



## **Economics Questions By Topic:**

### **The Financial Sector (4.4)**

### **A-Level Edexcel Theme 4**

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**SECTION A**

**Write your answers in the spaces provided.**

**1** (a) Explain **one** role of financial markets.

(2)

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(b) Explain **one** reason why the UK central bank used quantitative easing following the Global Financial Crisis of 2008.

(2)

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(c) Which **one** of the following would be the most likely cause of market failure in the financial sector?

(1)

- A** Banks charge higher interest rates on higher risk loans
- B** Banks do not create any external costs or benefits in their operations
- C** Banks know that the government will bear the risk of customers defaulting on loans
- D** Banks and their customers have symmetric information

Answer

**(Total for Question 1 = 5 marks)**

**END OF SECTION A**

## SECTION B

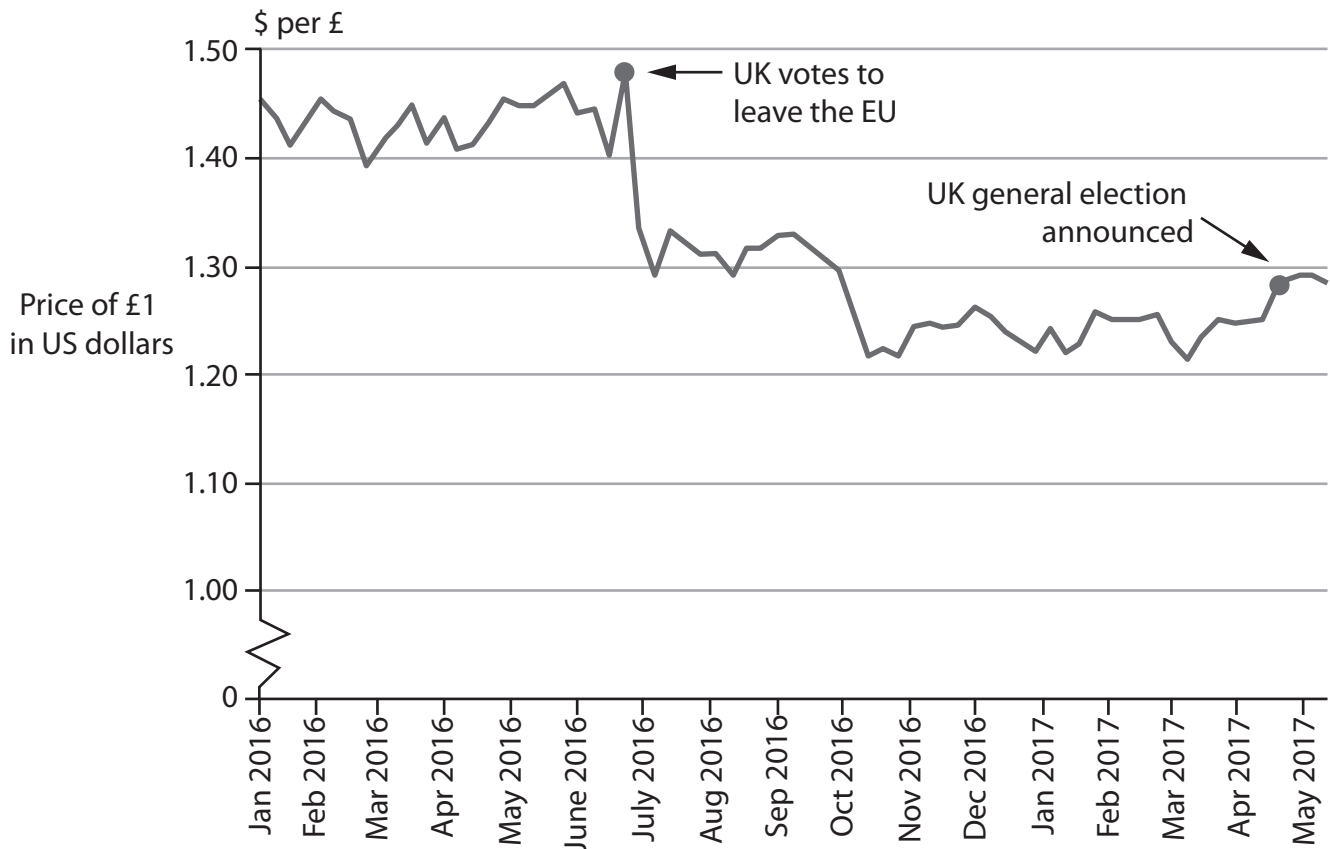
Read all extracts/figures before answering.

Write your answers in the spaces provided.

### Question 2

#### 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. 5

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. 10

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. 15

(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)

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

(15)

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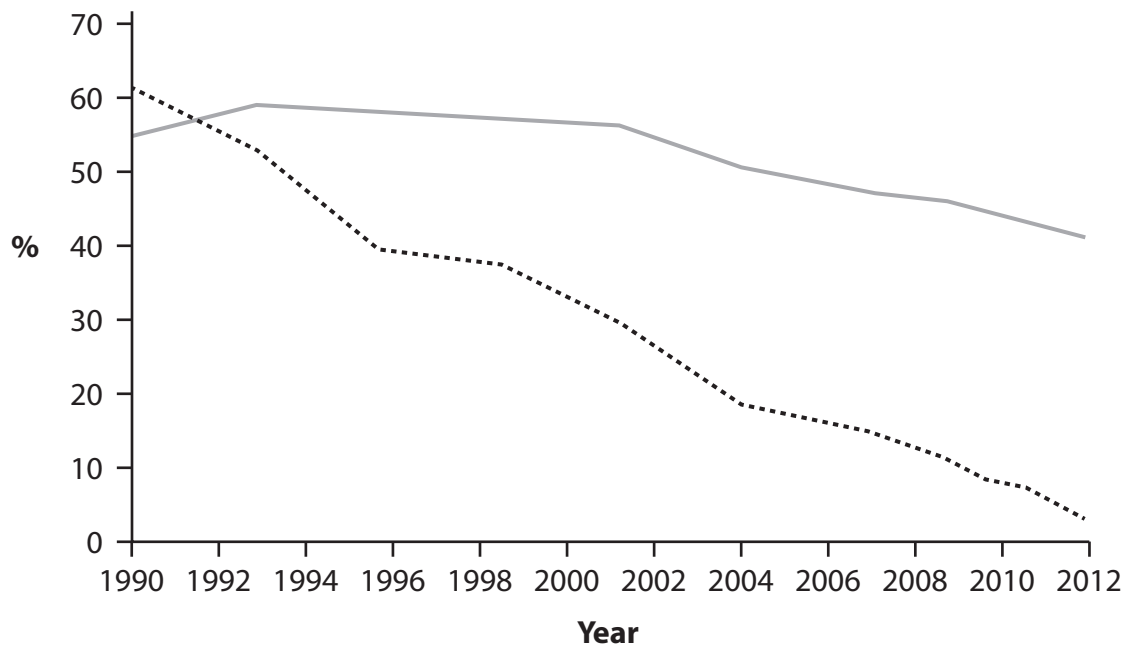
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### Question 3

#### Globalisation and Inequality

Figure 1: Proportion of population in absolute poverty (US\$1.90-a-day 2011 PPP)



**Key:**

— Sub-Saharan Africa

..... East Asia

(Source: <https://openknowledge.worldbank.org/bitstream/handle/10986/25078/9781464809583.pdf>)

## Extract A

### Lessons from globalisation

The past 25 years have seen a freeing up of trade. Capital has been free to move around the world. Formerly closed economies in Asia have been opened up and tariffs cut. In emerging economies, a billion people have been taken out of absolute poverty, but relative poverty remains a problem.

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In many advanced economies globalisation has come to mean, according to the Governor of the Bank of England, “low wages, insecure employment, stateless corporations and striking inequalities”. His solution to these problems is threefold: an acceptance by economists that not everybody has gained from trade and technology; a better mix of monetary policy, fiscal policy and structural reform to boost growth; and more inclusive growth. In essence, this is the same conclusion that was reached in the past when there was a fear that market forces had to be moderated to prevent capitalism from destroying itself.

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The good news is that this moderation of capitalism included real policy changes: an extension of the right to vote, the growth of trade unions, the creation of welfare states, a move to more progressive tax policies, nationalisation of key sectors of the economy, and more activist demand management.

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The bad news is that this process took about 100 years and was not completed until the end of the Second World War. What’s more, protectionism seems to be on the increase as countries seek to protect themselves from inequalities caused by rapid globalisation.

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(Source: adapted from <https://www.theguardian.com/business/2016/dec/05/mark-carney-globalisation-bank-of-england-capitalism>)

## Extract B

### Tackling inequality

Despite decades of substantial progress in boosting prosperity and reducing absolute poverty, the world continues to suffer from substantial inequalities. For example, the poorest children are four times less likely than the richest children to be enrolled in primary education across developing countries. Among the estimated 780 million illiterate adults worldwide, nearly two-thirds are women. Poor people face higher risks of malnutrition and death in childhood and lower chances of receiving key healthcare. Such inequalities result in high financial costs, limit economic growth, and generate social and political burdens and barriers. 5

These consequences highlight the importance of directing attention to the problem of inequality. There are other reasons to tackle inequality. Most economies are struggling to recover from the global financial crisis that started in 2008 and the subsequent slowdown in global growth. The goal of eliminating absolute poverty by 2030 might not be achieved without accelerated economic growth or reductions in inequalities within countries, especially in those with large numbers of poor. Generally speaking, poverty can be reduced through higher average growth, a narrowing in inequality, or a combination of the two. Achieving the same poverty reduction during a slowdown in growth therefore requires a more equal income distribution. 10 15

Some level of inequality is desirable to maintain an appropriate incentive structure in the economy or simply because inequality also reflects different levels of talent and effort among individuals. However, the substantial inequality observed in the world today offers great scope for reducing the gap between rich and poor. Policies to redistribute income from higher-income and wealthy households to those on lower incomes can be achieved without compromising growth, if done effectively. A trade-off between efficiency and fairness is not inevitable. 20 25

(Source: adapted from <https://openknowledge.worldbank.org/bitstream/handle/10986/25078/9781464809583.pdf>)



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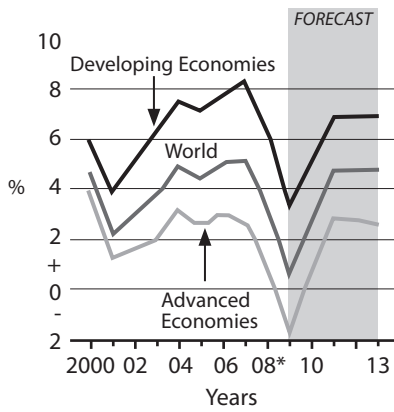


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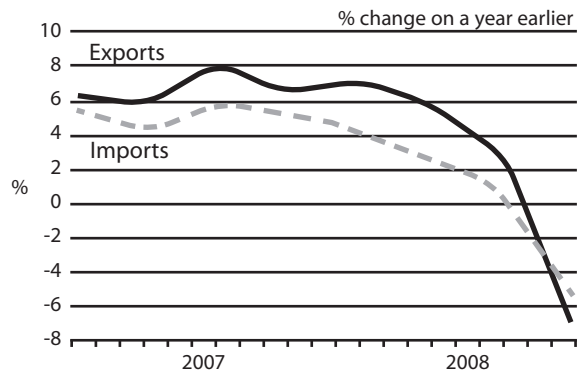


#### 4 The Global Financial Crisis

**Figure 1: Real GDP: % Change on Previous Year**

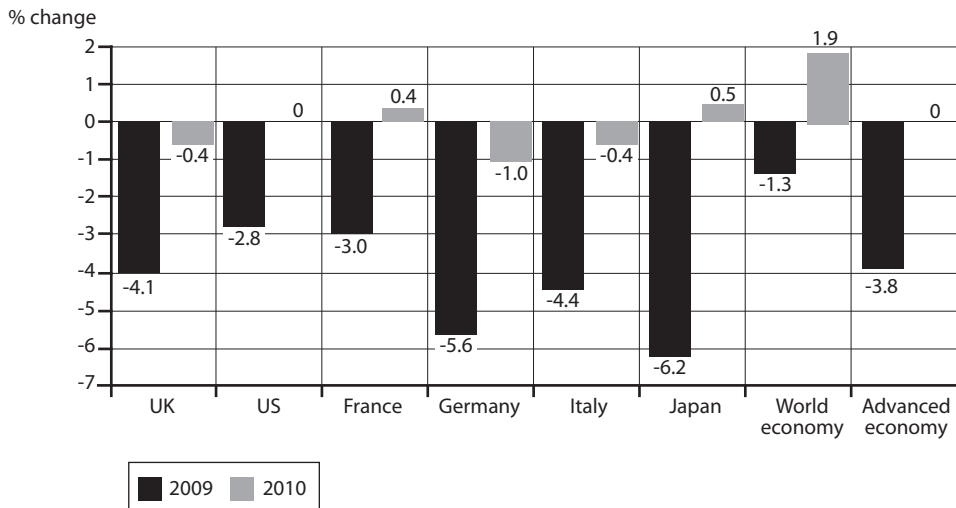


**Figure 2: Value of World Exports and Imports: % Change on a Year Earlier**



Source for Figure 1: *The Economist*, 21 February 2009 (Turning their backs on the world).  
 Source for Figure 2: *The Sunday Times*, 29 March 2009 (Export Giants sink most as World Trade Slumps by David Smith).

**Figure 3: Real GDP Forecasts in 2009 and 2010, selected countries (% change)**



Source: IMF.

## Extract 1: Globalisation in retreat?

Between 2000 and 2008 the value of world trade in goods and services rose by 12% a year. Free trade has made the biggest contribution to more than 60 years of global prosperity. However, a golden age of global trade has come to an abrupt end. The economic meltdown has popularised a new term: deglobalisation. For the first time for many years, trade and investment flows are declining, but is globalisation really ending? At the end of 2008, the International Monetary Fund (IMF) said the world economy would grow at 2.2% in 2009, but by March 2009 it expected negative growth of between 0.5% and 1% over the year. Moreover, this recession appears to be affecting most economies simultaneously.

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Falling trade has been the transmission mechanism from the financial crisis to the world's factories. In the second half of 2008 the value of trade fell: Pascal Lamy, the World Trade Organisation's (WTO) director-general estimates that world trade dropped by 5% in November 2008, by a further 7% in December and another 7% in January 2009.

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The downturn has been sharpest in the countries which opened up most to world trade, especially East Asia's tiger economies. Singapore's exports are 186% of GDP; its economy shrank at an annualised rate of 17% in the last three months of 2008. Taiwan's exports are 60% of its GDP and its economy may fall as much as 11% this year. The downturn will also hurt rich countries which specialise in manufacturing: the IMF forecasts a contraction of about 2%, but Germany and Japan, who are big exporters of capital goods, cars and electronics are expected to shrink by much more (see Figure 3).

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In contrast, the biggest emerging economies are doing less badly so far. In India, where exports are only around 15% of GDP, growth is expected to be 5% for 2009 and China was still growing by 6.8% in 2008.

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There are several reasons why the banking system's problems have affected trade so quickly. First, the global recession is more severe than most thought possible. Secondly, according to the World Bank, global supply chains mean that a downturn quickly spreads. The trade interdependence of economies has rapidly transmitted the recession around the globe. Another problem is that trade finance has dried up. Firms have found it difficult to get export credits, without which they cannot do business.

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A further issue is that the world recession is leading to protectionism. Lamy identifies several types, including import tariffs and subsidies to support industries which have faced difficulties.

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Financial deglobalisation is hitting countries in a variety of ways. Foreign direct investment (FDI) fell by 21% in 2008 and is expected to fall a further 12%-15% in 2009. Rich countries seem to have suffered most so far. They have seen FDI falls of 33% on average and by 50% or more in Britain, Italy and Germany while Finland and Ireland have seen net outflows. FDI flows to developing countries were still growing in 2008, but by only 4%, after a rise of 20% in 2007. Flows to big South American countries were up by about 20% and those to India more than 100%.

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Meanwhile, small countries that developed industries such as tourism, which grew as a result of globalisation, are also suffering. The WTO says international tourist numbers fell 1% in the second half of 2008, which may not sound bad, but this compares with growth of more than 5% per annum in the previous four years. In the Caribbean, visitors may fall by 33% this season: hotels are half empty, flights are being cancelled and fiscal deficits are rising.

Source: adapted from *The Economist*, 21 February 2009 'Turning their backs on the world' and *The Sunday Times*, 29 March 2009 'Export giants sink most as world trade slumps' by David Smith.



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**END OF SECTION B (Total for Question 4 = 12 marks)**