AQA A-LEVEL ECONOMICS · 7136

# ECONOMICS



## EXAM QUESTION PACK

### 3.2.4.1 THE STRUCTURE OF FINANCIAL MARKETS AND FINANCIAL ASSETS

| SCORE | PERCENTAGE |
| --- | --- |
| /49 | % |

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**1.** In 2012, the UK Government issued a £100 bond with a coupon of £3 per annum and 40 years until maturity. Two years later, the interest that could be earned on a similar asset had risen to 6%. What is likely to have happened to the price of the bond and its yield?

**A** The price of the bond will have risen but the yield will be unchanged. ⬭

**B** The price of the bond will have fallen but the yield will have increased. ⬭

**C** The price of the bond will have risen but the yield will have increased. ⬭

**D** The price of the bond will be unchanged but the yield will have fallen. ⬭

**[1 mark]**

**2.** Which one of the following combinations is most likely to increase the risk of bank failures?

| | Liquidity ratios | Capital ratios | |
|---|---|---|---|
| **A** | Increasing | Falling | ⬭ |
| **B** | Falling | Falling | ⬭ |
| **C** | Increasing | Increasing | ⬭ |
| **D** | Falling | Increasing | ⬭ |

**[1 mark]**



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**3.** Which one of the following combinations, **A**, **B**, **C** or **D**, best distinguishes between the functions of the money market and the capital market?

| | Money market | Capital market | |
|---|---|---|---|
| **A** | The market for issuing new shares | The market where foreign currency is exchanged at some point in the future | ⬭ |
| **B** | The market where commercial banks provide short-term loans to each other | The market where businesses obtain funds to finance long-term growth | ⬭ |
| **C** | The market where foreign currencies are traded | The main market in which commercial banks lend to each other | ⬭ |
| **D** | The market where the government finances its budget deficit by issuing bonds | The market where short-term debt is converted into equity finance | ⬭ |

**[1 mark]**

**4.** A government issued bond has a nominal value of £100 and the annual coupon is £6. The bond has 35 years until maturity. Its current yield is 5%. The current market price of the bond is

**A** £100 ⬭

**B** £105 ⬭

**C** £106 ⬭

**D** £120 ⬭

**[1 mark]**

**5.** **Government policy Extract F** (lines 14−17) states ‘Investment forecasts are being revised downward and on top of speculation of interest rate rises and criticism of the UK’s quantitative easing programme, the outlook is not looking as good as forecasts first indicated.’

Using the data in the extracts and your economic knowledge, evaluate the effectiveness of monetary policy in achieving macroeconomic stability in the UK.

**[25 marks]**



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**6.** **Government policy**

**Extract F: Austerity remains**

The Chancellor, George Osborne, has ruled out the possibility that the UK's improving economy will lead to immediate tax cuts or spending increases when he said reducing the budget deficit would be the priority of his Autumn Statement. The Chancellor said that the UK was still borrowing too much and that any increase in tax revenues generated from faster growth would be used to reduce the budget deficit and the national debt.

The move comes as no surprise, with the Chancellor stating, "I would just remind everyone that I still sit down at the table at the G20 with one of the highest budget deficits. The UK still continues to have some very serious public finance challenges that need to be addressed."

This week, the IMF revised up its forecasts for UK growth in both 2013 and 2014, six months after its chief economist, Olivier Blanchard, warned Osborne that he might cause more damage with his austerity plan. However, Osborne responded, “We have a clear plan and we are sticking to that plan."

The Chancellor's announcement may not be good for UK firms. It is common for business investment to lead the way when emerging from recession, but not this time. Investment forecasts are being revised downward and, on top of speculation of interest rate rises and criticism of the UK's quantitative easing programme, the outlook is not as good as forecasts first indicated.

In explaining its forecast downgrades for net investment over the last three years, the Office for Budget Responsibility (OBR) cites two main factors. Firstly, problems in credit markets have made it difficult for firms to borrow to invest. This may have particularly affected small and medium-sized firms that tend to be more reliant on bank financing. This will only be made worse if interest rates rise. Secondly, the uncertainty generated by the eurozone crisis and other events has stifled investment.

Source: News reports, 2013

**7.** The table below shows different combinations of changes in a commercial bank’s liquidity and capital ratios. All other things being equal, which one of the following combinations, **A**, **B**, **C** or **D**, is most likely to improve the bank’s financial stability?

| | Liquidity ratio | Capital ratio | |
|---|---|---|---|
| **A** | Increase | Decrease | ⬭ |
| **B** | Increase | Increase | ⬭ |
| **C** | Decrease | Increase | ⬭ |
| **D** | Decrease | Decrease | ⬭ |

**[1 mark]**



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**8.** A company has an issued share capital of £1 million and an outstanding corporate bond issue of £200 000. To fund its expansion, the company issues additional corporate bonds for £300 000. All other things being equal, after the issue of the additional corporate bonds the ratio of the company's total debt to its equity will be

**A** 0.2:1 ⬭

**B** 0.3:1 ⬭

**C** 0.5:1 ⬭

**D** 2.0:1 ⬭

**[1 mark]**

**9.** Commercial banks provide financial services for both individuals and businesses. In 2007–08, the financial crisis led many to argue for tighter regulation of the banks to prevent problems in financial markets affecting the real economy. However, financial markets are not the only source of cyclical instability. Governments can use a variety of policies to try to create a more stable economy.

Explain the role of commercial banks in the economy.

**[15 marks]**

**10.** A long-dated £100 government bond with a coupon rate of 5% has a current market value of £125. This implies that the

**A** current yield on the bond is 4%. ⬭

**B** current yield on the bond is 5%. ⬭

**C** market rate of interest is 2.5%. ⬭

**D** market rate of interest is 5%. ⬭

**[1 mark]**

**11.** The money market is the financial market in which

**A** companies issue new shares to the public and financial institutions. ⬭

**B** dealers are able to trade foreign currencies. ⬭

**C** long-term company securities and government bonds are traded. ⬭

**D** short-term finance is provided for companies and governments. ⬭

**[1 mark]**



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**12.** The table below contains a simple balance sheet for a bank.

| Assets (£ billion) | | Liabilities (£ billion) | |
|---|---|---|---|
| Cash | 20 | Customer Deposits | 700 |
| Cash held at Central Bank | 70 | Money owed to Central Bank | 30 |
| Securities held | 130 | Money owed to other banks | 170 |
| Loans | 730 | Shareholders Equity | 100 |
| Other assets | 50 | | |
| **Total assets** 1000 | | **Total liabilities** 1000 | |

From the balance sheet it can be concluded that this bank is

**A** a threat to financial stability because it holds no capital. ⬭

**B** an investment bank because it holds non-interest bearing cash. ⬭

**C** earning large profits because most of its assets are loans. ⬭

**D** most likely to be a commercial bank because its main liabilities are customer deposits. ⬭

**[1 mark]**



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