Please check the examination details below before entering your candidate information

Candidate surname: StemUp Model Solution

Other names:

Centre Number

Candidate Number

Pearson Edexcel Level 3 GCE

Monday 22 May 2023

Afternoon (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.

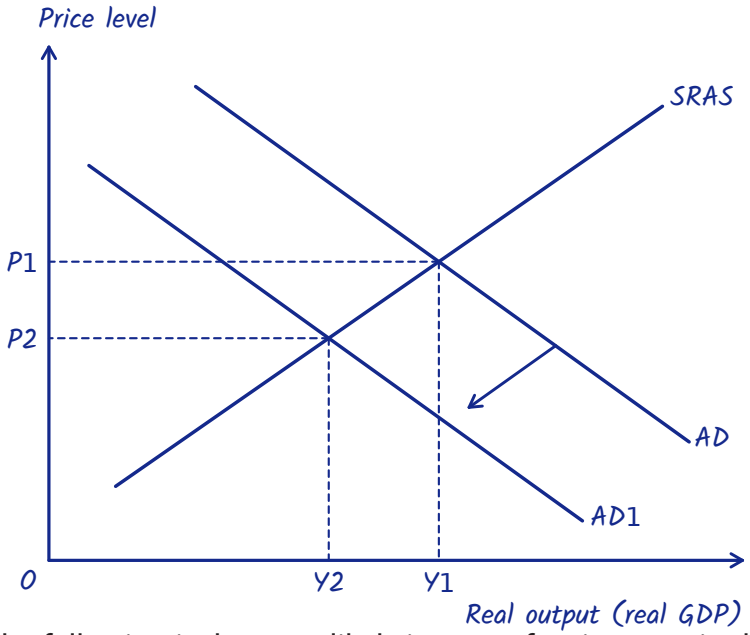
Use the data to support your answers where relevant. You may annotate and include diagrams in your answers.

1 In September 2022 the Bank of England increased the base interest rate from 1.75% to 2.25%.

(Source: adapted from https://www.bankofengland.co.uk/boeapps/database/Bank-Rate.asp)

(a) Draw an aggregate demand and aggregate supply diagram to illustrate the likely impact of an increase in the UK base interest rate on the average price level and real output.

(4)



(b) Which **one** of the following is the most likely impact of an increase in the base interest rate?

(1)

A decrease in the:

- ☒ **A** level of demand pull inflation
- ☒ **B** marginal propensity to save
- ☒ **C** rate of cyclical unemployment
- ☒ **D** value of the pound against the dollar

(Total for Question 1 = 5 marks)

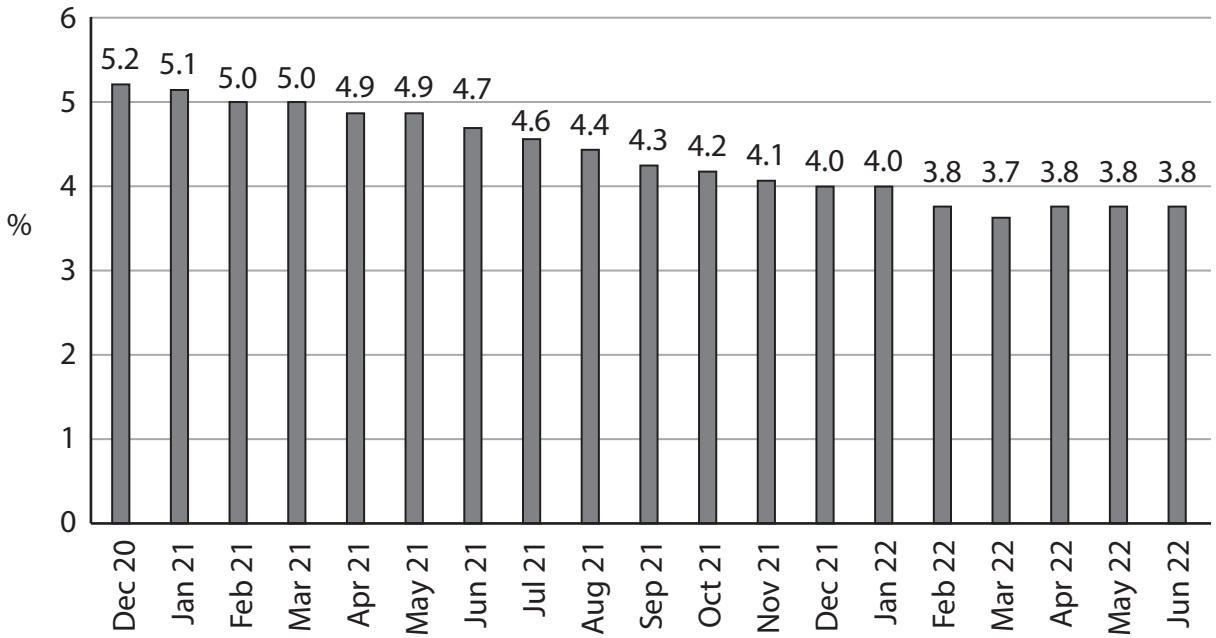
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QUESTION 2 BEGINS ON THE NEXT PAGE.

2 UK unemployment rate (%), December 2020 – June 2022



(Source: adapted from https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/employmentintheuk/august2022)

(a) With reference to the chart, which **one** of the following is true?

(1)

The unemployment rate:

- ☒ **A** fell by 1.4% between December 2020 and April 2022
- ☒ **B** fell by one percentage point between February 2021 and December 2021
- ☒ **C** was highest in March 2022 and lowest in December 2020
- ☒ **D** will continue to rise but at a slower rate

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(b) With reference to the chart on the previous page, explain **one** likely reason for the change in the UK's rate of unemployment.

(4)

The chart shows the UK unemployment rate fell from 5.2% in December 2020 to 3.8% in June 2022, reaching a low of 3.7% in March 2022, so the trend is downwards.

One likely reason is an increase in aggregate demand, especially consumption, as the economy reopened after the Covid-19 lockdowns. Households spent the savings they had built up on goods and services such as restaurants, travel and retail, increasing demand for goods and services in the UK and leading to economic growth.

Because the demand for labour is a derived demand, firms needed to hire more staff to meet the higher demand for their output. Vacancies were filled, cyclical unemployment fell and the negative output gap narrowed, so the unemployment rate fell.

(Total for Question 2 = 5 marks)

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3 UK real GDP, 2020–2022

	Annual percentage change on previous year	Total (£ millions)
2020	–9.9%	2 045 091
2021	7.5%	2 198 473
2022*	3.5%	

*2022 figures are forecast

(Source: adapted from https://www.ons.gov.uk/economy/grossdomesticproductgdp)

(a) Calculate the value of the total forecast GDP in 2022.

(2)

Forecast GDP 2022 = 2021 GDP × (1 + 3.5 ÷ 100)

= £2 198 473m × 1.035 = £2 275 419.6m

Answer: £2 275 420 million (about £2.28 trillion)

(b) Explain **one** likely cost of UK real GDP falling by 9.9% in 2020.

(2)

One likely cost is an increase in unemployment.

As real GDP fell by 9.9%, there was much less demand for goods and services, so firms cut output and looked to reduce their costs by laying off workers, since labour is a derived demand. Higher unemployment also means lower incomes and living standards and a fall in government tax revenue.

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(c) Which **one** of the following is most likely to lead to an increase in potential economic growth?

(1)

An increase in:

- ☒ **A** consumption
- ☒ **B** costs of raw materials and energy
- ☒ **C** income tax
- ☒ **D** technological advances

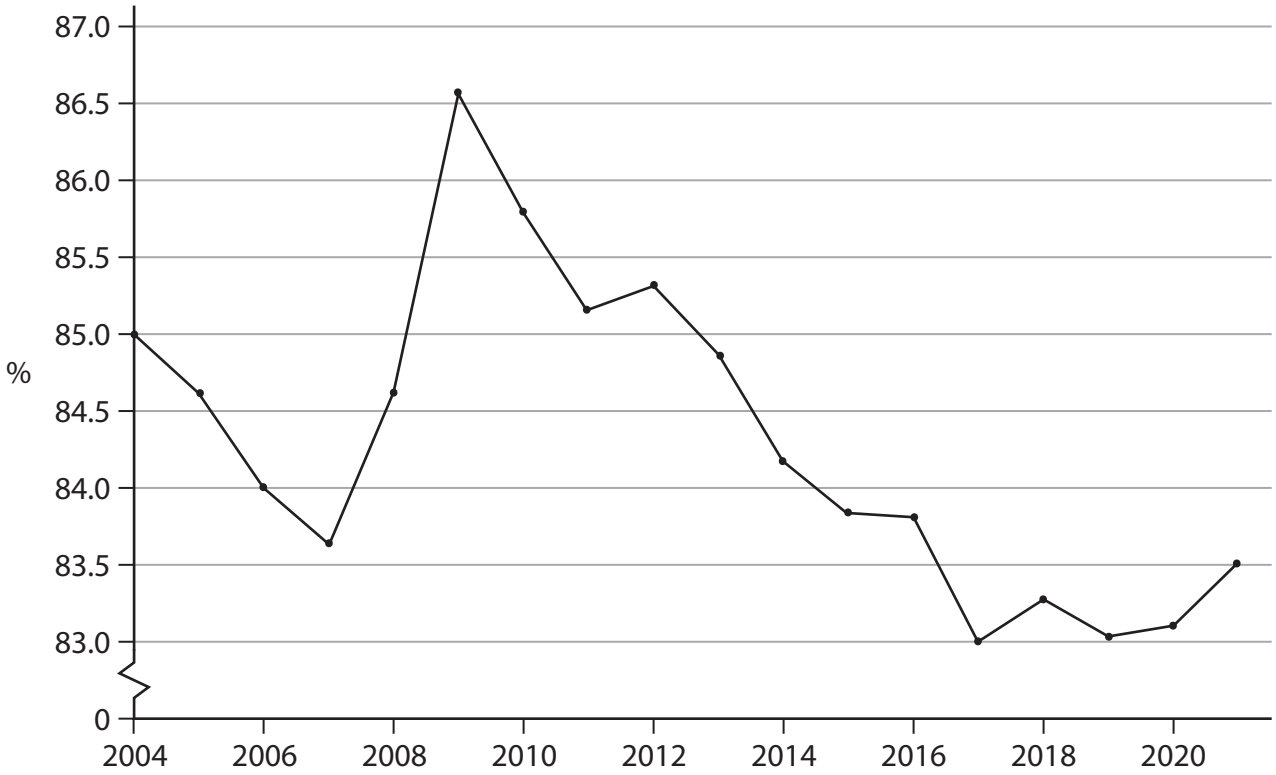
(Total for Question 3 = 5 marks)

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4 UK consumption, % of GDP, 2004–2021



(Source: adapted from https://data.worldbank.org/indicator/NE.CON.TOTL.ZS?end=2021&locations=GB&start=2002)

(a) Which **one** of the following is an example of consumption?

(1)

- ☒ **A** Construction of a new cycle lane
- ☒ **B** Expansion of Heathrow Airport
- ☒ **C** New school buildings
- ☒ **D** Purchase of new clothes

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(b) With reference to the chart on the previous page, explain the likely effect of a fall in the marginal propensity to consume on the level of real GDP. Refer to the multiplier in your answer.

(4)

The marginal propensity to consume (MPC) is the proportion of an extra £1 of income that is spent on consumption. The chart shows UK consumption as a percentage of GDP fell from about 86.5% in 2009 to 83% in 2017, which suggests the MPC fell.

The multiplier = 1 ÷ (1 − MPC), or 1 ÷ MPW. If the MPC falls from 0.8 to 0.75, the multiplier falls from 5 to 4. This is because more of each round of extra income is withdrawn from the circular flow of income as savings, taxes or imports, so the second round effects of spending are smaller.

Therefore any injection, such as an increase in government spending or investment, creates a smaller final increase in real GDP. Also, lower consumption directly reduces aggregate demand, so the level of real GDP is likely to fall, shown by AD shifting left, although other factors such as government spending may change too.

(Total for Question 4 = 5 marks)

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5 In 2021, the US total GDP was $23 trillion and national debt was $28.4 trillion.

(Source: adapted from https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=US and https://fiscaldata.treasury.gov/national-debt/)

(a) Calculate the US national debt in 2021 as a percentage of GDP.

(2)

National debt as % of GDP = ($28.4 trillion ÷ $23 trillion) × 100

= 1.2348 × 100 = 123.5%

Answer: 123.5% of GDP

(b) Explain the relationship between a fiscal deficit and the national debt.

(2)

A fiscal deficit is when government spending is greater than tax revenue in one year, while the national debt is the total accumulated debt of the government.

So there is a positive relationship: each year's fiscal deficit must be financed by borrowing, which adds to the total value of the national debt, and higher debt means increased government spending on interest payments.

(c) Which **one** of the following is the most likely consequence of an increase in the US national debt?

(1)

An increase in:

- ☒ **A** crowding out
- ☐ **B** inequality
- ☐ **C** poverty
- ☐ **D** unemployment

(Total for Question 5 = 5 marks)

TOTAL FOR SECTION A = 25 MARKS

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QUESTION 6 BEGINS ON THE NEXT PAGE.

SECTION B

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

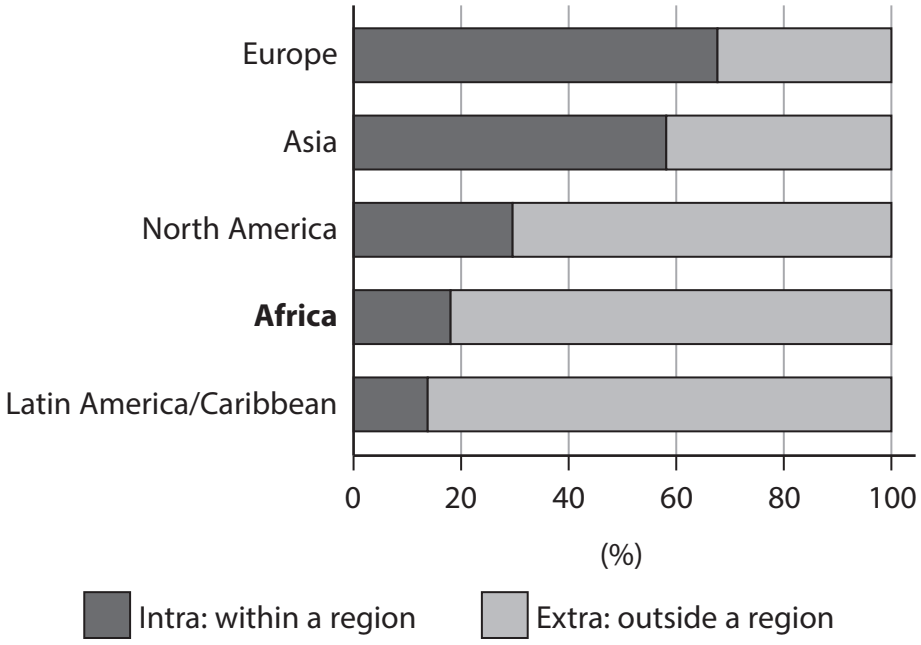
Write your answers in the spaces provided.

You are advised to spend 1 hour on this section.

Question 6

Trade and development in Africa

Figure 1: Intra- and extra-regional exports as a percentage of total exports, 2020



(Source: adapted from https://www.economist.com/middle-east-and-africa/2022/03/26/why-it-costs-so-much-to-move-goods-around-africa)

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Extract A: Why it costs so much to move goods around Africa

Lorries carrying, among other things, cobalt from Congo, copper from Zambia and tea from Malawi queued for miles as they waited to cross the Limpopo river into South Africa. Many were there for days. Some drivers bribe their way to the front; 1 000 rand (£49) is the going rate. Others cannot afford to.

African politicians say they want to end such delays. The African Continental Free Trade Area (AfCFTA) regional trade agreement, so far agreed by 41 of Africa's 55 countries, could boost the region's economies by making it easier to trade between themselves. In 2020 just 18% of exports were to other African countries (see Figure 1), lower than the equivalent in North America (30%), Asia (58%) or Europe (68%). More trade within the region could lead to more jobs, higher wages and less poverty.

The AfCFTA pledges to improve trade in two ways. The first is by reducing tariffs. This could boost intra-African trade by 15% to 25%, says the IMF. The second is to reduce non-tariff barriers which could cause a 50% rise in intra-African trade.

Poor infrastructure is a major barrier to trade. Africa's land area is bigger than China, India, the United States and much of Europe combined. Yet its railway network is not very much bigger than France's and Germany's put together. Many lines were built by colonial companies to link mines to ports, rather than countries to one another. Newer Chinese-built railways across African borders are under-used, either because they struggle to compete on price with road transport or because they lack additional services such as storage yards.

Ports are small and slow. Cargo waits for more than two weeks on average, compared to less than a week in Asia, Europe and Latin America. Handling costs are around 50% higher than in other parts of the world.

Nearly 90% of transport of goods goes by road, of which there are not enough. Road quality is poor. Just 800 000 km of the total of 2.8 million km in sub-Saharan Africa are paved.

The IMF estimates that if the quality of Africa's infrastructure were brought up to the global average this would increase intra-African trade by 7%. However, even bigger gains could be made by improving how trade flows. The key problem is a lack of information. In much of the world large firms can buy space on trains or lorries as they need it. But in Africa, where markets for this do not exist, firms such as miners have to sign long-term contracts with larger transport firms in which they agree to pay for capacity, whether they use it all or not.

(Source: adapted from https://www.economist.com/middle-east-and-africa/2022/03/26/why-it-costs-so-much-to-move-goods-around-africa)

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Extract B: Economic reform in Angola

When the new president, João Lourenço, took power in the southern African country of Angola in 2017, he pledged to reform the economy. This is a challenging task. The oil industry accounts for nearly all of Angola's exports and two-thirds of government revenues. The government is heavily involved in oil production along with significant foreign direct investment from international firms such as Chevron and Total. Declining production and falling oil prices brought about a collapse in GDP and rapidly rising debts to China and the IMF.

To reduce the cost of debt repayments, improve the country's fiscal position, and support a steadily declining debt-to-GDP ratio, the government of Angola has opted for debt relief. Together with a complete stop on debt repayments for the next three years, Angola will gain additional cash flow of $6.9 billion in 2020–22. This will help bring Angola's total annual borrowing to a much more manageable level of around 8.7% of GDP. With improved finances the government will have more money to spend supporting the economy and providing vital public services to its citizens, over 17 million of whom still live in absolute poverty.

The IMF, which has since 2018 agreed to lend $4.5 billion to Angola, is also encouraged by the country's fiscal policies. The finance minister, Vera Daves de Sousa, wants the state oil firm to sell shares to the public and for over one hundred state firms to be privatised. There have been delays – just 34 sales have taken place so far. But, she says, private firms must be the 'main driver' of growth and the economy must diversify away from oil.

Since 2019 Angola has ended government intervention in the foreign exchange market and moved towards a floating exchange rate. This led to a rapid depreciation in the kwanza (the Angolan currency) before stabilising after a few months.

(Sources: adapted from https://www.economist.com/middle-east-and-africa/2021/02/20/joao-lourencos-reforms-in-angola-are-pleasing-the-imf, https://www.cabri-sbo.org/en/blog/2021/country-spotlight-angolas-commitment-to-prudent-and-proactive-public-debt-management, and https://www.focus-economics.com/countries/angola/news/special/kwanza-dives-to-all-time-low-as-central-bank-floats-the-currency)

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6 (a) With reference to Extract A, explain what is meant by a 'regional trade agreement' (Extract A, line 7).

(5)

(b) With reference to Extract A, examine **two** causes of the high cost of transporting goods between African countries.

(8)

(c) Discuss the impact of improved transport links between African countries on economic growth rates.

(12)

(d) Assess **two** likely benefits of debt relief to Angola. Refer to Extract B in your answer.

(10)

(e) Discuss market-orientated strategies the Angolan government could use to improve development.

(15)

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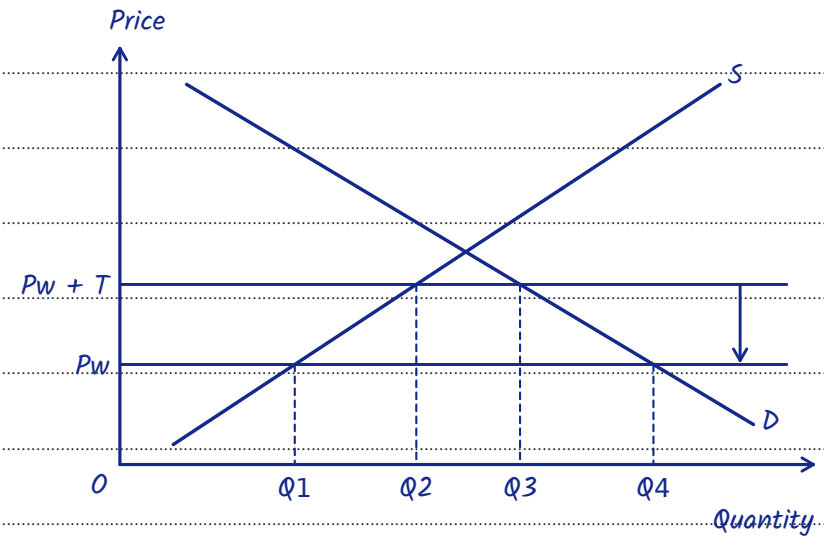
6 (a) With reference to Extract A, explain what is meant by a 'regional trade agreement' (Extract A, line 7).

(5)

A regional trade agreement is an agreement between countries in a particular region to reduce trade restrictions between members, aiming to promote and increase trade with each other, a form of trade liberalisation.

It usually involves reducing or removing tariffs between member countries, as well as cutting quotas, subsidies and other non-tariff barriers. An example is the African Continental Free Trade Area (AfCFTA), so far agreed by 41 of Africa's 55 countries.

Removing the tariff lowers the price of imports from member countries from Pw + T to Pw in my diagram, so imports rise from Q2 to Q3 up to Q1 to Q4. This leads to trade creation: the IMF says lower tariffs could boost intra-African trade by 15% to 25%.



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(b) With reference to Extract A, examine **two** causes of the high cost of transporting goods between African countries.

(8)

One cause is poor and limited road and rail infrastructure. Nearly 90% of goods are transported by road, but there are 'not enough' roads and quality is poor: just 800 000 km of the 2.8 million km of roads in sub-Saharan Africa are paved. Africa's railway network is not much bigger than France's and Germany's combined, and many lines link mines to ports rather than countries to one another.

As a result, lorries must travel slowly over long distances on damaged roads, which raises fuel and maintenance costs and the time taken to move goods between African countries. Delays from poor quality infrastructure increase costs, which firms pass on in higher prices.

A second cause is long delays at ports and border crossings. 'Ports are small and slow': cargo waits for more than two weeks on average, compared with less than a week in Asia, Europe and Latin America, and handling costs are around 50% higher than elsewhere. At the Limpopo crossing lorries queued for days, and some drivers pay bribes of 1 000 rand (£49) to get to the front.

Time spent waiting means drivers and lorries are not being used productively, goods may perish, and bribes add directly to the cost of each journey, so transport costs rise.

However, the relative significance of each cause is hard to be definite about, as it is a combination of factors. The lack of information may be even more important, since firms must sign long-term contracts and pay for transport capacity whether they use it or not.

Also, the new Chinese-built railways have the potential to speed up transport and cut costs if the problems of price and missing storage yards can be solved, so infrastructure problems may be reduced in future through investment from China.

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(c) Discuss the impact of improved transport links between African countries on economic growth rates.

(12)

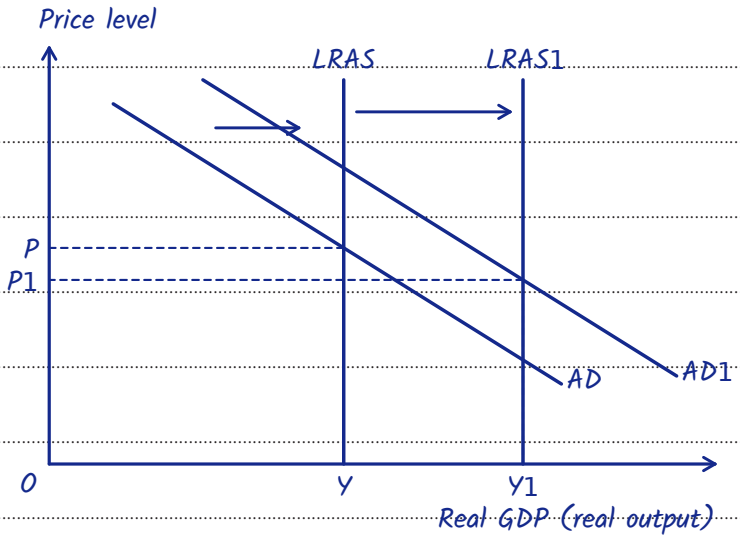
Economic growth is an increase in real GDP. Extract A shows that in 2020 just 18% of African exports went to other African countries, compared with 58% in Asia and 68% in Europe, so there is large scope to increase growth through more intra-African trade.

Improved roads, railways and ports would reduce the time and cost of moving goods across borders. If firms can move their goods more quickly and cheaply, they will be more able and willing to export to other African countries, so exports and net trade rise. This increases aggregate demand (AD = C + I + G + (X − M)) from AD to AD1 in my diagram, and through the multiplier effect real GDP rises by more than the initial increase in exports. More trade will also increase the demand for workers, boosting employment and incomes, which leads to more jobs, higher wages and less poverty.

Better transport links also raise the productive capacity of the economy. Lower transport costs mean the cost of imported raw materials and components falls, reducing firms' costs and inflation, and consumers benefit from cheaper goods. Workers can travel further to jobs, improving the geographical mobility of labour, and firms can sell to larger markets and gain economies of scale, lowering unit costs. Building the infrastructure is itself investment. This increases productivity and shifts LRAS right from LRAS to LRAS1, so real output rises from Y to Y1 and long-run growth rates rise without strong inflationary pressure. Better links also make African countries more attractive for foreign direct investment, adding further to growth.

However, the IMF estimates that bringing infrastructure up to the global average would only increase intra-African trade by 7%, while reducing tariffs could boost it by 15% to 25% and reducing non-tariff barriers by 50%. So improving information and cutting trade barriers may be a quicker, cheaper way to boost growth. Improved transport may also go underused if it is too expensive: the new Chinese-built railways struggle to compete on price with road transport.

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In addition, African governments are unlikely to have the funds to upgrade infrastructure, and borrowing to do so may worsen national debts, hampering growth in the future. Projects have long time lags, and geography makes building links across such a vast area difficult. Different African countries face different problems, and administrative problems at borders such as bribery, or civil unrest, may be a bigger barrier to growth than transport links.

Overall, improved transport links are likely to raise growth rates in the long run, especially for landlocked countries such as Zambia and Malawi, but the size of the impact depends on whether they are combined with lower tariffs and better information.

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(d) Assess **two** likely benefits of debt relief to Angola. Refer to Extract B in your answer.

(10)

Debt relief is when creditors cancel, reduce or reschedule the debt owed by a country. Extract B shows Angola has rapidly rising debts to China and the IMF after falling oil prices caused a collapse in GDP.

The first benefit is that it reduces the debt interest repayments Angola has to make, improving its fiscal position. With a complete stop on debt repayments for three years, Angola gains additional cash flow of $6.9 billion in 2020 to 2022, bringing annual borrowing down to around 8.7% of GDP. Because of the opportunity cost of repaying debt, the government now has more money to spend on public services such as healthcare and education. This can reduce absolute poverty, which affects over 17 million Angolans, and raises human capital, increasing productivity and attracting FDI inflows. There is also less need for Angola to raise taxes to pay off debts, protecting consumption.

The second benefit is more investment in infrastructure such as roads, power and ports, which is essential for industrialisation and increases the mobility of labour. In terms of the Harrod-Domar model, debt relief reduces the savings gap, as funds that would leave the country are available for investment, and it reduces the foreign currency gap, as fewer dollars are needed for repayments. A steadily declining debt-to-GDP ratio can also increase business confidence, leading to more private investment and helping the economy diversify away from oil.

However, it is only a temporary solution: the stop on repayments lasts three years, leaving the government with a debt problem in the future, especially if oil prices fall again. Debt relief may also reduce the confidence of creditors to lend to Angola in future, raising the interest rate on future debt. It could create moral hazard and a dependency culture, as the government may not pursue sound macroeconomic policies if it expects debts to be written off.

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Furthermore, IMF conditions may require cuts in food subsidies or other spending that harm the poor, and the benefits depend on governance: if the extra $6.9 billion is lost to corruption or poorly chosen projects, development will not improve. The relief may also be relatively small compared with Angola's total debt. Overall, debt relief gives Angola important short-term breathing space, but its long-run benefit depends on how well the funds are used.

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(e) Discuss market-orientated strategies the Angolan government could use to improve development.

(15)

Development is an improvement in living standards, including income, health, education and freedom, measured for example by the HDI. Market-orientated strategies reduce the role of the state and rely on the free market and the price mechanism to allocate resources.

The first strategy is privatisation, the transfer of state-owned firms to the private sector. The finance minister wants over one hundred state firms to be privatised and the state oil firm to sell shares to the public. Private owners have a profit incentive to cut costs, innovate and improve quality, so efficiency and competition in the economy increase. Selling shares in the oil company also raises funds the government can spend on health and education, improving development, and fits the minister's view that private firms must be the 'main driver' of growth.

The second strategy is encouraging foreign direct investment, for example through lower business taxes, deregulation and making it easier for foreign firms to set up. Angola already has significant FDI from Chevron and Total. FDI brings capital, technology, skills and jobs, and it could be targeted at non-oil sectors such as agriculture, manufacturing and tourism, helping the economy diversify away from oil, which is nearly all of its exports and two-thirds of government revenue. This reduces the risk from volatile oil prices.

The third strategy is moving to a floating exchange rate, which Angola has done since 2019, and trade liberalisation. Removing exchange rate controls lets the kwanza find its market value; the depreciation makes non-oil exports more competitive and encourages export-led growth. Removing tariffs and subsidies increases competition and gives consumers access to cheaper goods.

Other strategies include microfinance, which gives small loans to poor entrepreneurs, often women, so they can start businesses and escape absolute poverty, and labour market reform to increase the size and productivity of the workforce.

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However, privatised firms may cut the number of employees to reduce costs, raising unemployment and not boosting development, and there have been delays, with just 34 sales so far. Private monopolies may raise prices. Increased competition may mean some domestic firms cannot survive, and labour market reform may reduce workers' rights.

FDI may not be long term, and foreign firms may repatriate profits rather than reinvest in Angola, so the benefits to Angolans are limited, especially if FDI stays concentrated in oil. The rapid depreciation of the kwanza also raised import prices, causing inflation that hurts the poorest. Market-based strategies depend on property rights and the rule of law; without them the price mechanism fails and corruption distorts allocation.

Markets also under-provide merit and public goods such as healthcare, education and infrastructure, which are central to development. Interventionist strategies, such as government spending on these, may therefore be needed alongside market-orientated ones.

In conclusion, privatisation, FDI and a floating exchange rate can raise efficiency and help Angola diversify away from oil, but their success depends on good governance and on the benefits being shared widely, so a mix of market and interventionist strategies is likely to improve development most.

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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 In 2022 the value of UK exports fell by 14% compared with 2020. In contrast, the global average increase in exports was 8.2% over the same time period. The UK's competitiveness also fell, dropping five places from 18th in 2021 to 23rd in 2022 in the world competitiveness rankings.

(Sources: adapted from https://www.ft.com/content/021c629d-5853-4111-9600-ab5f0eb65a35 and https://www.imd.org/centers/world-competitiveness-center/rankings/world-competitiveness)

Evaluate macroeconomic policies that could be used to increase international competitiveness in the UK's export markets.

(Total for Question 7 = 25 marks)

OR

8 UK inflation, as measured by the CPI, rose to 10.1% in the 12 months to July 2022, compared to 2.0% in the 12 months to July 2021.

(Source: adapted from https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/july2022)

Evaluate macroeconomic policies, **apart from** monetary policy, the UK government could use to reduce inflation.

(Total for Question 8 = 25 marks)

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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

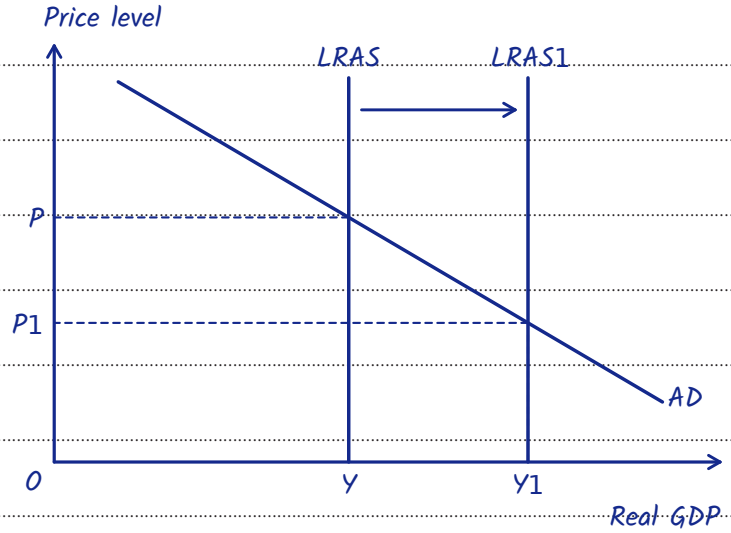
International competitiveness is the ability of a country's firms to sell goods and services in foreign markets at a price and quality that is attractive compared with rivals. UK exports fell by 14% between 2020 and 2022, while the global average rose by 8.2%, and the UK fell from 18th to 23rd in the world competitiveness rankings. Competitiveness depends on relative unit labour costs, productivity, the exchange rate and non-price factors such as quality.

One policy is fiscal policy in the form of lower business taxes, such as cutting corporation tax or offering investment allowances. This raises post-tax profits and the return on investment, so firms invest more in new capital and technology to improve productivity. Higher productivity reduces unit labour costs, so UK firms can charge lower prices in export markets. Lower income taxes could also encourage entrepreneurs and skilled workers from abroad to move to the UK.

A second policy is supply-side policy through increased government spending on education and training, which creates a more skilled and therefore more productive workforce. Spending on infrastructure such as transport and broadband reduces firms' costs and improves the geographical mobility of the workforce. These policies shift LRAS right from LRAS to LRAS1 in my diagram, so real output rises from Y to Y1 and the price level falls from P to P1, making UK goods relatively cheaper than foreign goods and improving export competitiveness.

Other supply-side policies include deregulation of businesses, improving the ease of doing business by simplifying tax regulations, freezing the minimum wage to reduce unit labour costs, and allowing more immigration to fill labour shortages that hold firms back from expanding. Subsidies to domestic producers reduce their costs of production, enabling them to charge lower prices.

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A third approach is trade policy: making trade agreements that remove tariffs and non-tariff barriers against UK exports. Since leaving the EU, UK exporters face customs checks and paperwork, so reducing these barriers would make it easier and cheaper for UK firms to export goods and services. Finally, allowing the pound to depreciate, for example through lower interest rates, makes UK exports cheaper in foreign currency, increasing price competitiveness. However, a reduction in business taxes leaves the government with less money to spend on education and infrastructure that may be necessary to improve competitiveness. Lower tax revenue also increases the fiscal deficit and national debt, which may reduce confidence in the UK economy, and tax cuts for firms and high earners may increase inequality. Firms may use higher profits to pay dividends rather than invest.

Spending on education and infrastructure has a very long time lag: students need to work through the education system, and construction projects can take decades from planning to opening, so they will not reverse the 14% fall in exports quickly. There is also an opportunity cost, and government failure if money is spent on the wrong projects.

Immigrants may not wish to work in the UK, depending on wages and the quality of public services, and a minimum wage freeze reduces real incomes for low-paid workers. Deregulation may have unintended consequences such as monopoly power of firms or lower environmental standards.

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Trade agreements, for example with the EU or other trading blocs, can be very time-consuming to negotiate, and other countries may demand concessions. A depreciation may only have a temporary effect, as it raises import prices and costs, causing inflation that erodes the price advantage; its success depends on the Marshall-Lerner condition.

The fall in UK exports may also reflect factors outside the government's control, such as the pandemic, Brexit uncertainty and weak demand in key markets, and the UK's strength in services means non-price factors such as quality and reputation matter more than price.

In conclusion, supply-side policies that raise productivity, such as investment in education, infrastructure and business investment incentives, are the most effective long-term way to improve UK competitiveness, while trade agreements reducing non-tariff barriers could give a quicker boost. The best approach is a combination, but its success depends on the time lags, the state of public finances and how well the policies are targeted.

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Question 8

Inflation is a sustained increase in the general price level, measured in the UK by the CPI. It rose from 2.0% in July 2021 to 10.1% in July 2022, far above the 2% target. Much of this was cost-push inflation from higher energy and food prices, together with demand-pull inflation as spending recovered after the pandemic. Apart from monetary policy, the government can use fiscal policy and supply-side policies.

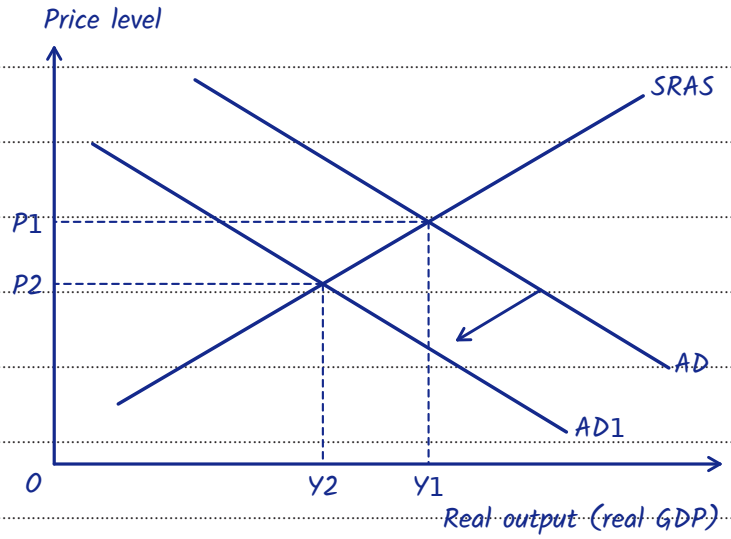
The first policy is contractionary fiscal policy. The government could increase income tax rates or lower tax thresholds, which reduces households' disposable income and therefore consumption, a component of aggregate demand. Raising corporation tax would reduce investment. Reducing government spending, for example through public-sector pay restraint, lowers AD directly. In my diagram, AD shifts left from AD to AD1, so the price level falls from P1 to P2, reducing demand-pull inflation. Pay restraint may also reduce the risk of a wage-price spiral.

The government could also change indirect taxes. A cut in VAT or fuel duty lowers prices directly and is shown by an increase in SRAS, reducing the measured CPI. Subsidies to energy firms or food suppliers, such as the Energy Price Guarantee, reduce their costs of production, shifting SRAS right and directly tackling cost-push inflation.

The second approach is supply-side policies. Increased spending on education and training creates a more skilled, more productive workforce, and spending on healthcare means workers spend less time off sick. Deregulation and privatisation increase competition and efficiency. These shift LRAS and SRAS to the right, so output can grow without inflationary pressure and unit costs fall. Investment in energy efficiency and renewable energy would reduce the UK's dependence on imported gas, lowering energy costs in the long run.

However, contractionary fiscal policy is unlikely to work well against cost-push inflation caused by global energy prices, because the cause lies outside the UK. Reducing AD would cut inflation only by reducing real output and raising unemployment, risking recession. Higher taxes

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on consumers may increase poverty and reduce living standards at a time when real incomes are already falling, and increases in taxes on firms may discourage them from operating in the UK, increasing unemployment. According to the Laffer curve, higher tax rates might even reduce tax revenue.

Less government spending may lead to a reduction in the quality of public services, for example long waiting times for NHS operations, and public-sector pay restraint could lead to strikes and staff shortages. The impact of these policies on inequality must also be considered, as cuts often hit the poorest hardest.

Subsidies will lead to higher government spending, which has to be funded either by borrowing, which must be paid back in the future, or by higher taxes; they may also increase demand and keep inflation high. A change in VAT will only affect inflation for one year, as once prices adjust the rate of inflation returns to its previous level.

Spending on education, healthcare and other supply-side policies is unlikely to solve the current inflation problem, as it takes too long to have an impact on AS; there are significant time lags and opportunity costs.

Many economists argue monetary policy, set independently by the Bank of England, would be better, as fiscal policy is subject to political pressure and long decision lags.

In conclusion, targeted subsidies and temporary tax cuts on energy are the most effective

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non-monetary policies in the short run, as they tackle the cost-push cause directly, while supply-side policies reduce inflationary pressure in the long run. Contractionary fiscal policy is only appropriate if demand-pull pressures are strong, so its success depends on the cause of inflation and the state of public finances.

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TOTAL FOR PAPER = 100 MARKS

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