined wealth of the 62 richest people in the world is the same as the wealth of the poorest half of the world's population. The value of the combined wealth of the poorest half of the world's population has fallen by 38% between 2010 and 2016.

(Source: adapted from https://www.oxfam.org/en/pressroom/pressreleases/2016-01-18/62-people-own-same-half-world-reveals-oxfam-davos-report)

(a) Explain the distinction between income and wealth.

**(2)**

*Income is a flow of money received over a period of time, such as wages, salaries, interest, rent, profits and dividends.*

*Wealth is a stock: the value of assets owned at a point in time, such as property, shares and savings. Wealth can create income (e.g. rent or dividends) and saving income can create wealth.*

(b) Explain **one** likely reason why global wealth inequality has increased.

**(2)**

*One reason is rising asset prices, such as shares and property, since 2010, partly due to low interest rates and quantitative easing.*

*The richest own most of these assets, so their wealth grows quickly, while the poorest half own few assets and cannot afford to buy them, so the gap widens: the poorest half's wealth fell by 38%.*

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(c) Which **one** of the following would be most likely to reduce a country's Gini coefficient?

An increase in:

**(1)**

- ☒ **A** import tariffs
- ☒ **B** progressive taxes
- ☒ **C** regressive taxes
- ☒ **D** value added tax

**(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 to C) before answering Question 6.**

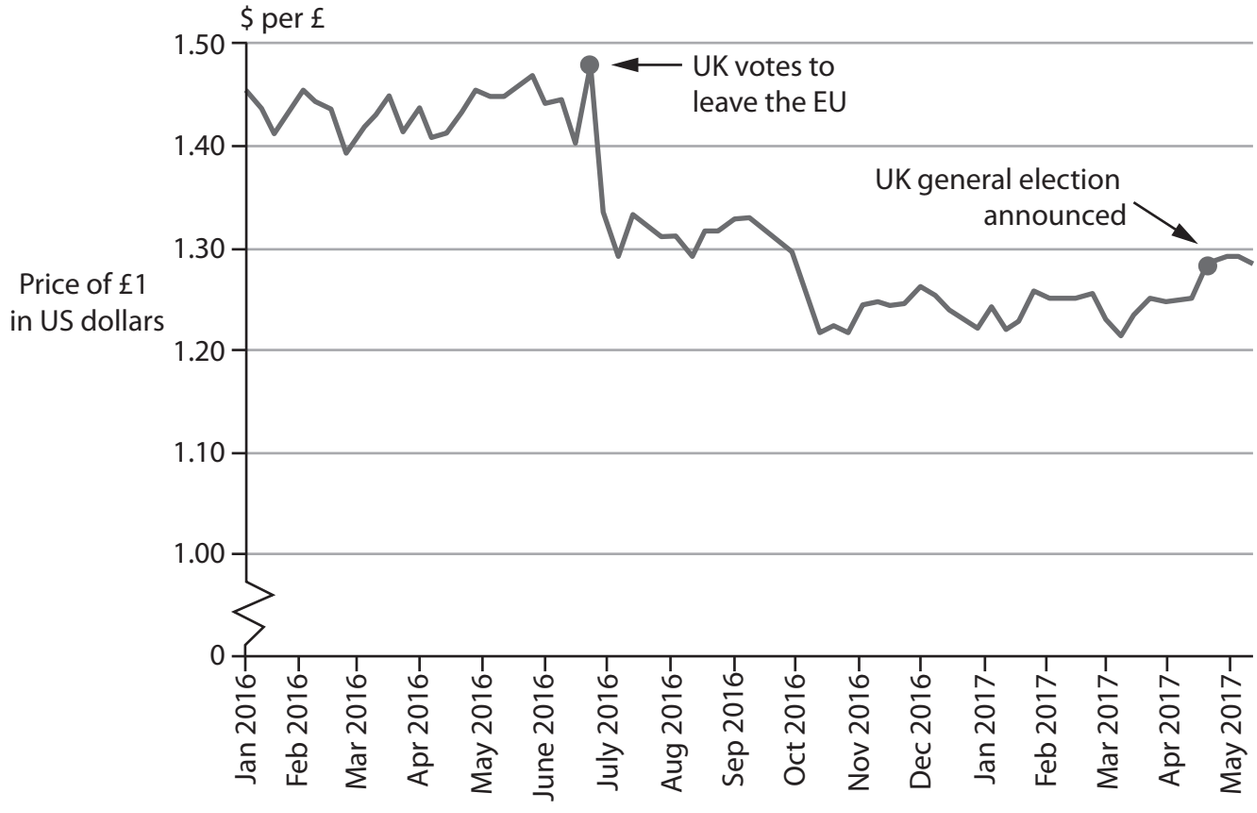
**Write your answers in the spaces provided.**

**You are advised to spend 1 hour on this section.**

**Question 6**

**The UK economy since the financial crisis**

**Figure 1: Pound sterling to US$ exchange rate, 2016-17**




(Source: adapted from https://www.ft.com/content/d50ce580-3968-11e7-ac89-b01cc67cfeec)

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## Extract A

### UK companies use forward currency market

The Norfolk-based picture frames maker Nielsen Bainbridge recently made forward contracts in the foreign exchange market to reduce the impact of currency fluctuations. The pound's post-Brexit referendum depreciation has been a test of nerve for Nielsen Bainbridge and many other importers. At present the company's suppliers are located in Europe or China. "Currency therefore has a big impact on our business and the margins we can obtain," says Ms Burdett, the Finance Director. Forward contracts enable institutions, businesses and individuals to lock in an exchange rate over a certain period of time regardless of how the rate moves during that time. Ms Burdett buys currency as soon as Nielsen Bainbridge confirms a large order as a way to fix costs. One third of UK business managers are considering shifting from EU to UK suppliers.

(Source: adapted from 'UK companies use pound strength to hedge forex risk' by Roger Blitz, Markets, © FT.com, 16 May 2017. https://www.ft.com/content/d50ce580-3968-11e7-ac89-b01cc67cfeec)

## Extract B

### Bank of England seeking to prevent future bank bailouts

The Bank of England has ordered big lenders in the UK to find £116 billion of funding to ensure that taxpayers will never again have to bail out the banking sector. The Bank intends to publish details of how each of the big lenders would cope in the event they find themselves in a situation similar to Royal Bank of Scotland and Lloyds Banking Group, which needed £65 billion of taxpayer bailouts during the 2008 Global Financial Crisis. This had a significant negative impact on the UK government's national debt and, many would argue, increased the need for contractionary fiscal policy. Having said that, the UK government sold all its shares in Lloyds Banking Group in 2017 and, according to the Chancellor of the Exchequer, "recovered every penny of its investment in Lloyds".

Sir Jon Cunliffe, the deputy governor at the Bank responsible for financial stability, said regulators needed to let banks fail in a similar way that traditional companies collapse. This has not been possible in the past because of the risk that savers lose their money and because a system did not exist to allow banks to be put into insolvency.

"Just like when other businesses fail, losses arising from bank failure would be imposed on shareholders and investors. This protects the public from loss and incentivises banks to operate more prudently," said Cunliffe.

(Source: adapted from 'Bank of England tells lenders to find £116bn to help prevent bailouts', by Jill Treanor, 02 October 2017, Copyright The Guardian News and Media Ltd https://www.theguardian.com/business/2017/oct/02/bank-of-england-bailouts-rbs-lloyds and 'Lloyds bank bailout repaid in full, Philip Hammond claims', by Jill Treanor, Larry Elliott, 21 April 2017, Copyright Guardian News & Media Ltd 2017 https://www.theguardian.com/business/2017/apr/21/lloyds-bank-bailout-repaid-in-full-philip-hammond-claims)

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**Extract C**

**Bank of England tells lenders to increase capital reserves**

The Bank of England has told lenders they will need to build a special reserve worth £11.4 billion by the end of 2018 as it tries to make banks more resilient to the risk posed by mounting consumer debt. This reserve of assets that can be readily turned into cash is a way of forcing banks to set aside capital reserves in good times in order to keep lending to the wider economy at a steady level, even during an economic downturn. In 2017 the Bank of England told UK banks it would raise the reserve ratio, relative to all assets, from zero to 0.5% and also forecast a further increase to 1% by the end of 2017.

The move is not intended to directly reduce consumer demand for credit, which in 2017 grew by 10.3% on an annual basis, but it may well lead to banks becoming less willing to lend to consumers. Since the Bank of England has recently become increasingly concerned about consumer borrowing, including rising car loans and credit card debt, this may be no bad thing as far as the Bank of England is concerned, even if it does have a negative impact on the wider economy.

Analysts are concerned about the impact on consumer confidence of rising inflation, partly caused by a falling pound. With falling real incomes consumers could become more vulnerable to falling behind with their credit card and personal loan repayments. Despite these concerns the UK economy recently recorded the lowest rate of unemployment since 1975.

(Source: adapted from 'Bank of England tells lenders to increase capital buffers by £11.4bn' by Caroline Binham, Gemma Tetlow and Martin Arnold © Financial Times 2017 https://www.ft.com/content/9bc99294-5b1b-11e7-9bc8-8055f264aa8b)

**6** (a) With reference to Extract A, explain the role of forward markets in currencies.

**(5)**

(b) With reference to Extract A and Figure 1, examine the likely impact of the change in the sterling exchange rate on the UK economy.

**(8)**

(c) With reference to the last paragraph in Extract C, assess the impact of a fall in real incomes on subjective happiness.

**(10)**

(d) With reference to Extract C, discuss the potential conflicts between macroeconomic objectives when the central bank attempts to control inflation.

**(12)**

(e) Discuss whether providing substantial government financial support to banks is the best policy response during a financial crisis.

**(15)**

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(a) With reference to Extract A, explain the role of forward markets in currencies.

**(5)**

*The forward market in currencies is where firms agree today a fixed exchange rate (a fixed price) for buying or selling a foreign currency at a future date, so they effectively buy their currency in advance.*

*Extract A shows that currency 'has a big impact' on the business and margins of Nielsen Bainbridge, because its suppliers are located in Europe and China, so it must pay in euros and yuan. The 'pound's post-Brexit referendum depreciation', from about $1.48 to around $1.30 in Figure 1, made its imports more expensive in pounds.*

*By buying currency as soon as a large order is confirmed through forward contracts, the firm locks in an exchange rate regardless of how the rate moves. This reduces risk and uncertainty: the firm can be certain about the cost of its imports in pounds, fix its costs and protect its profit margins, making it easier to set prices and plan.*

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(b) With reference to Extract A and Figure 1, examine the likely impact of the change in the sterling exchange rate on the UK economy.

**(8)**

Figure 1 shows the pound fell from about $1.48 to around $1.30 rapidly after the UK voted to leave the EU in June 2016, a fall of about 12%, and then to a low of just over $1.20 in October 2016. Extract A confirms the 'pound's post-Brexit referendum depreciation'.

A fall in the value of sterling makes UK goods appear cheaper to consumers in foreign countries when converted into their own currency, so exports become more price competitive and demand for them rises. At the same time, imports become more expensive to UK consumers and firms when converted into pounds, so they switch to UK products, as shown by one third of UK managers considering shifting from EU to UK suppliers. Net exports rise, which improves the current account and increases AD (AD to AD1). Through the multiplier, economic growth rises and unemployment falls, and cheaper UK assets may attract more FDI.

However, firms that import, like Nielsen Bainbridge, face higher costs of production, so SRAS shifts left (SRAS to SRAS1), causing cost-push imported inflation; together with demand-pull pressure, the price level rises from P to P1.

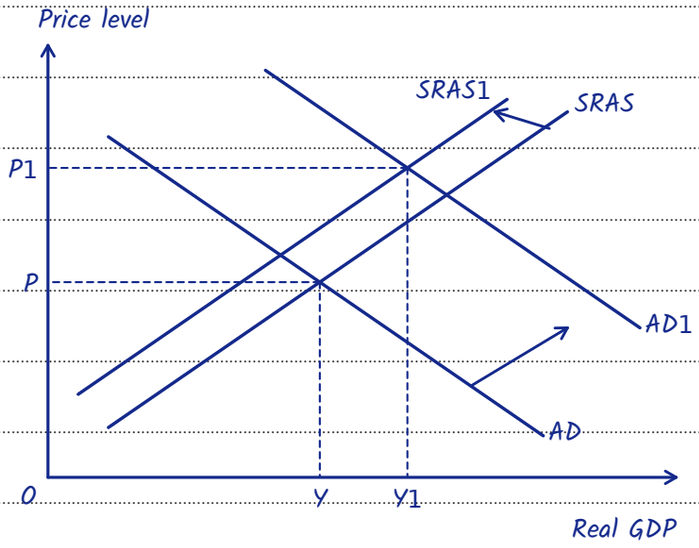
The impact depends on the price elasticity of demand for exports and imports. By the Marshall-Lerner condition, the current account only improves if PEDx + PEDm > 1. In the short run demand is inelastic, so the current account may first worsen, the J-curve effect. Also the fall may be short term: both Figure 1 and Extract A show the pound rising towards $1.29 in mid-2017, and firms using forward contracts are protected from the change for a time, so the overall impact may be limited.

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(c) With reference to the last paragraph in Extract C, assess the impact of a fall in real incomes on subjective happiness.

**(10)**

*Subjective happiness is how satisfied people feel with their lives, as reported by individuals in surveys such as the ONS wellbeing survey. Real income is income adjusted for inflation, showing the quantity of goods and services that can be bought. The last paragraph of Extract C explains that rising inflation, partly caused by a falling pound, means consumers face falling real incomes.*

*Firstly, with less real income consumers can afford fewer goods and services, such as holidays, eating out and leisure, that increase their happiness and satisfaction. Their standard of living falls, which is likely to reduce subjective happiness, especially for low-income households who must spend more of their income on necessities such as food and fuel whose prices rise with imported inflation.*

*Secondly, consumers may worry more about the state of their personal finances. Extract C states that with falling real incomes consumers could become more vulnerable to falling behind with their credit card and personal loan repayments. Worry about being able to continue paying mortgages and other debts causes stress and anxiety, which lowers wellbeing, and a fall in consumer confidence may further reduce happiness.*

*Thirdly, behavioural economics suggests people judge their position relative to others and to their past, so a fall in income from a previous level may be felt strongly: loss aversion means losses reduce happiness more than equal gains raise it.*

*However, other factors affect happiness besides real income, such as leisure time, health, relationships, job security and the environment. Extract C notes the UK recently recorded the lowest rate of unemployment since 1975; being in work is one of the strongest influences on happiness, so this may outweigh the effect of falling real incomes. Record low unemployment is also likely to lead to rising wages and real incomes in the future.*

*Also, people may maintain their consumption by increased borrowing to make up for falling real incomes, as shown by consumer credit growing by 10.3% in 2017, so happiness may not fall in*

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the short run, though rising debt may reduce it later. Research such as the Easterlin paradox suggests that above a certain level of income, changes in income have little effect on happiness, and a rise in real income may have a different effect on happiness from a fall.

Overall, the fall in real incomes is likely to reduce subjective happiness, mainly through financial worry about debt repayments, but the size of the effect depends on how large and long-lasting the fall is, and may be offset by low unemployment.

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(d) With reference to Extract C, discuss the potential conflicts between macroeconomic objectives when the central bank attempts to control inflation.

**(12)**

The main macroeconomic objectives are low and stable inflation (the Bank of England's target is 2% CPI), strong economic growth, low unemployment, a stable current account on the balance of payments and an equitable distribution of income. The central bank controls inflation using monetary policy: Bank Rate and quantitative easing (QE). Extract C shows inflation was rising, partly caused by a falling pound, and the Bank was concerned about consumer borrowing, which grew by 10.3% in 2017.

Firstly, there is a conflict between low inflation and economic growth. To reduce inflation the Bank raises interest rates, which increases the cost of borrowing and the reward for saving, so consumption and investment fall. Higher capital reserves (0.5% rising to 1%) also make banks less willing to lend to consumers. AD falls, which controls inflation but reduces economic growth; Extract C admits this may 'have a negative impact on the wider economy'.

Secondly, there is a conflict with low unemployment. Lower AD means firms need fewer workers, so unemployment rises. The short-run Phillips curve shows this trade-off: moving from A to B, inflation falls from $\pi 1$ to $\pi 2$ but unemployment rises from U1 to U2. This would threaten the UK's lowest unemployment rate since 1975.

Thirdly, higher interest rates attract hot money inflows into the UK, so demand for sterling rises and the exchange rate appreciates. UK exports become less price competitive and imports cheaper, which can worsen the current account deficit on the balance of payments.

Fourthly, there may be a conflict with equity. Higher interest rates benefit savers, who tend to be older and wealthier, while borrowers with credit card debt, loans and mortgages suffer higher repayments, so inequality may rise. Conversely, expansionary policy such as QE raised asset prices, benefiting the wealthy who own shares and property.

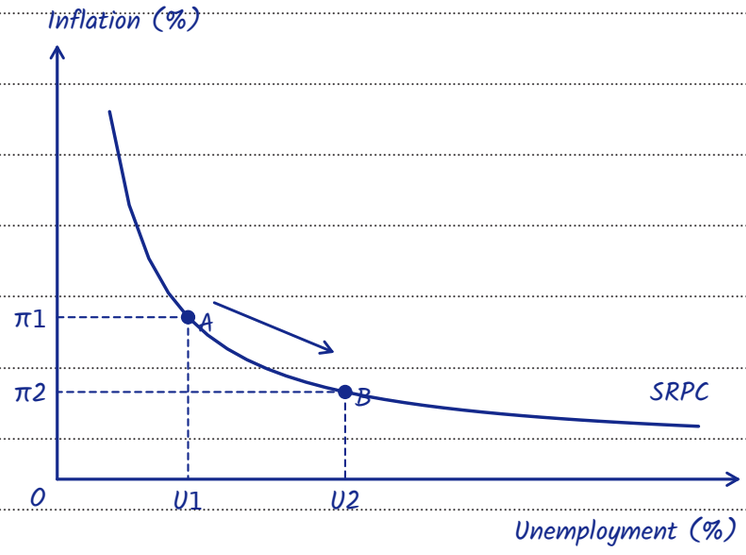
However, there may not be a conflict between some objectives. The UK has recently had both low inflation and low unemployment, which questions whether the Phillips curve is still valid;

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globalisation, flexible labour markets and anchored inflation expectations may have flattened it. In the long run, the long-run Phillips curve is vertical, so low inflation does not cost jobs.

If incomes keep pace with inflation, then inequality will not be an issue, and cutting QE reduces asset prices, thereby reducing wealth inequality. Low and stable inflation also creates confidence and certainty, supporting investment and long-run growth and international competitiveness.

The size of any conflict depends on the significance of the change in monetary policy: a 0.25 percentage point rise in Bank Rate from a very low level has a small effect, and inflation caused by a falling pound is cost-push and temporary, so the Bank may 'look through' it. Overall, conflicts are most likely in the short run and when policy changes are large.




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(e) Discuss whether providing substantial government financial support to banks is the best policy response during a financial crisis.

**(15)**

During a financial crisis, such as the 2008 Global Financial Crisis, banks may face insolvency or a lack of liquidity. Government financial support means bailouts, for example buying shares in banks (recapitalisation), lending to them or guaranteeing deposits. Extract B shows RBS and Lloyds Banking Group needed £65 billion of taxpayer bailouts.

There are strong arguments for this policy. The economy is dependent on the financial system working smoothly: banks provide the payments system, accept savings and provide credit to households and firms. If large banks had been allowed to collapse, there could have been systemic risk, with contagion spreading to other banks that had lent to them, so credit would dry up, investment and consumption would fall and AD would collapse.

People could have lost their savings if banks had been allowed to fail, leading to a massive drop in confidence and bank runs, as with Northern Rock in 2007. Falling confidence would reduce consumption further, so there was a potential risk of depression had the government not intervened, with mass unemployment and much lower tax revenues, which would itself worsen public finances.

Also, the government has recouped much of the money invested in bailing out the banks anyway: in 2017 it sold all its shares in Lloyds Banking Group and, according to the Chancellor, 'recovered every penny of its investment in Lloyds'. So the long-term cost to taxpayers may be small compared with the cost of a recession.

However, there are strong arguments against. Bailouts mean huge expenditure for a government that, in the case of the UK, already had a significant national debt. Extract B states the £65 billion bailout had a 'significant negative impact' on the national debt and increased the need for contractionary fiscal policy, so austerity cut public services, and the debt will have to be repaid by future generations of taxpayers. There is an opportunity cost, as the money could have been spent on health or education.

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Bailouts also create moral hazard: if banks know they are 'too big to fail', they will take excessive risks expecting to be bailed out again, making future crises more likely. It is unfair that taxpayers bear losses while shareholders and bankers kept the gains from risk-taking. In addition, the government looks unlikely to recoup its losses on RBS for some time, in contrast to Lloyds.

Other policies may be more effective. Expansionary fiscal policy and monetary policy, such as the cut in Bank Rate to 0.5% and QE in 2009, support AD directly. Better regulation can prevent crises: the Bank of England now requires big lenders to find £116 billion of funding so that 'taxpayers will never again have to bail out the banking sector', and higher capital reserves (Extract C) make banks more resilient. A system to let banks fail like other companies, with losses imposed on shareholders and investors (a 'bail-in'), protects the public and 'incentivises banks to operate more prudently'.

In conclusion, during a severe crisis when no resolution system exists, substantial support may be the best short-run response to prevent a collapse of the financial system and a depression, especially if the money is later recovered, as with Lloyds. However, because of moral hazard and the cost to public finances, the best long-run policy is strong regulation and bail-in arrangements so that banks can fail safely, with bailouts used only as a last resort.

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**(Total for Question 6 = 50 marks)**

**TOTAL FOR SECTION B = 50 MARKS**

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## SECTION C

**Answer ONE question from this section.**

**Write your answer in the space provided.**

**You are advised to spend 30 minutes on this section.**

**EITHER**

**7** Three of Africa's main trading blocs have agreed to form the Tripartite Free Trade Agreement (TFTA). This will create one of the world's largest free trade areas, stretching across 26 countries with a combined GDP of around £1trillion.

(Source: https://uk.reuters.com/article/uk-africa-trade/mega-african-trade-bloc-paves-way-for-continental-commerce-idUKKBN0OR28M20150611)

Evaluate the effects of the growth of trading blocs such as the TFTA on global trading patterns.

**(Total for Question 7 = 25 marks)**

**OR**

**8** Japan's budget deficit for 2017/18 is expected to be 4.6% of GDP. Its national debt is forecast to increase to above 250% of GDP by 2019.

Evaluate the impact of a large fiscal deficit and national debt on a country's economy.

**(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

A trading bloc is a group of countries that agree to reduce or eliminate trade barriers such as tariffs and quotas between members. Types include free trade areas, such as the TFTA, NAFTA and ASEAN, customs unions with a common external tariff, and common markets such as the EU single market, which also allows free movement of labour and capital. Trading patterns refer to which countries trade with each other, the goods and services traded and the volume of trade.

The TFTA brings together 26 countries with a combined GDP of around £1 trillion.

Firstly, trading blocs lead to trade creation. When tariffs between members are removed, domestic

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production is replaced with cheaper, more efficient imports from a member country. In my diagram, removing the tariff lowers the domestic price from Pw + tariff to Pw: domestic production falls from Q2 to Q1, consumption rises from Q3 to Q4, and imports rise from Q2Q3 to Q1Q4. Consumer surplus rises and there is a welfare gain. As a result, there is more trade within the trading bloc: for example, a large share of EU members' trade is with other EU members, and trade between African countries, currently only around 12% of Africa's total trade, is likely to rise.

Secondly, firms gain access to a larger market, so exports increase. A Kenyan or Egyptian firm can now sell tariff-free to 26 countries, so it can increase output and benefit from economies of scale, lowering average costs. Increased specialisation according to comparative advantage, where each country produces goods at a lower opportunity cost, raises output and leads to greater trade flows. Imports also increase due to the removal of protectionist barriers that previously existed between member countries, giving consumers more choice and lower prices.

Thirdly, trading blocs change the pattern of trade from trade with distant partners to trade with neighbours. African countries have historically exported primary commodities such as oil, minerals and cocoa mainly to Europe, the US and China. The TFTA may encourage African countries to trade manufactured goods with each other and develop regional supply chains, diversifying away from commodities. Trading blocs also attract FDI, as multinationals locate inside the bloc to avoid external tariffs, for example Japanese car firms locating in the UK to sell into the EU, which further increases trade within the bloc.

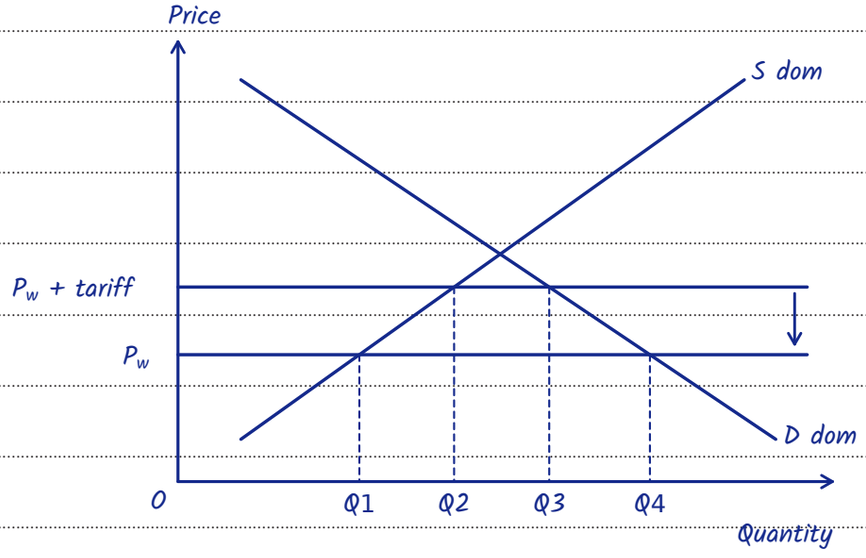
However, trading blocs can cause trade diversion. Where a common external tariff or other protectionist measures are imposed on non-member countries, countries may purchase imports from less efficient producers within the trading bloc instead of more efficient ones outside the bloc. This changes trading patterns away from the lowest-cost producers, such as China, causing a loss of allocative efficiency and harming developing countries outside the bloc. The net effect on world welfare depends on whether trade creation outweighs trade diversion.

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Products may still be cheaper from outside the trading bloc due to economies of scale and lower production costs. Chinese manufactured goods are produced at such low cost that, unless the TFTA imposes high external tariffs, African countries may continue to import from China, so trading patterns may change only a little. Also, the TFTA is a free trade area rather than a customs union, so each member keeps its own external tariffs, limiting trade diversion.

Other factors affect the ability to import and export, such as the quality of infrastructure at ports, airports, roads and railways. Many African countries are landlocked with poor transport links, and face non-tariff barriers such as border delays, corruption and differing regulations, so removing tariffs may have a limited effect on trade flows. Many members also produce similar primary products, so there is less scope for specialisation between them.

Countries may also benefit from bilateral trade deals without needing to join a trading bloc, and the growth of trading blocs may conflict with WTO rules on non-discrimination, as members give




each other preferential treatment. The growth of trading blocs could encourage regional rivalry and retaliation, reducing multilateral trade. In addition, since the TFTA is only within Africa, which accounts for under 3% of world trade, its effect on global trading patterns may be limited compared with the EU or NAFTA.

In conclusion, the growth of trading blocs such as the TFTA, the EU and ASEAN is likely to increase trade between member countries through trade creation, economies of scale and

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specialisation, shifting global trading patterns towards regional trade. However, the size of the effect depends on the level of external tariffs and trade diversion, infrastructure and non-tariff barriers, and the size of the bloc. For the TFTA, the effect on global trade patterns is likely to be small in the short run but could grow in the long run if infrastructure improves.

Question 8

A fiscal (budget) deficit occurs when government spending exceeds tax revenue in a given year, so the government must borrow. The national debt is the accumulated stock of government borrowing over time. Japan's deficit of 4.6% of GDP adds to a national debt forecast to be above 250% of GDP by 2019, one of the highest in the world, compared with around 85% in the UK.

Firstly, a large fiscal deficit is a fiscal stimulus and a net injection into the circular flow of income. Higher government spending or lower taxes increase aggregate demand, and through the multiplier effect real GDP rises by more than the initial injection. This can increase economic growth and reduce unemployment, which is why Japan has used deficit spending to fight deflation and stagnation since the 1990s.

Secondly, financing the deficit requires higher sales of government bonds, which may cause crowding out. Government borrowing increases demand for loanable funds, pushing up interest rates, so there are fewer funds available for investment by firms, and private sector investment falls. This reduces the positive impact on AD and harms long-run growth as the capital stock grows more slowly.

Thirdly, a large national debt means higher interest costs of servicing the debt. Money spent on debt interest has an opportunity cost: there is less money for public services such as health, education and pensions, lowering living standards. In Japan, with an ageing population, rising spending on pensions and healthcare adds further pressure.

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Fourthly, large deficits may require contractionary fiscal policy in the future as governments start to pay off the debt, through higher taxes or spending cuts, as with UK austerity after 2010. Higher taxes reduce incentives to work and invest, and future generations bear the burden, which raises issues of intergenerational equity. If markets lose confidence, a country may face a sovereign debt crisis and a downgraded credit rating, raising borrowing costs sharply, as in Greece in 2010 to 2012.

A large deficit may also affect the balance of payments and exchange rate. If foreigners buy government bonds, there are large inflows of finance on the financial account, which increases demand for the currency and causes appreciation, making exports less competitive and worsening the current account. However, if investors lose confidence and sell bonds, the currency may depreciate sharply.

However, government debt is not necessarily a problem as long as there are plenty of people and firms willing to buy it. Japan's debt is mostly held by domestic savers and the Bank of Japan, and its bond yields are close to zero, so interest costs remain low and there is little risk of a debt crisis. A country that borrows in its own currency with its own central bank is less likely to default.

Higher debts may mean governments are investing more in improving public services and infrastructure, such as transport, education and healthcare, which raises productivity and LRAS. If this boosts GDP, it will help pay for itself over time through higher tax revenues, and the debt to GDP ratio may fall as GDP grows. The impact depends on whether the deficit funds capital investment or current spending.

Crowding out is unlikely when the economy has a negative output gap and spare capacity, as in Japan, where private saving is high and interest rates are very low. In a recession the deficit is partly cyclical, caused by automatic stabilisers, and short-term fiscal deficits can be balanced out by surpluses in the future when the economy recovers, so a cyclical deficit is less of a concern than a structural one.

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*In conclusion, a large fiscal deficit can boost AD and growth in the short run, especially in a recession, but a very large national debt like Japan's raises debt interest costs, risks crowding out and future austerity, and burdens future generations. The overall impact depends on who holds the debt, the level of interest rates, what the borrowing is spent on and whether the deficit is cyclical or structural. For Japan, low interest rates mean the impact is manageable now, but its ageing population makes the debt a significant long-term risk.*

**TOTAL FOR SECTION C = 25 MARKS**
**TOTAL FOR PAPER = 100 MARKS**

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