AQA ECON4 ANSWERS

25 MARK QUESTIONS

JANUARY 2012

I wish to make clear that these answers are my own suggested approach and are not endorsed by AQA.

There are other approaches to the question besides the ones taken here, although the intention is that these are examples of good answers to the questions set. In particular, different evaluative judgements to those which I have made in answer to a question may be equally valid if supported by well-placed economic theory or real world evidence or examples. The guidance below provides some support in approaching questions.

Good luck with your studies and the exam.

Peter Cramp

Symbols – The answers here are annotated in much the same way that they would be by the examiner when marking candidate scripts. The symbols are designed to highlight the skills being demonstrated at each point in the answer:	
D	Definitions
Kn	Knowledge, for example of economic events or data
I	Issue – A relevant issue or point is raised. This is often in the first sentence of a paragraph.
Ap	Application – Applying the information in the extract, or knowledge of economic events or data, to help support the answer to the question.
An	Analysis – The use of relevant economic theory in answering the question, building up logical chains of reasoning.
E	Evaluation – Making judgements about the significance of particular factors, especially in providing a final answer to the question. Evaluation should be supported by relevant economic theory, information from the extract or the candidate's own knowledge

GUIDANCE

1. It is common exam practice to define key terms in the question in the introduction to your essay.
2. The first sentence of each main paragraph of your work should clearly specify the point or issue which will be analysed in the paragraph.
3. The issue to be analysed in each paragraph should be clearly related to the question. Suppose the question is “Evaluate the effects of economic growth in Brazil on the UK economy.” It is appropriate to use paragraphs beginning “One way Brazilian economic growth may affect the UK economy is………”
4. The analysis in each paragraph should be a logical chain of reasoning. The more detailed this analysis is, the better, so include as many “links” in your chain as possible.
5. Appropriate use of economic diagrams is another way of demonstrating the skill of analysis
6. You must have tight focus on the question set. Good economic analysis, but based on material which is irrelevant or of borderline relevance may result in a lower mark than if the material had not been included.
7. The skill of evaluation is vital to scoring high marks for 25 marks answers. This involves making reasoned judgements in response to the question.
8. The main place that evaluation is expected in your work is in your conclusion. You must reach a final judgement that answers the question set and your judgement must be backed substantially by appropriate economic theory and/or “real world evidence”
9. You are also likely to include some evaluation in the main body of your essay. This can usefully be undertaken at the end of a paragraph following substantial analysis, or in a separate evaluative paragraph following on immediately.
10. The more specific your judgement can be the better. Suppose for instance the question is to “Evaluate the effect of higher oil prices on macroeconomic performance”. After analysis of the impact of higher oil prices on the main macro indictors, some students might state by way of evaluation: “However, the effect all depends on whether the economy is based on manufacturing or services”. The evaluation would be much stronger if specific judgement is made, such as: “Some economies, such as the UK, increasingly specialise in services. Because services do not use as much oil as the manufacturing sector, the macro performance of these economies will be less damaged than the performance of industrial economies such as that of China, which needs oil to grow”. This may be one of a number of concluding judgements made. Another might be: “Although higher oil prices generally damage macro performance by constraining growth and employment and fuelling cost-push inflation, some economies might actually benefit. This might be

the case for net exporters of oil, whose trade position and therefore national income may improve. Such a scenario is especially likely for Middle East economies for which oil revenue is a large proportion of national income, such as Saudi Arabia”.

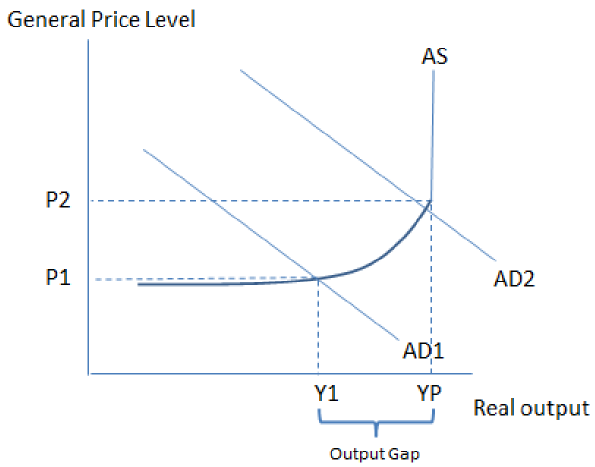
It is a good idea to study previous questions and to have a stock of examples and real world data that would help to answer them. You can pick up such examples from these suggested answers.

AQA ECON4 JANUARY 2012 CONTEXT 1

D Economic growth is the increase in an economy's productive capacity, allowing it to produce higher levels of output and income. It is measured as the year on year increase in gross domestic product, the value of all output produced in the domestic economy.

I One potential benefit of India's growth for the UK economy is that it could lead to increased UK exports. **An** As incomes in India grow, so too does consumption. Not all of this increased demand will be met by Indian firms, and this offers export opportunities for firms in other countries, including the UK. **Ap** It is also likely that Indian firms will need to purchase "world class services" in order to facilitate their growth, and these areas may boost UK exports too. **An** Exports are an injection into the UK circular flow of income and a source of aggregate demand for our products and services. Accordingly, demand from India could help the UK's recovery, including generating multiplier effects as the income created for some leads to increased spending and income for others. The derived demand for labour would be boosted too, helping to reduce UK unemployment. The effects are shown in the diagram.

An Diagram Indian economic growth could provide a boost to UK exports and hence AD



I/Ap/E The hope that India's growth would "speed the UK recovery through increased exports" may prove a little optimistic, however. As the extract identifies, India only accounts for 1% of the UK's exports at present. This has the potential to grow substantially in the future (official trade statistics show that the UK's exports to India grew by 43% in 2011) but it is doubtful whether our sales to India can grow quickly enough to make a strong contribution to recovery from this recession. The reality is that India's emerging economy is only just beginning to develop a strong consumer sector and it is this that is required if there is to be a substantial market for the UK's exports, so the benefits for the UK economy will be felt most strongly years down the line.

I India may have significant effects on the UK labour market. **An** Its population of 500m, as identified by the extract, results in a large labour supply, low wages and correspondingly low unit labour costs. Competition from workers in India and other emerging economies has depressed wages for some UK workers and indeed displaced them, leading to unemployment. **Kn** Many call centres that used to employ UK workers are now located in India, for example. **An** If UK workers do not possess transferable skills, such unemployment can be structural and enduring in nature.

I/Ap/E However, "India is now more likely to be creating jobs in the UK through direct investment rather than 'stealing' them". Indian firms may choose to locate in the UK as a gateway to Europe. **An** The EU's single market means that no tariff is paid when goods are exported to the European mainland from the UK. Further, the UK's relatively flexible labour market may make it an attractive location. Investment from Indian firms could create new capital in the UK economy, boosting its potential output and helping to create sustainable growth. The activities of firms such as Tata are already helping to create such benefits and there is surely much more potential here if the Indian economy continues to grow as strongly as it has done.

I Indian economic growth may cause inflationary problems for the UK economy, by contributing to world demand for food and other commodities. **Kn/Ap/An** To an extent, the UK's cost-push inflation that has kept inflation above its target rate for much of the time since 2008 can be attributed to growing incomes and consumption in emerging economies, as increased commodity prices have to some degree been passed on to UK consumers, with firms not able to fully absorb these increases.

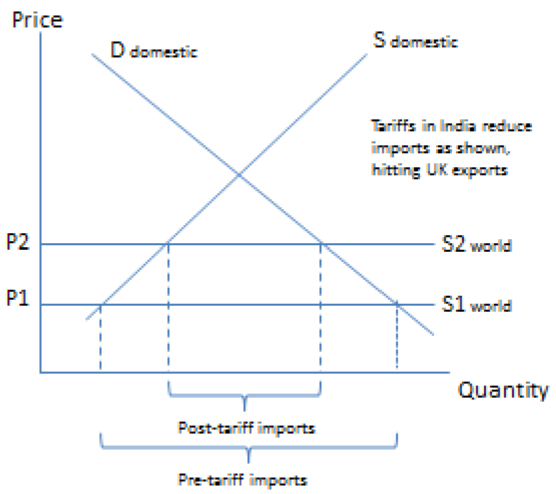
I It might also be argued that Indian economic growth could impact on the UK through environmental factors. **An** The introduction of hundreds of millions of new consumers to the global economy is likely to be associated with increased negative externalities in the form of carbon dioxide emissions, for example, and its contribution to global warming. This may make it more pressing for UK firms and government to incur costs in reducing UK emissions or combatting the effect of global warming.

Evaluation/final judgment (s)

An It is possible to conclude that the growth of India is likely to be of significant benefit to the UK economy in the long term, as long as good links are established. While its impact on commodity prices and the environment are a concern, the UK is in desperate need of rebalancing its economy towards the export sector, as our heavily indebted consumers and government are poorly placed to support economic growth. On this basis, India's economic growth can only be welcomed. It would be wrong to expect this to have huge impacts in the short term, however, and the UK needs to look to other sources to support its recovery and avoid a double-dip recession, such as growth in our largest single export market, America, for example.

I/Ap This conclusion is strengthened by the fact that at present "India remains fiercely protective". This implies that it is using measures to limit imports into its domestic market, such as tariffs for example (see the diagram below showing the effects of this). By raising the relative price of UK exports to India, such tariffs make it less likely that Indian firms and consumers will buy UK products. Even though the UK tends to specialise in exports that are not sensitive to price, protectionism can only limit the benefits to the UK of Indian growth until such time as agreements can be put in place to reduce these barriers.

An Diagram Protectionism in India may reduce UK exports

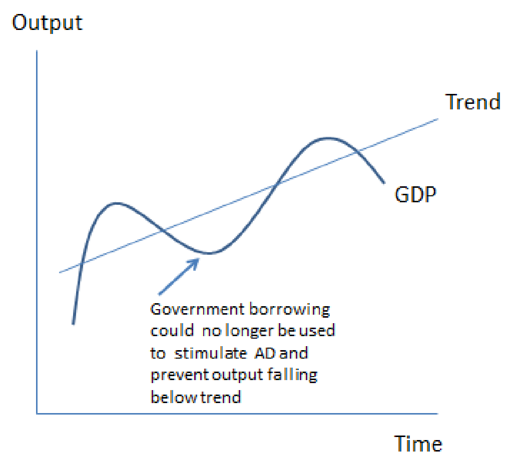


AQA ECON4 JANUARY 2012 CONTEXT 2

D Fiscal policy is government policy in relation to government spending and taxation. A requirement for all EU member states to balance their budgets would mean that all government spending would have to be financed by taxation revenue and no new government borrowing could occur.

I One effect of such a requirement for the UK would be that it would lose the power to run a budget deficit in order to help counter downturn or recession. **Ap** As the extract identifies, governments including that of the UK were keen to use Keynesian policies to boost aggregate demand in the face of the recession in 2009. **An** Government spending is an injection into the circular flow of income, while taxation is a leakage. Accordingly, government borrowing results in a net injection of aggregate demand to the economy, helping to generate business for firms and support output. This can be boosted by multiplier effects as the injection creates incomes for firms and workers, allowing them to spend and create income for others. Jobs are also created because the demand for labour is derived from the demand for goods and services that labour produces. In this way, running a budget deficit can help the government to counter recession by preventing the gap between current and potential output becoming too great.

An Diagram A balanced budget rule would reduce ability of UK to manage demand



I A second effect for the UK of being required to balance its budget would be that it might actually have to tighten its fiscal policy during a recession. **An** This is because government finances deteriorate automatically during a recession. Shrinking economic activity reduces the tax base and lowers government revenue, while transfer payments in the form of benefits are likely to increase. This may create a budget deficit which is contrary to the new balanced budget rule and necessitate that the government increases tax rates or cuts its spending. This may then make the recession worse.

I The UK could also suffer as a result of other EU member states being required to balance their budgets. **An** This is because the rule would limit the ability of governments across the EU to stimulate demand and support growth in their economies. Lower income would then result in lower consumption, and this would serve to reduce demand for UK exports, in turn hitting growth in the UK.

Evaluation/final judgement (s)

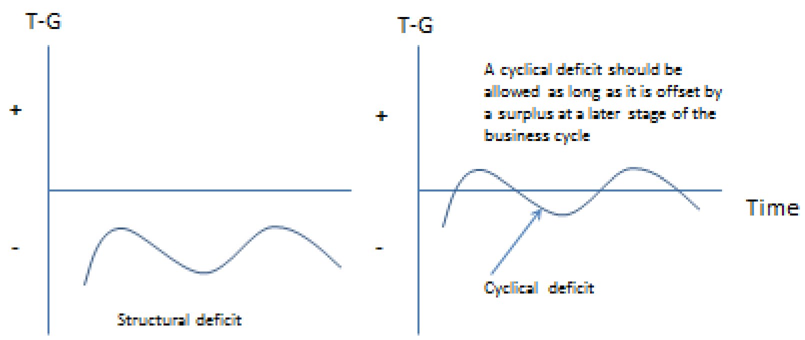
I It is clear, then, that a new balanced budget requirement in the EU would prevent both the UK government and others from being able to use fiscal policy to manage the short to medium term performance of their economies. **An** The recession in 2009 has shown just how important this ability can be. The loss of this power could have particularly serious effects because of the large extent to which trade between EU countries contributes to the output of them all. Collectively, the EU countries are the UK's largest trading partner by some distance and the UK could be badly damaged if the balanced budget requirement led to subdued growth in these countries. **Kn/Ap/An** This is especially important due in view of the UK's current need for a rebalancing of its economy so that it relies less on domestic consumption and can enjoy more export-led growth. While it is possible that over time emerging economies may become important markets for UK exports, we are currently highly dependent on our trade with EU countries, so could be hit badly by the balanced budget requirement.

I The effects of the balanced budget requirement may be more beneficial when considered in the long term, however. **Ap** As the extract suggests, "it cannot be denied that the best way forward is that which delivers macroeconomic stability across the EU". The balanced budget requirement would help to prevent member states from accumulating unsustainable national debts. The example of Greece with its "budget deficit of 14% of GDP and national debt of 115% of GDP in 2009" demonstrates the impact that this can have. **An** Investors began to see it as being too risky to lend to the Greek government, with the effect that interest rates rose and Greece was effectively bankrupt, needing support from other EU member states. Greece is now experiencing rapidly falling incomes and savage cuts. It is possible to argue that had a balanced budget requirement been adhered to in earlier years, the long term effects would have been much better for Greece, for the EU, and by implication for the UK's export markets.

I A straight forward balanced budget requirement would be too restrictive for EU and the UK, however. It would be better to require that budgets be balanced over the length of a business cycle. **An** This would allow governments to run deficits to counter recessions, so long as they run a corresponding surplus later in the business cycle. Any budget deficit would then be cyclical rather than structural. The national debt would not increase over time, but the government could still smooth the business cycle. Further, it would be sensible to allow governments to borrow for investment purposes, as this allows the capacity of the economy to increase, generating sustainable economic growth and increased tax revenues in the future.

An Both the UK government and other EU governments do need to ensure that their finances are well controlled. Without this, borrowing may become unsustainable or interest rates may increase, as investors demand a risk premium when lending to governments. **Kn** A number of European nations are now in this position, and even France has lost its AAA credit rating. **An** While a balanced budget requirement could help to produce macroeconomic stability, and in this way help to protect the UK's interests, the requirement should be applied over the length of an economic cycle and borrowing should be allowed for investment purposes. These are the rules that applied in the UK prior to the global financial crisis. However, once rules are set they should be adhered to, otherwise their potential benefits are lost. It would be beneficial for the UK if these rules were adopted by the EU, but with measures in place to ensure that they cannot be flouted by governments.

An Diagram Budgets should be balanced over the length of a cycle

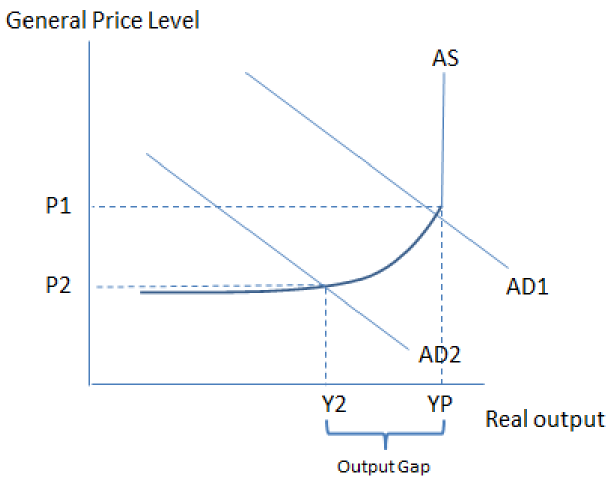


AQA ECON4 JANUARY 2012 ESSAY 1

D A deficit in trade in goods occurs when a nation imports a higher value of goods and services than it exports over a given period of time. Trade in goods is one component of the current account of the balance of payments. The current account also comprises trade in services, net investment income from abroad (interest, profits and dividends) and transfers (for example, foreign aid payments).

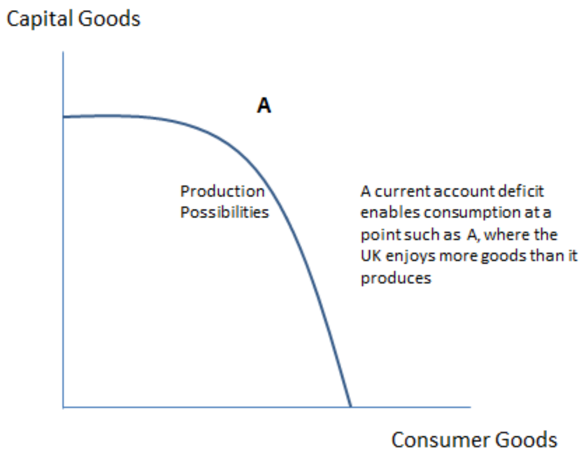
I An increasing trade deficit could be seen as a problem for the UK economy because it detracts from the level of aggregate demand for UK goods and services. **An** This is because exports of goods are an injection into the circular flow of income, while imports are a leakage. Lower aggregate demand is reflected in lower orders for the output of UK firms, and leads to lower demand for labour too, given that the demand for labour is derived from the demand for goods and services. Thus the trade deficit has the potential to detract from UK GDP and to cause unemployment, thus damaging key aspects of the UK's macroeconomic performance. The effects of lower AD are shown in the diagram.

An Diagram An increasing trade deficit could detract from UK aggregate demand



I An increasing trade deficit also has the potential to contribute to an overall deficit on the current account of the balance of payments. **An/E** This is a concern because it means that collectively the economic agents of the nation are earning less income internationally than they are spending. The current account deficit must be financed and this is likely to involve international borrowing by UK economic agents or inflows of capital through foreign purchases of UK assets. If the UK runs a large current account deficit in relation to China, for example, it is likely that firms in China will use their surplus earnings to take over firms in the UK economy. This creates future liabilities for the UK as profits from output produced in the UK will in future be repatriated to China. Thus, today's current account deficit can be interpreted as the nation "living beyond its means" by borrowing to finance consumption beyond current levels of production. This means that in the future, a higher proportion of output will have to be devoted to servicing the liabilities incurred. It can be seen that a current account deficit supports higher living standards today, at the expense of living standards in the future. This is illustrated in the diagram.

An Diagram A current account deficit implies consuming more than we produce



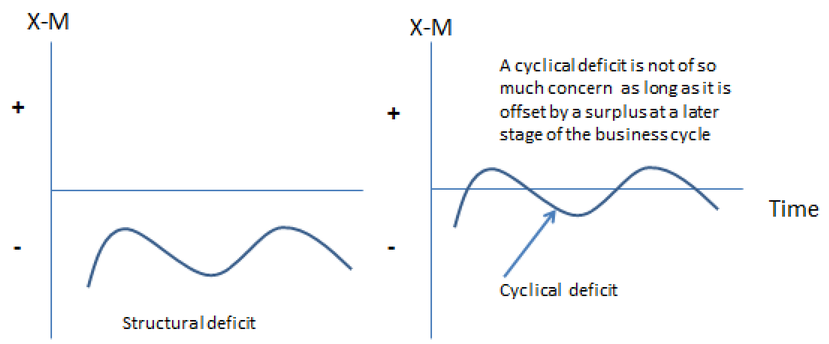
Evaluation/final judgement (s)

I The extent to which the "living beyond our means" argument is important depends on whether it is consumer or capital goods that are being imported as part of the growing trade deficit. **An** If the deficit is being used to facilitate investment, this has the potential to lead to growing economic capacity for the UK. This in turn can help to create the income to meet any liabilities incurred through the trade deficit, making that deficit less of a concern.

I The increasing trade deficit can also be seen as a cause for concern if it is a symptom of a wider lack of competitiveness for the UK economy. **An** It could be, for example, that UK workers are unable to compete effectively due to relatively high unit labour costs and that UK workers are not sufficiently productive to compensate for the fact that wages here are relatively high in comparison to emerging economies such as China and India. Alternatively, it may be the case that UK firms are not sufficiently innovative to compete on non-price factors in order to boost export earnings. It may also be the case that the UK is not a sufficiently attractive location for firms, and thus there is not sufficient production in the UK This may be the case due to relatively high levels of regulation, for example.

I/Kn An increasing trade deficit over time can be considered a major concern for the UK economy because of the fact that we run a structural deficit. This deficit has persisted for most of the past half-a-century. **An** A trade deficit is not so much of a concern if it exists only during boom periods of the business cycle when high levels of consumption lead to "sucking in" of imports, and that deficit is offset by a surplus at other stages of the cycle. The difference between a structural and cyclical deficit is shown in the diagram. It would be helpful to look at the extent of the deficit at the same point on successive business cycles. If the deficit were greater at the peak of one business cycle than at the peak of the last one, this would suggest that the structural deficit were growing over time and this would be especially concerning.

An Diagram A structural trade deficit is more concerning than a cyclical one



Kn/Ap The extent to which the increasing trade deficit is a concern is reduced by the fact that the UK runs a surplus in some other sections of the current account, notably trade in services. However, this surplus has usually been dwarfed the deficit in trade in goods, so this argument does not hold much weight.

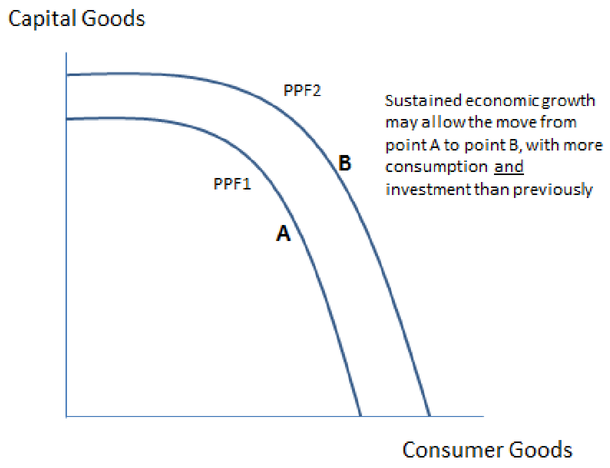
An Indeed, were the UK deficit in trade in goods to continue to grow, this would generally be seen as of great concern. The UK cannot consume more than it produces indefinitely and a growing deficit could be seen as a symptom of a fundamental lack of competitiveness. **Kn/Ap** Further, the UK desperately needs a rebalancing of its economy towards export led growth, as identified by economic leaders including Mervyn King. Governments and consumers are poorly placed to support aggregate demand in the future, given their high levels of indebtedness. This means that the UK desperately needs an improved trade performance, not a deteriorating one. **An** If the UK continues to run large trade deficits while countries such as China continue to run large surpluses, the global economic problems of recent years are likely to recur. There is a strong argument that the roots of the recent crisis lay in trade imbalances, as Chinese firms and banks lent their surplus trade earnings cheaply to western banks, which in turn encouraged them to take too much risk in lending to their customers. This has led commentators to realise that trade imbalances are more of a threat to economic performance than they has previously judged them to be. The combined strength of these arguments suggests that a growing trade deficit should be seen as a major problem for the UK economy.

AQA ECON4 JANUARY 2012 ESSAY 2

D Economic growth is usually measured as the year on year increase in real Gross Domestic Product (GDP) per capita, where GDP is the value of all goods and services produced in the domestic economy. Private consumption is spending on goods and services by households.

I It is clear that one benefit of economic growth is that it can boost private consumption. **An** This in turn boosts material living standards for the country's citizens. While the economy can grow in the short term by using capacity to meet increased demand, sustained economic growth is only possible when the capacity of the economy grows, this reflecting an increase in the quantity or quality of resources available. The amount of economic capital available can be increased by investment. In the diagram, this is achieved at the opportunity cost of consumption foregone. The return on this sacrifice is increased production possibilities in the future, including increased private consumption. On the assumption that this consumption generates utility for the nation's citizens, this serves to increase material living standards.

An Diagram Sustained economic growth may allow more consumption and investment



I Economic growth may bring about other benefits besides an increase in private consumption. This includes the possibility for increased investment. **An** In the diagram above, the increased future output permitted by economic growth can be shared between consumption and investment. This means that more of both kinds of output is possible than was the case in the first time period. This illustrates the fact that growth is cumulative in nature. It is possible to argue here that the value of investment is the fact that by raising production possibilities, it allows for more consumption in the future. Investment is seen as a short term sacrifice for the long term gain of consumption, rather than something which has an intrinsic value.

I Another potential benefit of economic growth is that when it has occurred it is possible for government spending to increase even if it accounts for the same proportion of GDP that it did previously. **An** Government spending has the potential to create a range of social benefits that may bring about an increase in living standards. It may be possible, for example, for government spending to be used to redistribute income to low income earners and it is sometimes argued that societies function better when there is a lower degree of inequality. **Kn/Ap** This argument was recently advanced by Richard Wilkinson and Kate Pickett in their book *The Spirit Level*. **An** Government spending may also be used to improve living standards through improved public services health care, education and policing. In various ways, these have the potential to influence non-material aspects of living standards. Society may experience greater well-being if increased spending on the police brings about reduced crime and reduced fear of crime, for example. It is also likely that some aspects of government spending will promote higher material standards of living in the future. Spending on education can improve the human capital of the workforce, for example, bringing about higher productivity of workers.

I A further benefit of economic growth is that the growing incomes that accompany it may lift some of a nation's citizens out of poverty. **An** Absolute poverty is measured by the World Bank using a threshold of income of $1.25 a day, while relative poverty means being poor in relation to others in society. This is usually measured using some fraction, such as 60%, of median income. Economic growth is particularly effective at lifting citizens out of absolute poverty in low-income economies, but is often accompanied by increases in relative poverty unless the government intervenes to redistribute income, perceiving very unequal income distribution to be a market failure associated with a lack of equity.

Evaluation/final judgement (s)

An There is a strong argument that the main benefit of economic growth in low-income countries is to lift people out of poverty, rather than to increase private consumption. **Kn/Ap** World Bank data shows that the proportion of the population living in absolute poverty in China's rapidly growing economy has fallen from over 60% to well under 20% since 1981, for example. **An** In developed nations, the motivation for economic growth is more likely to be to boost the already high living standards of its citizens through private consumption, although some pockets of absolute poverty do exist even in developed nations. As emerging economies such as China grow further, this may increasingly become their focus too.

I Associated with poverty reduction, a number of non-material benefits of growth may be particularly important in low-income economies. **An** If it is possible to reduce child mortality rates and increase access to primary education, this would be particularly beneficial. Meanwhile, in more developed economies, economic growth can also be used to bring about non-material benefits to living standards, but the focus may be different, for example reducing rates of death from heart disease.

I Over the coming few years, an increasingly important focus of economic growth may be that it makes environmental protection more affordable. **An** Growth in emerging economies tends to be environmentally damaging in its early stages (such as China's coal-fuelled growth, for example). As material living standards grow, it is possible that governments and citizens will be more willing to spend some part of output on protecting the environment. This is likely to become a more pressing focus of the benefits of economic growth in the coming years. **Kn/Ap** The *Stern Report* of 2006, for example, suggested that climate change could be tackled at a cost of 1% of global GDP as long as action was taken within a decade.

An Thus, the debate about the benefits of economic growth is very closely connected to the question of which aspects of living standards are most important. Private consumption has often been given prominence because it is easy to measure and because it is assumed that higher consumption of goods and services brings utility. In many ways, focusing on private consumption as a benefit of economic growth is a luxury not affordable to low-income economies and reducing poverty and increasing access to education are likely to be seen as more important. In many nations around the world, the non-material benefits of economic growth may become more important in coming years, due to pressing concerns such as the need to tackle global warming. Such a conclusion can be further backed by the consideration that there might be diminishing marginal utility from additional consumption. If this is the case, it becomes more likely that other benefits of economic growth will take precedence.

AQA ECON4 JANUARY 2012 ESSAY 3

D The exchange rate of the pound sterling its price in terms of another currency, in other words the amount of another currency that must be given up to buy £1. A significant fall would be known as a depreciation of the exchange rate. Unemployment consists of those of a working age actively seeking work at going wage rates but who have been unable to find a job.

I A depreciation of the exchange rate has the potential to bring about a reduction in unemployment. **An** This is because a weakening of sterling makes UK goods more competitive in international markets. This in turn is because the depreciation reduces the foreign currency price of UK exports. If £1=$1.80, then an export priced at £100 will sell in America for $180. After a depreciation to £1=$1.60, the same export will now cost only $160 in America. Thus, UK firms are likely to sell more exports, bringing about an increase in the sterling value of exports sold.

I The impact is bolstered by the fact that the sterling price of imports will rise. **An** This is due to the fact that £1 buys less foreign currency than it did before, and UK imports are priced in terms of foreign currencies. It is likely therefore that there will be a reduced demand for imports as UK consumers substitute towards the output of domestic firms.

I In combination, these factors increase aggregate demand for UK goods and services as UK net exports (X-M) will increase, with exports an injection into the circular flow of income and imports a leakage. **An** Higher demand for UK output generates an increase in the derived demand for labour, creating more employment opportunities. This has the potential to reduce demand-deficient unemployment.

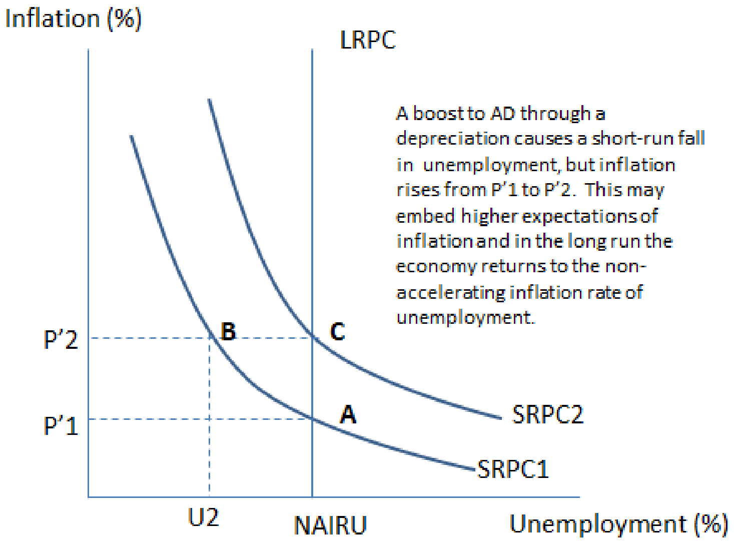
Kn/Ap The UK has experienced these effects in recent years, as the sterling effective exchange rate fell by around 25% in 2008-2009. This was a depreciation in the trade-weighted exchange rate index, which measures the value of sterling against a basket of other currencies. Despite depressed global demand, the UK export sector has shown signs of growth and has been able to generate some jobs. Without this, rising UK unemployment would have been even higher.

Evaluation/final judgement (s)

I The extent to which such reductions in unemployment could be sustained is doubtful, however. **An** The exchange rate tends to be volatile, and is influenced by many factors such as relative interest rates in different countries, competitiveness in trade, flows of foreign direct investment and speculation. It is easy to see how the value of sterling might quickly begin to rise again, if for example the Bank of England were to begin raising the base rate to control inflation. This would have the potential to undo any gains made in reducing unemployment. A rebalancing of demand towards the export sector of the economy is generally accepted as being of vital importance to creating sustainable growth and reductions in unemployment for the UK, but this would surely require under-pinning by factors more fundamental than the base rate. UK firms must be able to compete either on price (through relatively low unit labour costs) or more likely on non-price factors such as innovation and quality if the UK export sector is to succeed in the long-term. This would provide a better foundation for lasting reductions in unemployment than relying on a weak exchange rate.

I Further, the impact of a weak exchange rate is felt primarily on the demand-side of the economy and it is difficult to achieve sustained reductions in unemployment from the demand-side. **An** Export demand is only one source of UK aggregate demand and thus demand-side unemployment is influenced by many factors, and is usually closely associated with the business cycle. Whether an increase in labour demand comes from a weak exchange rate or other factors, there are limits to its ability to achieve sustained reductions in unemployment. This is because there is significant unemployment remaining even when the demand for labour has risen to match the supply of labour, and the labour market is in equilibrium. **An** Much unemployment is caused by supply-side issues such as a lack of labour mobility. Any further increase in aggregate demand is then likely to cause the demand for labour to exceed its supply, leading to accelerating wage claims and price inflation. The accelerating wage claims increase the costs of firms and make them less likely to employ. It is unlikely, then, that a demand-side factor such as a weakening of the exchange rate could enable a sustained reduction in unemployment, certainly not one to below the natural rate of unemployment. This can be illustrated using the Phillips Curve, as shown in the diagram.

An Diagram Depreciation is only likely to deliver short term reductions in unemployment



I To achieve sustained reductions in unemployment, it is far more important to tackle imperfections in the labour market, such as a lack of transferable skills or wage rigidities. Flexible working practices such as part-time work and shift work could also help to make labour supply more responsive to labour demand. **An** This would help by ensuring that firms do not have to pay for labour when workers are not needed to produce output, and this would make firms more likely to take on workers in the first place.

Kn/Ap There is some evidence that the UK has achieved sustained reductions in unemployment in recent years. Unemployment peaked at a lower level in the most recent recession than it did in the one of the early 90s, for example, although it has since begun to rise again. Such an occurrence may be attributed primarily to increases in labour flexibility in the UK. Factors such as this and improved education leading to higher labour productivity are likely to underpin sustained reductions in unemployment by making the UK fundamentally more competitive in the global economy. As welcome as a weakening of sterling might be in supporting job creation in the short to medium term, it is unlikely to be a source of sustained reductions in unemployment.