

FINANCIAL CRISIS PLACE MAT

1 When was the Financial Crisis?

2 What is meant by sub-prime debt?

3 What are the functions of a Central Bank?

4 Give one reason FOR and one AGAINST having an independent Central Bank

5 How is economic development measured?

16 How much QE has the Bank of England undertaken? What about the ECB, and the Federal Reserve?

15 Draw an AD/AS diagram to illustrate the likely impact of ultra-loose monetary policy on the economy

14 Find out the following macro data for China: inflation rate, growth rate, unemployment rate

13 State and explain 2 factors that have contributed to globalisation

12 What's the difference between an endogenous and exogenous shock?

11 If demand for buying new houses falls, what is the likely impact on the market for rental homes?

10 State and explain 2 problems that result from an ageing population

6 Explain why bond prices and bond yields are inversely related

7 What do you think is meant by a negative interest rate? How might this affect the distribution of income?

8 What is the law of demand?

9 Why do markets theoretically achieve allocative efficiency?

CASE STUDY

The Economics of a Low-Rate World

In the aftermath of the Financial Crisis, central banks in many developed economies were highly praised for their prompt actions of cutting interest rates to record low levels and using quantitative easing (printing money to purchase bonds). But by mid-2016, their ultra-loose monetary policies were under the spotlight, with a growing number of critics worrying about negative interest rates (which exist at the ECB, or European Central Bank for commercial banking), and too much reliance on government policy rather than markets for allocating resources.

Whilst central banks have certainly played their part in ensuring continued low interest rates, there are other factors at play too. One factor is the integration of China into the global economy; China is a "savings-rich" country. As with any market, an increase in supply (in this case, savings) leads to a fall in the price (in this case, the interest rate). A second factor is the ageing population in much of the developed world. Because the length of retirement is now longer due to people living longer, savings have to increase in order to fund retirement. Similarly, it is now harder for many younger people to buy property and take out large mortgages – they are saving more for longer in order to build up deposits. Finally, the Great Recession and Financial Crisis created an economic shock that radically altered the perception of risk in many households; when faced with a riskier future, people tend to save as a sort of 'insurance' against job loss or other misfortune.

FINANCIAL CRISIS PLACE MAT SUGGESTED ANSWERS

1 When was the Financial Crisis?

2007 – 2009

2 What is meant by sub-prime debt?

Sub-prime debt refers to loans made to people who are regarded as 'risky' borrowers, because they are less likely than the average person to pay back the debt i.e. more likely to default

3 What are the functions of a Central Bank?

The main functions of a Central Bank are: control the money supply in the economy, ensure stability in the financial system/markets, act as the banker for the government and lender of last resort, use monetary policy to manage the economy, act as the custodian of the country's foreign exchange reserves

4 Give one reason FOR and one AGAINST having an independent Central Bank

Reasons for having an independent Central Bank: reduces volatility associated with the 'politicisation' of monetary policy (i.e. the temptation by governments to lower interest rates prior to an election), improves the credibility of the Bank in controlling inflation which in turn reduces inflationary expectations.

Arguments against Central Bank independence: the Bank may stick to the 'wrong' or inappropriate target which conflicts with the policies of the government of the day; the Bank is usually run by people who are not elected and therefore have no democratic accountability for their decisions.

5 How is economic development measured?

The most common measurement of development is the Human Development Index, which is a composite index measuring real GNI per head, life expectancy at birth, and the number of years of schooling.

6 Explain why bond prices and bond yields are inversely related

A bond is printed with a "coupon rate" – a specific amount that will be paid annually to the holder of the bond. When demand for bonds rises, the price of bonds rises (as in any market). The coupon rate, as a % of the new bond price, falls. This is the "yield" on the bond.

7 What do you think is meant by a negative interest rate? How might this affect the distribution of income?

A negative interest rate is one in which savers have to pay a fee to the bank in order to deposit their money. Income will therefore be redistributed from savers to borrowers (often from the old to the young).

8 What is the law of demand?

The law of demand states that the price of a good is inversely related to the quantity demanded.

9 Why do markets theoretically achieve allocative efficiency?

Allocative efficiency refers to consumers maximising their utility and their needs being met; this occurs at a market equilibrium where demand is equal to supply at the market price.

10 State and explain 2 problems that result from an ageing population

There are many consequences of an ageing population: greater demand for healthcare services, changing nature of demand for goods (the "grey economy" e.g. stairlifts, teabags, care homes etc), increased dependency ratio / smaller working population.

11 If demand for buying new houses falls, what is the likely impact on the market for rental homes?

New home and rental homes are substitute goods with a positive XED, so falling demand for new homes is likely to increase demand for rental homes, leading to an increase in rents

12 What's the difference between an endogenous and exogenous shock?

An exogenous shock is one that occurs outside the AD model e.g. an ageing population, financial crisis in Greece. An endogenous shock is one that occurs within the system of AD e.g. a sudden fall in consumer spending.

13 State and explain 2 factors that have contributed to globalisation

There are many factors that have contributed to globalisation: improved communications/internet, containerisation, improved transport links, end of the Cold War, deregulation, growth of MNCs

14 Find out the following macro data for China: inflation rate, growth rate, unemployment rate

Chinese data at the time of writing this resource: inflation rate 1.3%, economic growth rate 1.8%, unemployment rate 4.05%

15 Draw an AD/AS diagram to illustrate the likely impact of ultra-loose monetary policy on the economy

The diagram should show the AD curve increasing i.e. shifting to the right [due to the increase in consumer spending, investment spending and net exports as a result of the fall in interest rates]. The diagram could also show an increase in LRAS, assuming that the lower interest rates stimulate investment spending thus boosting the productive potential of the economy.

16 How much QE has the Bank of England undertaken? What about the ECB, and the Federal Reserve?

Bank of England: £375bn. ECB: at least 1.1trillion. Federal Reserve: \$4.5trillion

HOUSING MARKET PLACE MAT

1 List 4 economic impacts on the UK of the Brexit vote.

a)

b)

c)

d)

2 Use a diagram to explain why house prices “should have slumped after Brexit”.

CASE STUDY

House prices continued to rise in London in the month after the Brexit vote – defying predictions that they might slump in the wake of the decision to leave the EU.

Jeremy Leaf, former chairman of the Royal Institution of Chartered Surveyors, said: “It is surprising that the **index** does not record more of a slowdown in price growth. On the ground we are finding that **people are much more cautious with their income**”.

Rob Weaver, of Property Partner, argued: “Whilst some potential buyers got cold feet following the Brexit vote, **many sellers too withdrew from the market, resulting in a further drop in the stock of homes available for sale. As a result, the expected housing crash simply didn’t materialise**”.

It is indeed true that average prices in Kensington and Chelsea were down **3% year on year to £1,287,850** but cheaper boroughs recorded **big increases with Newham prices up 20.8 per cent to £359,231**. The average house price in London is **£531,000** (see right).

12 Explain why people are likely to be more cautious with their income?

11 Using a demand and supply diagram, explain why the slump in house prices didn’t materialise.

10 Comment on the likely PED and PES for houses.

8 Calculate the average price of a house in Kensington and Chelsea last year.”

9 Calculate the average price of a house in Newham last year.

7 Explain why the likely factors affecting the difference in price changes between the two London areas

3 What is a price index?

4 Why do we use a weighted index to help calculate inflation?

UK House Prices by Region (ONS, Oct 2015)



5 Choose two areas, other than London, and then calculate the % difference in house prices between London and your chosen zones/regions.

6 For each of your two zones, explain one (different) reason why you think that house prices are lower there than they are in London.

HOUSING MARKET PLACE MAT SUGGESTED ANSWERS

1 List 4 economic impacts on the UK of the Brexit vote.

- Likely downturn in investment into UK as potential investors choose to invest elsewhere due to deteriorating business confidence
- Exchange rate depreciating as people withdraw their money from UK banks (short-term capital outflow increases), so exports become cheaper but imports are more expensive.)
- Falling UK consumer and business confidence may lead to a fall in AD and therefore real GDP.
- Immigration is likely to fall as UK reconsiders its border policies now that it doesn't have to adhere to freedom of movement laws.

2 Use a diagram to explain why house prices "should have slumped after Brexit".

Demand should have fallen as people "got cold feet", losing confidence and reducing their spending (perhaps because they were fearful of job security due to a lack in consumer/business confidence as a result of uncertainty of the market). The falling demand would lead to a fall in quantity and a fall in the price of housing.

3 What is a price index?

It is a normalized average of **prices** (usually weighted) for a given class of goods or services in a given region, during a given interval of time.

4 Why do we use a weighted index to help calculate inflation?

Weights are used in the CPI because they reflect the relative importance of individual goods and services in overall consumer spending – a small increase in price of a good such as fuel has a larger impact on consumers than a large increase in the price of a good such as a chewing gum.

5 Choose two areas, other than London, and then calculate the % difference in house prices between London and your chosen zones/regions.

Example – North East average price is £158,000 and London average price is £531,000, therefore house prices in the NE are $(158,000/531,000 \times 100)$ 29.76% of those in London

6 For each of your two zones, explain one (different) reason why you think that house prices are lower there than they are in London.

One reason why houses in the NE are cheaper than those in London is that incomes in the NE are much lower than those in London therefore demand is lower. Also, supply of housing in London cannot easily increase because of planning/building regulations, whereas there may be more space for building in the NE.

7 Explain why the likely factors affecting the difference in price changes between the two London areas

Higher incomes of people looking to live in desirable Kensington and Chelsea (closer to the centre of London, and very high quality large houses) people more willing and able to buy houses there, compared with Newham, that has low-quality flats and fewer job opportunities.

8 Calculate the average price of a house in Kensington and Chelsea last year."

£1,327,680

9 Calculate the average price of a house in Newham last year.

£297,376

10 Comment on the likely PED and PES for houses.

PED – likely to be inelastic as houses are necessities and have no effective substitutes.
PES – inelastic because it takes a long time to build a house and there are large number of housing regulations making it difficult to increase the quantity supplied quickly.

11 Using a demand and supply diagram, explain why the slump in house prices didn't materialise.

The falling demand for housing should have resulted in a fall in price, but many house vendors decided that they were no longer going to sell their homes, causing the supply of homes for sale to fall, thereby offsetting the impact of the fall in demand.

12 Explain why people are likely to be more cautious with their income?

Economic uncertainty has increased - households may worry about job security following Brexit, and businesses may worry about access to the Single Market. There is usually a positive correlation between confidence and spending, so when confidence falls, spending tends to fall.

MOTOR VEHICLE INDUSTRY PLACE MAT

- 1 What does “labour-intensive” mean?
- 2 Why might governments take interest in the health of labour-intensive industries?
- 3 Using the info from the 1st two paragraphs and the table, make a judgement about which type of market structure best explains the UK MVR industry.
- 4 Estimate the likely 4 firm concentration ratio for the UK MVR industry.

- 11 What is the opposite of heterogeneous?
- 10 Why does heterogeneity result in a downward sloping demand curve?

- 9 What is meant by ‘barriers to entry’ and why might barriers to entry be low in the MVR industry?

- 7 Define Income Elasticity of Demand (YED).
- 8 Comment on the likely YED value for new cars.

- 5 Using the data, explain the concept of derived demand.
- 6 Comment on the likely XED relationship between cars and motor vehicle repairs.

CASE STUDY

Motor Industry Placement

Motor Vehicle Repair (MVR) is very labour-intensive work. In 2014, it was estimated that the UK MVR industry market was worth £23bn and it employed just over 200,000 people in about 38,000 businesses. Statistics show that the industry is dominated by small and medium-sized businesses with over half of the workforce employed in businesses of fewer than 10 people.

The vehicle repair and servicing industry is very heterogeneous. There are general repairers, specialist repairers, dealers and petrol stations – not to mention car washes! Table 1 shows many of the different services offered.

The MVR industry grew rapidly after the Second World War. As the volume of cars grew so the motor repair sector began to expand, providing employment to the many mechanically trained ex-servicemen. The market grew so quickly that there was little chance of erecting entry barriers. For example, although there were moves to introduce specific qualifications for mechanics, this was never fully established.

The Motor Vehicle Repair industry has performed reasonably well over recent years. Low levels of consumer and business confidence following the economic downturn discouraged people from purchasing new vehicles, with many instead opting to pay for the repair and maintenance of existing vehicles, stimulating strong industry growth. However, the economic recovery has resulted in a steady increase in new car sales. Although new cars tend to require fewer repairs, the greater the number of cars on the road, the greater the demand for industry services.

Industry Products

- Repairs
- Servicing and MOT tests
- Body work
- Car Washes

Industry Activities

- Repairing mechanical problems
- Repairing electrical components
- Servicing motor vehicles
- Repairing bodywork
- Painting motor vehicles
- Repairing windscreens
- Repairing tyres
- Washing and polishing cars
- Repairing motor vehicle parts

MOTOR VEHICLE INDUSTRY PLACE MAT SUGGESTED ANSWERS

1 What does “labour-intensive” mean?

Work/production requiring a large workforce (relative to capital) or a large amount of work in relation to output e.g. agriculture, mining, hospitality

2 Why might governments take interest in the health of labour-intensive industries?

Governments are generally sensitive to the needs of voters who may be concentrated in these industries; politicians tend to seek re-election, and to do this they must be appealing to voters – voters with jobs may be more likely to vote to retain the government status quo. This partially explains the US government decision to bail-out the American car manufacturers after the Great Recession 2007.

7 Define Income Elasticity of Demand (YED)

The responsiveness of demand to a change in income.

8 Comment on the likely YED value for new cars

YED for new cars is likely to be positive (i.e. a normal good) – this is supported by the evidence in the extract which says that the economic downturn led to a fall in demand. Cars are generally expensive, luxury items that are also expensive to run, therefore YED is likely to be above 1.

3 Using the info from the 1st two paragraphs and the table, make a judgement about which type of market structure best explains the UK MVR industry

The fact there are many small businesses, with no indication that there are any firms with market power, implies that the market structure is either perfect competition or monopolistic competition. It certainly cannot be oligopolistic or monopoly. The extract also states that the industry is heterogeneous, and this is supported by the information in the table showing a range of services. Therefore it is likely to be monopolistically competitive.

4 Estimate the likely 4 firm concentration ratio for the UK MVR industry.

Given the information provided, the 4-firm concentration ratio would be very low.

5 Using the data, explain the concept of derived demand

Derived demand refers to the demand for a good/service which is a consequence of the demand for something else.

6 Comment on the likely XED relationship between cars and motor vehicle repairs

XED refers to the responsiveness of demand for one product to a change in the price of another. Cars and motor vehicle repairs are complements. The utility of the car is enhanced/improved/increased by the purchase of repairs. They are likely to have a negative XED value.

9 What is meant by ‘barriers to entry’ and why might barriers to entry be low in the MVR industry?

Barriers to entry (BTE) are any obstacles that prevent new competitors from easily entering an industry or area of business. BTE appear to be low in the MVR industry because there are no minimum training requirements enforced by law.

10 Why does heterogeneity result in a downward sloping demand curve?

Homogeneity would imply that a consumer can get exactly the same good/service from another provider and, therefore, if the price increased, no rational consumer would shop there, so firms face a perfectly elastic (horizontal) demand curve. This is different under heterogeneity, because products are differentiated enough that when prices increase, firms won’t see their market share fall to zero as they have some ability to retain customers wanting their exact service/good.

11 What is the opposite of heterogeneous?

Homogeneous – all products are exactly the same.