PEARSON EDEXCEL A-LEVEL ECONOMICS B · 9EB0

ECONOMICS



EXAM QUESTION PACK

4.5 RISK AND THE FINANCIAL SECTOR

SCORE	PERCENTAGE
/157	%

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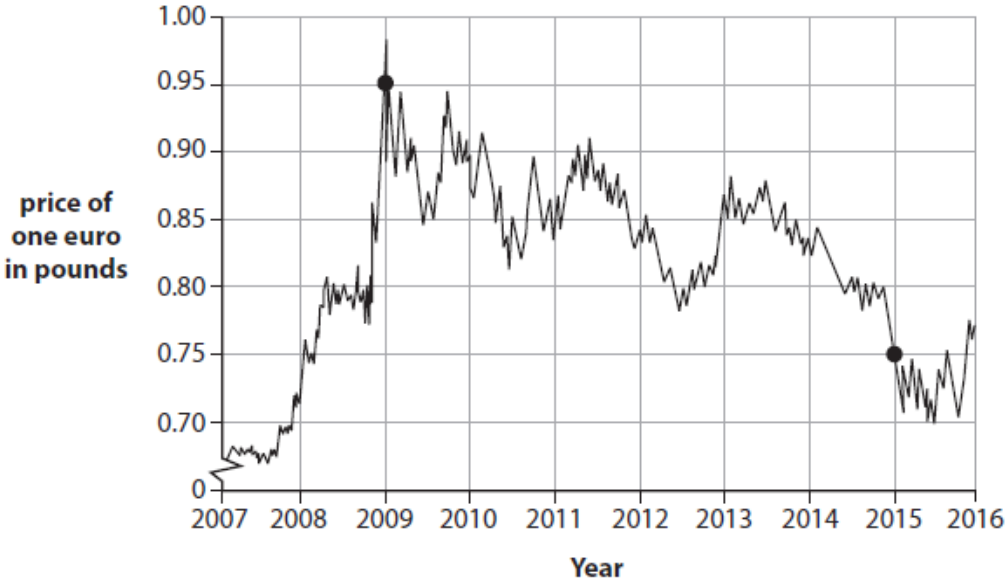
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Questions

Q1.

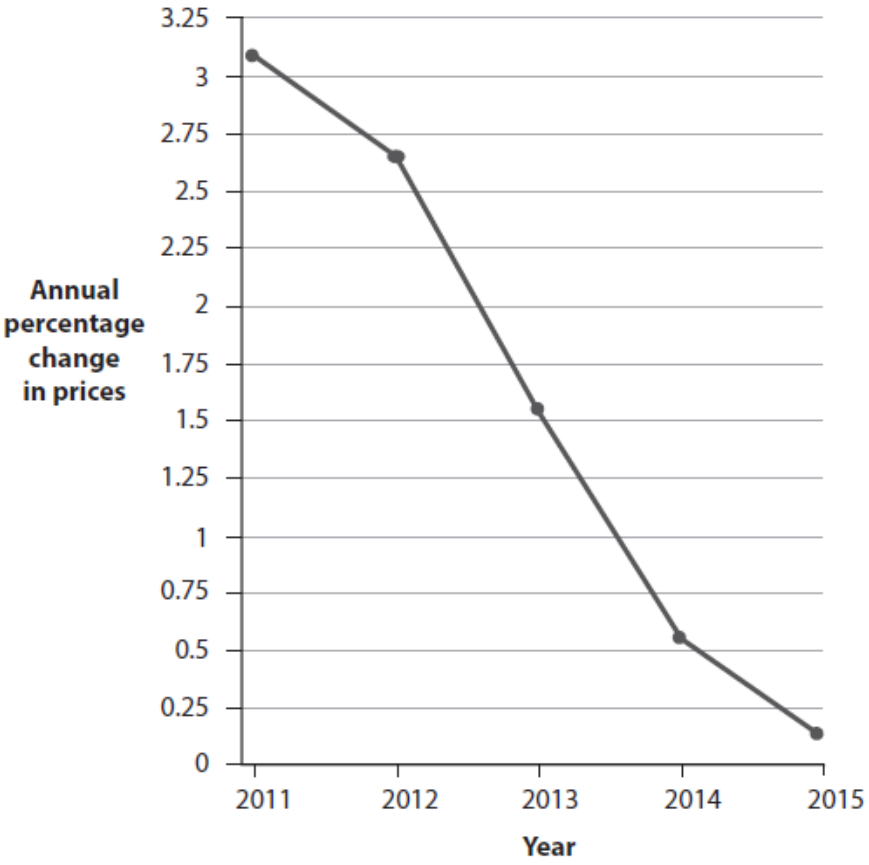
The Eurozone economy

Figure 1: Exchange rate of the euro (€) to the British pound (£)



(Source: https://www.ecb.europa.eu/stats/exchange/eurofxref/html/eurofxref-graph-gbp.en.html#)

Figure 2: Eurozone inflation rate as measured by the Consumer Prices Index (CPI)



(Source: adapted from http://www.imf.org/external/pubs/ft/weo/2015/02/weodata/download.aspx)

Extract A

European Central Bank disappoints markets with weaker than expected stimulus

Mario Draghi, president of the European Central Bank (ECB), surprised financial markets in November 2015 with a less ambitious package of monetary stimulus than many had anticipated.

The ECB cut its base interest rate by 0.1% to minus 0.3% in order to encourage private banks to lend funds to companies and households rather than deposit them at the central bank. The central bank agreed to extend its €60 billion (£45 billion) monthly bond-buying quantitative easing (QE) programme for a further six months. The ECB's €1.1 trillion QE scheme had originally been due to end in September 2016.

"We are doing more because it works," Mr Draghi said. Yet the ECB did not increase the size of its monthly asset purchases and also disappointed those expecting that it would cut interest rates more aggressively.

The euro rose almost 3% against the dollar to $1.08 after the announcement. Italian and Spanish bond yields both jumped by 0.27% to 1.62% and 1.72% respectively.

The ECB's economists reduced their inflation forecasts for the next two years. They now predict consumer prices in the Eurozone rising by just 1% in 2016 and 1.6% in 2017 – still below the central bank's ceiling of 2%. In November 2015, the inflation rate was just 0.1% and core inflation, excluding volatile items such as fuel and food, dropped to 0.9%.

Mr Draghi stressed again that monetary policy alone could not restore the Eurozone to economic health. He called for looser fiscal policy among member states to support aggregate demand and more rapid implementation of supply-side reforms. "In order to reap the full benefits from our monetary policy measures, other policy areas must contribute decisively," he said.

(Source: http://www.independent.co.uk/news/business/news/ecb-disappoints-traders-with-weaker-than-expected-stimulus-a6759786.html, 4th December 2015)

(a) With reference to Figure 1, calculate the percentage change in the value of the euro in pounds from the start of 2009 to the start of 2015.

(5)

(b) With reference to the information provided and your own knowledge, examine **two** factors which might explain the change in the rate of Eurozone inflation as shown in Figure 2.

(8)

(c) Since mid-2015 the euro has appreciated. Assess the likely impact of an appreciation of the euro on the current account of the balance of payments for Eurozone countries.

(10)

(d) Discuss the likely success of the ECB's quantitative easing programme in moving Eurozone inflation closer to 'the central bank's ceiling of 2%' (Extract A, line 17).

(12)

(e) Discuss 'looser fiscal policy' and 'supply-side reforms' (Extract A, lines 20 and 21) that may be used by governments of Eurozone countries to increase economic growth.

(15)

(Total for question = 50 marks)

Q2.

Use the data to support your answers where relevant. You may annotate and include diagrams in your answers.

The European Central Bank introduced a new round of quantitative easing (QE) in March 2020, purchasing up to €750 billion of assets. The objective of this QE was to reduce the serious risks to the effectiveness of monetary policy resulting from a significant recession. The European Central Bank's target for inflation remains at 'below but close to 2%'.

(Source adapted from: https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html)

Evaluate the effectiveness of quantitative easing during 'a significant recession'.

(Total for question = 2 marks)

Q3.

(a) With reference to Extract C, explain what can be inferred about the price elasticity of demand for coffee beans.

(5)

(b) With reference to Figure 4, examine the likely impact of the 19% increase in the price of coffee beans between January and February 2014, on the price of a cup of coffee bought from a coffee shop.

(8)

(c) Discuss the different degrees of contestability in the farming of coffee beans **and** in the UK coffee shop market.

(12)

EITHER

(d) With reference to the information provided and your own knowledge, evaluate the likely microeconomic and macroeconomic effects of fluctuating coffee bean prices on coffee-producing countries.

(25)

OR

(e) With reference to the information provided and your own knowledge, evaluate the likely microeconomic and macroeconomic effects of the depreciation of the *real* on Brazil's economy.

(25)

(Total for question = 50 marks)

Q4.

Some questions must be answered with a cross in a box (☒). If you change your mind about an answer, put a line through the box (☒) and then mark your new answer with a cross (☒).

Use the data to support your answers where relevant. You may annotate and include diagrams in your answers.

In May 2020, the UK government introduced a loan scheme to help small businesses survive the downturn in the economy. Small businesses could borrow up to £50 000 at an interest rate of 2.5% for up to 6 years from a bank. The government guaranteed 100% of the loans, to enable banks to issue them quickly, and only minimal checks were made on borrowers.

(Source: adapted from https://www.ft.com/content/1ca15db2-93e4-4e34-877d-110309cd9716)

(a) With reference to the information above, explain **one** role of financial markets.

(4)

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(b) Which **one** of the following would be a risk if 'only minimal checks were made on borrowers' in this loan scheme?

(1)

☒ **A** Asymmetric information

☒ **B** Crowding out

☒ **C** Market rigging

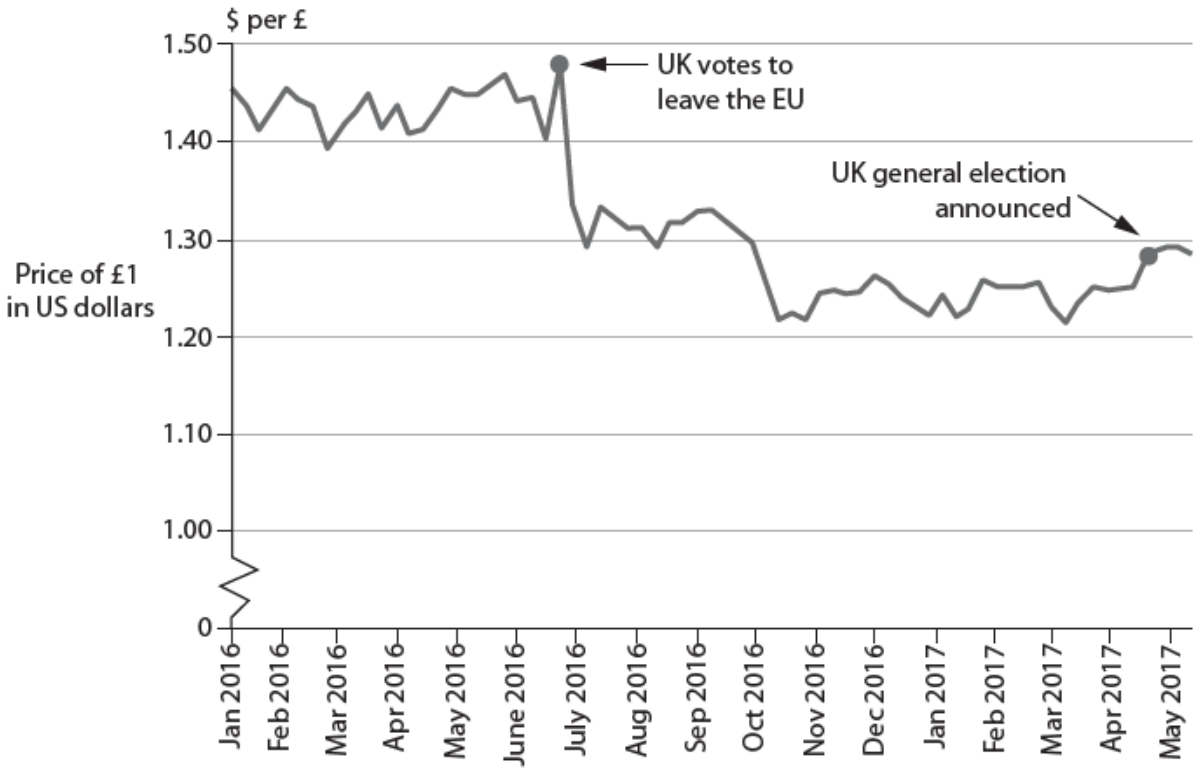
☒ **D** Speculation

(Total for question = 5 marks)

Q5.

The UK economy since the financial crisis

Figure 1: Pound sterling to US$ exchange rate, 2016-17



(Source: adapted from https://www.ft.com/content/d50ce580-3968-11e7-ac89-b01cc67cfeec)

Extract A

UK companies use forward currency market

The Norfolk-based picture frames maker Nielsen Bainbridge recently made forward contracts in the foreign exchange market to reduce the impact of currency fluctuations. The pound's post-Brexit referendum depreciation has been a test of nerve for Nielsen Bainbridge and many other importers. At present the company's suppliers are located in Europe or China. "Currency therefore has a big impact on our business and the margins we can obtain," says Ms Burdett, the Finance Director. Forward contracts enable institutions, businesses and individuals to lock in an exchange rate over a certain period of time regardless of how the rate moves during that time. Ms Burdett buys currency as soon as Nielsen Bainbridge confirms a large order as a way to fix costs. One third of UK business managers are considering shifting from EU to UK suppliers.

(Source: adapted from 'UK companies use pound strength to hedge forex risk' by Roger Blitz, Markets, © FT.com, 16 May 2017. https://www.ft.com/content/d50ce580-3968-11e7-ac89-b01cc67cfeec)

Extract B

Bank of England seeking to prevent future bank bailouts

The Bank of England has ordered big lenders in the UK to find £116 billion of funding to ensure that taxpayers will never again have to bail out the banking sector. The Bank intends to publish details of how each of the big lenders would cope in the event they find themselves in a situation similar to Royal Bank of Scotland and Lloyds Banking Group, which needed £65 billion of taxpayer bailouts during the 2008 Global Financial Crisis. This had a significant negative impact on the UK government's national debt and, many would argue, increased the need for contractionary fiscal policy. Having said that, the UK government sold all its shares in Lloyds Banking Group in 2017 and, according to the Chancellor of the Exchequer, "recovered every penny of its investment in Lloyds".

Sir Jon Cunliffe, the deputy governor at the Bank responsible for financial stability, said regulators needed to let banks fail in a similar way that traditional companies collapse. This has not been possible in the past because of the risk that savers lose their money and because a system did not exist to allow banks to be put into insolvency.

"Just like when other businesses fail, losses arising from bank failure would be imposed on shareholders and investors. This protects the public from loss and incentivises banks to operate more prudently," said Cunliffe.

(Source: adapted from 'Bank of England tells lenders to find £116bn to help prevent bailouts', by Jill Treanor, 02 October 2017, Copyright The Guardian News and Media Ltd https://www.theguardian.com/business/2017/oct/02/bank-of-england-bailouts-rbs-lloyds and 'Lloyds bank bailout repaid in full, Philip Hammond claims', by Jill Treanor, Larry Elliott, 21 April 2017, Copyright Guardian News & Media Ltd 2017 https://www.theguardian.com/business/2017/apr/21/lloyds-bank-bailout-repaid-in-full-philip-hammond-claims)

Extract C

Bank of England tells lenders to increase capital reserves

The Bank of England has told lenders they will need to build a special reserve worth £11.4 billion by the end of 2018 as it tries to make banks more resilient to the risk posed by mounting consumer debt. This reserve of assets that can be readily turned into cash is a way of forcing banks to set aside capital reserves in good times in order to keep lending to the wider economy at a steady level, even during an economic downturn. In 2017 the Bank of England told UK banks it would raise the reserve ratio, relative to all assets, from zero to 0.5% and also forecast a further increase to 1% by the end of 2017.

The move is not intended to directly reduce consumer demand for credit, which in 2017 grew by 10.3% on an annual basis, but it may well lead to banks becoming less willing to lend to consumers. Since the Bank of England has recently become increasingly concerned about consumer borrowing, including rising car loans and credit card debt, this may be no bad thing as far as the Bank of England is concerned, even if it does have a negative impact on the wider economy.

Analysts are concerned about the impact on consumer confidence of rising inflation, partly caused by a falling pound. With falling real incomes consumers could become more vulnerable to falling behind with their credit card and personal loan repayments. Despite these concerns the UK economy recently recorded the lowest rate of unemployment since 1975.

(Source: adapted from 'Bank of England tells lenders to increase capital buffers by £11.4bn' by Caroline Binham, Gemma Tetlow and Martin Arnold © Financial Times 2017 https://www.ft.com/content/9bc99294-5b1b-11e7-9bc8-8055f264aa8b)

(a) With reference to Extract A, explain the role of forward markets in currencies.

(5)

(b) With reference to Extract A and Figure 1, examine the likely impact of the change in the sterling exchange rate on the UK economy.

(8)

(c) With reference to the last paragraph in Extract C, assess the impact of a fall in real incomes on subjective happiness.

(10)

(d) With reference to Extract C, discuss the potential conflicts between macroeconomic objectives when the central bank attempts to control inflation.

(12)

(e) Discuss whether providing substantial government financial support to banks is the best policy response during a financial crisis.

(15)

(Total for question = 50 marks)