AQA ECON4 ANSWERS

25 MARK QUESTIONS

JANUARY 2013

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”.

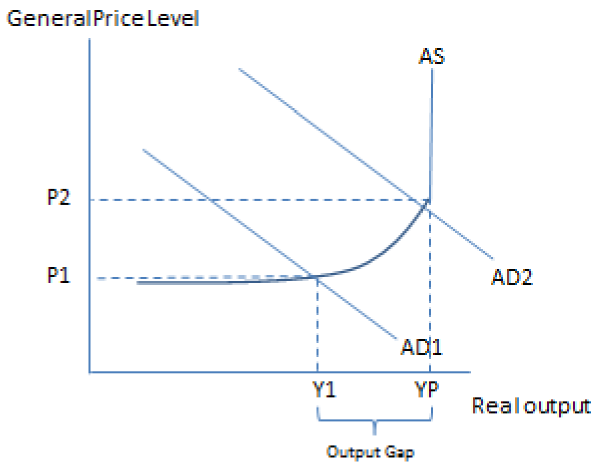
It is a good idea to study previous questions and to have a stock of examples and real world data that would help to answer them. You can pick up such examples from these suggested answers.

AQA ECON4 JANUARY 2013 CONTEXT 1

D Unemployment consists of all those of a working age (currently 16-65 for the UK, although the state pension age is due gradually to be increased to 68) who are actively seeking work but do not have a job. **Ap** "UK unemployment in mid-2011 was around 8%" (Extract B, Line 10) a figure which might have been expected to be higher against the backdrop of the global economic crisis and a **k** lower percentage of the labour force than had been unemployed at the peak of unemployment in the previous recession in the early 1990s.

I One way of reducing unemployment in developed economies such as the UK is to boost aggregate demand. **An** This can be achieved through a relaxation of fiscal policy. If, for example, the government were to cut income tax, this would raise disposable incomes and encourage consumption, thus raising aggregate demand. Higher demand for products and services would in turn raise the derived demand for labour. The economy's output gap would be closed and unemployment reduced as a consequence. Alternatively, in the field of monetary policy, cutting the base rate could have similar effects by reducing the return on saving and making borrowing cheaper. The effect on the macro economy is shown below.

An Diagram Stimulating AD can close the output gap, reducing demand-deficient unemployment



An/E In the midst of the global economic crisis, there should be significant scope for countries such as the UK to reduce unemployment in this way. This is because there is a substantial output gap due to subdued demand. It is very likely that part of the UK's unemployment is Keynesian, demand-deficient unemployment, and this makes stimulating aggregate demand an appropriate policy. **An/E** There would be almost no danger of stimulating demand-pull inflation, at least in the short to medium term, when there is so much spare capacity. **Ap** Indeed the Director of the IMF has argued that “recovery in aggregate demand is ‘the single best cure for unemployment’.” (Extract B, Line 19) **An/E** There must be considerable doubt, however, about the extent to which countries such as the UK can actually stimulate demand in the current climate. **K** The base rate is already at 0.5% and unconventional monetary policy in the form of quantitative easing has already been tried. Meanwhile, the UK government is pursuing an austerity programme to reduce the budget deficit, and this suggests that it cannot easily use fiscal policy to raise aggregate demand.

I Another way of reducing unemployment is from the supply-side, using ‘targeted programmes in the labour market’. One such programme is to pay wage subsidies to employers for vulnerable groups such as the young unemployed. **An** Economic theory suggests that firms will only employ workers if the worker generates more revenue for the company than the cost of employing him. If the employer’s costs are subsidised by the government, then it will be more profitable for the firm to employ the groups of workers in question. **E** Such a policy could be of considerable value. **K** Youth unemployment in the UK is currently around the 1 million mark and is causing much concern. **An** If young workers are unemployed, they are not gaining valuable experience and work skills. This can damage their future productivity and hence hinder economic growth. **E** It is thus important that youth unemployment is tackled, and this problem is actually more significant in other developed countries than in the UK. **K** Spain, for example, has a youth unemployment rate in excess of 50%. **E** Wage subsidies should be considered not just for the young unemployed but for other groups such as the long term unemployed. Similar arguments apply here because the long term unemployed may lose valuable skills and become less employable over time.

I Other ‘targeted programmes’ include policies designed to improve occupational and geographical labour mobility. **An** These are important in reducing structural unemployment and some of these policies can again be targeted on the young and/or long-term unemployed. When labour is immobile there may be a mismatch such that vacancies go unfilled even while unemployment is high. This is damaging not just in terms of unemployment but can also hinder the growth of firms who cannot find workers with the right skills to fill their vacancies. **K/E** Substantial numbers of vacancies have remained in the UK even during the recession, so policies to increase labour mobility may have some promise. **E** Despite this, there may be some doubts about their effectiveness. Equipping young people with the skills required by employers may not prove easy to achieve.

Evaluation/final judgement (s)

An It is clear that both policies to raise aggregate demand and ‘targeted programmes’ in the labour market have the potential to reduce unemployment, **Kn** and there is scope for both types of policy to be used because both demand-side and supply-side unemployment exist in significant quantities in countries such as the UK at present.

There is plenty of reason to support the IMF’s Director’s view that stimulating aggregate demand is of paramount importance. **An** If there is not sufficient demand in the economy to generate enough jobs then unemployment figures will continue to remain high. The longer subdued aggregate demand continues, the greater the potential for loss of skills and “hysteresis” effects damaging future productivity. The great problem here is that policy makers are running out of ways to stimulate demand in the current economic climate.

An On this basis, it is likely that 'targeted labour market programmes' are the best way forward. The fact that they are targeted on the most vulnerable groups, rather than applied to all, may reduce their expense and make them more affordable. Equally, by helping groups such as the long term and young unemployed some of the worst effects of unemployment in damaging skills and future capacity may be avoided. This would leave countries such as the UK better placed to enjoy a strong recovery once it is under way.

An Supply-side reductions in unemployment are sustainable in a way that demand-side reductions are not and can achieve a lower trend or natural rate of unemployment. **K/An** The fact that the current crisis has not produced unemployment peaks as high as in the previous recession, suggests that such supply-side improvements have already been made over the past 20 years. Significant further improvements may be possible. On this basis, in the current context, 'targeted programmes in the labour market' are indeed the best way to reduce unemployment.

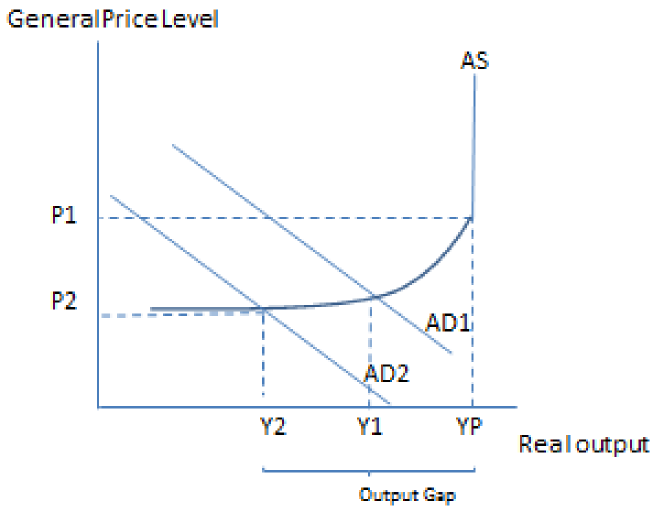
AQA ECON4 JANUARY 2013 CONTEXT 2

D The Eurozone consists of the countries that use the Euro, a currency shared by many of the member states of the European Union.

I The possible break-up of the Eurozone is a consequence largely of the divergence of economic conditions in different member countries. **An** As some of the weaker economics have lost competitiveness against stronger ones such as Germany they have lacked the tools to catch up. **Ap** This is in part because there is a single interest rate set by the European Central Bank: "Some countries still in recession saw their interest rates rise to 1.25% in July 2011" (Extract D, Line 20). **An** Normally, a country experiencing a loss of competitiveness might see this offset by exchange rate floating downwards, but this is not possible within the Eurozone. **K** The immediate trigger for the Euro crisis was government debt. Heavily indebted governments in countries such as Portugal, Italy, Greece and Spain found their borrowing costs rising to unsustainable levels as lenders began to fear they would default on their debt. **Ap** This created a situation where "stronger members found themselves being called upon to offer financial support to those economies in trouble" (Extract B, Line 8).

I One possible impact on the UK economy if a number of countries were to leave the Eurozone would be a reduction in UK exports. **An** There would almost inevitably be disruption to the economies leaving the Eurozone, at least in the short term, and with subdued incomes and increased uncertainty demand from these nations would be restricted, including demand for UK exports. This would serve to reduce UK aggregate demand, thus increasing the size of the UK's output gap. Derived demand for labour would be reduced, this creating an increase in unemployment. The potential effect on the UK economy is shown in the diagram:

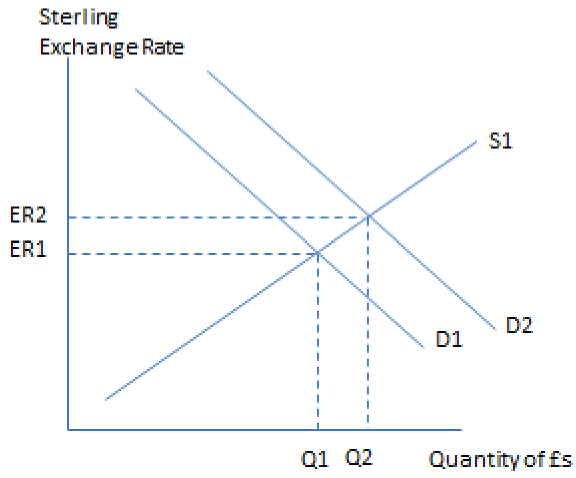
An Diagram Reduced exports to the Eurozone could increase the UK's output gap



I/E It should be noted that while a reduction in UK exports seems likely if countries leave the Eurozone this is not a necessary outcome. **An** It is possible, for example, that the economies of those countries which leave the Eurozone may recover swiftly once they have the freedom to set policy according to their own domestic needs. **E** Should the anticipated reduction in UK exports occur it is likely to be especially damaging. **An** Not only would trade with those countries leaving the Eurozone be hit, it is likely that there would be knock-on effects on the economies of the stronger EU countries and hence our trade with them too. **K/E** Given that the UK is in desperate need of an export led recovery a major shock to an area which accounts for around 50% of all UK exports could be tremendously damaging to the UK economy. **E** The effects of the shock would differ by region in the UK economy. **An** Areas of the country which retain significant manufacturing sectors would tend to be hardest hit, because manufactured goods are the most "exportable" sector of the economy. It is likely that regional downwards multiplier effects would occur.

I A second possible impact on the UK economy would be a strengthening of Sterling. **An** If the weaker economies of the Eurozone were to leave, it is likely that their new national currencies would be weak, with Sterling strong against them by implication. **Ap** It is also the case that "international money, seeking a safe haven, might favour the pound sterling" (Extract D, Line 36). **An** An increase in the demand for Sterling would put upwards pressure on its value as shown in the diagram. A stronger Sterling exchange rate would reduce the competitiveness of UK exports as customers in other countries have to give up more of their own currency to pay for goods in Sterling. Our trading position would deteriorate further as the strength of the pound would give UK consumers more purchasing power in relation to imports, encouraging them to substitute away from domestically produced goods.

An Diagram If Sterling is seen as a safe haven its value is likely to increase



I/E While this could cause significant damage, a benefit of such an occurrence is that cost-push inflation could be reduced as imports of raw materials and goods become cheaper when Sterling is strong. **K/E** With the UK having experienced significant cost-push inflation from 2008 onwards up to and including the time of writing in early 2013, any help in restricting such inflation would be welcome.

I As highlighted in Extract D, further potential consequences for the UK economy if countries were to leave the Eurozone emanate from the potential for another banking crisis. **An** If countries leave the Eurozone this would almost certainly be accompanied by at least partial debt default by their governments, which are currently reliant on other Eurozone countries for financial support. This would then severely damage those banks who have lent to the governments in question. **K** It should be remembered that these banks are only just beginning to recover from the crisis of 2007-2008.

Evaluation/final judgements

An Of the possible threats to the UK economy posed by countries leaving the Eurozone, a banking crisis should be considered the most significant. Looking back to the knock-on consequences of the credit crunch which began in 2007 would suggest as much. **K** Small and medium sized businesses, and to some extent consumers, are still struggling to access credit in the aftermath of the initial banking crisis and this is suppressing demand and holding back economic growth. **An** A second banking crisis could have catastrophic impacts not just for the Eurozone and the EU but for the global economy. The UK would then suffer from "second round" impacts on its exports as the break-up of the Eurozone impacted on other economies such as America.

An While there are potentially some very serious effects on the UK economy should the Eurozone break up, with really only the possible benefit of a strengthening of Sterling reducing cost-push inflation as a relief, it must be remembered that none of this is certain to occur. As noted in the extract, the effects might differ according to how many countries were to leave and which ones. **Ap** If a large economy such as Italy were to leave, with accompanying default on government debt, the effects would surely be much greater than if a smaller country were to leave. **I** It is also within the bounds of possibility that some countries leaving might help to provide a solution to the crisis, with beneficial long term effects on the UK economy.

An So, like the Eurozone crisis itself, the effects on the UK of some countries leaving the Eurozone are characterised by uncertainty. The effects would be greatest in the event of a "disorderly break-up" of the Eurozone with some countries force to leave at short notice, for example due to their government's borrowing costs spiralling. **K** Even the Bank of England has tended to exclude such an eventuality from its forecasts on the grounds that the results are incalculable. The strong likelihood, however, is that if countries were to leave the Eurozone this would provide a significant drag on UK exports and growth.

AQA ECON4 JANUARY 2013 ESSAY 1

D Globalisation refers to the process by which the world has become more like a single economy, with the individual economies which comprise the global economy becoming ever more integrated. In a globalised economy production can take place anywhere, potentially thousands of miles away from the final market for the product. There is free movement of labour in a globalised economy, and other factors of production such as capital (witness multi-national corporations) and enterprise. Finally, there is also free movement of financial capital in a globalised economy.

An The process of globalisation has been facilitated by, amongst other things, technological advance, which has made business communications much easier. Reduced transport costs have been important too given that final market for the product may be some distance away. Other factors contributing to globalisation include the activities of bodies such as the WTO which has negotiated agreements to reduce protectionist barriers in world trade.

I One consequence of globalisation for developing countries has been to increase the potential size of the market for their exports. **K** This has been crucial in supporting economic growth for many of them. China's specialisation in manufacturing has enabled it to earn large amounts of foreign currency through exports. The same is true of India, which has developed something of a specialisation in IT and support services. Many developing countries have been able better to employ their key natural resources by making increased money through tourism in the globalised economy.

I/An/E While the potential export market has also increased in size for developed economies, the effect has not been so dramatic, as they have long been relatively open to trade with each other. **K** Potential new export markets in developing countries are not yet large as incomes in these countries are not comparable to those in the developed nations. **K** The difference is borne out by the fact that developing countries collectively run a large surplus on the current account of the balance of payments, by definition equal to the deficit of the developed nations. **An** It is possible to generalise by suggesting that globalisation has helped to create export-led growth in developing nations but has simply spurred consumption in developed countries, this aided by strong price competitiveness of the exports of countries such as China which has given the consumer of developed nations greater purchasing power. **I/E** It would also be accurate to suggest that these effects may differ over time. **An** As development continues in poorer countries they are likely to be able to rely more on domestic consumption from their citizens who now have higher incomes. **K** This may offer much greater export opportunities to nations which are already developed: At Christmas 2012, one in three shoppers in the Oxford Street sales was Chinese.

I A consequence of globalisation for developed countries has been to help hold down inflation, at least initially. **An** Many developing economies have plentiful labour supplies, leading to relatively low wages. In turn, this creates low unit labour costs, enabling a high degree of price competitiveness. This has reduced the pricing power of firms in developed nations, who are unable to raise prices as much as they might have done for fear of losing business to companies from the developing world. **K** This is a significant explanation of why economies such as the UK were able to enjoy 15 years of continuous growth from 1992 to 2007 without any substantial inflation.

Indeed during this period, inflation was low in both developed and developing countries. **I/E** Again, this effect has changed over time. **An** The development of emerging economies has increased global demand for commodities such as food, fuel and metals. This has put upward pressure on commodity prices and created a source of cost-push inflation. **K** In the UK, inflation was rarely below target from 2008 to the time of writing in 2013, **An** this despite the fact that a large output gap meant the absence of demand-pull pressure. **K** Equally, countries such as China began to experience their own inflationary problems, **An** removing some of their competitive edge. Developing economies arguably have moved from helping to hold down global prices to exporting inflation.

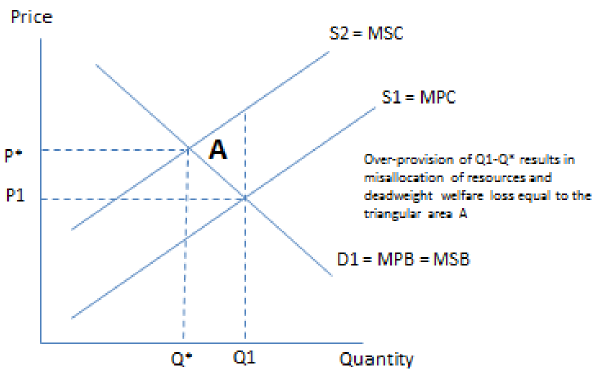
I A further effect of globalisation on developed economies has been the challenge posed by low wages and cheap production in the developing world. **An** Workers in developed economies are effectively in direct competition with workers from all around the world, on the basis that multi-national corporations can locate their production wherever they choose. Inevitably, this has supressed wages, especially for low-skilled workers. **I** Globalisation has arguably also been a source of unemployment in developed countries **An** both due to a loss of demand for labour as firms choose to locate elsewhere, and an inwards migration of labour adding to labour supply in developed nations. Such an increase in labour supply does not have to cause unemployment if the labour market is sufficiently flexible, but it is at least likely to contribute to unemployment in the short term.

I Workers in developed countries have had to become more adaptable to meet the challenges. **An** Strong competition in manufacturing has meant that countries such as the UK have seen their manufacturing bases eroded and have developed new areas of comparative advantage, for example in financial services. Workers with skills particular to manufacturing have needed to retrain in order to find employment in other areas of the economy.

I One area in which it might seem globalisation has had similar effects on developed and developing nations is with regard to its effect on the environment. **An** The transport of products around the world has contributed substantially to carbon dioxide emissions and through this to global warming: Trade generates significant negative externalities (see the diagram below). Global warming potentially affects all nations and neither the poor nor the rich are immune from its effects.

I/E Even here, however, the effects are in fact significantly different. **An** The most direct effects of global warming are likely to be felt by poorer, developing nations. Their populations are likely to be more immediately threatened by factors such as rising sea levels or an increase in disease due to rising temperatures. The populations of developed countries may to a degree be protected by devoting some of their income to offset the effects of global warming. **I** It might also be said that environmental effects are not limited to global warming. **An** The fact that manufacturing is increasingly concentrated in developing countries has led to serious environmental impacts. The air quality in many Chinese cities is awful, for instance. The natural beauty of countries which rely on tourism may also have been damaged by an increased number of visitors.

An Diagram Globalisation has generated environmental damage affecting both developed and developing nations.



Evaluation/final judgement (s)

I The popular perception in developed nations is that globalisation has been largely to the benefit of developing nations, who have enjoyed export-led growth, with some developing nations now on the verge of developing consumer societies. **An** This would be to neglect the effect on these countries of the environmental damage caused by globalisation. It would also be to ignore the benefits that the consumer in developed countries has enjoyed through cheap output from the developing world.

I This said, globalisation has undoubtedly posed big challenges to developed nations through factors such as strong competition in manufacturing. **An** To those factors already covered, we could add the effects of the financial and economic crisis which began in 2007. This has been argued by some commentators to have originated from the trade imbalances created by globalisation. The effects of the crisis have been felt most keenly in the economies of developed nations, where both consumers and governments were heavily indebted when the crisis began. **K** At the beginning of 2013, output in the UK was still some 5% below its pre-crisis peak. While the crisis will undoubtedly have affected developing countries too, in many cases the effect has been to slow down growth rather than to cause a contraction.

An The effects of globalisation, then, are many and varied. It is absolutely clear that these effects differ substantially in nature and extent between developed and developing countries. There is insufficient information, however, to reach a clear conclusion about whether globalisation has been to the net benefit or detriment of either group of countries.

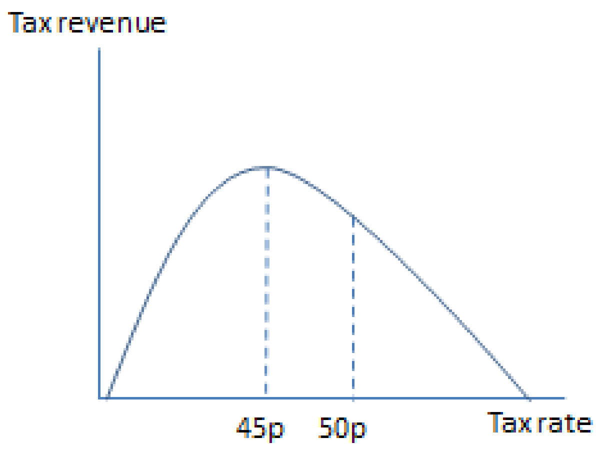
AQA ECON4 JANUARY 2013 ESSAY 2

D The budget deficit is the gap between government spending and taxation revenue. This gap has to be bridged by borrowing. **I** The deficit of 7.9% of GDP in 2011-12 represents a reduction from the size of the deficit at the peak of the economic and financial crisis, but is nevertheless a significant deficit, adding to an already sizeable national debt.

I One way of achieving the fiscal objective of reducing the deficit to 1.5% of GDP in 2015-16 is to raise taxes. **An** This could include raising indirect taxes such as specific unit duties on cigarettes and alcohol or raising the rate of VAT. **K** Indeed, the government has already raised the rate of VAT to 20%. **An** It could also include raising the rate of direct taxes such as corporation tax and income tax. **K** At the height of the crisis, the top rate of income tax was raised to 50p, although this has since been brought back down to 45p.

I/E The effects of raising indirect and direct taxes differ. They are not necessarily equally desirable ways of reaching the fiscal objective. **E** There are dangers in raising direct taxes. **An** An increase in corporation tax might make the UK a less attractive business location, for example. This should be given consideration in today's globalised economy where firms are increasingly mobile. **I** Similar arguments could be made in relation to raising income tax. **An** Higher taxes reduce the take home pay per hour worked and therefore reduce the opportunity cost of leisure. This could serve to restrict the labour supply and in turn economic capacity. **I/E** There is also the danger that highly skilled workers might choose to work elsewhere in the world other than the UK. **An/E** There is a significant risk therefore that higher taxes may restrict UK growth. This could occur both from the supply-side factors already outlined and from reduced demand, as tax is a leakage from the circular flow of income, and resultant multiplier effects. **An/E** In these ways, raising direct tax rates could actually prove self-defeating. If tax increases restrict economic activity, this limits government tax revenues too. This is the possibility highlighted by the Laffer Curve:

An Diagram: The Laffer Curve – Higher tax rates may reduce government revenue



I/E In contrast, targeted increases in indirect taxes could have positive economic effects. **An** It might be possible to increase the efficiency of resource allocation by discouraging consumption of demerit goods such as cigarettes and alcohol for instance. It could also be argued that it is good to tax expenditure in order to encourage saving, although neither the UK economy nor the government finances would benefit from a fall in consumption in the short term. **I/E** On the other hand, raising indirect taxes would pose significant equity issues. **An** Indirect taxes are regressive because those on low incomes tend to have a higher propensity to consume, thus exposing a greater proportion of their income to tax. **E** It is clear that neither direct nor indirect taxes offer an easy path to meeting the fiscal objective.

I A second way of reducing the budget deficit would be to reduce government spending. **An** This implies either reducing current spending, such as on teachers wages, or capital spending, such as the building of schools. In either case, reductions in government spending are likely to reduce aggregate demand and hit growth, with accompanying multiplier effects. **I** Reducing current spending is difficult to achieve because it has more immediate impacts on people's living standards. **An** This can be especially serious for those at the lower end of the income scale who may be dependent on the state to meet even a basic standard of living. **I/E** A lack of capital spending, however, can have more serious long term effects. **An** Investment in infrastructure is needed to maintain the quality of the UK's public services and indeed its future competitiveness. Thus long term growth is dependent to a degree on maintaining government investment. **K** This explains why the government has chosen to press ahead with the £33bn HS2 rail link in spite of the current fiscal constraints.

Evaluation/final judgement (s)

An Neither raising taxes nor increasing government spending seems desirable against the backdrop of sluggish growth in the UK economy. It could be argued to be necessary, however. **K** Countries with excessive government borrowing have sometimes lost the confidence of investors in recent years, Greece being a case in point. Meanwhile, the UK government which has followed an austerity programme has enjoyed historically low interest rates on its borrowing.

I Were it to be possible, a better solution would be to meet the fiscal objective through economic growth. When the economy grows, the tax base increases, and so automatically does tax revenue. Meanwhile higher incomes and reduced growth reduce payments of means-tested government benefits. Together, these factors would reduce the budget deficit. It would only be possible to meet the fiscal objective in this way if the economy returned to growth. This might require a looser monetary policy or growth in the economies of our trade partners to fuel export led growth. **K** The evidence of the ability of such factors to support growth is limited at the time of writing in early 2013. This might imply that the government will have to raise taxes or reduce government spending in order to cut the deficit.

I/K The case against doing either is strengthened by IMF research of December 2012 which shows the fiscal multiplier to be larger than previously thought. **An** In other words, lowering government spending or cutting taxes have a greater impact on the economy than had been appreciated, hindering growth. **K** Concerns over the lack of growth led to significant calls early in 2013 for the government to pursue a Plan B, perhaps reducing the extent of its austerity programme. This was especially the case as the private sector did not seem capable of generating sufficient growth to take up the slack caused by fiscal tightening.

I Despite these considerations, it appears unlikely that the government can meet its fiscal objective without raising taxes or cutting government spending at all. **An** If taxes are to be raised this should be in relation to demerit goods in order to discourage their consumption. Direct tax increases should be avoided because of their impact on incentives, and VAT should not be raised further as this may discourage spending and would also be regressive in its effect. Care should be taken with any reductions in government spending and it is important that government capital spending is maintained. Wherever possible the government should look to reduce its spending by making efficiency savings rather than cuts which would affect government services on which the public rely.

AQA ECON4 JANUARY 2013 ESSAY 3

D Price deflation refers to a sustained fall in the general price level. Such a fall would serve to increase the internal (domestic) purchasing power of money.

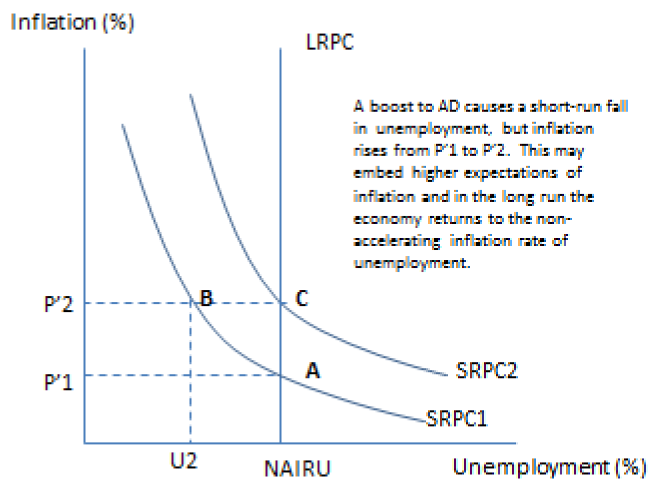
I Avoiding price deflation could be the major macroeconomic objective for governments. **An** Deflation can have a number of damaging effects. For example, when price levels fall it gives consumers and firms an incentive to defer expenditure. Thus periods of deflation are associated with falling aggregate demand, which may cause prices to fall further and the economy can become caught in a downwards spiral. **I** Further, deflation raises the real value of debt. **An** This makes debt default more likely, to the cost of lenders, who may then become more reluctant to lend, damaging credit flows within the economy. **I** It is also true that both consumers and firms are likely to be reluctant to borrow if they believe that falling prices will increase the real value of their debt. **An** Sustained deflation is usually accompanied by a stagnating or shrinking economy and rising unemployment. This provides a reason why avoiding it might be considered the major macroeconomic objective.

I Maintaining low and stable inflation is an alternative objective. **K** In recent history, many governments have treated this as the major macroeconomic objective; in the UK, for example, the Bank of England is charged with meeting an inflation target of 2%. **An** Such price stability is seen as important because high and volatile inflation can be economically damaging. It can disrupt the price mechanism, for example, creating a situation where resources cannot be allocated efficiently due to "inflationary noise" camouflaging price signals. **I/An** Investment is also less likely during a period of unpredictable inflation because firms have less certainty about real rates of return on their investment. **I** Further still, inflation erodes international competitiveness. **An/E** Against this background, price stability can be seen as an essential requirement if the economy is to achieve strong and sustainable economic growth, which in turn generates high living standards and reductions in unemployment.

I Maintaining full employment is an alternative objective. **K** Governments in the post-war period tended to make full employment the major objective. **An** This reflected Keynesian beliefs that when output was subdued and unemployment high the government could stimulate aggregate demand in order to create multiplier effects and higher derived demand for labour. **I/E** While high levels of employment are desired by most governments, experience suggests that generating full employment is not a realistic objective to pursue.

An/E This is especially the case if there are supply-side causes of unemployment such as labour immobility. Once any demand-deficiency has been tackled and the unemployment rate has been reduced to the natural rate, any further increases in demand may generate only temporary reductions in unemployment. These reductions may not be sustainable, but may be accompanied by inflation which can then become in-built into the economy through higher inflationary expectations. A wage-price spiral may occur. Thus, the natural rate can be reinterpreted to be the non-accelerating inflation rate of unemployment (NAIRU) This is represented in the Philips Curve diagram below.

An Diagram Full employment may not be sustainable



I A further possible macroeconomic objective is to achieve an acceptable position on the current account of the balance of payments. **K** While the balance of payments has often been treated as less important than other economic objectives, the current economic problems may have their root in balance of payments issues. **K/An**The large and persistent current account deficits of countries like the UK and USA allowed nations such as China to accumulate large foreign currency reserves which were then lent back to western banks. **An** It could be argued that this encouraged risky lending, which eventually led to debt defaults and the credit crunch. At the moment, UK policy makers believe that export led growth is required if growth is to be sustainable. **E** This suggests that the balance of payments has considerable importance, even if it is questionable whether it should be the major macroeconomic objective.

Evaluation/final judgement (s)

The various possible macroeconomic objectives discussed above all have their merits. **I** To an extent, which one is of paramount importance depends on context. **K** Until recently, when economies such as the UK has not experienced the threat of deflation since the 1930s, claiming that the avoidance of deflation was the most important objective would have made very little sense. However, against the background of the circumstances that persisted from 2007 to the time of writing early in 2013, the claim has a lot more merit. Policy makers have witnessed the damage caused by deflation in Japan and have taken extraordinary attempts to avoid it, such as slashing the base rate and adopting programmes of Quantitative Easing.

I In many ways, avoiding deflation is a restatement of the objective of maintaining low and stable inflation: deflation is simply what happens if an economy undershoots an inflation target. **K** However, the current context has led to debate even about the merits of inflation targeting. Some central banks, such as that of the UK, appear to have been tolerating above target inflation from cost-push factors such as world commodity prices in order to promote economic growth and job creation. In this context, it would be easy to see economic growth as the primary objective.

I It should be remembered, however, that in more normal circumstances, the damage that can be caused by inflation has been well demonstrated. **An** Maintaining a degree of price stability, whether this means avoiding inflation or avoiding deflation, is a necessary pre-condition for creating a climate in which firms are willing to invest and the economy can enjoy growth in the long term. Thus price stability should remain the primary objective providing there is some flexibility for governments to deal with short term circumstances such as those experienced in recent years.