6-10 questions

2. UK socio-economic trends

Demography

- The study of populations using statistical methods
  - Via census returns (every decade)
  - Other official surveys e.g. annual abstract of statistics/social trends

Trends

- Population increases but not for all age groups
  - Proportion of the population aged 65+ has increased
  - Proportion of the population below age 16 has fallen
- Impact on the economy (aging population)
  - Fewer workers, more pensioners
  - Less tax being paid for state expenditure on:
    - State pensions
    - State health care
    - State education and training of the young
  - Decline in the number of young people
    - Future workforce under threat

2. UK socio-economic trends

Global economy

- Key elements
  - Growth in emerging markets
  - International trade
  - Financial globalisation
  - Technology change
  - Increased demand for commodities
- Environment
  - Pressure on natural resources
  - Impact of climate change

3. Economic Indicators

Government borrowing

- Public sector net cash requirement (PSNCR)
  - The difference between what the government has spent in the public sector and what it has generated in income
- Composed of:
  - Central government net cash requirement
  - Local government net cash requirement
  - Public corporations net cash requirement

Inflation

- Measures of inflation
  - RPI – Retail Prices Index, RPIX – RPI adjusted to strip out mortgage payments
  - CPI – Consumer price index (aka harmonised index of consumer prices)
- Key terms
  - Inflation – A general rise in prices
  - Deflation – A general fall in prices
  - Disinflation – A reduction in the rate of inflation

3. Economic Indicators

Inflation

- Inflation is an on-going process whereby price levels are rising and money is losing value (as opposed to changes in price levels which are one-time adjustments in price).

- Demand-pull inflation
  - Inflation arising from an initial increase in aggregate demand
    - Caused by anything that increases aggregate demand

- Cost-push inflation
  - Inflation arising from an initial increase in costs
  - Two main sources of cost-push inflation
    - Increase in money wage rates
    - increases in the prices of raw materials

3. Economic Indicators

Base rate

- Monetary policy
  - Controlling interest rates, and the supply of money
  - In the past attempting to control exchange rates
  - The priority is now the control of inflation
  - Monetary policy is more effective for short-term intervention
- Setting interest rates
  - Monetary Policy Committee of the Bank of England – set interest rates
  - Interest rate rises – contraction
  - Interest rate falls – expansion
  - Government inflation target of 2% – based on CPI
  - If inflation is more than 1% either way (<1% or >3%) – MPC to explain why

3. Economic Indicators

- Retail sales
  - Volume of sales in the retail sector.
- Level of unemployment
  - An indication of the 'health' of an economy.
  - High unemployment may indicate falls in:
    - Production
    - Tax receipts
  - Low unemployment may lead to:
    - Increased wages
    - Inflation
- Stock market indices
  - Current shares prices reflecting the future expectations for each company.
  - Current index values, therefore, reflect the future expectation for all companies in the economy.

Further information

Economic indicators

Leading indicators

- Change before the economy as a whole changes
- Short-term predictors of the economy
- E.g. stock market, index of consumer expectations, building permits, money supply

Coincident indicators

- Change at approximately the same time as the economy as a whole
- Current state of the economy
- E.g. GDP, retail sales, industrial production

Lagging indicators

- Change after the economy as a whole does
- E.g. unemployment rate

3. Economic Indicators

Trade figures

UK balance of payments

- Current Account
  - X - M
  - Visibles
    - Actual physical goods
  - Invisibles
    - Services / Tourism / Banking
- Capital Account
  - Includes UK investment abroad and foreign investment in the UK

3. Economic Indicators

Current account and exchange rates

- Current account deficit (exports < imports)
  - Allow sterling to depreciate
    - Local goods now look relatively cheap
    - Exports increase/imports decrease
- Current account surplus (exports > imports)
  - Allow sterling to appreciate
    - Local goods now look relatively expensive
    - Exports decrease/imports increase

3. Economic Indicators

Measures of economic activity

Gross domestic product (GDP)

- The market value of goods and services produced within a country
  - Does include: Production by foreign owned factors of production in the UK
  - Does not include: Production by UK owned factors of production held abroad

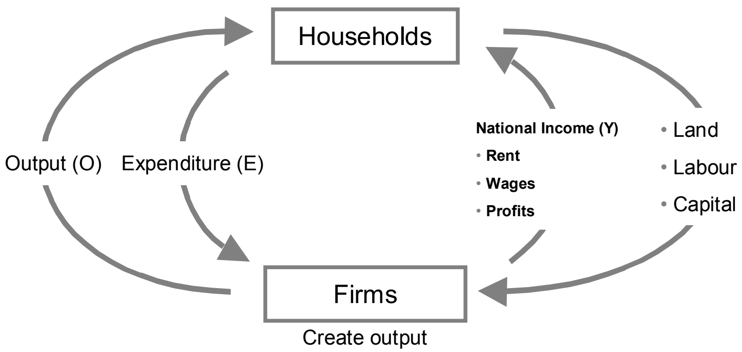
Gross national product (GNP)

- GNP is the market value of goods and services made by a country
- GNP = GDP + Production by UK owned factors of production held abroad - Production by foreign owned factors of production in the UK

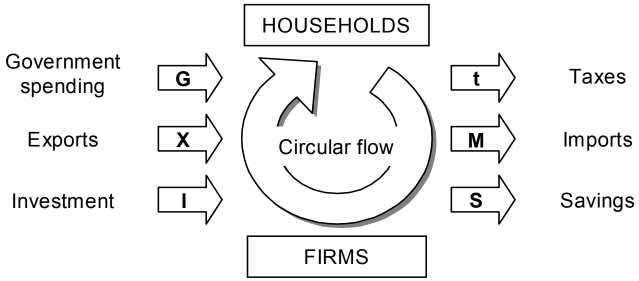
4. The Economy: A Simple Model

The circular flow

Circular flow in a simple economy



4. The Economy: A Simple Model

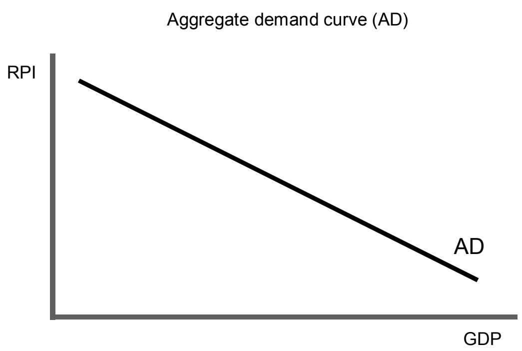


If the economy is in equilibrium:

$$\underbrace{G + X + I}_{\text{INJECTIONS}} = \underbrace{t + M + S}_{\text{LEAKAGES}}$$

6. Aggregate Demand

Aggregate demand: a definition

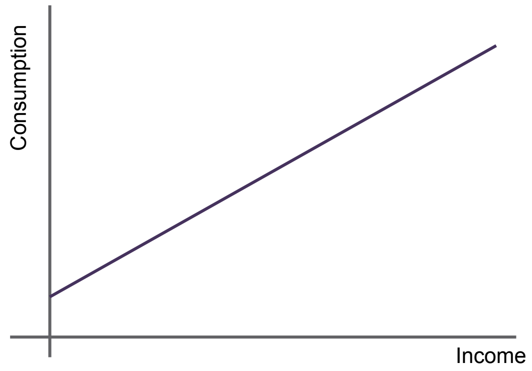


6. Aggregate Demand

The consumption function

The relationship between consumption (C) and income.

C = a + bYd



Keeping on target

If an apartment costs £500 per month, bills cost £400 per month and food costs £200 per month. What is the total consumption of somebody earning £1,900 per month if the marginal propensity to consume is 0.7?

A. £1,100
B. £1,240
C. £1,800
D. £1,660

Keeping on target

If the minimum cost of living is £9,000pa and a person earns £30,000 per year and saves £4,200pa, what is the marginal propensity to save (assuming there are no taxes)?

A. 0.7
B. 0.2
C. 0,8
D. 0.3

6. Aggregate Demand

Multipliers

The **Keynesian** multiplier is the phenomenon where an increase in income leads to a disproportionate increase in consumption.

- Closed economy (simple multiplier)

$$Multiplier = \frac{1}{(1 - MPC)}$$

- Economy with international trade and tax (full multiplier)

$$Multiplier = \frac{1}{\left[1 - (MPC_t - MPM)\right]}$$

  - Where MPM is the marginal propensity to import

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Keeping on target

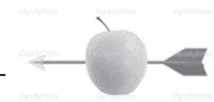
In a closed economy with no government, if the marginal propensity to save is 0.2, the values of the marginal propensity to consume and the multiplier are:

A. 0.8 and 5 respectively

B. 5 and 1.25 respectively

C. 0.8 and 1.25 respectively

D. 1.25 and 5 respectively



Answer to the questions on the previous slide:

D

Autonomous consumption = £500 + £400 + £200 = £1,100

Disposable income = £1,900 - £1,100 = £800

Consumption = £1,100 + 0.7 X £800 = £1,660

B

Trial and error

£25,800 + £9,000 + **0.8** x £21,000

or the formula can be rearranged

£30,000 - £4,200 = £25,800

£25,800 - £9,000 = £16,800

£16,800 / (£30,000 - £9000) = 0.8

1 - 08 = 0.2

7. Central Banks

The government and central bank have two main controls over the economy:

- Fiscal policy: the difference between government spending (G) and taxes (t):
  - If G<t we have a budget surplus
  - If G>t we have a budget deficit
  - If G=t we have a balanced budget

- Crowding out

- Monetary policy: the raising and cutting of interest rates. This is normally the responsibility of the central bank.

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Answer to the question on the previous slide:

A

0.8 and 5 respectively

7. Central Banks

The Bank of England and open market operations

- Inflation targets
  - Via the Monetary Policy Committee
- Open market operations
  - Influencing the supply of money by buying/selling government securities in the open market
- Quantitative easing (QE)
  - A supplement to dropping interest rates
  - Increasing money supply to stimulate growth
- Sterilisation
  - Adjusting the money supply in order to compensate for balance of payments surpluses/deficits

Keeping on target

Consider the following economic events:

Action 1: Income tax is increased by 2.5%

Action 2: Quantitative easing increases the money supply by 1%

Action 3: Interest rates are reduced by 0.5%

Action 4: Government expenditure on school and university construction is increased by 20%

Which of the following statements is true?

A. All four actions are contractionary policies

B. Actions 1 and 4 are both expansionary policies

C. All four actions are fiscal policies

D. Actions 2 and 3 are both monetary policies

8. Money Supply, Inflation and Unemployment

Money supply figures

Credit creation expands the money supply and can cause inflation.

- Measures of the money supply:
  - M0 = Notes and coins in circulation + Banks' till money + Deposits at the Bank of England + The clearing banks' operational balances at the Bank of England to cover daily settlement between the banks
  - M1 = Currency in circulation + Private sector sight deposits
  - M3 = M1 + Certificates of deposit + Private sector time deposits
  - M4 = M3 + Private sector holding of building society deposits + shares (less building society cash deposits and certificates of deposits)

Further information

The quantity of notes and coins in private hands and held by the banking system is called the monetary base. It is also referred to as the stock of high-powered money.

M0 and M4 are now the only measures of money supply published by the Bank of England.

Keeping on target

The wide monetary base increases by £10m and M1 increases by £15m. The money multiplier is:

A. 150
B. 0.7
C. 1.5
D. 25

Keeping on target

The wide monetary base decreases by £20m. If money multiplier is 2.3 what is the change in M3 money?

A. (£46m)
B. £46m
C. £8.7m
D. (£0.1m)

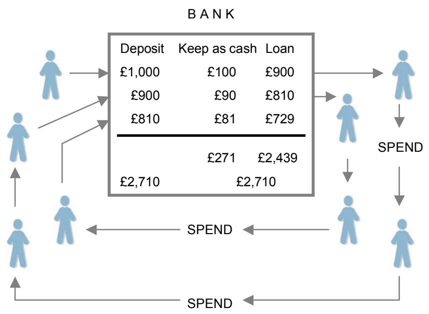
Answer to first question on the previous slide:

D

Actions 2 and 3 are both monetary policies

8. Money Supply, Inflation and Unemployment

Fractional reserve banking



- Regulation of credit control
  - Bank of England: Regulates interest rates
  - Banks: Capital ratios
  - FCA/PRA: Capital and liquidity requirement under Basel Accord

Further information

The money multiplier looks at the expansion of money based on investment and the banks' capital ratios

$$\text{Money multiplier} = \frac{1}{\text{reserve requirement}}$$

Answer to the questions on the previous slide:

Money stock = money multiplier × monetary base

C

£15m = ? X £10m

£15 m / £10m = 1.5

A

(£20m) x 2.3 = (£46m)

8. Money Supply, Inflation and Unemployment

The quantity theory of money (the Fisher equation)

What is the theory?

- 'That changes in price levels are mainly caused by changes in the money supply'

$$MV = PT$$

M – Money supply, V – Velocity of circulation, P – Price, T – Transactions

What does this mean?

- Since velocity (the speed at which money circulates) and the number of transactions are fairly constant…
- Prices and money supply must influence each other

A 5% increase in the money supply → A 5% increase in prices

A 5% decrease in the money supply → A 5% decrease in prices

8. Money Supply, Inflation and Unemployment

Money supply figures

Inflation:

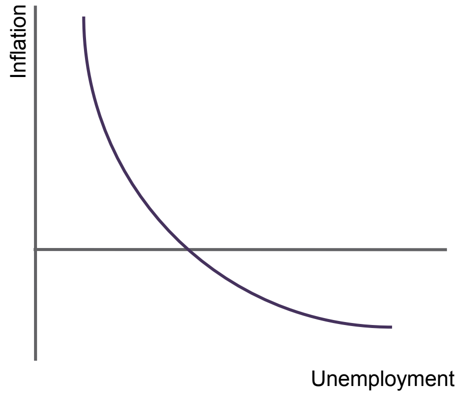
- Creates uncertainty for investors
- Causes concerns for pensioners
- Can reduce international competitiveness

The Bank of England controls inflation with interest rates

8. Money Supply, Inflation and Unemployment

The Phillips Curve

The short-run Phillips curve looks at the relationship between inflation and unemployment holding constant expected inflation and the natural rate of unemployment.



An unanticipated increase in aggregate demand lowers unemployment and increases aggregate demand

Keeping on target

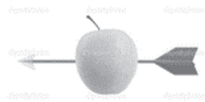
Which of the following is **true** of the natural rate of unemployment?

A. Exists when there is equilibrium in the labour market

B. Exists when there is disequilibrium in the labour market

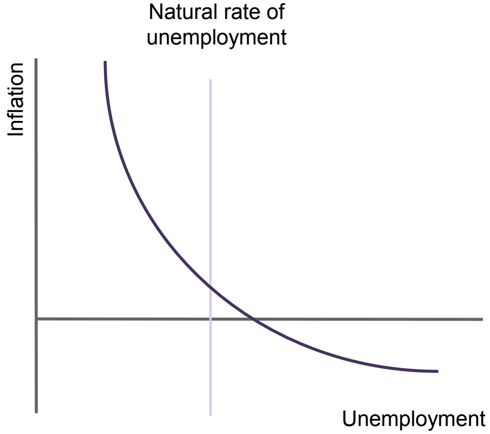
C. All natural unemployment is frictional

D. Theoretically the labour market can never be in equilibrium



8. Money Supply, Inflation and Unemployment

The long-run Phillips curve shows the natural rate of unemployment; unanticipated inflation will cause short run fluctuations around the natural rate but wages eventually adjust and the economy returns to the natural rate.



Answer to the question on the previous slide:

A

Exists when there is equilibrium in the labour market

Course Evaluations

Following your course you will receive an email containing an evaluation form. Please take the time to complete this and return it by email – your feedback is really important to us.

Many thanks

Andy Bennett
Head of Regulatory Exam Training

The Method to Pass

- Preparing to pass – Study methods
  - Read each chapter of the text, make notes/mind maps®
  - Test your understanding of each chapter with practice questions
  - Re-read the text – you'll learn more every time you re-read it
  - Complete all practice questions and mock exams, ideally twice (>80%)
  - Complete additional questions, ideally twice (>80%)

- In the exam – techniques
  - Remember the hard work has already been done
  - Read the questions carefully
  - Rule out wrong answers
  - Come back to more difficult questions later on
  - If you've read the question correctly, your first thought is generally the right answer
  - Be wary of changing answers
  - You can do it – believe in yourself
  - Enjoy your celebrations when you pass