

AQA A-LEVEL ECONOMICS • 7136

ECONOMICS



EXAM QUESTION PACK

3.2.4.4 THE REGULATION OF THE FINANCIAL SYSTEM

SCORE

/43

PERCENTAGE

%

STEMUP

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1.

Systemic risk is most likely to occur in financial systems when

- A** investment banks have low capital-output ratios.
- B** most banks carry out both commercial and investment banking activities.
- C** the central bank acts as lender of last resort to financial institutions.
- D** the commercial banks have high liquidity ratios.

☐☐☐☐

[1 mark]

2.

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]

3.

Moral hazard results when individuals and organisations make investment decisions

- A** based on asymmetric information.
- B** because they expect to make a large profit.
- C** based on the returns made on previous investments.
- D** knowing that others will bear the loss if things go wrong.

☐☐☐☐

[1 mark]

4.

Since 1998, the Bank of England has had responsibility for the operation of monetary policy and maintaining price stability. In response to the financial crisis of 2007–08, the Financial Services Act 2012 gave the Bank of England overall responsibility for financial stability. This was designed to reduce systemic risk and the impact on the real economy of problems that arise in financial markets.

Evaluate the view that strict rules and regulations on financial markets are essential to help create a more stable economy.

[25 marks]

5.

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]

Mark schemes

1. B [1]

2. B [1]

3. D [1]

4. **Areas for discussion include:**

- definitions/explanations: financial markets, macroeconomic stability, financial stability
- relating rules and regulations to the FPC, FCA, and PRA and explaining the functions of each of the regulatory bodies
- explaining both micro and macro prudential regulation
- giving examples, such as explaining the build up to the last major financial crisis in the UK in 2007/08
- explaining systemic risk and the impacts on the real economy in terms of:
 - growth
 - unemployment
 - inflation
 - government finances
- explaining liquidity ratios and the 'stress-testing' of banks
- explaining the role of other economic agents in attempting to create macroeconomic stability
 - such as the MPC's role in price stability and helping achieve the government's objectives for growth and unemployment
 - such as the OBR's role in monitoring the impact of government budgetary changes
 - such as the EU's rules regarding fiscal stability
 - such as the Basel accords
- considering the possibility of government failure in banking or regulatory capture
- considering financial market failure, speculative bubbles and moral hazard
- considering that too much regulation may cause 'banking brain-drain' and damage the UK's financial services industry in the long run
- considering the relative success (or failure) of current regulations or improvements that can be made to the system
- considering the possibility of market failure in banking such as asymmetric information in financial products
- considering that economic stability is much more than just financial stability
- considering that some external economic shocks may not be fully insulated against.

The use of relevant diagrams to support the analysis should be taken into account when assessing the quality of the student's response to the question.

Level of response	Response	Max 25 marks
5	Sound, focused analysis and well-supported evaluation that: - is well organised, showing sound knowledge and understanding of economic terminology, concepts and principles with few, if any, errors - includes good application of relevant economic principles to the given context and, where appropriate, good use of data to support the response - includes well-focused analysis with clear, logical chains of reasoning - includes supported evaluation throughout the response and in a final conclusion.	21 – 25 marks
4	Sound, focused analysis and some supported evaluation that: - is well organised, showing sound knowledge and understanding of economic terminology, concepts and principles with few, if any, errors - includes some good application of relevant economic principles to the given context and, where appropriate, some good use of data to support the response - includes some well-focused analysis with clear, logical chains of reasoning - includes some reasonable, supported evaluation.	16 – 20 marks
3	Some reasonable analysis but generally unsupported evaluation that: - focuses on issues that are relevant to the question, showing satisfactory knowledge and understanding of economic terminology, concepts and principles but some weaknesses may be present - includes reasonable application of relevant economic principles to the given context and, where appropriate, some use of data to support the response - includes some reasonable analysis but which might not be adequately developed or becomes confused in places - includes fairly superficial evaluation; there is likely to be some attempt to make relevant judgements but these aren't well-supported by arguments and/or data.	11 – 15 marks
2	A fairly weak response with some understanding that: - includes some limited knowledge and understanding of economic terminology, concepts and principle but some errors are likely - includes some limited application of relevant economic principles to the given context and/or data to the question - includes some limited analysis but it may lack focus and/or become confused - includes some evaluation which is weak and unsupported.	6 – 10 marks
1	A very weak response that: - includes little relevant knowledge and understanding of economic terminology, concepts and principles - includes application to the given context which is, at best, very weak - includes attempted analysis which is weak and unsupported.	1 – 5 marks

[25]

5.

Relevant issues include:

- definitions/explanations: commercial banks, financial markets
- distinguishing between a commercial bank and an investment bank
- giving examples of major commercial or high street banks
- explaining the role of commercial banks:
 - accepting deposits (current accounts and savings accounts)
 - lending and credit (loans and mortgages)
 - access to cash
 - currency trading
 - business advice
 - insurance
 - cheque and credit card processing
 - share trading
 - safety/security
 - providing an efficient means of payment
 - promoting saving
- explaining the assumption that commercial banks are profit seeking
- explaining that the basic model of commercial banks is that they lend with higher interest than the interest paid on saving
- explaining how consumption and therefore aggregate demand (AD) can be affected by commercial banks
- explaining how investment and therefore AD and aggregate supply (AS) can be affected by commercial banks
- explaining the role of commercial banks in credit creation.

The use of relevant diagrams to support the analysis should be taken into account when assessing the quality of the student's response to the question.

Level of response	Response	Max 15 marks
3	A good response provides an answer that: • is well organised and develops a selection of the key issues that are relevant to the question • shows sound knowledge and understanding of economic terminology, concepts and principles with few, if any, errors • includes good application of relevant economic principles to the given context and, where appropriate, good use of data to support the response • includes well-focused analysis with clear, logical chains of reasoning.	11 – 15 marks
2	A reasonable response provides an answer that: • focuses on issues that are relevant to the question • shows satisfactory knowledge and understanding of economic terminology, concepts and principles but some weaknesses may be present • includes reasonable application of relevant economic principles to the given context and, where appropriate, some use of data to support the response • includes some reasonable analysis but which might not be adequately developed or becomes confused in places.	6 – 10 marks
1	A weak response provides an answer that: • has identified one or more relevant issues • has some limited knowledge and understanding of economic terminology, concepts and principles but some errors are likely • has very limited application of relevant economic principles to the given context and/or data to the question • might have some limited analysis but it may lack focus and/or become confused.	1 – 5 marks

[15]