2.14 Financial Market Failure, the 2007-08 Crisis and Regulation: Test Pack

Total Marks

AQA 7136 · Calculators not allowed · about 20 minutes

Name: _____ Date: ____ / ____ / _____

Answer all questions. Full sentences are required for questions worth 3 marks or more. Timed guidance: 20 minutes in total.

1 Multiple choice question on asymmetric information in financial markets, context: mortgage lending before 2007 in the UK and US.

- ☐ A: Lenders had better information than borrowers about borrowers' true ability to repay
- ☐ B: Borrowers had better information than lenders about their own repayment risk
- ☐ C: Regulators had perfect information about bank balance sheets
- ☐ D: Investors and banks had symmetric information about mortgage risk

(Total for Question 1 is 1 mark)

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2 Explain briefly the purpose of the Bank of England's Financial Policy Committee (FPC) and the Prudential Regulation Authority (PRA) created after the crisis, in terms of reducing systemic risk and improving microprudential supervision.

(Total for Question 2 is 2 marks)

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3 Define the term 'moral hazard' as it applies to banks and the expectation of government bailouts during the 2007-08 crisis.

(Total for Question 3 is 2 marks)

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4 Explain what an asset price bubble is and how speculative behaviour can sustain such a bubble in housing markets prior to 2007.

(Total for Question 4 is 3 marks)

5 Explain briefly the role of excessive leverage in banks' balance sheets as a cause of financial market failure in 2007-08.

(Total for Question 5 is 2 marks)

6 Explain two ways in which the credit crunch after 2007-08 affected the wider economy.

(Total for Question 6 is 3 marks)

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Question 1

Correct option B **B1**

Answer: B

Question 2

FPC: macroprudential body tasked with identifying and addressing system-wide financial risks, for example by adjusting countercyclical capital buffers or using sectoral tools to curb credit booms **M1**

PRA: microprudential regulator supervising individual banks to ensure safety and soundness, setting capital and liquidity requirements and enforcing resilience of firms **A1**

Answer: The FPC monitors and acts on system-wide risks using macroprudential tools like countercyclical buffers, while the PRA supervises individual banks to ensure safety and enforce capital and liquidity standards.

Question 3

an increase in risk-taking when an economic agent does not bear the full consequences of its actions **B1**

applied: banks may take excessive risks if they expect government bailouts, shifting losses to taxpayers **B1**

Answer: Moral hazard is increased risk-taking when agents do not bear full costs; banks expecting bailouts may therefore take excessive risks.

Question 4

an asset price bubble is a sustained and large positive deviation of asset prices above fundamental values **M1**

speculative behaviour occurs when buyers purchase expecting future price rises rather than for underlying value **M1**

expectations of continuing price rises can become self-fulfilling, sustaining the bubble until a shock or loss of confidence triggers a collapse **A1**

Answer: A bubble is prices far above fundamentals; speculation buys on expected price rises, which can sustain prices until confidence collapses and the bubble bursts.

Question 5

excessive leverage means banks held large amounts of assets funded by relatively small equity, magnifying losses when asset prices fell **M1**

large losses relative to capital meant banks became insolvent or illiquid quickly, spreading fear and triggering a credit crunch **A1**

Answer: High leverage amplified losses when housing assets fell, rapidly eroding bank capital and helping turn mortgage defaults into systemic insolvency and a credit crunch.

Question 6

reduced lending led to lower investment and consumption, causing a fall in aggregate demand and output **M1**

tightened credit increased borrowing costs and business failures, raising unemployment and deepening recession **M1**

together these channels explain how a banking-sector shock transmitted to a prolonged real-economy downturn **A1**

Answer: Reduced lending cut investment and consumption, lowering AD and output; higher borrowing costs and credit constraints caused business failures and unemployment, transmitting the banking shock into a recession.

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