

Unit 2: Economic Environment

Student Workbook

Unit 2

Unit Aim: Understand the function of the economy and measures of economic performance.

Relevance of this unit to the course: The unit introduces macroeconomic terms and concepts that will be applied in later units that explore the risks and rewards of assets and investments, as well as in chapter 11.

Learning Objective	Learning Outcomes	Chapter Section
2.1.1	Know the factors which determine the level of economic activity: • State-controlled economies • Market economies • Mixed economies • Open economies	2
2.1.2	Know the stages of the economic cycle and the roles of the government in determining: • Economic policy • Fiscal policy • Monetary policy	3
2.1.3	Know the function of central banks: • The Bank of England including the Monetary Policy Committee • The Federal Reserve • The European Central Bank	4
2.1.4	Understand the impact of the following economic data: • Inflation / deflation • Gross Domestic Product (GDP) • Balance of payments • Budget deficit/surplus • Level of unemployment • Exchange rates	5

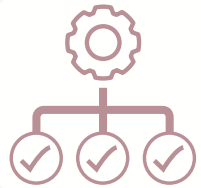
How to use this student workbook

Throughout this student workbook, look out for the different icons to support your learning:

Understand and learn – these sections will help you to develop your knowledge and understanding of the assessed learning objectives.



Apply and practise – Practise and test your newly acquired learning by undertaking a range of activities to help you prepare for the multiple choice assessment at the end of the course.



Further your knowledge – Consolidate your understanding of key concepts by reading and interacting with current, credible resources to help further enhance your learning.



Understanding the UK economy

Before we look at the Unit 2 learning outcomes in more detail, let's take a look at the main areas that contribute to economic activity in the UK.

This ONS report brings together the latest data on employment, prices and trade to give an overview of the economy in the UK

In your notes, produce a summary of the key data and briefly **state** what impact the data has on:

1. **Consumers**
2. **Businesses**



Module Learning Outcome 2.1

Identify the factors which determine the level of economic activity:

- State-controlled economies
- Market economies
- Mixed economies
- Open economies

Different types of economies

Read chapter 2 of the course workbook and **complete** the table below:

	Planned / State controlled / command economy	Mixed economy	Market economy
Who controls the economy?			
Examples of countries that operate this type of economy			
Key characteristics			
Advantages			
Disadvantages			

Open Economy

An open economy refers to a country's economic relationship with the rest of the world.

Make a list below of the key characteristics of an open economy:

1.

2.

3.

4.

5.

Match terms to definitions

1. Open economy

2. Protectionism

3. World Trade Organisation

4. Command economy

5. Mixed economy

6. Free market economy

China’s transition from a planned to a market economy

In recent years a number of countries have transitioned from command economies to mixed / market economies. China’s transition from a centrally planned economy to a market-led economy represents one of the most remarkable economic transformations in modern history.



Case study

Read the case study here and **consider**:

1. What factors led to the economic growth of China?

2. What are the key advantages and challenges for China's economic transition?





Module Learning Outcome 2.2

Understand the stages of the economic cycle and the roles of the government in determining:

- Economic policy
- Fiscal policy
- Monetary policy

Macroeconomic Objectives

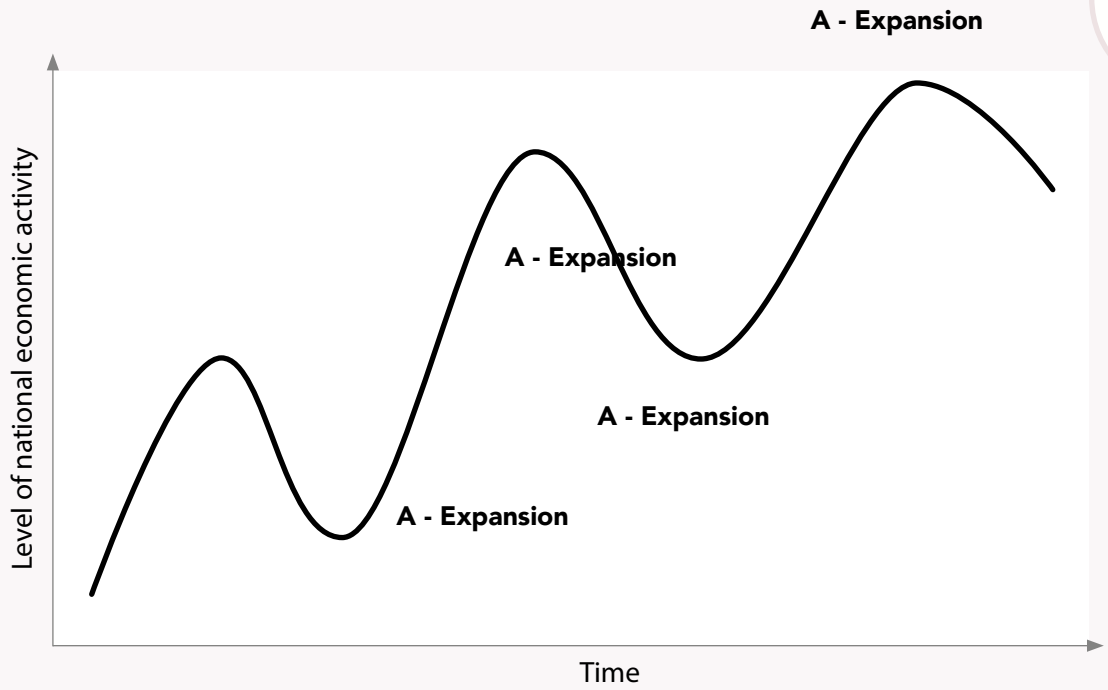
Macroeconomic policies help the government manage and regulate the economy. The main macroeconomic objectives in the UK are to achieve:

Objective	This means…

Use chapter two of your course workbook to help

The economic cycle

- **Read** chapter two of the course workbook.
- **Label** the cycle and axes.
- **Place** the descriptions below in the right place on the cycle to indicate what economic activity occurs at each point.
- **Complete** the description for box D. What do you think GDP figures tell us?



A
- Consumers increase spending again
- Business confidence begins to return
- Businesses begin to invest and build stocks
- Unemployment starts to decrease slowly

B
- GDP declines for a prolonged period
- Weak consumer spending and business investment
- Prices begin to fall and unemployment rises
- Businesses are at a much higher risk of failing

C
- Falling levels of consumer spending and confidence
- Two consecutive quarters of negative growth
- Rising unemployment

D

Write your own description in this box

Fiscal Vs Monetary Policy

To achieve macroeconomic objectives, the government uses a variety of policies to manage and control the economy, using namely **fiscal** and **monetary** policies. **Summarise** the key characteristics of each policy below using chapter two in the course workbook.

Fiscal Policy	Monetary Policy

Fiscal or Monetary policy?

Choose which policy is correct for each statement:

	Monetary Policy	Fiscal Policy
Increase the personal tax allowance	◯	◯
Decrease the base rate of interest	◯	◯
Issue more notes and coins	◯	◯
Increase the base rate of interest	◯	◯
Increase the rate of VAT	◯	◯
Re-introduce the 50p rate of tax	◯	◯
Increase spending on the NHS	◯	◯
Decrease spending on education	◯	◯
Inject money into the economy - quantitative easing	◯	◯



Module Learning Outcome 2.3

Understand the function of central banks:

- The Bank of England including the Monetary Policy Committee
- The Federal Reserve
- The European Central bank

The role of central banks

Read chapter two about the role of central banks and using your knowledge from unit 1 about retail and investment banks, **decide** which activities are undertaken by each type of bank.

	Retail Banks	Investment Banks	Central Banks
Provides personal loans for customers	◯	◯	◯
Manages the national debt	◯	◯	◯
Provides credit cards for customers	◯	◯	◯
Issues notes and coins	◯	◯	◯
Acts as a banker to the government	◯	◯	◯
Currency exchange for people travelling	◯	◯	◯
Influences the value of a nation's currency	◯	◯	◯
Mortgage lending for people to buy homes	◯	◯	◯
Buy and sell financial assets to make a profit	◯	◯	◯

The role of central banks Continued...

	Retail Banks	Investment Banks	Central Banks
Holds the nation's gold and money supply	○	○	○
Sets the official short-term rate of interest (base or bank rate)	○	○	○
Advise businesses wanting to borrow money in bond markets (debt)	○	○	○
Provides savings and current accounts for individuals	○	○	○
Advise businesses wanting to issue shares (equity)	○	○	○
Acts as a banker to the banking system i.e. Commercial banks	○	○	○
Regulates the domestic banking system	○	○	○
Controls the money supply	○	○	○
Advise businesses on strategy and growth (Mergers and acquisitions)	○	○	○
Provides a depositors' protection scheme	○	○	○
Arranges overdraft facilities for customer accounts	○	○	○

Bank of England (BoE)

Read chapter two in the course workbook about the role of the Bank of England.
To extend your learning, **The Bank of England website** includes a number of resources to help you learn about their role in managing the UK economy. Click on the link here to access. The website also explains how it uses monetary policy, the Monetary Policy Committee and the Financial Policy Committee

The Bank of England YouTube Channel also includes a series of videos about how the bank operates and explores the different policy committees and how quantitative easing works



Questions

After reading the course workbook and the Bank of England resources, **answer** the following questions.

1. What are the two core purposes of the Bank of England?

2. Describe the concept of monetary stability and how it is achieved.

3. What is the inflation target set by the government and how does the Bank of England work towards meeting it?

4. Discuss the importance of financial stability and its relationship with monetary policy.

5. Explain the composition of the Monetary Policy Committee and the role of external members.

Questions Continued...

After reading the course workbook and the Bank of England resources, **answer** the following questions.

6. What is quantitative easing and how does it stimulate the economy?

7. Analyse the potential risks and benefits of quantitative easing.

8. Explain the purpose of the Financial Policy Committee and how does it influence regulatory bodies?

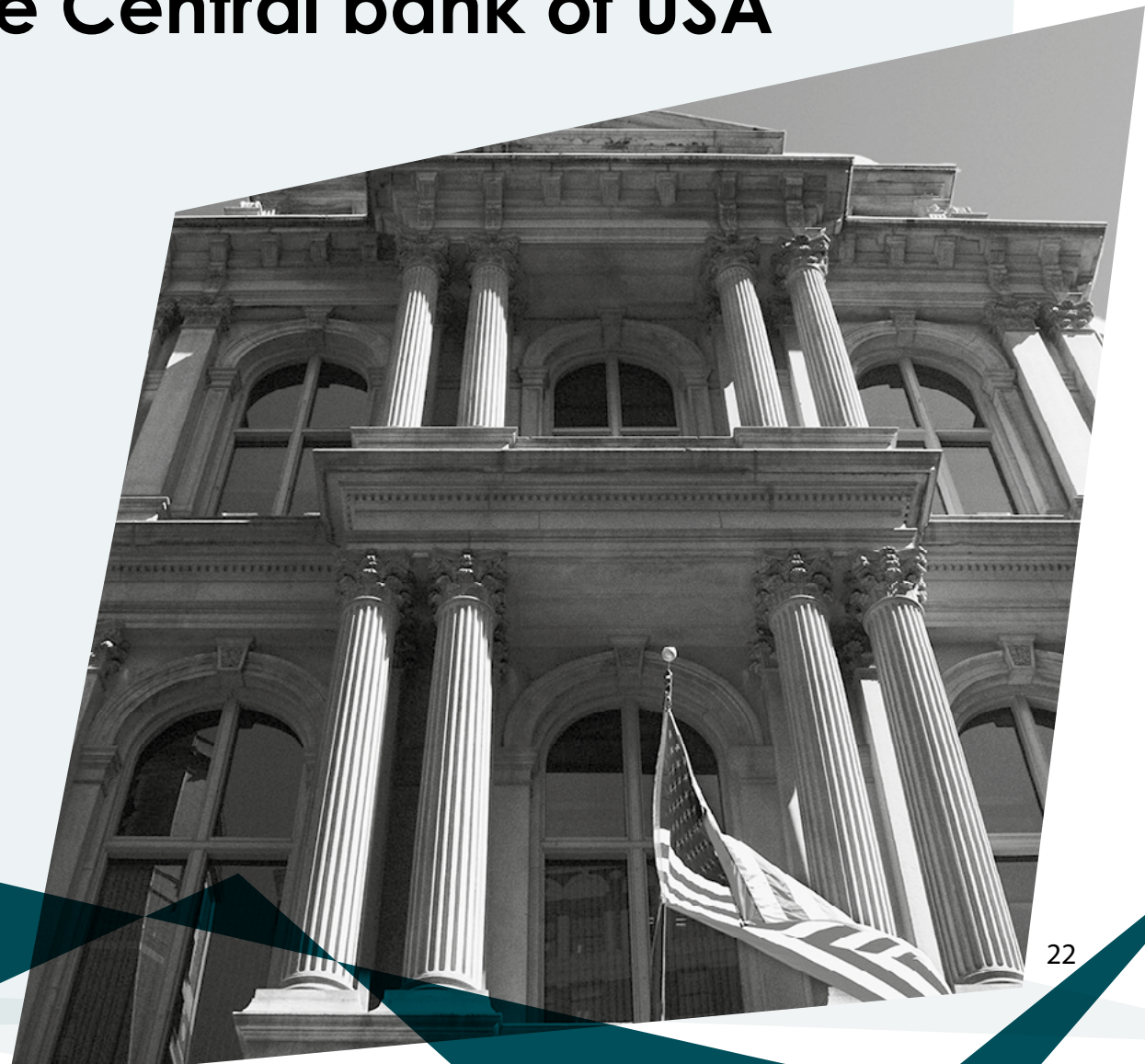
9. Describe the responsibilities of the Bank of England that extend beyond monetary and financial stability.

10. Who is responsible for managing the national debt and operating the depositors' protection scheme?

The Federal Reserve (FED) – The Central bank of USA

How does the Federal Reserve work and who owns it?

- Federal Reserve Board is an independent agency of the federal government and its decisions don't need approval from the president, legislators, or any elected officials
- The Fed is comprised of a government-appointed central board and 12 regional banks
- The Fed's primary function is to manage inflation
- The Fed is accountable to the public and Congress
- The Fed's funding comes from investments



The role of the European Central Bank (ECB)

Write a brief summary about the role of the ECB.

1. What is their role?

2. What is the composition of the ECB?

3. How does the ECB work?

Central Banks – True or False?

	True	False
Central banks operate independently of government control	○	○
Central banks act as lenders of last resort in financial crises	○	○
Central banks are responsible for regulating the domestic banking system	○	○
The Bank of England manages the UK's foreign exchange and gold reserves	○	○
The Bank of England is responsible for managing the national debt	○	○
The Monetary Policy Committee is responsible for setting the UK's official interest rate	○	○
The consists of nine members, including the Chancellor	○	○
Quantitative easing (QE) involves the central bank buying government bonds to inject cash into the economy	○	○
The Financial Policy Committee (FPC) monitors the stability and resilience of the UK financial system	○	○
The FPC has the power to give binding instructions to banks and other financial institutions	○	○
The Bank of England is responsible for managing the national debt	○	○
The Federal Reserve in the US comprises 10 regional Federal Reserve Banks	○	○
The Federal Open Market Committee (FOMC) is responsible for setting monetary policy in the US	○	○
The ECB has a supervisory role to monitor the financial stability of banks in Eurozone states	○	○



Module Learning Outcome 2.4

Understand the **impact** of the following economic data:

- Inflation/deflation
- Gross Domestic Product (GDP)
- Balance of payments
- Budget deficit/surplus
- Level of unemployment
- Exchange rates

Inflation

Inflation is a persistent increase in the general level of prices. Inflation can be caused by:

- Rising wages
- Increase in the cost of raw materials
- Increase in taxes
- Falling interest rates
- Excess demand in the economy
- Scarcity of resources
- Rapidly increasing government spending
- Imports becoming more expensive



Case Study – The impact of inflation on business

Read the case study about Samir and his bakery, then **answer** the questions on the next page.

Samir runs a family bakery located in a busy market town. He and his family have been serving freshly based goods for over a decade. Due to recent economic factors, the rate of inflation has risen, affecting both the business success and Samir's personal finances.

Samir has had to put his prices up as the cost of ingredients and his production costs have increased e.g. the cost of flour, price of electricity. He has also given his staff a wage increase to compensate for higher prices. Furthermore, his customers are now finding the price of his baked goods are much more expensive than supermarket own brands so sales have fallen, impacting on his profits. However as he owns his business premises, the value of the building and it's assets have also increased so he mindful that he could sell up and move to cheaper premises. He is also considering refinancing the property to help him with his cashflow and to protect the business if inflation continues to rise.



The impact of inflation

1. Summarise the positive and negative effects of inflation on the Samir's business

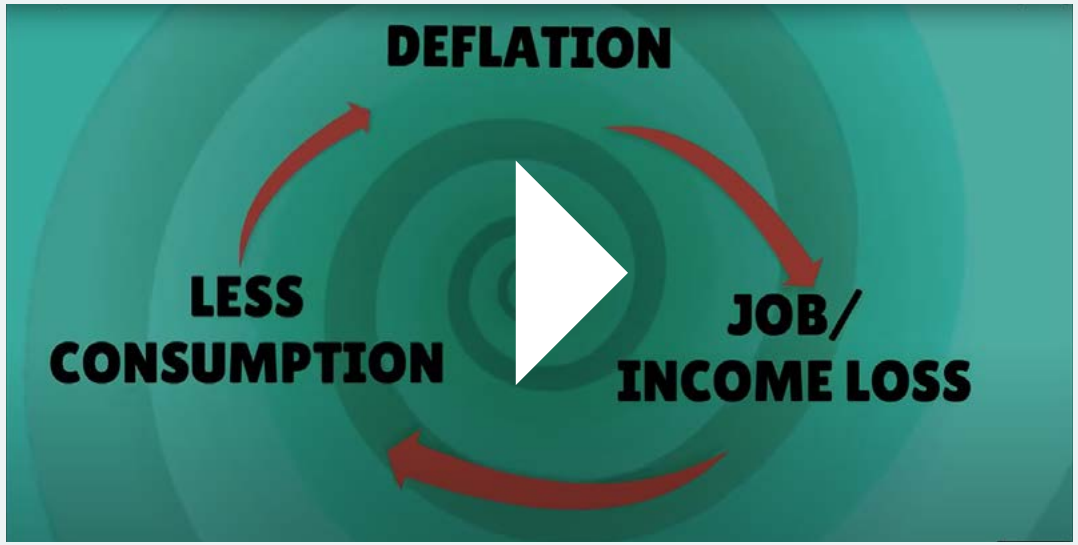
2. The case study mentions that inflation has also affected Samir personally too. What impact might inflation have on him as a consumer?

Deflation

Watch the video on deflation and **answer** the following questions:

- What is deflation?

- What are the positive and negative economic consequences on both consumers and businesses?



The CISI does not claim ownership over these videos

Read chapter two in your course workbook for further information about deflation.

Measuring inflation

- Inflation is calculated by the Office of National Statistics (ONS) who produce a monthly inflation report.
- To calculate changes in prices, the ONS tracks a "typical basket of goods" to determine how much the price of the basket has changed over time.
- Every month the ONS collects data on around 700 goods and services covering various categories such as food, clothing, housing and bills, transport and white goods.
- The ONS then work out how much prices have gone up or down using different measurements, including:
  - **Consumer Price Index (CPI)** – Cost of goods excluding mortgage interest payments and other housing costs
  - **Consumer Price Index including Housing (CPIH)** – includes all of the above plus housing costs
  - **Retail Price Index (RPI)** – due to be phased out by 2030

Using the latest ONS report on inflation:

- What is the current rate of inflation?
- What is the current trend in inflation?
- What is the outlook for inflation?

Gross Domestic Products (GDP)

Read chapter two about GDP and the latest ONS report about GDP. **Summarise** the following:

- What is GDP?

- In your own words, explain the circular flow of income

- How is GDP calculated and measured?

- Using the ONS GDP year on year growth chart, explain the recent trend in economic growth in the UK. What factors may be the cause of this trend?

- What is the impact of this for both consumers and businesses?

Balance of Payments

Match the terms to the definitions

1. The total value of goods and services that flow into and out of a country.

2. A summary of all the transactions between a country and the rest of the world.

3. International capital transactions related to investment in business and stocks.

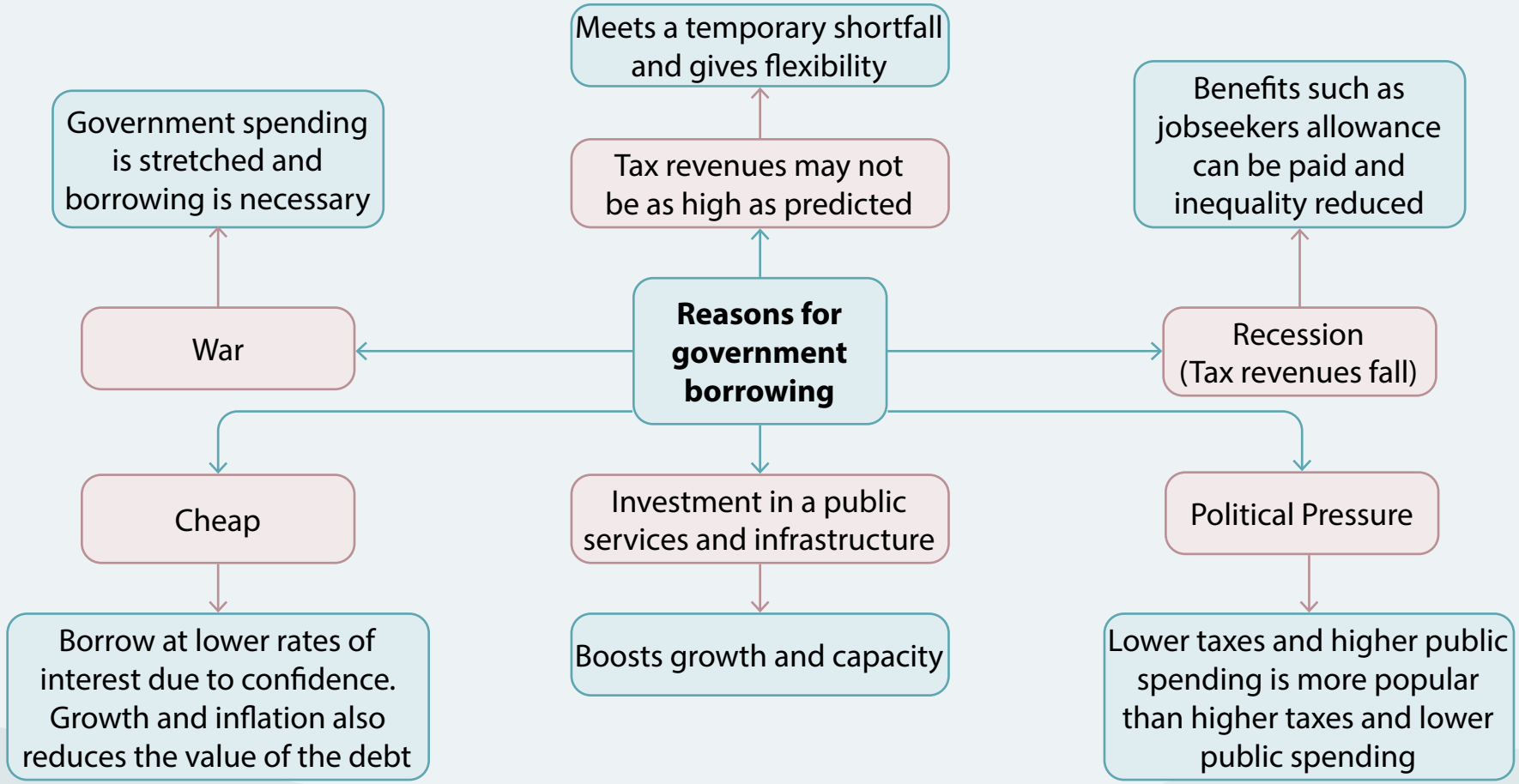
4. The difference between the value of imported and exported goods and services.

The ONS publishes the UK's balance of payments quarterly. Read the latest release UK trade report.

Explain the recent trend in the balance of payments in the UK. What economic factors may be the cause of this trend?

What is the impact of this for both consumers and businesses?

Why does the government need to borrow money?



Budget deficit / surplus

Read chapter two in the course workbook and the ONS latest data on public sector finance.

1. What is the difference between government debt and budget deficit?

2. What is the current UK public sector net debt figure?

3. What percentage of GDP is national debt?

4. Why might national debt be rising?

5. What is the impact of increasing national debt on businesses and consumers?

Level of unemployment

Unemployment data is a key indicator of the health of the UK economy. With more people out of work, this reduces consumer spending and therefore demand for goods and services falls.

If demand for goods and services falls, businesses need fewer people to produce products or provide services, therefore increasing unemployment further.

If businesses sell fewer goods and services, this will reduce business revenues and profits, causing further business decline.

There are also a number of health and social factors that impact consumers as a result of unemployment, affecting relationships, mental and physical health.



Level of unemployment

Read the ONS' most recent labour market review.
Summarise the trend in

- Employment / unemployment rate
- The inactivity rate

Using chapter two of the course workbook, how has the rise of the "gig economy" impacted on the UK labour market? What effect does this have on collection of income tax?

Exchange Rates

Read chapter two in the course workbook and answer the multiple-choice questions.

1. What is an exchange rate?

2. What characterises a fixed exchange rate system?

3. What is a floating exchange rate system?

4. What is another name for a managed float exchange rate system?

END OF CHAPTER QUESTIONS



End of Unit 2
Multiple Choice Assessment

Test your knowledge

1. Protectionism refers to

- When government expenditure is focused on defence
- When a country preserves its domestic markets by preventing other countries from trading with it
- When interest rates are increased to curb inflation
- When two or more countries form a trade alliance

2. WTO stands for

- World Trade Organisation
- World Trading Opportunity
- World Tourism Organisation
- World Trade Offering

Test your knowledge

3. A market economy relies upon

- the government to allocate resources
- supply and demand to allocate resources
- central banks to allocate resources
- regulators to allocate resources

4. Managing the economy through taxation is an example of

- Monetary policy
- Protectionism
- Fiscal policy
- Capitalism

Test your knowledge

5. Which of the following is NOT a role of the Bank of England

- Controlling the money supply
- Acting as a banker to the banking system
- Acting as a banker to the government
- Managing the national debt

6. Inflation is most accurately described as

- A persistent increase in a country's level of exports
- A persistent increase in an organisation's profits
- A persistent increase in a country's GDP
- A persistent increase in the general level of prices

Test your knowledge

7. Which Bank of England Committee reviews and controls the base rate of interest?

- ○ Financial Policy Committee
- ○ Monetary Policy Committee
- ○ Fiscal Policy Committee
- ○ Base Rate Review Committee

8. How many Federal Reserve Banks are there?

- ○ 8
- ○ 12
- ○ 25
- ○ 50

Test your knowledge

9. Which of the following is a potential benefit of inflation for individuals?

- The value of savings and future pensions may be difficult to assess
- House prices are likely to rise
- Interest rates are likely to decrease
- Consumer goods will fall in price

10. Which of the following is NOT true about the RPI Index

- It takes into account transport and entertainment goods
- It takes into account mortgage and rent payments
- It excludes mortgage interest payments
- It is known as the 'headline' rate of inflation

Test your knowledge

11. Two consecutive quarters of negative economic growth is described as

- A recovery
- A recession
- A slump
- A depression

12. During an economic boom

- There is rising unemployment
- Businesses are at a much higher risk of failing
- Business confidence is low
- There is increased risk of high inflation

Test your knowledge

13. Which of the following is a risk associated with falling GDP

- Inflation
- Rising unemployment
- An increase in government expenditure
- A depreciation in the value of the domestic currency

14. A credit to the Balance of Payments current account occurs when

- Income and transfers go abroad
- Goods and services come into the UK from abroad
- A country purchases foreign investment assets
- Goods and services leave the UK

Test your knowledge

15. Why would increasing interest rates help to reduce a Balance of Payments deficit?

- It would reduce the demand for imports
- It would depreciate the value of a currency
- It would encourage businesses to expand
- It would encourage new business start-ups

16. Who manages the UK national debt?

- The Bank of England
- The IMF
- The DMO
- The WTO

Test your knowledge

17. The ECB is based in which of the following cities?

- Frankfurt
- Brussels
- Paris
- Berlin

18. The former Soviet Union was an example of which type of economy

- Mixed economy
- Open economy
- Market economy
- Planned economy

Test your knowledge

19. Which of the following is not a cause of inflation

- Excess demand in an economy
- Scarcity of resources in an economy
- Rapidly increasing government spending in an economy
- Increasing levels of unemployment

20. Greater inequality can occur as a result of which type of economy?

- Market economy
- Mixed economy
- Planned economy
- Open economy

Monitoring my progress – Unit 2

My multiple choice assessment mark is / 20

I am happy with the progress that I made on the multiple choice assessment

○ Yes ○ No

To improve my knowledge and understanding, I now need to….

1.

2.

3.

Need more help?

If you feel that your multiple choice score can be improved further, complete the end of unit 2 multiple choice questions in the course workbook.

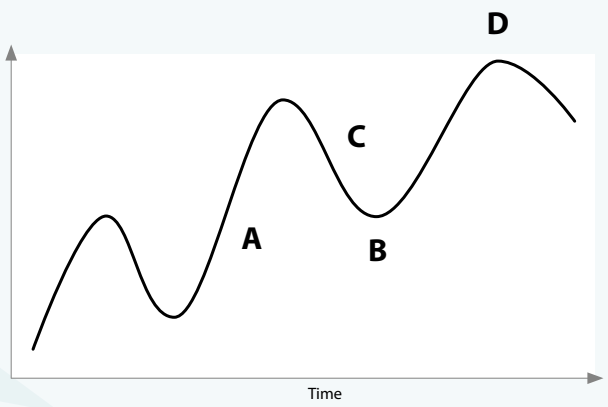


Answers

Page 8

1 – D
2 – B
3 – C
4 – F
5 – E
6 – A

Page 13



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Monetary policy

- Decrease the base rate of interest
- Issue more notes and coins
- Increase the base rate of interest
- Inject money into the economy – quantitative easing

Fiscal policy

- Increase the personal tax allowance
- Increase the rate of VAT
- Re-introduce the 50p rate of tax
- Increase spending on the NHS
- Decrease spending on education

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Retail banks

- Provides credit cards for customers
- Provides personal loans for customers
- Currency exchange for people travelling
- Mortgage lending for people to buy homes
- Provides savings and current accounts for individuals
- Arranges overdraft facilities for customer accounts

Investment banks

- Advise businesses wanting to borrow money in bond markets (debt)
- Advise businesses wanting to issue shares (equity)
- Advise businesses on strategy and growth (Mergers and acquisitions)
- Buy and sell financial assets to make profit

Central banks

- Provides a depositors' protection scheme
- Issues notes and coins
- Acts as a banker to the banking system i.e. Commercial banks
- Acts as a banker to the government
- Regulates the domestic banking system
- Holds the nation's gold and money supply
- Influences the value of a nation's currency
- Sets the official short-term rate of interest (base or bank rate)
- Manages the national debt
- Controls the money supply

Answers

Page 24

1 – F
2 – T
3 – T
4 – T
5 – F
6 – T
7 – F
8 – T
9 – T
10 – T
11 – F
12 – F
13 – T
14 – T

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1. The total value of goods and services that flow into and out of a country – Current Account (C)
2. A summary of all the transactions between a country and the rest of the world – Balance of Payments (A)
3. International capital transactions related to investment in business and stocks – Capital Account (D)
4. The difference between the value of imported and exported goods and services – Trade balance (B)

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1 – A
2 – C
3 – C
4 – B

Test your knowledge

1B
2A
3B
4C
5D
6D
7B
8B
9B
10D
11B
12D
13B
14D
15A
16C
17A
18D
19D
20A