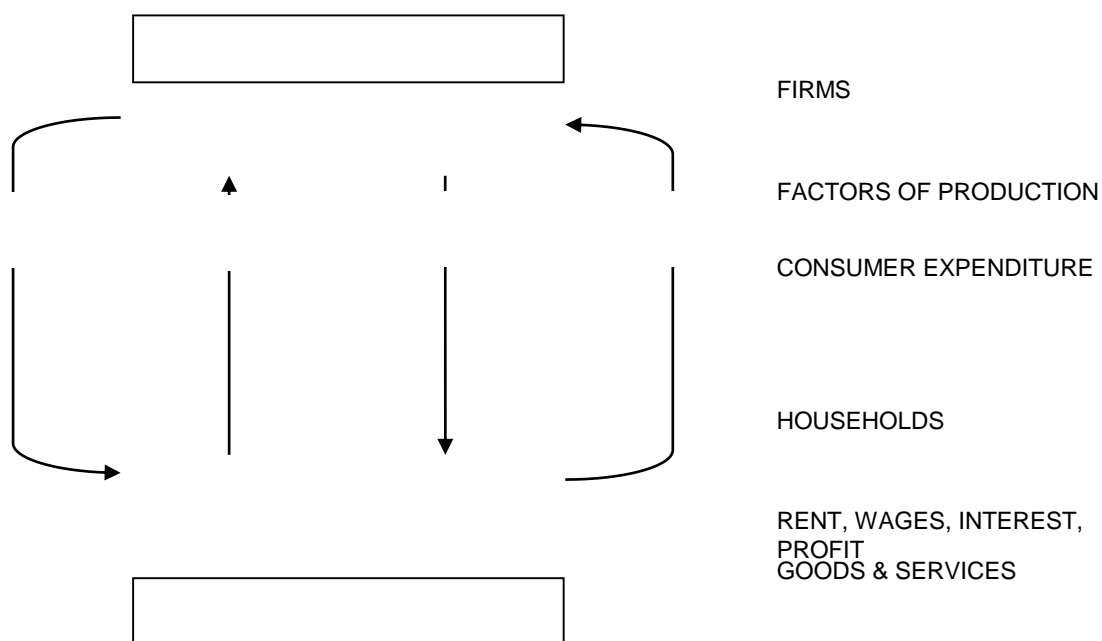


## 55. The Circular Flow of Income

### 1. Missing words

For an economy to be in \_\_\_\_\_, injections must be \_\_\_\_\_ to withdrawals. Injections into the circular flow are made up of investment, \_\_\_\_\_ and \_\_\_\_\_, while withdrawals comprise of savings, \_\_\_\_\_ and \_\_\_\_\_. If injections do not equal withdrawals, then the economy is said to be in disequilibrium. If withdrawals are greater than injections, the economy will suffer declining incomes, output and \_\_\_\_\_. Eventually, lower incomes will reduce the levels of taxation and saving, causing leakages to shrink until they equal injections. If injections are greater than withdrawals, the economy will be expanding (economic growth). When the economy is growing (injections are \_\_\_\_\_ than withdrawals), households and firms will pay \_\_\_\_\_ tax, and are also likely to save more. Households are also likely to buy more goods from \_\_\_\_\_. This will cause the value of leakages to increase, up to the point where they are equal to injections. At this point the economy has returned to equilibrium. **Missing words: expenditure, imports, more, govt spending, equal, greater, exports, overseas, equilibrium, taxation**

### 2. Complete the diagram for a closed economy.



### 3. Organise the following (a-h) under the 4 headings.

Households	Firms	Government	Banks

- a) Receive tax from firms and households    b) Pay interest on deposits held    c) Hold savings

- d) Hire the factors of production
- e) Purchase output from firms
- f) Pay income tax
- g) pay corporation tax
- h) Receive income for factors of production

#### 4. Analysis

When the model is advanced to an open economy, there is a need to account for three important sectors in the modern economy: the financial sector (e.g. banks), the government sector and the international sector. When these are allowed for, injections and withdrawals must be included in the circular flow.

4.1 List the three injections and three withdrawals (leakages) from the circular flow.

3 injections:

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3 withdrawals: \_\_\_\_\_

4.2 On the back of this page, redraw the circular flow of income diagram, adding in both injections and withdrawals to your diagram.

## 52. Measuring Economic Performance

### I. Define the following terms

I.1 Gross Domestic Product (GDP) \_\_\_\_\_

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I.2 Gross National Product (GNP) \_\_\_\_\_

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I.3 Real National Income \_\_\_\_\_

I.4 Nominal wealth \_\_\_\_\_

## 2. Data Analysis

Country	Real GDP (\$ billion), 2008	Population (million)	Real GDP (\$) per capita
China	2,645	1,323.6	2,000
USA	13,164	301.0	43,730
UK	2,377	59.8	39,750
Germany	2,897	82.7	35,030
Japan	4,368	128.2	34,080

Source: adapted from 'The Economist, Pocket World in Figures, 2009 Edition'

2.1 Based on the table above, which is the biggest economy? \_\_\_\_\_

2.2 Why is it important to adjust data for GDP to real GDP? \_\_\_\_\_

2.3 What does the final column mean by GDP per capita? Why is it important to convert data to per capita?

\_\_\_\_\_

\_\_\_\_\_

2.4 Which economy is likely to enjoy the highest standard of living? Explain your answer. \_\_\_\_\_

\_\_\_\_\_

## 3. Data Calculations

Economists must be careful when using figures to ensure that they account for the effects of inflation over a given time period. Values which are unadjusted are referred to as nominal values, given at current prices. Real values have been adjusted for inflation. Complete the table below for the goods listed.

Good (product)	Price in year 1 (£)	Rate of Inflation for good	Price in year 2 (£)
HD TV	800	10%	
Sony Playstation 3	300		375
Hi-Fi system		-15%	272
Fridge Freezer	900		1000

3.1 Which good was the cheapest in year 1? \_\_\_\_\_

3.2 Which good was the most expensive at the end of year 2? \_\_\_\_\_

3.3 Which good experienced the highest rate of inflation? \_\_\_\_\_

3.4 Why might the inflation rate for each good differ? \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

## 4. True or False?

4.1 The economic cycle is the same as the business cycle.

4.2 When the rate of economic growth declines, the economy is in recession.

4.3 Higher levels of GDP are always desirable as there are no negative consequences associated with growth.

## 86. Inflation: what causes it and what are its costs?

### I. Fill in the missing words

Inflation is a sustained rise in the general \_\_\_\_\_ level. It is generally measured in percentage terms; the Bank of England's \_\_\_\_\_ Policy Committee aims for an \_\_\_\_\_ target of \_\_\_\_\_ using the Consumer Price Index, CPI. There are two main causes of inflation: demand-pull, when aggregate demand shifts to the \_\_\_\_\_, so rising expenditure drives up the price level, or cost-push inflation, when \_\_\_\_\_ shifts to the left, and rising \_\_\_\_\_ costs are passed onto consumers in the form of higher prices. If the money supply continues to rise, then this leads to sustained rises in prices and so inflation. Sustained falls in the price level are also possible and this is called

\_\_\_\_\_ . Choose the words from: deflation, right, Monetary, price, inflation, production, aggregate supply, 2%.

**2. Costs of inflation – match each question with one of the answers in the opposite column.**

	Question		Answer
2.1	Menu costs are:	A	When the opportunity cost of holding cash increases and so people will keep more money in interest-bearing accounts, making more trips to the bank necessary.
2.2	Uncertainty and lower investment as:	B	Exports become relatively more expensive and imports relatively cheaper. The trade position will therefore deteriorate, unless the exchange rate deteriorates to compensate, other countries have higher inflation, or exports do not sell on the basis of price alone.
2.3	A wage price spiral occurs as:	C	Inflation changes make it harder for firms to predict costs and revenues and so they may be deterred from investment projects.
2.4	A fall in competitiveness as:	D	those on fixed incomes, such as pensioners, see real incomes fall, and the real value of their savings also fall. Furthermore, borrowers benefit as the real value of debt is eroded.
2.5	Shoe-leather costs are:	E	The costs due to reprinting price tags, catalogues, altering vending machines etc as prices become out of date.
2.6	Income is redistributed as:	F	Consumer sovereignty relies on producers responding to changes in prices. Inflation means that producers may believe that demand for their good has risen (and hence increase production) when, in fact, only the general price level has increased, causing allocative inefficiency.
2.7	Inefficient allocation of scarce resources as:	G	When workers bid for higher wages as they find their real income have been eroded by rising prices. This can lead to cost-push inflation and then demand for higher wages again, causing further inflation.

**3. Identify whether each of the following leads to demand-pull or cost-push inflation:**

3.1 An increase in the price of gas and oil:

\_\_\_\_\_

3.2 A decrease in the marginal propensity to save: \_\_\_\_\_

3.3 An increase in nominal wages, above productivity growth: \_\_\_\_\_

3.4 An increase in VAT from 17.5% to 20%: \_\_\_\_\_

3.5 An increase in consumer and business confidence: \_\_\_\_\_

**4. Are the following true or false?**

4.1 There are no costs to inflation is it is fully anticipated. \_\_\_\_\_

4.2 No country has suffered hyperinflation since Germany in the 1920s. \_\_\_\_\_

4.3 Japan has suffered deflation since the early 1990s. \_\_\_\_\_

4.4 The UK government made the Bank of England independent and gave them responsibility for meeting an inflation target.

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## 87. Inflation: how is it measured?

### I. Fill in the missing words

The RPI, \_\_\_\_\_ Index measures the average household \_\_\_\_\_. The weighted index is based on the spending decisions of \_\_\_\_\_ households (taken from across regions and income levels) surveyed via the \_\_\_\_\_ Survey. Weights are allocated to the top \_\_\_\_\_ goods and services, with the weight determined by the amount spent on that good. Therefore goods that take up a \_\_\_\_\_ proportion of income have a larger impact on the RPI. The contents and weights of items in the basket are reviewed each \_\_\_\_\_ and 120,000 price estimates are taken each \_\_\_\_\_. The average price for each good is used in the index. The top 4% of income earners and low-income pensioners (reliant on the state pension) are excluded from the survey, as they are likely to have a distorting impact. **Missing words: cost of living, year, large, 6785, Retail Price, Expenditure & Food, 650, month**

**2. Different measures of inflation – match these price indices, CPI, RPI, RPIX, RPIY to the following:**

2.1 Sometimes referred to as the **headline rate of inflation**, the government uses it for the uprating of pensions and benefits. Private contracts use it for uprating housing rents and wage bargaining.

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2.2 This index has **formed the basis for the government's inflation target since 2003** and has been developed according to internationally agreed rules and is internationally known as the HICP, and is used by the European Central Bank for their inflation target.

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2.3 This index **excludes mortgage payments** and so allows policy makers to view inflation rates without the distortion of changes in house prices, and so reflects the **underlying rate of inflation**. -

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2.4 This index **excludes mortgage payments and indirect taxes** so policy makers can see how prices change without the distortion of changes in tax, and so reflects the **core rate of inflation**.

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### 3. Are the following characteristics of RPI or CPI?

3.1 This measure excludes many housing costs (council tax, mortgage interest payments, house depreciation, buildings' insurance, estate agents' and conveyancing fees):

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3.2 This measure is based on the expenditure of all private households in the UK including the richest 4% of households and pensioners dependent on state benefits:

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3.3 This measure cannot be used for international comparison of inflation rates:

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### 4. Data response - What's in your basket?

The nation's changing tastes has seen hot rotisserie chicken added to the goods basket used to measure the cost of living. Today the Office of National Statistics publishes their monthly price indexes for February 2009. This will mainly hit the news because inflation will be approaching 0% for the first time in 50 years but, of equal interest will be the announcement of a series of changes to the 'basket of goods' the ONS used to calculate inflation. The first basket was collated in 1947 and contained, amongst other things, ox liver, herrings, mutton leg, and tinned prunes. The noughties, for better or worse, has seen Rotisserie chicken, ready meals, Rose wine, parmesan cheese, double cream and yoghurt, all being added to our bulging baskets, highlighting the dual importance of convenience and indulgence in our current demanding, time-poor lifestyles. *Source adapted from: Tim Hayward, The Guardian, 24/3/09*

4.1 What might be the impact on income distribution of food prices remaining unchanged with 0% inflation.

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4.2 With reference to the concept of weights, explain how the cost of living is measured.

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4.3 Why might changes to the ONS's basket of goods make the price index an inaccurate measure of inflation?

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## 89. Types of Unemployment

### I. Fill in the Gaps

There are typically 5 types of unemployment. For each of the following fill in the missing words.

1. **Frictional unemployment:** Occurs when people are \_\_\_\_\_ jobs. This can be reduced by increase labour mobility and the incentive to work. This can be done by increasing the number of job centres and reducing benefits.
2. \_\_\_\_\_ unemployment: Occurs when jobs are dependent on the time of year. For example a ski instructor can only do his/her job in the winter. This can be reduced through retraining and increasing \_\_\_\_\_ mobility.
3. \_\_\_\_\_ unemployment: This results from a lack of demand for the skills that a group of workers offer. It is associated with the changing structure of the economy. An example of this was the decline in the ship-building industry in the UK and therefore the need for ship builders. This can have an impact on certain regions and therefore is closely associated with regional unemployment. This can be reduced through education & \_\_\_\_\_ to give workers new skills and increasing labour mobility.
4. **Cyclical unemployment:** This is also known as \_\_\_\_\_-deficient unemployment. This occurs when there is a fall in aggregate \_\_\_\_\_ in the economy and is associated with the \_\_\_\_\_ cycle.



To solve this the A<sub>1</sub> curve needs to be shifted to the \_\_\_\_\_. This can be done using \_\_\_\_\_ management policies, such as increasing government spending.

5. **Voluntary unemployment:** This is also known as \_\_\_\_\_ unemployment or real \_\_\_\_\_ unemployment. This is associated with people choosing to not work at the prevailing market wage rate. This can be reduced by cutting the level of unemployment benefits.

6. **Which is Which?** For each of the following examples identify which category of unemployment the person might be placed. There may be more than one.

- a) Unemployed car manufacturers after a transfer of car production to Slovakia. \_\_\_\_\_
- b) Recent graduate looking for a job as a solicitor, but unwilling to take any other job \_\_\_\_\_
- c) Office worker taking a break whilst looking for a new job \_\_\_\_\_
- d) Workers in a computer manufacturers who have lost their jobs after a slump in demand for computers \_\_\_\_\_
- e) Workers in an architects who have lost their jobs after not agreeing to take a pay cut \_\_\_\_\_
- f) Unemployed people who work as Santa Claus at Christmas \_\_\_\_\_

## 92. The Balance of Payments

### 1. Missing Words

The Balance of Payments can be defined as a record of all the trade between one country and the rest of the world.

The Current Account is made up of four accounts. These are (complete the following)

- 1. \_\_\_\_\_ : A record of a country's net trade in \_\_\_\_\_ such as a table or chair
- 2. Trade in Services: A record of a country's net trade in services such as \_\_\_\_\_ or \_\_\_\_\_
- 3. Investment \_\_\_\_\_ : A record of a country's income from investments abroad minus the income made by foreign based firms in the UK
- 4. Current Transfers : Membership fees paid for by the government, Overseas Development Assistance (Aid) and earnings from abroad sent back to the UK less any earnings by foreigners in the UK sent out of the UK – these include fees paid for the UN, EU and IMF

### 2. Data Response Question

A country has the following international transactions:

- a) Exports of manufactured goods **£36bn**
- b) Food imports **£20bn**
- c) Foreign tourists in the UK spend **£8bn**
- d) Dividends paid to foreign shareholders **£4bn**

- e) Profits repatriated by foreign multinationals **£8bn**
- f) Purchase of oil from abroad **£6bn**
- g) EU commission provides agricultural subsidies to British farmers **£2bn**
- h) Repatriated earnings of UK citizens working overseas **£14bn**
- i) Sale of gas to foreign countries **£8bn**
- j) Payments by foreigners to UK financial institutions for services rendered **£9bn**
- k) UK tourists abroad spend **£8bn**
- l) UK government provides financial aid to various countries **£5bn**
- m) Imports of manufactured goods **£54bn**

**2.1 Which of these items are:**

Exports of goods? \_\_\_\_\_

Exports of services? \_\_\_\_\_

Imports of goods? \_\_\_\_\_

Imports of services? \_\_\_\_\_

Investment Income (specify whether M or X)?  
\_\_\_\_\_

Current Transfer (specify whether M or X)? \_\_\_\_\_

**2.2 Calculate:**

The balance of trade in goods: \_\_\_\_\_

The balance of trade in services: \_\_\_\_\_

The balance of trade in goods and services: \_\_\_\_\_

The current account balance: \_\_\_\_\_