example, the UK has seen a decline in its clothing industry because of cheaper competitors in China. However, it has benefited from growth in financial services.

Free trade also enables firms to specialise and benefit from economies of scale. This is important for industries with high fixed costs such as automobiles and aeroplane manufacture. The greater economies of scale will lead to lower costs and lower prices for consumers.

Free trade also helps to promote competition. With tariffs a domestic monopoly may be protected from international competitors. However, if tariffs are removed it will have a greater incentive to cut costs and become more efficient to remain competitive and stay in business.

For these reasons free trade has been an important engine of growth and has enabled many developing economies, especially in the Far East to see an increase in living standards and economic development.

However, despite the advantages, free trade also has some drawbacks. Firstly, some developing economies may struggle to remain competitive if tariffs are reduced. Some economies may have a comparative advantage in producing primary products (e.g. Food). However, they may have good reasons to try and develop a better manufacturing base. However, to develop a manufacturing industry they may struggle to remain competitive against foreign competition in the short run. Tariffs enable a new (infant) industry to sell to the domestic market before facing international competition. After a few years of tariff protection, when the industry has developed, it may be OK to remove these tariffs.

Without tariffs to protect infant industries, developing economies may be unable to diversify their economy. If an economy relies on one foodstuff, the economy may be subject to fluctuations in foreign earnings depending on food prices. For this reason, many argue free trade gives a greater benefit to developed economies (who don't need to develop infant industries). But developing economies, in Africa can struggle as a result.

However, it is worth bearing in mind, developing economies have often struggled due to high tariffs placed on EU and US agriculture. If these tariffs were reduced, it would help farmers in developing economies.

Another potential disadvantage of free trade is that it could lead to environmental problems. It may encourage firms to produce in countries with the least environmental protection and then export to the developed world. Thus free trade can be a way to overcome environmental laws. However, this is not strictly a problem of free trade but a lack of sufficient regulation.

Often the EU has experienced surplus of foodstuffs. These have then been 'dumped' - sold very cheaply on world markets. This depresses food prices and therefore incomes of farmers. In this case tariffs can be justified to protect against dumping.

In conclusion, free trade has many potential advantages for consumers, firms and general economic welfare. However, in certain situations, tariffs can be justified. In particular, developing economies, which try to diversify away from relying solely on

Higher borrowing presents a burden on future taxpayers. Future taxpayers will have to pay the debt and the interest payments on the debt. In the UK, debt interest payments are already over £40 billion a year. A crucial issue is whether government borrowing rises faster than economic growth. If it does, national debt as % of GDP will increase making it harder to pay back in the future.

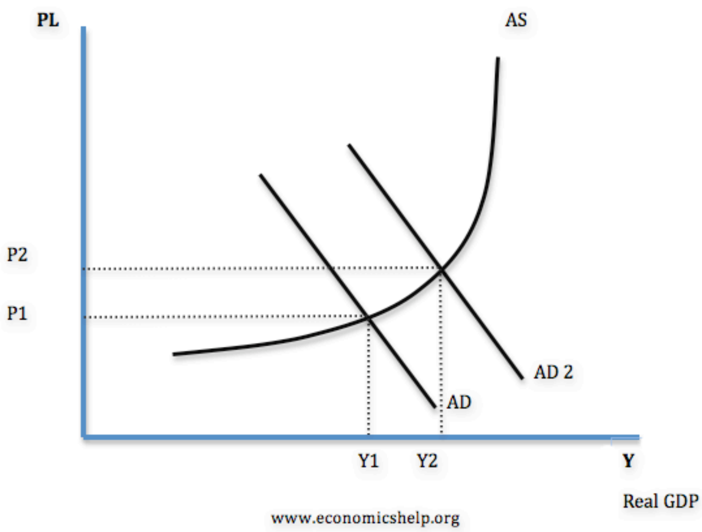
Higher borrowing makes it difficult to finance expansionary fiscal policy in the time of a recession. For example, the government increase borrowing during economic growth of 2002-2007. When the economy entered recession in 2008, it had little room for expansionary fiscal policy because borrowing was already quite high.

A key issue is whether bond markets feel government borrowing is sustainable. If markets feel the government will be able to meet its borrowing requirements, bond yields are likely to remain low and it will remain relatively cheap for the government to borrow. However, if markets fear that borrowing is too high, they may worry the government may default or print money and create inflation. In this case markets may require higher interest rates to compensate for the increased risk. In this case, the governments may find it very difficult to borrow. They may need to introduce painful austerity packages (cut spending) or even require a bailout from IMF. In 2010, EU countries such as Greece and Ireland were in this situation. Markets worried they borrowed too much so bond yields rose quickly.

Some countries may respond to excessive government borrowing by printing money. This can create inflation making it easier to pay back the bond holders of government debt. However, it means the real value of bonds falls making investors reluctant to buy debt from that country again. For example, Zimbabwe and Germany in 1920s, had run away inflation due to high government borrowing and the printing of money.

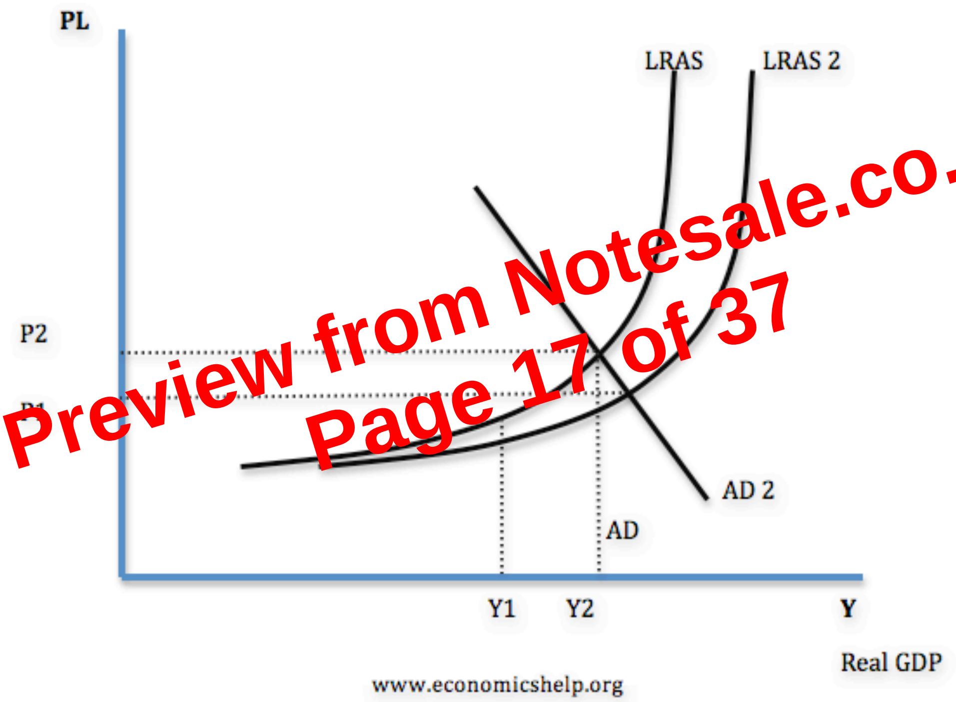
11. Explain possible causes of economic growth.

Economic growth means an increase in Real GDP. It requires an increase in Aggregate Demand (AD) and or an increase in AS. In the short term, economic growth may be caused by an increase in Aggregate Demand.



For example, rising house prices would give most households an increase in wealth. This would increase their confidence to spend; it would also enable them to re-mortgage to gain equity withdrawal. This would cause a rise in consumer spending and therefore aggregate Demand. Alternatively, aggregate demand could rise due to higher global economic growth. Higher global growth would cause a rise in demand for UK exports, therefore increasing AD. A third factor that may increase economic growth could be a change in monetary or fiscal policy. For example, a cut in interest rates is likely to stimulate consumer spending and investment because of the lower borrowing costs and less incentive to save; this would cause economic growth.

As well as demand side factors, it is also important to look at supply side factors. Long term economic growth requires an increase in the productive capacity of the economy and an increase in long run aggregate supply. For example, an increase in the population, due to immigration, would increase the labour force and increase aggregate supply. Also better education and training would help to increase labour productivity, enabling faster rates of low inflationary growth.



The above diagram shows economic growth in the long run. The rate of growth in the long run depends on the growth of AS – how much productive capacity increases.

Technology also plays an important role; improvements in technology are one of the best ways to increase aggregate supply and productivity.

Countries like Japan and China have often had economic growth driven by export led growth. Their competitiveness in manufacturing has enabled them to export to the West and this has been an important factor in their growth rates. In the period 2000-06, growth rates in the UK and US, were mainly caused by rising domestic demand – often funded by low savings ratios, high borrowing and rising house prices.

12. Evaluate the potential impact on the economic growth of the UK economy if it were to adopt the single European currency.

If the UK joined the single currency, there could be some factors which help boost economic growth. Firstly, a single currency lowers transaction costs of trade and therefore, helps exports. Since exports to the EU account for 60% of the UK's trade it is important. However, transaction costs for trade between the UK and the EU are already low. Therefore, a single currency would only have a relatively modest impact on increasing exports and therefore growth.

A bigger benefit could be the stability in exchange rates. At the moment, UK exporters could suffer from rapid appreciations in the exchange rate against the Euro. If we join the Euro, this will not occur. Therefore, this gives us greater stability and might encourage investment. However, firms already hedge (insure) against exchange rate volatility so the impact is not going to be huge.

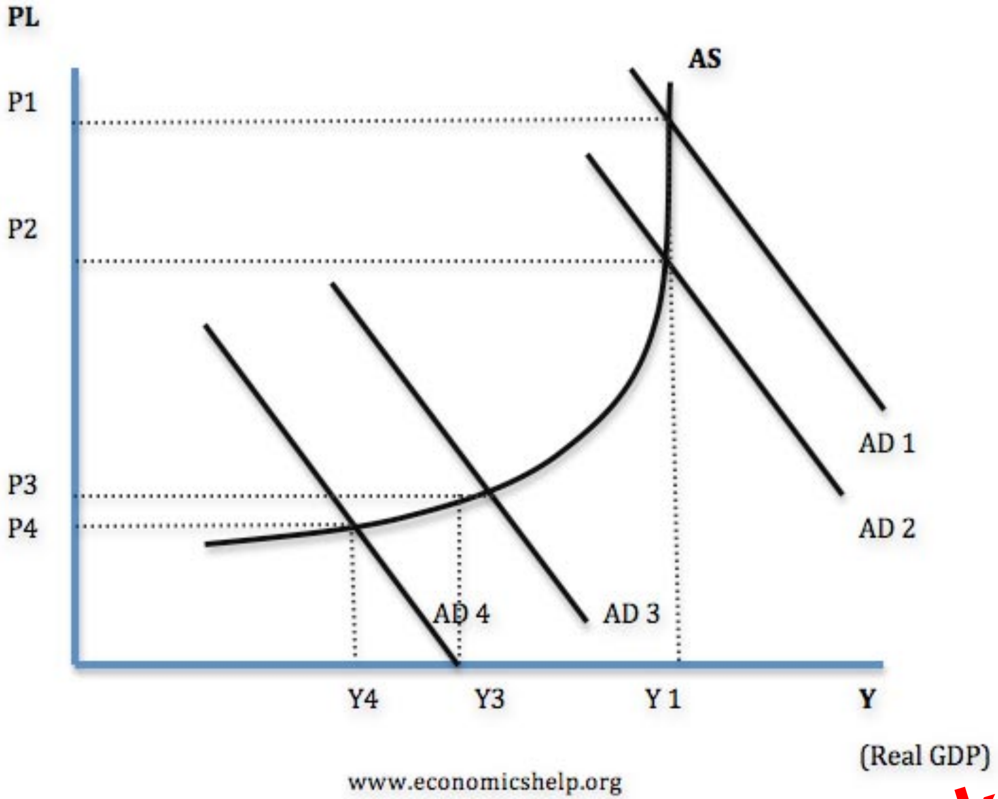
If the UK adopts a single currency it might encourage foreign direct investment from firms (e.g., Japanese or Chinese) looking to invest in the Euro area. Investment would boost both aggregate demand and aggregate supply. However, the Euro is only one factor of many which determines inward investment. Another benefit of the Euro is greater price transparency. If we joined the Euro, it would be easier to compare prices throughout the Eurozone. This may help increase competitive pressures and keep prices low.

Economic growth could be influenced to a greater extent by the impact of the single monetary policy. This means, if we join the Euro, UK interest rates would be set by the ECB (European Central Bank). The concern is that interest rates set by the ECB may be unsuitable for the UK economy. For example if the UK economy entered a recession, but the rest of the Euro zone was still growing, interest rates are likely to be too high. If this is the case UK growth could suffer. Higher interest rates would cause lower spending and investment and make the recession worse. Furthermore, because of the nature of the UK housing market (many people have large variable mortgage), higher interest rates would have a big effect on reducing growth rates.

On the other hand, if the UK economy was growing and inflation in Europe was low. Interest rates may be kept low. This would cause the UK economy to expand more quickly, at least in the short run, and cause problems such as inflation and a housing boom.

In the boom period of 2002-2007, ECB interest rates were lower than UK interest rates; if we had been in the Euro, we would have had a bigger bubble in the property market. Also, when the UK went into recession in 2008/09, we were able to devalue the Pound helping the economy to recover. The UK could also pursue its own monetary policy - quantitative easing to help the economy recover. If the UK had been in the Euro we wouldn't have been able to benefit from weaker pound and quantitative easing.

If the UK economy harmonises with the EU economic cycle, then a common monetary policy may not be such a problem, and UK economic growth would not be affected very much. However, there is no guarantee that the UK economy will be able to harmonise with the EU. For example, there is a lack of labour mobility between the



In the above diagram an increase in interest rates at AD1 would reduce inflation but not cause lower growth. However, reducing AD from AD3 to AD4 does cause a fall in real GDP.

Finally, some people may benefit from a rise in interest rates. Savers would get more income from their savings and therefore, there disposable income would rise, this could increase their consumer spending. However, these days the savings ratio is low and borrowers tend to outnumber savers.

19. Explain what would cause an appreciation in the Euro.

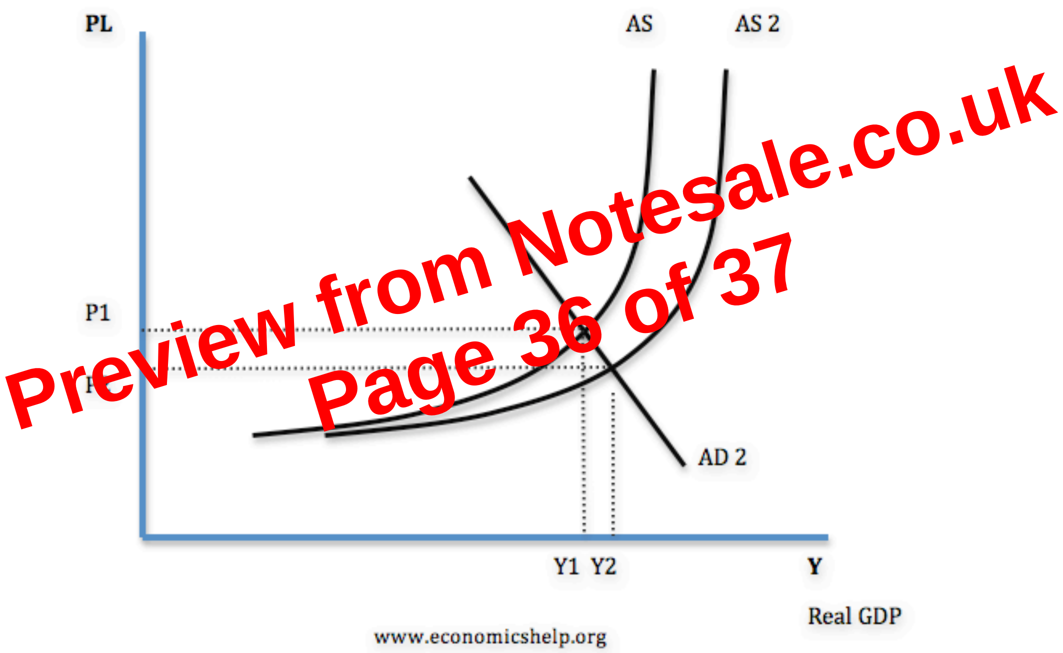
An appreciation in the Euro, means the Euro increases in value compared to other currencies. There would be an appreciation in the Euro if there was higher demand for the Euro. Demand for the Euro would increase if European interest rates increased compared to other countries. This would make the EURO a better place to save money because the rate of return is higher. This is known as hot money flows and is an important factor in influencing exchange rates.

Another factor is the relative competitiveness of the Euro. If euro exports become more competitive, lower inflation, better products then demand for the Euro would increase, causing an appreciation in the exchange rate.

with falling prices, we tend to get rising real wages, and this can cause real wage unemployment. An inflation target of 2%, helps real wages to adjust more easily.

Deflation is likely to make conventional monetary policy ineffective. Interest rates cannot fall below zero, therefore if we have deflation, real interest rates (nominal - inflation) are likely to be too high for that stage in the economic cycle. This high real interest rate may be another factor leading to lower growth. However, there are alternatives to cutting interest rates. The Central Bank could resort to quantitative easing - increasing the money supply - this should increase the supply of money. However, evidence from Japan suggests that in a period of deflation, increasing the money supply may be insufficient to overcome deflation and promote growth. This is because banks don't lend the money but just increase their reserves.

Deflation is not necessarily a bad thing. If deflation is caused by increased productivity, lower prices can be compatible with increased output and economic growth. For example, if there was a period of exceptional technological innovation, the decline in costs could be passed onto consumers in the form of lower prices, this leads to deflation but can help increase living standards.



A prolonged period of deflation, will also help the countries exports become more competitive; this should lead to an improvement in exports and improve the current account. Sometimes countries pursue deflation as a policy of internal devaluation. This enables them to improve competitiveness without reducing value of exchange rate.

However, overall the cost of deflation is often potentially high. The rise in real value of debt can be a significant problem for banks and business leading to a potentially damaging period of negative or stagnant growth. It is interesting to note, that the UK's longest period of deflation was in the 1920s and 1930s - an era of high unemployment and low growth.