Paper 3 Sample Essays [Free Version]

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Expert Tuition Managing Director, Ahmed Alaskary, has put this revision pack together to help students with their A-Level Economics revision. Ahmed has over 10 years experience teaching A-Level Economics, with a particular expertise in the Edexcel examination board.

This pack is intended to supplement a students learning and **should not** be used as an alternative to thorough revision of the specification. The intention is to show students how they can apply their knowledge to exam-style questions. The essays are a combination of amended past papers (adjusted for the new specification) and other questions based on the specification.

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Marks Breakdown[1]

5 Mark Question:

Knowledge 1, Application 1, Analysis 3

8 Mark Question:

Knowledge 2, Application 2, Analysis 2, Evaluation 2

12 Mark Question:

Knowledge 2, Application 2, Analysis 4, Evaluation 4

25 Mark Question:

Knowledge 4, Application 4, Analysis 8, Evaluation 9

[1] *We strongly recommend that students familiarise themselves with the mark scheme and in particular, as part of their revision, read through Examiner Reports for questions they find difficult when studying.*

Evaluate the likely microeconomic and macroeconomic effects of market failure in the financial sector[2][25]

Market failure is where the free market economy fails to allocate resources efficiently. The Global Financial Crisis of 2008[3] is a clear example of how market failure in this sector can have wide-ranging and long-lasting negative effects on the economy.

One microeconomic effect of market failure in the financial sector is that individual homeowners could suffer from negative equity. This is where the mortgage debt exceeds the value of the property and thus, homeowners would not be able to sell their house without owing money to their mortgage lender. When the housing bubble popped, it resulted in a dramatic fall in house prices – this meant that if an individual had borrowed £240,000 for a property that was initially valued at £300,000, when the value of that house fell to £100,000, they could not walk away from the property without owing money to the lender. Given this, it could create geographical immobility, as workers would not be able to move from one area to another to take up a job as they could not sell their property without incurring enormous losses. As such, the collapse of the housing market and resulting market failure would have resulted in significant geographical immobility of labour – creating further market failure in the labour market.[4]

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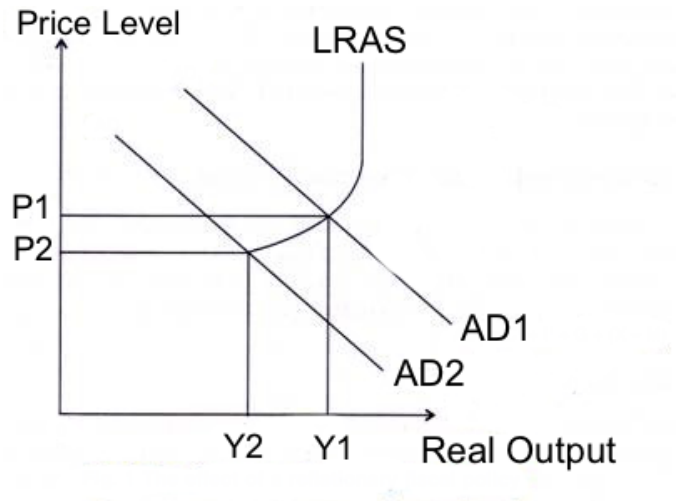
[2] *It can be very tempting for a question like this to simply speak about what happened in the Financial Crash or to go through different types of market failure in the financial sector. This would be incorrect as the question is asking about the effects of market failure, so avoid the storytelling approach.*

[3] *In the US, there was a bubble in the housing market that was caused by subprime mortgages being provided to individuals who stood no chance of paying off their debt in the long run. In many instances, individuals were able to get onto the property ladder without needing to show proof of income, without a down payment and without a thorough credit history check. These are known as subprime mortgages. The banks were unconcerned since the value of housing was rising, so even when those individuals defaulted, they would have the asset and sell it on for a profit. The mortgages were packaged together as collateralised debt obligations (CDOs), which were then sold to other banks and investors around the world. Many CDOs were bought by investors and financial institutions who, suffering from asymmetric information, did not realise that many of the mortgages that made up their CDO were subprime mortgages that would inevitably default. Unsurprisingly, these individuals began to default on their mortgage as they could not continue to pay and thus, the bank repossessed their house and put it up for sale. However, given that default rates were high, the supply of houses on the market resulted in a significant fall in house prices – in other words, the housing bubble popped. This meant that those who had CDOs found that the asset was almost worthless since it relied on people paying their mortgages for it to pay out. Given this, institutions and investors suffered huge losses and there was a significant negative wealth effect. The essay explains some of the problems that arose from this market failure, but we would strongly recommend students watch the video titled 'The Crisis of Credit Visualized' by Jonathan Jarvis on YouTube. It does an excellent job of explaining the crisis!*

[4] *You could evaluate this point by discussing how house prices have risen again in the UK since the crash – especially in London.*

A macroeconomic effect of market failure in the financial sector is that it resulted in a negative wealth effect. This is where individuals feel less confident as the value of their assets have fallen – house prices tumbled and the value of shares fell by approximately 1906% between 2008 and 2009. The fall in consumer confidence would result in a fall in consumption. AD = C + I + G + (X-M) and so a fall in consumption would shift AD inwards. Also, in the UK, consumption accounts for approximately 66% of AD and so, a fall in consumption would be significant.



The fall in consumer confidence and consequent fall in consumption causes AD to shift inwards from AD1 to AD2. As a result, economic growth falls from Y1 to Y2 and unemployment rises as the economy moves towards spare capacity. The UK economy contracted by 2.2% in the fourth quarter of 2008 and the UK suffered from a negative output gap.

A significant macroeconomic consequence of the financial crisis is that it increased the UK's fiscal deficit and national debt. A fiscal deficit is where government spending exceeds taxation in one year and national debt is the accumulation of all unpaid fiscal deficits up to that point. The 2008 crash negatively affected both the structural and cyclical deficits. This is because the UK government was forced to bailout several banks such as RBS, Lloyds and Northern Rock. The bank rescue package cost the government approximately £500 billion and thus, the structural deficit dramatically increased. Also, given that the UK economy was pushed into a recession in 2009 due to the scale of the crisis, this would have increased the cyclical deficit. The government would have received less tax revenue in terms of income taxes as more people were unemployed, indirect taxes as spending was low due to negative wealth effects and low consumer confidence, and corporation tax as firms profits were falling. At the same time, the government would automatically have been paying out more in unemployment benefits. As such, the market failure in the financial sector resulted in a substantial increase in UK national debt.

However, since 2010 the UK government has embarked on an austerity programme to reduce the size of the national debt. Austerity is significant cuts to government spending and increases in taxation. Also, some of the assets purchased by the government during the crisis have started to be sold off. For example, Northern Rock was sold to Virgin – although it is estimated that they made a £400 million loss. Furthermore, the UK economy has slowly started to recover and thus, the cyclical deficit has decreased. The rate of unemployment has fallen from approximately 8.4% in 2011 to 4.8% in 2016 – given this, the government could be receiving more tax revenue and paying out less in unemployment benefits.

Another microeconomic effect arising from market failure during 2008 was that individuals and firms struggled to attain credit[5]. The severity of the losses made by the banks led to several banks receiving government bailouts and a large fall in the amount of credit being issued to consumers. If banks are unwilling to lend, this can create cash flow problems for firms and individuals, who could struggle to continue operating. For example, if a firm has bills to pay but insufficient money in its account, they would normally go to the bank to get a loan until they generate enough to pay this back with interest. However, the credit crunch meant that access to credit was restricted and thus, a firm might shutdown when financial markets do not function efficiently.

However, the Central Bank in the UK, US and EU all cut interest rates during the financial crisis. In the UK, interest rates were cut to 0.5% and the Bank of England also adopted a Quantitative Easing Programme. This is where the central bank purchased illiquid assets off the commercial banks such as UK government bonds (gilts) using electronic money, as a means of increasing liquidity in the financial system.[6] Given this, individuals and firms should have more access to credit as the banks have more liquidity and can borrow from the central bank at near 0% interest.[7]

Furthermore, the extent of the damage caused by market failure in the financial markets depends on the structure of the economy. In the UK, the financial services sector is a significant component of the economy and so, the effects were more profound. In contrast, countries in Sub-Saharan Africa such as Angola, who were isolated from the financial markets were not as badly hit. Nonetheless, the global slowdown in the economy and the fact that

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[5] *This means they were unable to borrow money from the banks*

[6] *You could also mention the Funding for Lending Scheme that was used by the MPC to try and incentivise commercial banks to lend more money*

[7] *You could double evaluate by saying that if the UK experiences deflation such as other EU countries (Greece and Italy), then this would be catastrophic for the UK. This is because interest rates are already at a record low of 0.25% so they are likely to suffer from a liquidity trap. This is where monetary policy becomes ineffective and thus, the UK would struggle to get out of deflation.*

several developed countries fell into recession had a spillover effect around the world. This is because individuals in those countries had less disposable income and thus, demand for goods both domestically and internationally, would have fallen. Given this, whilst the severity of the financial crisis differed between countries, it still impacted even those whose financial services sector is not as developed.

In conclusion, the financial sector plays an extremely important role in the globalised world. Countries are interconnected and interdependent on one another more than ever before, and the financial system provides a mechanism for the flow of money both within and between countries. As such, market failure in the financial services sector, such as the Global Financial Crisis in 2008, is extremely damaging both on a micro and macro basis.

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