A Level · AQA · Economics

2 hours   16 questions

Exam Questions

12. Financial Markets & Monetary Policy

Financial Markets / Financial Assets / Commercial & Investment Banks / Central Banks & Monetary Policy / Monetary Policy Transmission Mechanisms / Regulating the Financial System

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Total Marks **/102**

1 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)

2 All other things being equal, in which one of the following circumstances is the Bank of England most likely to raise Bank Rate to maintain financial stability?

A. A fall in bank liquidity and capital ratios following several years of rapid growth in bank lending and a boom in house prices

B. An increase in the government's target for the rate of inflation following a significant increase in the rate of productivity growth

C. An increase in the savings ratio as the economy recovers from a recession

D. A rise in share prices on global stock markets due to the growth in world trade

(1 mark)

3 **Table 2** shows the inflation rate and the rate of growth of the money supply for an economy between 2016 and 2019.

Table 2

Year	Inflation	Rate of growth of money supply
2016	3.1%	3.5%
2017	3.5%	3.3%
2018	2.9%	3.2%
2019	2.5%	2.0%

From the data in **Table 2** it may be concluded that, all other things being equal, there was

A. a fall in the value of money throughout the entire period.

B. a policy of quantitative easing in operation throughout the entire period.

C. an inverse relationship between inflation and the rate of growth of the money supply.

D. continuous disinflation throughout the entire period.

(1 mark)

4 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)

5	**Essay 2:**
	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.

Explain how the monetary policy transmission mechanism works when the Monetary Policy Committee (MPC) raises Bank Rate.

(15 marks)

6 Essay 2

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

(25 marks)

7 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)

8 Despite its central bank operating a policy of quantitative easing for several years, an economy has rising unemployment and a rate of inflation significantly below the target rate set by the government. All other things being equal, which one of the following actions is the central bank most likely to take in order to meet the target for inflation?

A. A policy leading to an appreciation of the exchange rate.

B. An increase in its base rate of interest and the reversal of its quantitative easing policy.

C. Providing forward guidance indicating that the bank will continue with its programme of quantitative easing.

D. Selling some of its stock of government bonds to other financial institutions.

(1 mark)

9 Extract F: A new financial crisis?

Has increased regulation worked or could the UK be on the verge of another financial crisis? The Bank of England is keeping a close watch on consumer spending amid signs that households are reducing their savings and building up debts. The Governor of the Bank, Mark Carney, said that consumption has been high in recent times, helping the economy, but he repeated the warning that living costs were likely to rise on the back of a weak pound and put a strain on households' real incomes. He also stated: "The saving ratio has fallen towards its pre-crisis lows, and consumer borrowing has accelerated noticeably."

It can be argued that rising borrowing has been caused by Bank Rate being kept too low for too long. The Austrian economist, Friedrich Hayek, highlighted artificially low interest rates and excessive credit creation as being the main causes of cyclical instability, damaging both investment and confidence. Asset price bubbles occur, including unsustainable rises in house prices, and eventually boom turns to bust. A major cause of the financial crisis in 2007/08 was arguably the unsustainably high level of debt that had been accumulated, but total world debt is now far in excess of the 2008 level.

Some form of financial crisis appears to occur every 7 to 10 years. As inflation rises, there will come a time when the Monetary Policy Committee decides to increase Bank Rate. This will affect many people who have become accustomed to cheap credit and who are tied into mortgages where the monthly repayments vary with interest rates.

Source: News reports, 2016

Extract F (lines 10–12) states 'The Austrian economist, Friedrich Hayek, highlighted artificially low interest rates and excessive credit creation as being the main causes of cyclical instability.'

Using the data in the extracts and your knowledge of economics, evaluate the view that maintaining low interest rates for a sustained period of time may be damaging to the UK's macroeconomic stability.

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(25 marks)

10 In recent years, several central banks around the world have implemented a policy of quantitative easing (QE). All other things being equal, which one of the following combinations **A**, **B**, **C** or **D**, is most likely to be the result of this policy?

	Bank liquidity	Bond prices	Long-term interest rates
A	Decrease	Fall	Rise
B	Increase	Fall	Rise
C	Decrease	Rise	Fall
D	Increase	Rise	Fall

(1 mark)

11 A large, unexpected decline in house prices could lead to a systemic crisis in the financial system.

This is most likely to happen if, following the fall in house prices, commercial banks and building societies

A. have a low ratio of capital to their total assets.

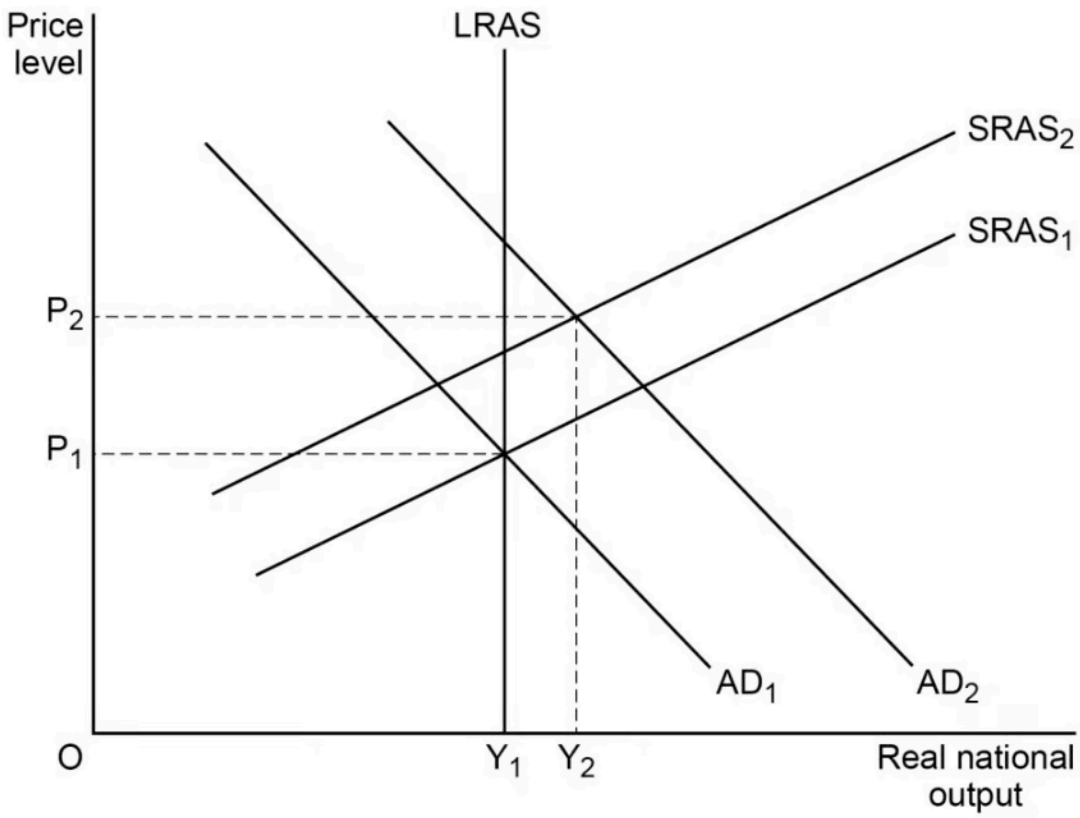
B. have followed Prudential Regulation Authority (PRA) guidance to reduce the amount they lend to high-risk borrowers.

C. have the option to use the Bank of England as the lender of last resort.

D. hold a high proportion of liquid assets on their balance sheets.

(1 mark)

12 The diagram below shows two aggregate demand (AD) curves, two short-run aggregate supply (SRAS) curves, and the long-run aggregate supply (LRAS) curve for an economy.



The increase in the price level from P_1 to P_2 raises the rate of inflation above the target rate set by the government. In an attempt to bring inflation back to its target rate, the central bank announces a change in interest rates. Other things being equal, this is most likely to

A. create upward pressure on the exchange rate.

B. increase bond prices.

C. make business loans more affordable.

D. reduce the cost of servicing the national debt.

(1 mark)

13 Extract F: The Japanese problem

If the UK wishes to see another economy's experience of when deflation turns bad, then it only needs to look at Japan. Over the last two decades, Japan has used a variety of policies in an attempt to overcome deflation. For almost 20 years, the Bank of Japan's main interest rate has hovered around 0% and at times been negative. Japan has embarked on several fiscal stimulus programmes, although with a debt to GDP ratio of 245% in 2015, some see this as a worry. Furthermore, the Bank of Japan is currently carrying out quantitative easing equivalent to approximately £500bn per year. So far, the Japanese economy has not escaped from the risk of deflation.

So what can the UK learn from Japan? For much of 2015, CPI inflation in the UK was at, or very close to, 0%. Consumer spending is fairly robust at the moment but if economic agents anticipate falling prices, they may begin to factor this into their expectations. This could lead to bad deflation which can be very difficult to tackle effectively.

In recent times, the UK has arguably seen a stronger recovery than many other developed economies, although there is uncertainty over what should be done to maintain this in the future. After the financial crisis of 2007/08, UK Bank Rate was reduced to an historic low of 0.5%, and although it has since been cut to 0.25%, there is little scope to reduce it much further. The Bank of England has also used quantitative easing to try to stimulate the economy. However, the results of this are debatable. In terms of fiscal policy, the current government appears to be determined to continue with its austerity programme. What is not clear is what should be done if low inflation turns to bad deflation.

Source: News reports, 2016

Extract F (lines 19–20) states 'What is not clear is what should be done if low inflation turns to bad deflation.'

Using the data in the extracts and your knowledge of economics, evaluate the view that monetary policy is the most effective way of tackling deflation in developed economies such as the UK and Japan.

(25 marks)

14 A bank makes a new loan to a customer. All other things being equal, which combination of events, **A**, **B**, **C** or **D**, shows what will happen?

	Bank's liabilities	**Bank's assets**	**Money supply**
A	Increase	Increase	Increases
B	Increase	Fall	Increases
C	Fall	Increase	Falls
D	Fall	Fall	Falls

(1 mark)

15 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)

16 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)