# ECO.MAC11 Financial Markets: Structure, Functions and Types of Asset

Total Marks

AQA 7136 · Calculators not allowed · about 75 minutes

Name: ________________________________ Date: ____ / ____ / ______

**Answer all questions. Write full sentences for the extended 25-mark essay only. A calculator is not required. Allow about 60 minutes for the short questions and 15 minutes for the essay.**

**1** Define the money market in the context of the UK financial system and state its main function for short-term finance and liquidity management.

**(Total for Question 1 is 2 marks)**

**2** Define the capital market in the UK context and give one clear example of an instrument traded there and its purpose.

**(Total for Question 2 is 2 marks)**

**3** Define the foreign exchange market (forex) and state one of its functions in supporting international trade settlement and currency conversion.

**(Total for Question 3 is 2 marks)**

**4** Define a share (equity) as a financial asset and state one contractual or residual claim that a shareholder holds on the issuing company.

**(Total for Question 4 is 2 marks)**

**5** Define a government bond or gilt in UK financial markets and state what typically distinguishes it from a corporate bond.

**(Total for Question 5 is 2 marks)**

**6** Define a corporate bond as a financial asset and state one reason a firm issues a corporate bond rather than selling more shares.

**(Total for Question 6 is 2 marks)**

**7** Define a forward contract in financial markets and give one practical use of a simple forward contract by a UK exporter or importer.

**(Total for Question 7 is 2 marks)**

**8** Scenario: A UK manufacturing firm borrows overnight funds from a bank to cover payroll today, planning to repay on the next business day. Identify which type of financial market this transaction belongs to and explain briefly why.

**(Total for Question 8 is 2 marks)**

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**9** Distinguish between the spot foreign exchange market and a forward foreign exchange contract, and state one consequence for a firm choosing a forward rather than a spot transaction.

**(Total for Question 9 is 3 marks)**

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**10** Distinguish between primary and secondary capital markets, and state one advantage for a company of listing its shares on the secondary market after a primary issuance.

**(Total for Question 10 is 3 marks)**

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**11** Explain the difference between an equity investor and a bond investor in terms of claims on income and priority on the firm's assets in the event of liquidation, and state one implication for expected returns.

**(Total for Question 11 is 3 marks)**

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**12** Extended essay: Evaluate the view that well functioning financial markets are essential for the efficient allocation of capital and the broader performance of the UK economy. In your answer, analyse mechanisms such markets provide, consider limitations and counterarguments, and reach a supported judgement. You may draw simple diagrams to support your explanation; if you do, describe the diagram you would draw.

Evaluate the view that well functioning financial markets are essential for the efficient allocation of capital and the broader performance of the UK economy.

**(Total for Question 12 is 25 marks)**

# Mark scheme · ECO.MAC11 Financial Markets: Structure, Functions and Types of Asset

### Question 1

- **B1** a market for short-term borrowing and lending of funds and securities, typically with maturities under one year, such as Treasury bills and commercial paper
- **B1** its main function is to provide short-term liquidity and enable firms, financial institutions and the government to manage cash flow and meet short-term financing needs
- **Answer: A market for short-term borrowing and lending (assets with maturities under one year) such as Treasury bills and commercial paper; it provides liquidity and short-term funding.**

### Question 2

- **B1** a market for medium to long-term finance, where firms and governments raise capital through instruments like equities and long-term bonds
- **B1** valid example: shares listed on the London Stock Exchange, used by firms to raise equity finance
- **Answer: A market for medium to long-term finance trading equities and long-term bonds; example: shares on the London Stock Exchange, used to raise equity finance.**

### Question 3

- **B1** a market for buying and selling different currencies, where exchange rates are determined by supply and demand
- **B1** function: to convert one currency into another so importers and exporters can settle cross-border payments, and to facilitate currency risk management
- **Answer: A market for exchanging currencies where exchange rates are set; it enables conversion of payments for imports and exports and helps firms settle international trade.**

### Question 4

- **B1** a share is a unit of ownership in a company giving a claim on a proportion of the firm's residual profits and assets
- **B1** claim example: entitlement to a share of dividends or voting rights at shareholder meetings
- **Answer: A share is ownership of part of a company giving a residual claim on profits and assets; shareholders may receive dividends or have voting rights.**

### Question 5

- **B1** a government bond or gilt is a debt security issued by the government promising periodic interest payments and repayment of principal at maturity
- **B1** distinguishing point: gilts are government backed and typically carry lower default risk than corporate bonds issued by private firms
- **Answer: A gilt is government debt with periodic interest payments and repayment at maturity; it is typically lower risk than a corporate bond because it is government backed.**

### Question 6

- **B1** a corporate bond is a debt instrument issued by a firm agreeing to pay fixed interest (coupon) payments and repay principal at a set maturity date
- **B1** reason: firms may issue bonds to avoid diluting existing owners equity, to access fixed-rate long-term finance, or because interest payments may be cheaper than the cost of equity
- **Answer: A corporate bond is a debt instrument where a firm agrees fixed interest payments and to repay principal at maturity; firms issue bonds to raise finance without diluting ownership and often at a lower cost than equity.**

## Question 7

- **B1** a forward contract is an agreement to buy or sell an asset or currency at a specified price on a specified future date, typically arranged OTC between two parties
- **B1** use example: an exporter can lock in an exchange rate to hedge future foreign currency receipts, reducing uncertainty over the value of export earnings
- **Answer: A forward contract is an agreement to buy or sell an asset or currency at a set price on a future date; a UK exporter might use it to lock in an exchange rate to hedge future foreign currency receipts.**

## Question 8

- **B1** identifies the money market
- **B1** reason: the loan is very short term liquidity borrowing, typical of money market instruments and interbank/short-term funding
- **Answer: Money market, because this is very short-term borrowing to manage liquidity, characteristic of the money market.**

## Question 9

- **B1** spot forex is immediate exchange of currencies at the current market exchange rate
- **B1** a forward contract locks in an exchange rate today for a currency exchange at a specified future date
- **B1** consequence: using a forward removes exchange rate risk but may prevent benefiting from a favourable spot rate movement
- **Answer: Spot forex exchanges currencies immediately at the current rate; a forward locks in a rate today for a future date. Forwards remove exchange rate risk but stop a firm from benefiting if the spot rate moves favourably later.**

## Question 10

- **B1** primary markets are where new securities are issued and sold for the first time, raising funds for issuers
- **B1** secondary markets are where existing securities are traded between investors after the initial issuance
- **B1** advantage: a liquid secondary market can make it easier and cheaper for the company to raise future finance and provides price discovery and reputational benefits
- **Answer: Primary markets issue new securities to raise funds; secondary markets trade existing securities among investors. Listing on a liquid secondary market aids price discovery, enhances the companys reputation and makes future fundraising easier.**

## Question 11

- **B1** equity investors hold residual claims on profits (dividends) and ownership rights, returns are uncertain
- **B1** bond investors have contractual claims to fixed interest payments and are higher priority creditors on assets in liquidation
- **B1** implication: equities typically offer higher expected returns to compensate for greater risk and lower priority, while bonds offer lower but more predictable returns
- **Answer: Equity investors have residual claims on profits and ownership rights with uncertain dividends; bond investors have contractual interest claims and higher priority on assets in liquidation. Therefore equities tend to offer higher expected returns to compensate for higher risk, while bonds give lower but steadier returns.**

### Question 12

- **Level 1** (1-5): Simple statements about one or two ways financial markets operate with limited development, little use of theory or examples and no sustained judgement.
- **Level 2** (6-10): Some accurate analysis of how markets allocate capital and support economic activity, with sound examples and some recognition of limitations, but evaluation is partial and conclusion is weak or implied.
- **Level 3** (11-15): Clear analysis of mechanisms by which markets promote efficient capital allocation and wider economic performance, explicit consideration of limitations and counterarguments, use of examples and diagrams where appropriate, and a well supported judgement.
- **Level 4** (16-20): Detailed and well-developed analysis, balancing benefits and limitations, showing command of relevant theory (e.g. price discovery, liquidity, risk sharing, intermediation) and realistic evaluation of real world frictions, with a reasoned and supported conclusion.
- **Level 5** (21-25): Comprehensive evaluation: multiple analytical strands, nuanced understanding of strengths and limits of markets, insightful consideration of policy trade-offs and distributional consequences, relevant diagram description and a balanced, supported judgement that addresses the question fully.
- **Indicative content:**
  - Mechanisms: price discovery for capital allocation, liquidity provision allowing investors to buy and sell, risk sharing via diversification and derivatives, maturity transformation and intermediation by banks enabling savers to fund borrowers.
  - How these mechanisms help: allocating funds to the most productive projects, enabling firms to invest, supporting consumption smoothing, and facilitating international trade via forex and forward markets.
  - Examples: equities allowing start ups to access growth capital; corporate bonds funding long term investment; money markets providing liquidity to manage short term needs; forward contracts hedging currency risk for exporters.
  - Diagram: AD/AS style or a simple supply of loanable funds diagram showing savings flowing through financial intermediaries to investment, with arrows labelled liquidity, risk sharing, and price signals. If drawn, label axes and show movement that better intermediation raises investment at each interest rate.
  - Limitations and counterarguments: market imperfections such as transaction costs, information asymmetries, and regulatory constraints can impede efficient allocation; short-termism, mispricing or speculative activity can misallocate capital; liquidity does not guarantee productive investment if incentives are wrong.
  - Policy considerations: the role of regulation to ensure transparency and stability, trade-offs between market freedom and consumer protection, and the importance of institutions such as credit rating agencies and central banks.
  - Distributional and macro effects: functioning markets can support growth and employment but may raise inequality if gains concentrate among asset holders; financial deepening can increase risk of cycles if not well regulated.
  - Judgement: a balanced conclusion weighing the strong role markets play in allocating capital and supporting economic activity against plausible real world frictions and the need for appropriate regulation and institutional frameworks.