AQA - A Level Economics

The national and international economy

12.2 Financial markets and monetary policy

Worked Examples

Contents

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12.2 Financial markets and monetary policy

Exam Style Question 1

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

(b) Explain **one** reason why the UK central bank used quantitative easing following the Global Financial Crisis of 2008. **[2]**

(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

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Exam Style Question 1

Answer:

(a) Explain one role of financial markets. [2 marks]

One role of financial markets is to **mobilise savings** (1), which can then be used for **lending to businesses and individuals** so they can invest in things like new equipment or houses (1).

(b) Explain one reason why the UK central bank used quantitative easing following the Global Financial Crisis of 2008. [2 marks]

The UK central bank used **quantitative easing to increase the money supply** (1), which helped to **stimulate economic growth** during a time when interest rates were already very low and couldn't be cut further (1).

(c) Which one of the following would be the most likely cause of market failure in the financial sector? [1 mark]

✅ **Correct Answer: C –** Banks know that the government will bear the risk of customers defaulting on loans

Explanation:

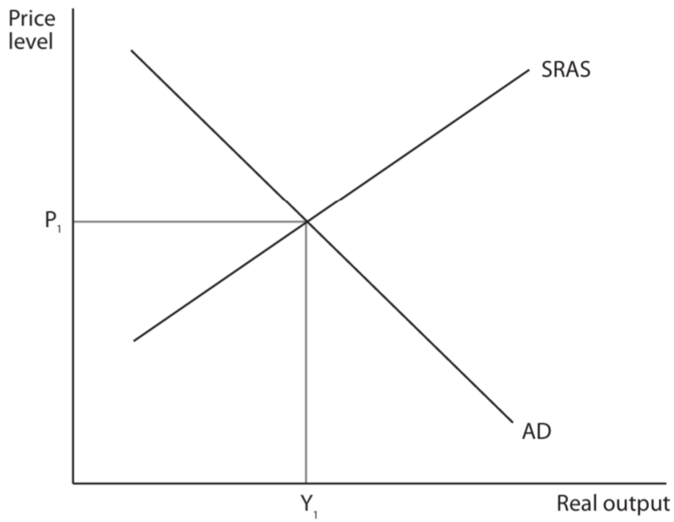
This is known as **moral hazard** where banks take more risks because they expect the government to bail them out if things go wrong, which can lead to market failure.

Exam Style Question 2

In August 2018 the Monetary Policy Committee of the Bank of England raised the UK's base interest rate from 0.5% to 0.75%.

(a) Define the term 'interest rate'. **[1]**

(b) Annotate the aggregate demand (AD) and short-run aggregate supply (SRAS) diagram below to show the possible impact of a rise in the base interest rate on the equilibrium level of real output and the price level. **[2]**



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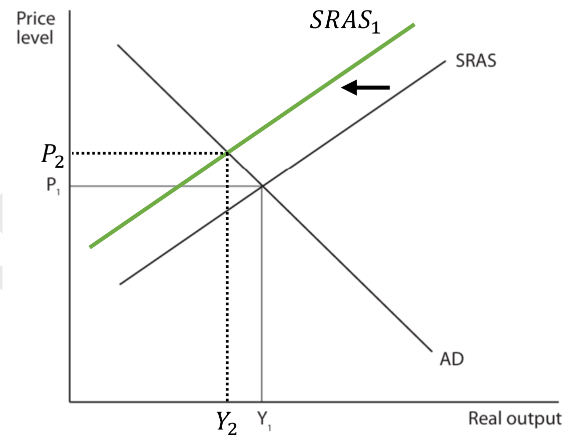
Exam Style Question 2

Answer:

(a) Define the term 'interest rate'.

The **interest rate** is the cost of borrowing money or the reward for saving money, expressed as a percentage. When you take out a loan, it's the extra amount you pay back to the lender. **[1]**

(b) Annotate the diagram to show the impact of a rise in interest rates.



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Exam Style Question 3

The UK has experienced a budget deficit since 2001. The government aimed to reach a budget surplus by 2019, but in 2016 this target was abandoned.

(Source: adapted from https://www.gov.uk/government/news/autumn-statement-2016-some-of-the-things-weve-announced)

(a) Explain **one** likely reason why the 2019 budget surplus target was abandoned. **[2]**

(b) Explain the likely impact of abandoning the budget surplus target on the UK national debt. **[2]**

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Exam Style Question 3

Answer:

(a) Explain one likely reason why the 2019 budget surplus target was abandoned.

One key reason why the UK abandoned its budget surplus target in 2016 was the economic uncertainty following the Brexit referendum. The decision to leave the EU created instability in financial markets, lowered business confidence **[1]**, and slowed economic growth. To avoid further economic downturn, the government chose to continue borrowing and spending rather than cutting expenditures or increasing taxes to achieve a surplus. **[1]**

(b) Explain the likely impact of abandoning the budget surplus target on the UK national debt.

By not achieving a budget surplus, the UK continued to spend more than it collected in revenue, which meant the government had to keep borrowing. **[1]** This increased the national debt **[1]** because the country had to finance its spending through loans, leading to higher interest payments in the future.

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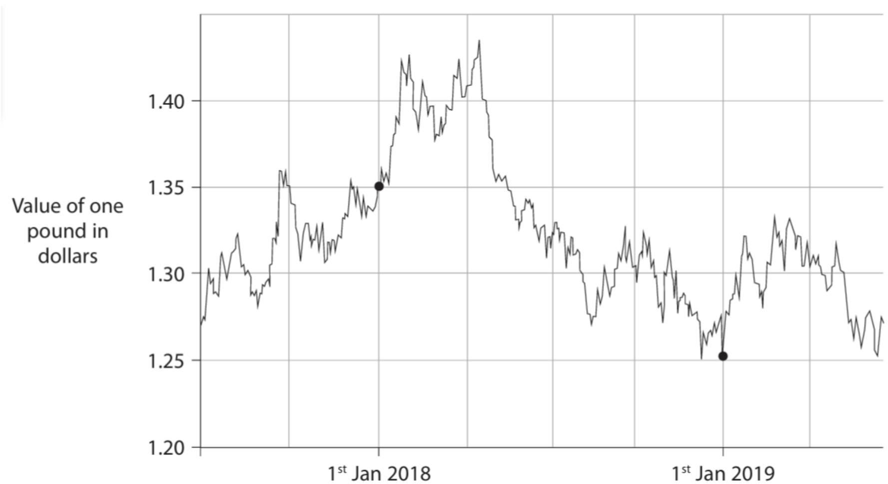
Exam Style Question 4

British pound to US dollar exchange rate (value of one pound in dollars), June 2017 to June 2019.



(Source adapted from: https://www.xe.com/currencycharts/?from=GBP&to=USD&view=2Y)

(a) Which **one** of the following has been the overall change in the British pound to US dollar exchange rate from 1st Jan 2018 to 1st Jan 2019?

[1]

A Appreciation

B Depreciation

C Devaluation

D Revaluation

(b) Explain the likely impact of the change in the exchange rate of the pound shown in the graph from 1st Jan 2018 to 1st Jan 2019 on the UK current account of the balance of payments. **[4]**

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Exam Style Question 4

Answer:

(a) Which one of the following has been the overall change in the British pound to US dollar exchange rate from 1st January 2018 to 1st January 2019?

✅ **Correct answer: B –** Depreciation **[1]**

Why the other answers are wrong:
A – wrong as the pound has fallen in value
C and D – wrong as the pound-dollar is a floating exchange rate system

(b) Explain the likely impact of the change in the exchange rate on the UK current account of the balance of payments.

The **current account** is part of a country's balance of payments and mainly records exports and imports of goods and services, as well as income from investments.

Between 1st January 2018 and 1st January 2019, the value of the British pound **depreciated** against the US dollar, falling from around **$1.35 to $1.26**. **[1]**
A **depreciation** means that the pound is worth less in terms of other currencies. This makes **UK exports cheaper** for foreign buyers and **imports more expensive** for people in the UK. **[1]**

As a result, UK exports are likely to increase because they're more competitive abroad, and imports are likely to fall because they now cost more. This would likely lead to an **improvement in the UK's current account** meaning a smaller deficit or even a surplus. **[2]**

This assumes that the **Marshall-Lerner condition** is met (i.e. the total demand for exports and imports is elastic enough to respond to price changes).

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Please see the '12.1 Financial markets and monetary policy Revision Notes' pack for detailed notes.

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