TOPIC 2

Economic policy and financial regulation

LEARNING OBJECTIVES

Government policies affect the financial services industry in many ways, both directly and indirectly. Regulation and legislation affect the way in which the industry operates. International standard setters and other regulatory organisations may influence the UK's regulatory framework. Non-UK legislation and regulation may have extraterritorial effect on UK financial institutions that offer their products or services overseas or are part of internationally active groups. Furthermore, economic policies might have a more indirect effect, for example by making personal saving or business investment more appealing, or by making borrowing cheaper.

In this topic we will outline some key economic objectives that governments generally share, whichever political party is in power, before introducing the regulatory environment within which financial services organisations operate.

By the end of this topic, you should have an understanding of:

- key macroeconomic objectives:
  - price stability;
  - low unemployment;
  - stable economic growth;
  - balance of payments equilibrium;
- monetary policy and the impact of interest changes;
- fiscal policy;
- the role of the European Union in regulating financial services;
- the different levels of regulatory control in the UK.

This topic covers Unit 1 syllabus learning outcome U1.3 and U8.1–8.3.

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TOPIC
2

THINK ...

What do you already know about economic policy and regulation? Issues relating to this topic are in the news almost every day, and the state of the economy affects your daily life in numerous ways.

For instance:

- Have you heard or read news reports about the decisions the Bank of England makes on raising interest rates, lowering them or keeping them the same?
- Do you know what effect high inflation might have on your savings?
- Have you ever had to decide between a fixed-rate or variable-rate mortgage?
- Do you know which bodies impose the regulations that financial services institutions have to follow?

2.1 What are the key macroeconomic objectives?

Most governments aim to achieve four key economic objectives; their political beliefs shape the way they go about achieving these objectives and the relative importance they give to each. They are known as macroeconomic objectives because they concern economic aggregates, ie totals that give us a picture of the economy as a whole, as opposed to microeconomic objectives that concern individual firms or consumers.

KEY TERMS

INFLATION

A sustained increase in the general level of prices of goods and services, resulting from "too much money chasing too few goods". In more formal economic terminology, it can be defined as a situation where the rate of growth of the money supply is greater than the rate of growth of real goods and services.

DISINFLATION

A fall in the rate of inflation, ie prices are still rising, but less quickly than they were.

DEFLATION

A general fall in the price of goods and services. In other words, the inflation rate is below zero per cent – a negative inflation rate.

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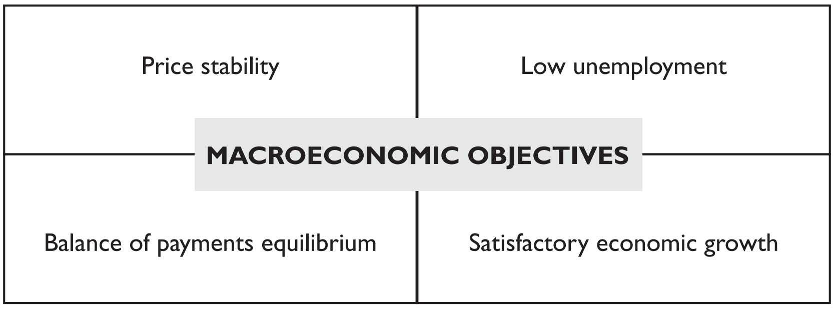
FIGURE 2.1 KEY MACROECONOMIC OBJECTIVES



- **Price stability** – involves a low and controlled rate of inflation. It does not mean, however, that zero inflation is desirable and there is a body of economic opinion that believes that moderate inflation can stimulate investment, which is good for the economy.

- **Low unemployment** – involves expanding the economy so that there is more demand for labour, land and capital.

- **Balance of payments equilibrium** – a situation in which expenditure on imports of goods and services and investment income going abroad is equal to (ie in equilibrium with) the income received from exports of goods and services and the return on overseas investments. The exchange rate of the country's currency is linked to the balance of payments, and most governments aim to keep the price of currency stable at a level that is not so high that exports will be discouraged but not so low as to increase inflation.

- **Satisfactory economic growth** – the output of the economy is growing in real terms over time and standards of living are getting higher.

In practice, it has proved impossible to achieve all of these objectives simultaneously, as the history of the British economy shows. For example, if a government tries to reduce the rate of unemployment by means of expansionary measures such as lower interest rates and lower taxation, there is an increase in demand for goods and services. As a result, inflation begins to rise. At the same time, people buy more imports and the balance of payments suffers, although the economy will probably grow.

The four objectives given above tend to fall into two pairs:

- policies to reduce unemployment will also boost growth;

- measures to reduce inflation will also help to improve the balance of payments.

Governments generally have to trade off objectives against each other, ie they want price stability but know that the price of getting rid of inflation altogether would be very high unemployment, so they accept a low inflation rate to avoid pushing the economy into recession.

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KEY TERMS

RECESSION

A significant decline in economic activity over a sustained period. Technically, it is two consecutive quarters of negative economic growth as measured by a country's gross domestic product (GDP).

GROSS DOMESTIC PRODUCT (GDP)

GDP is a measurement of a country's overall economic activity. Technically it is the monetary value of all the goods and services produced within the country (ie 'domestically') in a given period, eg one year.

Over time, economies typically go through four main phases:

- recovery and expansion;
- boom;
- contraction or slowdown; and
- recession.

Economic activity is measured by the fall and rise in GDP. When GDP in one quarter falls compared to the previous quarter, the economy is said to be contracting or slowing down. When it rises, it is said to be expanding or in recovery. Two successive quarters of declining GDP signals that the economy is in recession. When GDP is at its highest level, the economy is said to be booming.

Each phase of the cycle is characterised by fluctuating patterns of economic activity.

TABLE 2.1 ECONOMIC ACTIVITY

Phase of cycle	Pattern of economic activity
Recovery and expansion	Interest rates, inflation and unemployment are low. Consumers have money to spend. Demand for goods and services rises, pushing prices up. Share prices improve as businesses flourish.
Boom	To prevent the economy from overheating, the Bank of England may intervene by putting up interest rates to control consumer spending and dampen inflation.

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Contraction or slowdown	Once the interest rate rises start to bite, consumer spending falls. Demand for goods and services falls, profits fall (as do share prices) and unemployment rises. Inflation slows down.
Recession	As the economy heads towards its lowest level of activity, the Bank of England may intervene to reduce interest rates in a bid to stimulate demand and set the economy on the path back to recovery.

The approach to economic policy in the UK from the beginning of the 1960s until the 1990s is often described as 'stop-go': successive governments accelerated and decelerated the economy in turn. This led to a situation in which periods of fast growth, high employment and high inflation were followed by a slowdown, resulting in high unemployment and lower inflation.

CONSUMER PRICES INDEX

A measure of the change in price of a 'basket' of consumer goods and services over a period. Items to be included in the 'basket' are reviewed regularly to ensure it provides an accurate reflection of consumer spending. It is the equivalent of the Harmonised Index of Consumer Prices (HICP) used within the eurozone.

Since the 1990s, the approach in both the UK and Europe has been to keep inflation steady at a low rate, in the hope that price stability will provide the certainty that leads to sustained economic growth. The aim is to keep aggregate demand in line with the productive capacity of the economy.

In order to achieve this objective, successive UK governments have set an official direct target, which is to keep inflation, as measured by the Consumer Prices Index (CPI), at an average annual rate of 2 per cent, with a maximum divergence either side of 1 per cent. The main method used to control inflation is by manipulating interest rates (see section 2.2).

There are two major types of policy used by governments in their attempts to achieve long-term economic objectives: monetary policy and fiscal policy. Both types of policy try to influence the level of aggregate demand in the economy and therefore the level of output, unemployment and prices. Fiscal policy and monetary policy are closely linked, and governments generally use a combination of the two to try to achieve their economic goals.

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FACTFIND

Research the latest exchange of letters between the Chancellor of the Exchequer and the Governor of the Bank of England concerning CPI inflation at the bottom of the following page:

www.bankofengland.co.uk/monetary-policy/inflation

2.2 Monetary policy

Monetary policy is based on the ideas of the monetarist school of economic theory and particularly on those of the American economist Milton Friedman (1912–2006). Monetary economists believe that inflation is caused by an increase in the money supply. Broadly speaking, they conclude that, since most of the growth in the money supply is caused by an increase in the amount of credit created by banks, a government that wants to control the growth of the money supply must control the amount of credit that banks create. A common way to do this is by manipulating interest rates, which in turn influences the demand for credit by customers.

MONETARY POLICY

Measures taken to control the supply of money in the economy (eg by raising or lowering interest rates) in order to manage inflation.

Other methods can be used, and they have been used in the past. For example, restrictions can be imposed on the amount that banks can lend, or borrowers can be required to provide a minimum cash deposit when borrowing to make a purchase.

Neither of these approaches is currently in use in the UK, where the favoured method of monetary policy is the manipulation of interest rates. The Monetary Policy Committee (MPC) of the Bank of England decides on the rate of interest at which the Bank of England will lend to banks and other financial institutions, and it is this official rate (known as Bank rate) that determines all the other interest rates charged to borrowers and paid to lenders.

The Treasury retains the right to give instructions to the Bank of England regarding its monetary policy in "extreme economic circumstances"; otherwise the Bank acts independently of the government.

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KEY TERMS

BANK RATE

The rate at which the Bank of England lends to other financial institutions. In this text the term 'Bank rate' is used, but you might also see it written 'Bank Rate' or referred to as 'base rate'.

INFLATION TARGET

The level of inflation that economists judge is appropriate to keep the national economy functioning efficiently. As we have seen, in the UK the inflation target (at the time of writing, January 2022) is 2 per cent, as measured by the Consumer Prices Index, with a 1 per cent maximum divergence either way. The Bank of England has responsibility for achievement of the government's inflation target. Current and predicted future levels of inflation are a key consideration in setting the Bank rate.

THE MPC AND INTEREST RATES

Interest rates are set by the Bank of England's Monetary Policy Committee (MPC).

Each member of the MPC has expertise in the field of economics and monetary policy. The MPC usually meets eight times a year over three days to set the interest rate that it judges will enable the inflation target to be met. The minutes of the meetings are published simultaneously with the interest rate decision.

To help produce its projections, the MPC uses a model of the economy that provides a framework to organise thinking on how the economy works and how different economic developments might affect future inflation.

Every quarter, the Bank publishes its Inflation Report, which gives an analysis of the UK economy and the factors influencing policy decisions.

2.2.1 The impact of interest rate changes

If the MPC decides to change the Bank rate, the effect is that banks and similar deposit-takers tend to follow suit and alter the interest rates at which they lend and borrow by something close to the same amount. Whether lending

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or taking deposits, a bank will apply a margin between the rate at which it borrows money and the rate at which it lends the money out, in order to cover costs and generate a profit. Adjusting rates in this way means that margins are maintained and the lender or deposit-taker can continue to cover its costs and generate profit.

This means that banks' base rates are inevitably variable because they follow the rate of the Bank of England, which is adjusted as necessary to implement the monetary policy used to control the UK's economy. However, in the difficult financial conditions since the financial crisis of 2007–09, bank interest rates (particularly the variable rates charged to borrowers) have not followed the Bank rate as closely as they did in more stable times. Due to concerns about the fragile state of the economy, the Bank rate was maintained at 0.5 per cent between 2009 and 2016, and was then cut further to 0.25 per cent in August 2016. Since then, interest rates have been on the way up, having increased to 0.5 per cent in November 2017 and to 0.75 per cent in August 2018. With the rate still at a low level, it remains difficult for banks and building societies to make a reasonable profit on their lending activities without setting their lending rates at a higher margin above the Bank rate than they would normally charge.

!

KEEPING UP TO DATE

You should keep up to date with changes in the economic situation; if you are working in the financial services industry, you need to make sure you understand the current situation.

Until relatively recently, most loan interest rates, including mortgage rates, were variable rates. A major disadvantage of variable rates, particularly in relation to a large transaction such as a mortgage, is that it is difficult for borrowers to budget for the likely future cost of repaying their loan. Sudden, large interest rate increases can lead to borrowers being unable to make their mortgage repayments; in the worst cases, some borrowers may even lose their homes if the lender has to take possession.

With the development of a large and active wholesale money market, it is now possible for lenders to obtain large amounts of money at fixed rates, which they can in turn lend out to their mortgage borrowers and others. The majority of fixed-rate mortgages in the UK still tend to be fixed only for a short initial period, with the rate reverting to the variable rate for the remainder of the term. Longer-term fixed rates are available in many other European countries, and it has been suggested that a greater use of long-term fixed rates in the UK would assist in stabilising the UK housing market, which is sometimes very volatile.

Fixed-rate mortgages do have their own disadvantages, however:

- There is a danger that a borrower will lose out if the variable rate falls and they are locked into a higher fixed rate.

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- There is normally a penalty for paying off the mortgage within the fixed-rate period, too, in order to protect the lender. This is because the funds used to subsidise fixed-rate loans are normally raised in the money markets on terms that bind the lender to the medium/long term. If there were no early repayment penalties attached to the mortgages funded by this borrowing, and the mortgages were redeemed early, the lender would earn less interest than anticipated and thus face a potential financial loss. There may also be an arrangement fee, charged by the lender for reserving sufficient funds at the fixed rate.

2.3 Fiscal policy

Fiscal policy (which is sometimes called budgetary policy) involves influencing the money supply and the overall level of economic activity, including consumption and investment, by manipulating the finances of the public sector (which comprises central government, local authorities and public corporations).

The public sector has a responsibility to provide certain services that are of national or regional importance, such as education, healthcare and transport. To pay for these services, the government must raise funds from the private sector, ie from individuals and firms, in the form of direct and indirect taxes.

Because the public sector is responsible for taking a large amount of money from the private sector and for making large amounts of expenditure on its behalf, any changes in either side of the account and thus in the balance have a significant effect on the economy as a whole. There are three general outcomes, as illustrated in Figure 2.2.

KEY TERMS

DIRECT TAXES

Apply to individuals and their assets (income tax, capital gains tax, inheritance tax, National Insurance).

INDIRECT TAXES

Applied to goods and services at the time they are purchased (eg VAT, stamp duty).

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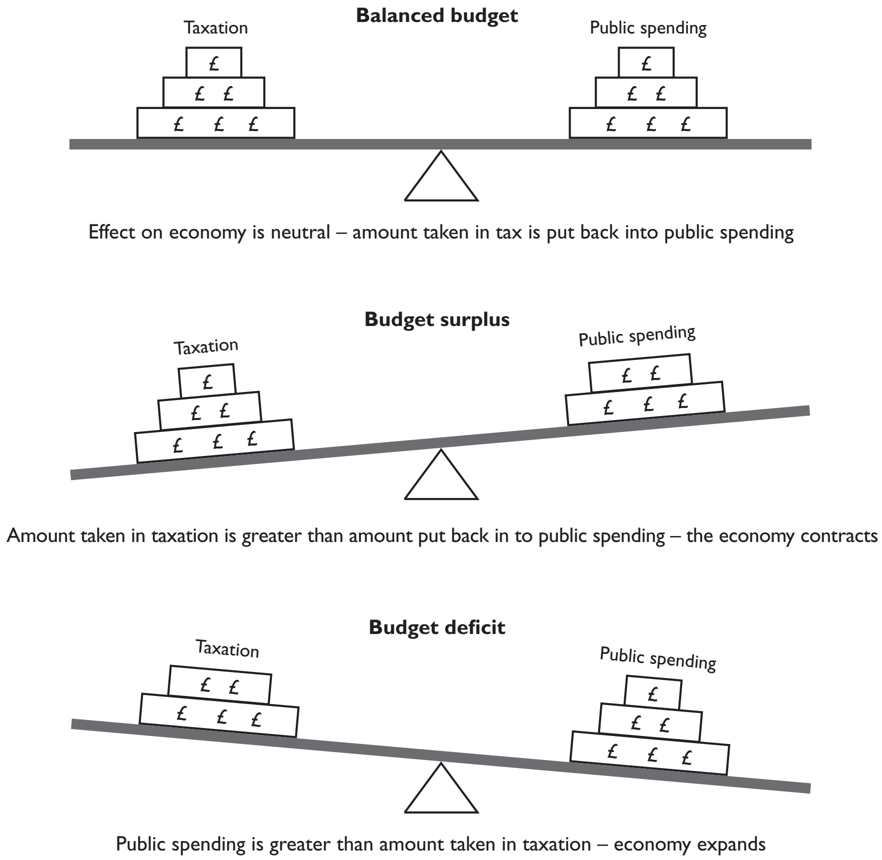
FIGURE 2.2 BALANCED BUDGET, BUDGET SURPLUS, BUDGET DEFICIT



KEY TERMS

FISCAL POLICY

The adjustment of levels of taxation and public spending in a way that is intended to achieve the government's macroeconomic objectives.

PUBLIC SECTOR NET CASH REQUIREMENT

A government that has a deficit must borrow to finance it. The public sector net cash requirement (PSNCR) is a cash measure of the public sector's short-term net financing requirement.

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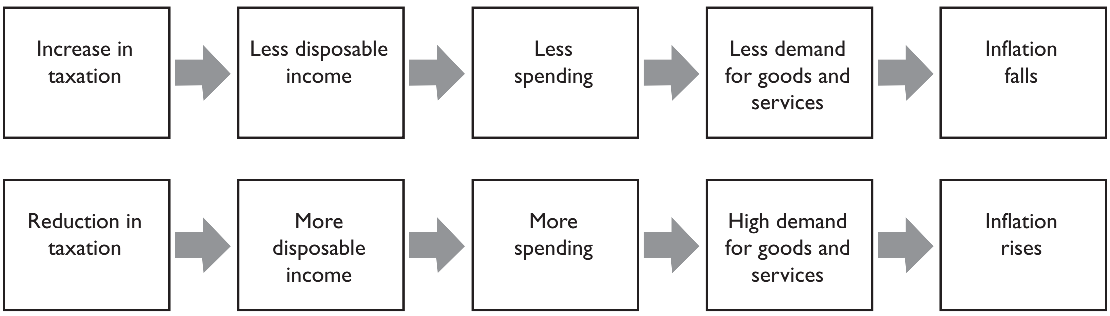
THE BUDGET

The government outlines its fiscal policy in the annual Budget statement made by the Chancellor of the Exchequer. Traditionally, this has been in March but in some years it has been changed to the autumn and accompanied by a spending review, in which case a separate statement has been made in March. Shifting the budget to autumn provides the government more time to legislate for changes before the start of the next fiscal year. The Budget statement includes revenue plans (including taxation of individuals and companies) and the government's planned expenditure. Prior to the Budget, the government publishes a Pre-Budget Report that allows it to consult the public on specific policy initiatives. Since 2018, the Spring Statement became a response to the Office for Budget Responsibility's (OBR) economic forecast, rather than a major fiscal event but the government is reserving the right to make tax changes if the economic circumstances demand it. The proposals in the Budget are detailed in a Finance Bill which, if approved, is then passed into law via a Finance Act, with different provisions taking effect at dates specified in the Act.

Monetary policy acts on the economy as a whole, currently through changes in the general level of interest rates. Fiscal policy can have a macroeconomic effect on the level of activity in the economy, too, as Figure 2.3 indicates.

FIGURE 2.3 USING TAXATION TO CONTROL INFLATION



Fiscal policy also has microeconomic effects and can be targeted on particular areas of the economy. For example, tax incentives can be given to manufacturing industries to boost employment in what is a declining sector, or government grants can be given to firms that move to particular areas of the UK, thus helping to develop local economies.

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Changes in taxation affect the market for financial services and products in two main ways:

- Increased general taxation reduces the amount of money available for investment or to fund loan repayments.
- Tightening of the taxation regime in relation to particular products or activities makes them less attractive to investors. For example, in April 2016 a stamp duty land tax supplement was introduced in respect of the purchase of second properties. This followed concern that first-time buyers were being priced out of the housing market as a result of demand from buy-to-let landlords.

2.4 How does the European Union regulate financial services?

So far in this topic we have been focusing on the UK government's economic policy objectives and how the decisions that government makes affect the financial services industry. We are now going to look briefly at the role of government in the regulation of financial services. Regulation will be covered in much more detail in Topics 17–25.

THE IMPACT OF BREXIT

On 23 June 2016, the British public voted in a referendum for the UK to leave the European Union (referred to as Brexit).

Brexit has resulted in significant changes in the regulatory landscape for UK financial service organisations and overseas organisations providing services into the UK.

The UK stopped being a member of the European Union (EU) on 31 January 2020. During a transition period that ran until 31 December 2020, the UK continued to follow all the EU's rules and its trading relationship remained the same (BBC, 2020).

As the UK onshored aspects of the EU's financial regulatory framework (ie retained certain EU laws and regulations in UK statue), legislation and wider issues relating to the UK, and its legacy of membership of the EU covered in this text, remain important areas within the syllabus for this qualification.

You might find this link on the FCA's website a useful resource: www.fca.org.uk/brexit.

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Prior to Brexit, much of the regulatory regime for financial services in the UK was determined at EU level. This includes regulation relating to banking, investment, life assurance, general insurance, operating as a financial adviser, compensation for losses, money laundering, data protection and many other areas.

EU laws can take a number of forms, of which the two most common are regulations and directives.

IN BRIEF

REGULATIONS

- Have general application.
- Are binding in their entirety, both in respect of what is to be achieved and how it is to be achieved.
- Are directly applicable in all member states (unless particular states have specific dispensation).

DIRECTIVES

- Are binding upon each member state to which they are addressed as to the result to be achieved.
- Each member state has discretion as to how they go about achieving the stated aim of the directive.
- The directive objectives must be achieved within a specific timescale (typically two years) but exactly how they are achieved is left to the authorities within each member state to determine.

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IMPACT OF EU LEGISLATION ON THE FINANCIAL SERVICES SECTOR

An example of an EU directive is the EU Mortgage Credit Directive (MCD), which the UK has retained post-Brexit through the Mortgage Credit (Amendment) (EU Exit) Regulations 2019.

The MCD aimed to harmonise regulation of the EU mortgage credit market and promote competition. As the system of mortgage regulation in the UK was already robust, the FCA decided to make certain changes to the rules set out in its Mortgages and Home Finance: Conduct of Business Sourcebook to accommodate the changes required by the directive.

You will find out more about the FCA's regulations in relation to mortgage advice and product sales in Topic 21.

Another example of how EU directives affect the financial services sector is the changes to the deposit protection limits in the UK. Until 31 December 2015, the UK's Financial Services Compensation Scheme (FSCS) guaranteed deposits up to a maximum of £85,000 per depositor per institution. At the time the FSCS was established, £85,000 was the sterling equivalent of €100,000, the level of depositor protection provided for under the European Deposit Guarantee Schemes Directive. The directive requires that the sterling scheme is revalued every five years to make sure that the level of protection remains in line with the €100,000 provided for under the EU-wide scheme. In the UK the revaluation is carried out by the Prudential Regulation Authority (PRA). Changes in currency values meant that in January 2016, the level of protection under the FSCS was reduced to £75,000 per depositor per institution. Following the decision to leave the EU in June 2016, the value of sterling fell and the level of protection provided for deposits by the FSCS was restored to £85,000 in January 2017.

You will find out more about the FSCS in Topic 25. You can find out more about the European Deposit Guarantee Schemes Directive at: ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/deposit-guarantee-schemes_en.

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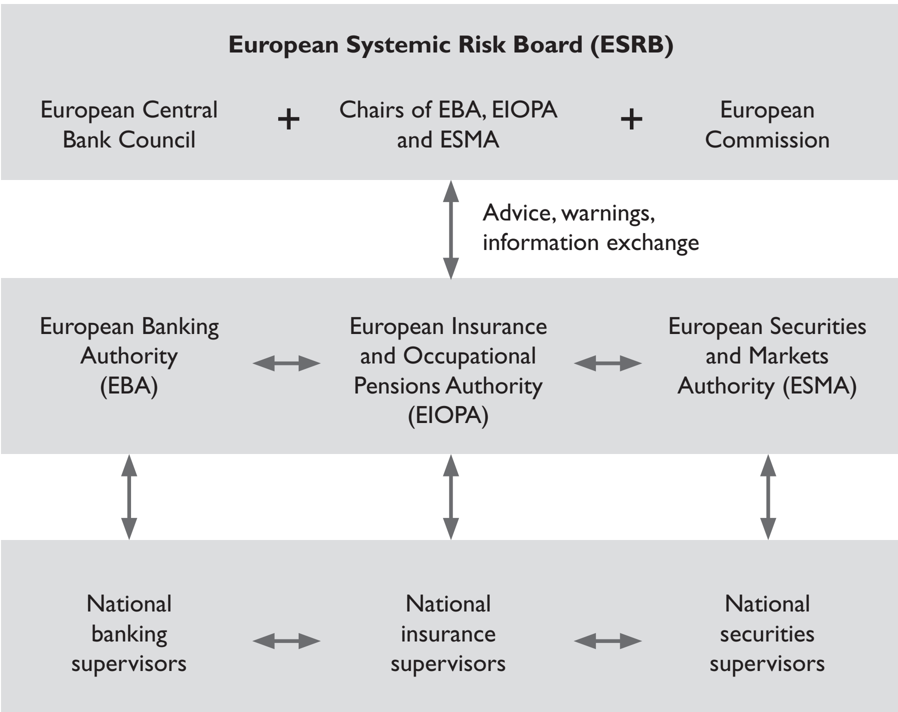
An example of an EU regulation that has implications for the financial services industry is the General Data Protection Regulation (GDPR). This has strengthened existing data protection rules and created a consistent set of data protection rules for citizens in the EU. It was adopted by the EU in April 2016, with full implementation in May 2018.

You will find out more about the regulations surrounding data protection in Topic 24. You can find out more about the General Data Protection Regulation at: ico.org.uk/for-organisations/guide-to-data-protection/guide-to-the-general-data-protection-regulation-gdpr/.

2.4.1 The European System of Financial Supervision

The financial crisis of 2007–09 exposed significant weaknesses in Europe's financial regulatory systems and highlighted the need for reform of virtually every area of EU-wide financial services. In response, the EU set up the European System of Financial Supervision (ESFS); its aim is to ensure consistent financial supervision across the member states.

FIGURE 2.4 THE EUROPEAN SYSTEM OF FINANCIAL SUPERVISION



Source: European Securities and Markets Authority (no date)

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As Figure 2.4 indicates, the ESFS is decentralised, operating via three supervisory authorities and a network of national regulators. The European Supervisory Authorities (ESAs) are the:

- European Securities and Markets Agency (ESMA);
- European Banking Authority (EBA); and
- European Insurance and Occupational Pensions Authority (EIOPA).

The ESAs have significant powers to propose new rules and make decisions that are binding upon national supervisors, such as the FCA, and firms. The aims of the ESAs include:

- creating a single EU rule book by developing draft technical standards, which will then be adopted by the European Commission as law;
- issuing guidance and recommendations with which national supervisors and firms must comply;
- investigating national supervisory authorities that are failing to apply, or are in breach of, EU law;
- in a crisis, providing EU-wide co-ordination and, if an emergency is declared, making decisions that are binding upon national supervisors and firms;
- mediating in certain situations where national supervisory authorities disagree and, if necessary, making decisions that are binding on both parties to ensure compliance with EU law;
- conducting reviews of national supervisory authorities to improve consistency of supervision across the EU;
- considering consumer protection issues.

ESMA has direct supervisory responsibility for credit reference agencies.

Another key organisation is the European Systemic Risk Board. Its role is to prevent and mitigate systemic financial risk across the EU. Its responsibilities include:

- identifying and prioritising risks;
- issuing warnings and recommendations and monitoring their follow-up;
- co-operating with other members of the ESFS; and
- co-ordinating action with other international financial organisations, such as the International Monetary Fund (IMF).

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THE IMPACT OF BREXIT ON REGULATION

The UK's financial services regulators – the Prudential Regulation Authority and Financial Conduct Authority – are not formally part of the ESFS post-Brexit. However, the ESAs still retain some jurisdiction over UK financial institutions as third-country institutions where they are providing service to clients in an EU member state. As such, the ESFS remains an important area within the syllabus for this qualification.

2.4.2 The Single Supervisory Mechanism

The Single Supervisory Mechanism (SSM) is the name for the mechanism by which the European Central Bank holds responsibility for the supervision and monitoring of banks in EU member states.

The SSM provides a common approach to banking supervision. The ECB is supported by national regulators and it is the ECB that has the final decision on supervisory matters.

CHECK YOUR UNDERSTANDING

1) The European Union has issued a new regulation. This means that each member state:

   a) has the choice whether or not to adopt the regulation.

   b) must pass legislation to implement the regulation within two years.

   c) is bound by the regulation in its entirety regardless of existing legislation.

   d) has the choice of how to adopt the regulation's objectives.

2) Post-Brexit, which of the following is correct when the EU changes a regulation or introduces new regulation?

   a) The UK is legally required to adopt or implement the new or reformed EU regulation.

   b) The UK is legally required to ignore the new or reformed EU regulation entirely.

   c) The UK should consider whether it adopts a new regulation or develops its own alternative approach; and, in the case

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of reformed EU regulation, whether it wishes to amend the legislation it onshored before Brexit.

2.5 What are the levels of regulatory oversight in the UK?

Regulation of the financial services industry in the UK is, broadly speaking, a five-tier process.

1) Onshored EU legislation that the government retained in UK statute following Brexit and any EU legislation that impacts on the UK financial industry. The two main types of EU legislation are regulations and directives (see section 2.4).

2) Acts of Parliament that set out what can and cannot be done. Examples of legislation that directly affect the industry are the Financial Services and Markets Act 2000 and the Financial Services Act 2012. The requirements set out in an Act of Parliament are often put into effect through subsidiary legislation known as statutory instruments.

3) Regulatory bodies that monitor the regulations and issue rules about how the requirements of the legislation are to be met in practice. The main regulatory bodies in the UK are the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).

4) Policies and practices of the financial institutions themselves and the internal departments that ensure they operate legally and competently, eg the compliance department of a life assurance company.

5) Arbitration schemes to which consumers' complaints can be referred. In most cases, this is the Financial Ombudsman Service.

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FIGURE 2.5 THE FIVE TIERS OF REGULATORY OVERSIGHT IN THE UK

Fifth Level
Arbitration schemes (eg Financial Ombudsman Scheme)

Fourth Level
Policies/practices of the financial institution (the bank's own procedures)

Third Level
Regulatory bodies (monitoring regulations and issuing rules and requirements)

Second Level
Acts of Parliament (eg Financial Services and Markets Act 2000)

First Level
Onshored EU legislation at the time of Brexit and other EU legislation (regulations and directives that impact on the UK financial services industry)

THINK AGAIN ...

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- summarise the four key macroeconomic objectives?
- explain the difference between inflation, disinflation and deflation?
- explain how decisions made by the Monetary Policy Committee affect banks and consumers?
- describe the different effects of a budget surplus or deficit on employment?
- explain how an EU directive differs from a regulation in the way that it is applied?
- explain the role of the EU and the impact of EU regulation and directives on the UK post-Brexit?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

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European Securities and Markets Authority (no date) *European Supervisory Framework* [online]. Available at: www.esma.europa.eu/about-esma/governance

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Test your knowledge

Use these questions to assess your learning for Topic 2. Review the text if necessary.

Answers can be found at the end of this book.

1) What is meant by a 'macroeconomic objective'?
2) What are the four key macroeconomic objectives that UK governments generally seek to achieve?
3) What is a potential negative consequence of expanding economic growth to reduce unemployment?
4) All governments aim to achieve zero inflation. True or false?
5) What is the UK government's inflation target and how is it measured?
6) Disinflation means that:
   a) prices are rising faster than previously.
   b) prices are falling.
   c) prices are rising but more slowly than previously.
   d) prices are staying the same.
7) In June, the Monetary Policy Committee (MPC) decides to raise the Bank rate by half a percentage point. In August, Paul and Amanda's mortgage payments increase. Explain how these two events are likely to be linked.
8) Which of the following economic measures taken by a government would not help to achieve a budget surplus?
   a) Increasing taxation.
   b) Increasing public spending.
   c) Reducing public spending.
9) A new piece of EU legislation is being introduced. It is being implemented at the same time and in exactly the same way across all member states. This indicates that the legislation is in the form of:
   a) a directive.
   b) a regulation.

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10) Which UK body and which EU body are responsible for monitoring the financial system for systemic risk and taking steps to reduce it (refer back to Topic 1 if necessary)?

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