

CHAPTER 25 Financial Markets

Study guide

Strictly speaking, the *London Money Market* consists of a number of separate markets each dealing with a different type of short-term loan. The most important market is the *Discount Market*. It consists of a number of institutions connected by the parts they play in dealing in bills of exchange, including Treasury Bills. As we shall see in Chapter 27, it is through this market that the Bank of England can influence liquidity in the economy by varying the amount of Treasury Bills it offers at the weekly tender.

In recent years there has been some revival in the importance of *commercial bills* on the Discount Market. These are mostly '*internal*' bills. For instance, merchant banks give loans to firms wanting short-term finance by 'accepting' the firm's bill of exchange which can then be sold on the Market for ready cash. Such bills are an important form of 'near money'.

The *Capital Market* consists similarly of a number of different markets where firms specialise as intermediaries in the particular purposes for which long-term capital is required. For example, in the purchase of houses, we have mortgage brokers who link lenders (the building societies and banks) with borrowers.

Note that all these separate markets, for both short-term and long-term capital, are connected by the price system. Although the requirements of both borrowers and lenders differ in type, time and risk, loans are substitutes for one another and so eventually a change in the price of one will be reflected in a similar movement in the price of the others until equilibrium is restored.

CHAPTER 25 Questions

1. What is the process called when a bill of exchange is sold before the end of its full currency?
2. What effect will a rise in short-term interest rates in London tend to have on:
 - a) the rate of interest charged on 'call' money;
 - b) the sum obtained for a bill of exchange;
 - c) the inflow of foreign short-term capital.
3. Why is it important that the Bank of England acts as a 'lender of last resort'?
4. What are the two ways by which the Bank of England issues Treasury Bills?
5. What are 'institutional investors'?
6. What is the main function of the Sterling Inter-bank Market?
7. Banks compete vigorously against each other for funds in the open market and yet lend to one another in the inter-bank market. Why is this?
8. What advantages are there to small investors of purchasing shares in an 'investment trust'?

9. What functions does the Stock Exchange perform in the economy?
10. What is the basic difference between the money market and the capital market?

Multiple Choice Questions

11. Institutions in the money market deal in:

- a) mortgages;
- b) long-term loans;
- c) pension funds;
- d) equities;
- e) short-term loans.

12. Institutions in the capital market deal in:

- a) medium and long-term capital;
- b) commercial bills;
- c) Treasury bills;
- d) short-term loans;
- e) Eurodollars.

13. Which of the following types of institution is *not* part of the capital market:

- a) insurance companies;
- b) discount houses;
- c) investment trusts;
- d) unit trusts;
- e) the National Savings Bank?

14. Which of the following is not a function of the Stock Exchange:

- a) it facilitates borrowing by government and industry;
- b) it helps to even-out short-term fluctuations in the price of securities;
- c) it advertises security prices;
- d) it protects against fraud;
- e) it discounts Treasury Bills?

15. The three leading world financial centres are:

- a) Tokyo, London and Shanghai;
- b) London, New York and Taiwan;
- c) Tokyo, London and New York;
- d) Hong Kong, Tokyo and Shanghai;
- e) Frankfurt, London and Paris.

CHAPTER 26 Clearing Banks

Study guide

There are many types of banks – central banks, clearing banks, merchant banks, saving banks, foreign banks, etc. This chapter deals with the joint-stock banks, known more usually today as the ‘clearing’ or ‘commercial’ banks. Not only are they the largest source of short-term credit for industry, but their cheque system and central clearing arrangements enable them to economise in the use of cash and therefore to *create credit* which serves as money. Their operations in creating and granting ‘liquidity’, therefore, affect aggregate demand and thus the level of activity.

This chapter is mostly descriptive, but you should note the following:

1. Banks create credit on the basis of a cash or liquidity ratio. Where deposits (D) are created on the basis of a cash ratio r and cash is C, we have: $D = C/r$.
Thus, if $r = 0.1$ and $C = 100$, $D = 1000$.
2. Banks are concerned, not only with the *quantity* of credit created, but the *quality* of the borrowers. Thus their lending policy is guided by the principles of security, liquidity and profitability.
3. Banks are limited in their ability to create credit by:
 - a) the willingness of satisfactory borrowers to take up loans;
 - b) the amount of cash and liquid assets available to them after the demand of the public and outside institutions has been fulfilled;
 - c) government monetary policy.

CHAPTER 26 Questions

1. What are the main advantages of cheques to bank customers?
2. What are the main advantages of cheques to the banks?
3. United States bankers speak of ‘demand deposits’ and ‘time deposits’. To what accounts of a British bank do these correspond?
4. Explain carefully why:
 - a. a bank deposit is money
 - b. a bank overdraft is money.
5. Why are Treasury Bills important to the banks?
6. What are the three basic lending requirements of the banks?
7. What are the three main ways that the banks respond to their three basic lending requirements?
8. Securities can always be sold on the Stock Exchange. Why, then, are they not regarded by the banks as liquid assets?
9. What is ‘call money’?
10. Explain why ‘liquidity and profitability’ are described as conflicting objectives for the banks.

Multiple Choice Questions

11. If the cash or reserve asset ratio is 10%, the deposit to cash multiplier equals:

- a) 100
- b) 10
- c) 1
- d) 5
- e) 2

12. A £1000 deposit, with a cash ratio of 12.5%, will lead to total liabilities of:

- a) £12,500
- b) £1,250
- c) £125,000
- d) ££8000
- e) £10,000

13. The shorter the period of a loan, the greater is the bank's:

- a) liquidity
- b) profitability
- c) liability
- d) responsibility
- e) satisfaction

14. With the development of the cheque system:

- a) bad debts have dramatically increased
- b) bad debts have dramatically decreased
- c) cash requirements have decreased
- d) cash requirements have increased
- e) liquidity has increased

15. Treasury Bills are mainly obtained from:

- a) commercial banks
- b) merchant banks
- c) foreign banks
- d) finance houses
- e) discount houses

CHAPTER 27 The Bank of England

Study guide

Today monetary control is exercised mainly by varying the short-term rate of interest. But the Bank of England has three major responsibilities: (1) implementation of monetary policy; (2) administration of the National Debt; (3) protection of the exchange value of sterling and the foreign currency reserves. This complicates policy because the use of a particular weapon may achieve one aim but conflict with another. For example, funding operations to reduce the supply of Treasury Bills also puts up the cost of servicing the National Debt, while an increase in interest rates to protect the reserves may have harmful consequences on the level of economic activity internally. The result is that in the past the Bank of England has occasionally fallen back on 'direct controls' – requests to the banks and other financial institutions, variations in the terms of hire-purchase. These hold back spending directly – and act quickly. The difficulty today is that, with the international nature of capital markets, direct controls are difficult to enforce, e.g. on foreign banks.

CHAPTER 27

1. What is a 'Central Bank'?
2. What is the broad aim of a Central Bank's monetary policy?
3. When the Bank of England sells securities in the market, what is likely to happen to:
 - a. the price of bonds
 - b. the rate of interest?
4. How can the Bank of England influence liquidity by its management of the National Debt?
5. Draw a diagram to illustrate how the supply of money is determined if the rate of interest is fixed.
6. Draw a diagram to show how the interest rate is determined if the supply of money is fixed.
7. What is the main weapon used by the Bank of England to control inflation at the moment?
8. How does the Bank of England act as the government's banker?
9. What international roles does the Bank of England perform?
10. What significant role has the Bank of England had since 1997?

Multiple Choice Questions

11. Open market purchases by the central bank:
 - a) increase the commercial banks' cash reserves;
 - b) increase the commercial banks' holding of treasury bills;
 - c) decrease the commercial banks' cash reserves;
 - d) raise interest rates;
 - e) none of the above.

12. Special deposits are:

- a) an attempt to increase the banks' liquid assets;
- b) an attempt to decrease the banks' liquid assets;
- c) a substitute for reducing the rate of interest;
- d) the same as treasury bills;
- e) none of the above.

13. At present monetary control is exercised mainly by:

- a) the government;
- b) the discount houses;
- c) varying the short-term rate of interest;
- d) varying reserve assets;
- e) fiscal changes.

14. One of the major responsibilities of the Bank of England is:

- a) amending taxes;
- b) amending government spending plans;
- c) lending to private customers;
- d) discounting commercial bills;
- e) administration of the National Debt.

15. If the money supply is fixed, then interest rates will be determined by:

- a) the commercial banks;
- b) the demand for money;
- c) the government;
- d) varying reserve assets;
- e) none of the above.

CHAPTER 28 Measuring the Level of Activity: National Income Calculations

Study guide

Concentrate on the principles of national income calculation rather than the detail. The essential point to remember is that the national income figure is an attempt to measure the product (in money terms) attributable to the factors of the UK over a given period (usually a year). In deciding what to include, therefore, we have to ask: 'Was it a payment to a factor service of the UK for current production?' On this basis, all transfer incomes, stock appreciation, spending on imports, indirect taxes etc., have to be excluded. In certain circumstances where no money payments take place, e.g. the yearly value of owner-occupied houses, arbitrary money figures are given. In others, e.g. the services of housewives and painting one's own house, the productive effort is

excluded. An important omission is the 'black economy' which could amount to ten per cent of national income.

CHAPTER 28 Questions

1. Complete the following:
 - a. Gross National Product = Net National Product +.....
 - b. Gross National Product = Gross Domestic Product +.....
 - c. GNP at market prices = GNP at factor cost +.....-.....

2. What is the relationship between:

- a. stock appreciation;
- b. value of the physical increase in stocks;
- c. increase in the value of stocks?

3. Which of the following should be included in calculating national income?

- a) salary paid to a college lecturer
- b) dividend received from Marks and Spencer shares
- c) interest received on a government bond
- d) child benefits received by a family
- e) £3000 commission paid to a salesman
- f) lottery winnings of an individual

4. From the following figures, calculate:

- a. Gross National Product
- b. Net National Income

	£ million
Wages and salaries	19000
Profits and rents	5500
Payments to foreigners on assets held in the UK	500
Income from foreign assets held by British residents	1000
Depreciation	2000

5. Given the following information, what is:

- a. gross private capital formation?
- b. net private capital formation?

6. The following figures relate to the economy of country X:

	Year 1	Year 2
GNP at current prices (£m)	20000	27000
Population (m)	20	24

- a) What was the percentage increase in GNP between Year 1 and Year 2?
- b) What was the percentage increase in population between Years 1 and 2?
- c) Calculate GNP per head of population in Year 1 and Year 2.
- d) How is your answer to c) related to the answers to a) and b)?

7. The economy of X (in question 6) experienced an 8% rise in the general level of prices between year 1 and year 2.
- If the index of the average price level was 100 in Year 1, what was it in Year 2?
 - Compare the percentage rise in money GNP over the period with the percentage rise in real GNP
 - What has happened to real GNP per head over the period?
8. How could a nation increase its standard of living in the short period, without increasing its production?
9. Explain why, over any given period of time, net investment might be negative while gross investment over the same time is positive.
10. Why is an estimate of the annual rental value of owner-occupied houses included in the national income accounts?

Multiple Choice Questions

11. 'Transfer incomes' are:
- Incomes of footballers;
 - Incomes from work done by agents;
 - Income for which no corresponding product or service is exchanged;
 - Incomes of foreign nationals;
 - Undeclared incomes of criminals.
12. The difference between GNP and GDP is:
- depreciation;
 - indirect taxes;
 - subsidies;
 - net property income from abroad;
 - value added.
13. The difference between GNP and NNP is:
- depreciation;
 - indirect taxes;
 - subsidies;
 - net property income from abroad;
 - value added.
14. 'Value added' is calculated as:
- the difference between wholesale and retail prices;
 - price after tax minus price before tax;
 - the share in the value of the product accounted for by labour costs;
 - gross national product minus net national product;

e) value of output minus goods and services purchased from outside.

15. The difference between Gross National Product at factor cost and national income is:

- a) capital consumption;
- b) indirect taxes;
- c) subsidies;
- d) net property income from abroad;
- e) value added.

CHAPTER 29 Unemployment

Study guide

Apart from the waste of resources, unemployment is a human problem. It is this aspect of unemployment which has conditioned Britain's post-war economic policy. In order to achieve a low level of unemployment, Britain has risked inflation as being a lesser evil. Experience of the disadvantages of rising prices, however, has led to more emphasis being put on a stable price level and growth, at the cost of more unemployment.

Unemployment other than cyclical can be attributed to a breakdown of 'market clearing' at the micro level. In a dynamic economy, the conditions of demand and supply change, and labour remains unemployed because: (a) it has the wrong skills, and (b) there are frictions to its moving – see Chapter 20 (the immobility of labour) and Chapter 35 (regional unemployment). Government policy must concentrate on retraining and moving industry to the unemployed workers.

At the macro level a dynamic economy, and especially one that trades internationally, is susceptible to changes in aggregate demand and aggregate supply. Such changes mean that the plans for entrepreneurs, who produce for an uncertain demand, and those of consumers, both domestic and foreign importers, may diverge. The result is periodic movements between boom and recession – cyclical unemployment. This is considered in Chapters 30-33 and 43.

'A position of full employment' usually refers to full employment in the macro sense – that there is sufficient demand to employ all factors able and willing to work (ignoring frictions to movement arising through immobility). But even when full employment in terms of aggregate demand has been achieved, there is still unemployment because of these frictions.

CHAPTER 29 Questions

1. Give two reasons why unemployment of labour is more serious than unemployment of other factors.

2. Why will there always be some unemployment even in conditions of full employment?
3. Why has the level of unemployment in a) the North East of England; b) South-east Lancashire; c) mid-Scotland; and d) South Wales usually been persistently higher than in the rest of the UK?
4. What is the main reason for structural unemployment persisting?
5. Draw a diagram to illustrate the effect on employment of a wage increase in an export industry.
6. Define 'unemployment'.
7. What is the real economic cost of unemployment?
8. How is it that the UK can have a situation where there are thousands of vacancies and thousands of people unemployed?
9. Why do some economists advocate reducing benefits in order to reduce unemployment?
10. What is the 'replacement ratio'?

Multiple Choice Questions

11. Assisted Areas policy is principally designed to remove which type of unemployment:

- a) cyclical;
- b) seasonal;
- c) structural;
- d) search;
- e) frictional.

12. A South Wales miner is likely to suffer which type of unemployment:

- a) cyclical;
- b) seasonal;
- c) structural;
- d) search;
- e) frictional.

13. Offering off-season rates at holiday resorts, is an attempt to reduce which type of unemployment:

- a) cyclical;
- b) seasonal;
- c) structural;
- d) search;
- e) frictional.

14. Unemployment may occur in export industries because the demand for UK exports is:

- a) highly elastic;
- b) highly inelastic;
- c) inelastic;
- d) perfectly inelastic;
- e) rising.

15. Recessions and recoveries in the economy cause which type of unemployment:

- a) cyclical;
- b) seasonal;
- c) structural;
- d) search;
- e) frictional.

CHAPTER 30 The Level of Output and Aggregate Demand: the Keynesian Explanation

Study guide

This chapter highlights the factors determining the level of economic activity. The essential point to grasp is that there is a circular flow of income. Payments by firms to households comprise the incomes of the households. Income is spent on the goods and services produced by firms, and this expenditure forms the receipts of firms. From these receipts, firms pay for the factors of production provided by households.

'Withdrawals' from the circular flow occur through saving, taxation and spending on imports (the production of firms outside the UK). But these withdrawals can be compensated for by 'injections' into the circular flow – government spending, investment spending and spending on UK exports by foreigners (that is, on goods produced by UK firms).

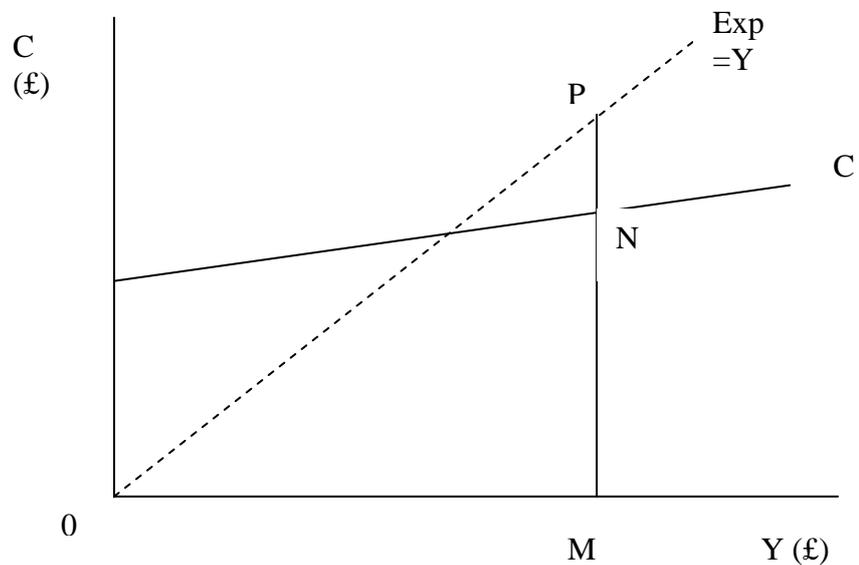
If total injections, $I+G+X$ (exports) exceed total withdrawals, $S+T+M$ (imports), the level of factor payments (income) will expand. If total injections are less than total withdrawals, the level of factor payments will contract. Equilibrium will exist (that is, there will be no change in the level of factor payments) when total injections and total withdrawals are equal.

Note that I does not have to equal S , or G equal T , and so on. The level of Y is maintained if the *total* of $I+G+X$ equals the *total* of $S+T+M$.

CHAPTER 30 Questions

- How does an increase in aggregate demand actually affect firms
a) in the short period; b) in the long period?
- Suggest three reasons why an increase in spending will not lead to an increase in employment.
- If a person saves part of her money income and keeps it under the mattress, what effect will it have on aggregate demand?

Questions 4-7 relate to the following diagram:



- In the diagram, if PN is the level of saving, what is the level of consumption?
 - In the diagram, is there a diminishing marginal propensity to consume?
 - In the diagram, does consumption spending increase as income increases?
 - In the diagram, is saving always positive?
- Why is investment more likely to fluctuate in volume than saving?
 - Assume that investment increases by £100 m at all levels of income. If the marginal propensity to consume is $0.8Y$, by how much does national income increase?
 - Why would a cut in personal taxes expand total output by less than an increase in government spending of the same amount?

Multiple Choice Questions

11. The marginal propensity to consume is said to be diminishing when:
- a) as income increases, the amount of consumption increases;
 - b) a part of any increase in income is not spent on consumer goods;
 - c) a part of any increase in income is saved;
 - d) as income increases, the proportion consumed falls;
 - e) none of the above.
12. Other things being equal, the introduction of a proportional tax into an economy:
- a) lowers the value of the multiplier;
 - b) increases the value of the multiplier;
 - c) lowers the value of the accelerator;
 - d) increases national income;
 - e) has no effect.
13. The acceleration principle refers to the relationship between:
- a) the multiplier and national income;
 - b) income and consumption;
 - c) investment and savings;
 - d) changes in the rate of investment and changes in the level of income;
 - e) physics and economics.
14. If there is an ageing population, then:
- a) the marginal propensity to consume of the community is likely to increase;
 - b) the marginal propensity to consume of the community is likely to decrease;
 - c) the marginal propensity to consume of the community is likely to be unaffected;
 - d) savings are likely to decrease;
 - e) none of the above.
15. Aggregate demand (AD) in an open economy equals:
- a) $C+X+M$
 - b) $G+X+M$
 - c) $I+X+M$
 - d) $I+G+M$
 - e) $C+I+G+(X-M)$

CHAPTER 31 Employment and the Price Level

Study guide

This chapter analyses the relationship between two of the government's economic objectives – full employment and a stable price level.

The clash between the two can be made easier by supply-side policies which lower the aggregate supply curve. But it takes time for the appropriate measures to become fully effective, and their impact may be small. In fact supply-side measures become almost irrelevant in the short-term when real output is in the horizontal part of the AS curve (as Keynes assumed). Thus in the UK recession of 1990-93 the need was to stimulate aggregate demand; but this failed to respond to even a high level of government spending.

The model merely represents a theoretical outline. The government has to apply practical remedies. Here it faces considerable difficulties – action has to be taken on information which is often inadequate and based on statistics collected some three to six months previously. Above all, it is dealing with people and how they react to price rises or when confidence has been undermined.

CHAPTER 31 Questions

1. Why, in practice, must the government's full employment target be flexible?
2. Why does the aggregate supply curve AS start to rise as full employment is approached? (3 reasons)
3. What is meant by 'fiscal policy'?
4. What is meant by 'monetary policy'?
5. What is meant by the expression 'built-in stabilisers of the economy'?
6. How does a high PSNCR (formerly PSBR) create problems for the government?
7. V. A. T. is an *ad valorem* tax. Why is that a stabilising force in the economy?
8. What is meant by the expression 'rational expectations of workers'?
9. What major difficulty arose when demand management was used to keep down the rate of unemployment?
10. What are the three main objectives of supply side policy?

Multiple Choice Questions

11. During times of rising prices, one way of reducing prices would be to:

- a) increase available supply of goods;
- b) lower the interest rate on bank loans;
- c) decrease personal income tax;
- d) increase government expenditure;
- e) increase social benefits.

12. Which of the following policies would a government be most likely to follow if the prices of goods in general were rising rapidly and employment was at a high level?

- a) lower the rate of interest;
- b) encourage bank lending;
- c) increase taxation without altering government spending;
- d) increase government spending without altering taxation;
- e) none of the above.

13. Which of the following is a supply side policy?

- a) restrictions on competition;
- b) increasing government spending;
- c) nationalising major industries;
- d) reducing corporation tax to encourage investment;
- e) increasing government controls.

14. The aggregate supply curve AS becomes vertical eventually because:

- a) economies of scale increase;
- b) firms' costs fall;
- c) there is a large pool of unemployed labour;
- d) new technology increases output;
- e) diminishing returns set in.

15. Fiscal policy refers to:

- a) interest rate adjustment;
- b) credit relaxation;
- c) taxation and government spending;
- d) the work of the Bank of England;
- e) employment regulations.

CHAPTER 32 Inflation: Its Effects

Study guide

One of the features of successful economies, such as those of Germany and Japan, has been their low rate of inflation over the last fifty years. This factor merely presents the effects of inflation, but in doing so it goes a long way to explaining why most countries, including the UK and France, now give priority over other government objectives to a stable price level.

With regard to measuring inflation, the Retail Prices Index, in spite of its weaknesses, has the merit that it concentrates on retail prices. As a result it has been found acceptable for practical purposes e.g. indexing pensions, deciding on wage claims. Each month two separate measures are given: (a) '*headline*' inflation including mortgage interest payments; and (b) '*underlying*' inflation from which mortgage interest payments are excluded. The latter should be used when making comparisons with other countries.

CHAPTER 32 Questions

1. How does inflation reduce the real burden of debt?
2. How does inflation reduce the burden of the National Debt?
3. What is meant by saying that an asset has 'an inflation hedge'?
4. How is inflation likely to affect a country's balance of payments a) on current account; b) on the capital account?
5. Why might inflation discourage saving?
6. How could hyperinflation develop?
7. Suggest two reasons why interest rates are likely to rise if inflation rises.
8. Which measure of inflation does the UK government use?
9. What is the difference between the Consumer Prices Index (CPI) and the Retail Prices Index (RPI)?
10. What are the three most serious problems caused by inflation?

Multiple Choice Questions

11. 'Weighting' of an index number refers to:
- a) selection of the base year;
 - b) revision of the items in the index;
 - c) allowance for the relative importance of items;
 - d) correction for sampling and other errors;
 - e) the time it takes to compile.

12. The Retail Prices Index:

- a) measures changes in the general level of prices;
- b) measures changes in standards of living;
- c) indexes shop values;
- d) index links retail sector pensions;
- e) none of the above.

13. If the Retail Prices Index rises over a given period from 125 to 135, it shows that:

- a) money has increased in value;
- b) the purchasing power of the pound has declined;
- c) the value of pounds in savings accounts has remained unchanged;
- d) the cost of living has fallen;
- e) prices have gone up by ten per cent.

14. The 'menu' cost of inflation is:

- a) the redistribution of income it causes;
- b) the rise in interest rates it causes;
- c) the fall in saving it causes;
- d) the fall in living standards it causes;
- e) the additional administrative costs it causes.

15. Inflation:

- a) imposes a penalty on those holding money;
- b) imposes a penalty on those holding real assets;
- c) benefits savers;
- d) benefits no-one;
- e) can not be controlled.

CHAPTER 33 Policies to Achieve Price Stability

Study guide

Prices rise when AD for goods and services increases faster than output can increase at current prices. But this is mostly a statement of fact. However, from the point of view of policy, what we want to know is: (a) where the impulse for additional spending has come from and (b) why extra output eventually involves rising costs.

There are two basic impulses:

1. On the *demand* side, there may be an autonomous increase in consumption, investment or government spending at the current income level: this is known as demand- pull. Monetarists consider that

- an increase in demand results largely from an increase in the money supply.
2. on the supply side, factors of production may secure increased rewards not matched by a corresponding increase in productivity; this is known as cost-push.

In applying policies to contain inflation, governments have had to learn from experience. Initially excess AD was regarded as a *condition*, and policy consisted of reducing AD, possibly at the cost of some unemployment.

As the rate of inflation accelerated through cost-push, the government had to deal with a *process*. At first it was hoped to halt this process by seeking the cooperation of trade unions and, when this failed, introducing a Prices and Incomes policy.

Eventually, because inflation persisted, the Thatcher government first reduced the power of the trade unions to take industrial action, and then sought to influence their expectations of the likely future rate of inflation as being downwards by announcing monetary and fiscal targets. Later the policy shifted to shadowing the DM exchange rate, and within the ERM, maintaining interest rates compatible with a £1-2.95 DM exchange rate. When the UK left the ERM, a targeted money supply, M_4 , was once more adopted. Recent monetary policy controls demand for money through the interest rate.

CHAPTER 33 Questions

1. In what circumstances may an increase in the quantity of money **not** lead to a rise in prices?
2. What is an inflationary gap?
3. What are the three ways in which demand-pull inflation may arise?
4. Why is full employment liable to produce cost-push inflation?
5. The analytical distinction between demand-pull and cost-push inflation is useful in practice because it helps the authorities to take appropriate measures to slow down the inflationary process. What are the appropriate measures if:
 - a) there is demand-pull inflation?
 - b) there is cost-push inflation?
6. How can demand-pull inflation also lead to cost-push inflation?
7. What is necessary to avoid a wage-cost inflation?
8. What relationship does the Phillips Curve purport to show?
9. Define the 'natural rate' of unemployment.
10. How does the 'natural rate' of unemployment arise?

Multiple Choice Questions

11. Cost-push inflation has caused difficulties in Britain because:

- a) pay rises have not been matched by increased productivity;
- b) firms have put up prices too often to increase profit margins;
- c) increased prices have caused a reduction of the money supply;
- d) government spending has been too high;
- e) consumer spending has been too high.

12. A drawback of a rigid prices and incomes policy is:

- a) even if it works inflation may not be slowed;
- b) it interferes with the allocative function of markets;
- c) unemployment will increase;
- d) inflation will increase;
- e) none of the above.

13. In the Quantity Theory of Money (and Fisher equation $MV = PT$), if the money supply M increases with V and T constant, then:

- a) prices must fall;
- b) prices stay the same;
- c) prices must rise;
- d) velocity of circulation must rise;
- e) real output must fall.

14. A large increase in the price of imported oil is likely to lead to:

- a) falling prices;
- b) rising output;
- c) demand-pull inflation;
- d) cost-push inflation;
- e) contraction of the money supply.

15. A large increase in government spending is likely to lead to:

- a) falling prices;
- b) rising output;
- c) demand-pull inflation;
- d) cost-push inflation;
- e) contraction of the money supply.

CHAPTER 34 Economic Growth

Study guide

The rate of growth is measured by comparing real GNP per head over a given time period.

An *annual* rate of increase may start from a recession and must therefore be used with care when comparing the current rate with that of the previous year or with that achieved by other countries. Nevertheless an estimate of this likely rate of growth is essential to the government's short-term planning so that estimates can be made of its effects on tax yields, unemployment-related expenditure, the PSNCR and the balance of payments.

The *secular* rate of growth measures the average annual increase in real GNP per head over a longer time span, say twenty-five years. It is indicated by an outward movement of the production possibility curve. It may not proceed smoothly over this period. In the case of the UK, growth has proceeded erratically over the past thirty years, largely as the result of anti-inflationary 'stop-go' policies.

Remember too, that growth has its costs, which are becoming of increasing significance and even extending well beyond the boundaries of the country concerned, e.g. the effect of increased tourism on Kenya's national parks.

CHAPTER 34 Questions

1. Distinguish between the 'widening' of capital and the 'deepening' of capital.
2. Suggest a reason why, as an economy grows, *real income per person* tends to grow more slowly than the economy's *productive capacity per person*.
3. Why does economic growth make it easier for the government to follow policies to redistribute income?
4. It has been suggested that low growth rates in some developing countries are due to the fact that these countries are in a 'vicious circle of poverty'. What is meant by this?
5. How does economic growth make it easier for the government to achieve its objectives in improving education and health care?
6. Why might growth rates increase as countries industrialise, but slow down as demand for services increases?
7. What costs might be associated with economic growth?
8. How does technical progress affect the marginal efficiency of capital?
9. Economic growth may come about because of an increase in the available stock of factors of production. How can this happen?
10. Why might the UK housing market prove to be a constraint on economic growth?

Multiple Choice Questions

11. The rate of growth in an economy is best measured by changes in:

- a) total industrial production;
- b) its capital stock;
- c) its balance of payments surplus;
- d) its GNP;
- e) its real GNP per capita.

12. The capital-output ratio is:

- a) the share of investment in GNP;
- b) the amount of capital necessary per unit of output;
- c) the amount of output necessary to produce a unit increase of investment;
- d) the level of stocks corresponding to a given level of output;
- e) the amount of investment in London.

13. The long-term rate of growth of the UK of 2.5 per cent per annum will double GNP in:

- a) 100 years;
- b) 75 years;
- c) 50 years;
- d) 28 years;
- e) 12 years.

14. An increase in the capital invested in labour can result from:

- a) lower taxes;
- b) lower government spending;
- c) more and better education and training;
- d) improvement in the terms of trade;
- e) more consumer spending.

15. Accumulating capital involves:

- a) foregoing present consumption;
- b) consumer spending;
- c) government spending;
- d) spending by firms;
- e) foregoing future consumption.