Rewarding Learning

ADVANCED
General Certificate of Education
2010

Economics

Assessment Unit A2 1

Business Economics

[AE211]

AE211

FRIDAY 28 MAY, AFTERNOON

TIME

2 hours.

INSTRUCTIONS TO CANDIDATES

Write your Centre Number and Candidate Number on the Answer Booklet provided.
Answer **Question 1** and **one** question from **Questions 2, 3 or 4**.

INFORMATION FOR CANDIDATES

The total mark for this paper is 80.
Quality of written communication will be assessed in all questions **except 1(a), 1(b)(i) and 1(b)(ii)**.
Figures in brackets printed down the right-hand side of pages indicate the marks awarded to each question or part question.

ADVICE TO CANDIDATES

You are advised to take account of the marks allocated to each question part in allocating the available examination time.

Question 1

Study the information below and answer the questions that follow.

Case Study: Crisis in the UK banking market

Source 1: The bank that sank

At the beginning of 2009 the Royal Bank of Scotland was on the brink of collapse after reporting the biggest loss in British corporate history. As news of the scale of the losses spread around the City, investors dumped RBS shares in a selling frenzy. Billions of pounds were wiped from its stock market value despite the Government's pledge to keep it afloat with more money from the taxpayer. RBS, worth £75 billion in January 2007, is now valued at a mere £4.5 billion, even though it received £32 billion from taxpayers and shareholders in late 2008.

The turmoil in the banking sector had a knock on effect on other sectors, with the FTSE 100 (an index of the share price of the top 100 companies in the UK) falling by approximately 30% since September 2008. As one city analyst put it, "confidence has been rocked by the collapse of banking shares, with both casual traders and institutional investors reducing their demand for equities. Recent research shows that the number of people willing to buy shares is at its lowest in over 20 years".

Shares in RBS and FTSE 100 March 08 to Feb 09

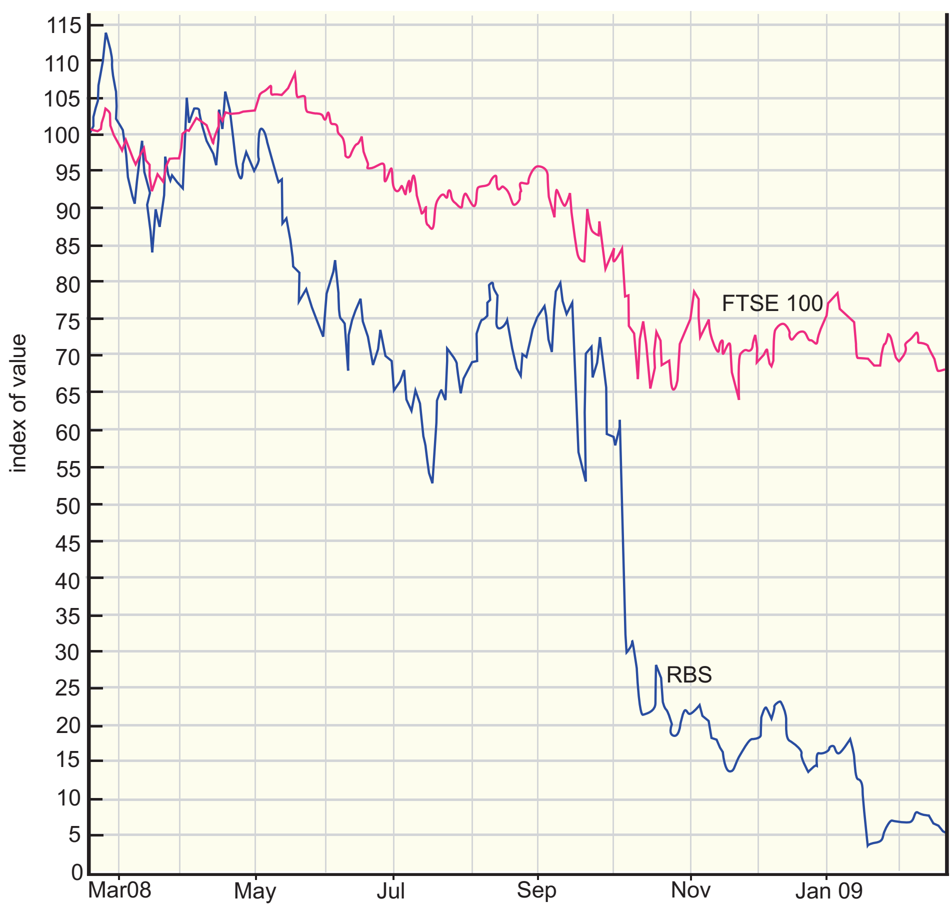

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Fig. 1

The collapse in RBS's share price, shown in **Fig. 1** opposite, is a graphic illustra continued banking uncertainty that has prompted calls on the government from La o nationalise the whole system, an idea resisted firmly by the Chancellor, Alistair Darlin

The scale of losses at RBS is breathtaking. The bank, which also owns NatWest, announc October 2008 that bad debts and losses on past takeovers could leave it as much as £28 billi in the red for 2008, nearly double Vodafone's record £15 billion loss in 2006.

The bank's admission that it had paid between £15 billion and £20 billion too much for the Dutch bank ABN Amro last year prompted an angry response from Mr. Brown. A spokesman for the Prime Minister stated that he was, "furious that taxpayers' money was being used to cover the losses of banks. These losses are a direct result of the irresponsible risk taking by bank managers who were focused on maximising short-term profits at the expense of long-term stability".

Source 2: Lloyds–HBOS merger gets the go ahead

The merger of banks Lloyds TSB and HBOS has been granted the final legal approval by a court in Edinburgh. The announcement came after it was revealed that the Treasury is to own 43.4% of the merged bank after few shareholders bought new shares. Only 0.2% of the new shares HBOS offered to shareholders were taken up. At Lloyds, only 0.5% were purchased. Both banks have found it tough to raise capital given continuing uncertainty in world financial markets. The government stepped in last year and bought up the unsold shares, in a bid to prevent further turmoil in the financial system, as it became clear that HBOS was in difficulty.

The newly named Lloyds Banking Group will control about 25% of British customers' personal bank accounts and about 28% of the mortgage market. While the size of the new firm would usually have triggered competition worries, the government waived such concerns arguing that the deal would help maintain the stability of the banking sector.

Worries have been expressed by consumer groups that the bank could limit choice for consumers. At the end of 2008, the Office of Fair Trading said there could be a "substantial lessening of competition" in personal current accounts, bank services for smaller firms, and the mortgage market as a result of the merger.

Source 3: Our banks are too important to be left in private hands

The plunge in the share price of banks such as RBS and others has led to renewed calls for full scale nationalisation of the UK banking market. The government had hoped that last October's £50bn hand-out of taxpayers' money would be enough to restore confidence in the banking system and bring long-term stability to the sector. Such hopes have gone unfulfilled with the government being forced to provide an additional £500bn in an attempt to rescue the banking system.

Some economists however, are yet to be convinced that the most recent £500bn package will be enough to make any impression on the current financial crisis.

One critic of the government's plan stated recently, "once again, the British gov[illegible] doing too little, too late, to head off the impact of the global financial crisis. Instead [illegible] up private banks with ever more complicated incentives to maintain credit flows, the [illegible] answer is to nationalise them".

"By only partly nationalising banks, the government is getting the worst of both worlds. Taxpayers are being asked to shoulder the risk of the banks' debt, yet in return they have no power to force them to increase lending. It's a recipe for failure. Full nationalisation would instead allow the government to get lending flowing again without further delay".

But despite these arguments in favour of nationalisation, ministers remain unconvinced. A spokesman for the government stated, "Governments shouldn't be in the business of running banks. If the 1970s and 1980s taught us anything, it was that nationalisation doesn't work. Nationalisation removes the profit motive and only leads to organisational slack and inefficiency".

However, as the scale of devastation wreaked by the banks on the global economy becomes clearer, the case for a socially owned finance sector grows stronger. If the banking system is so vital to a modern economy that it cannot be allowed to go bust – then it is too important to be left in the hands of private companies dedicated to maximising profits for their shareholders.

Adapted from: © Our banks too important to be left in private hands by Seumas Milne, Guardian News 20-1-2009
http://www.guardian.co.uk/commentisfree/2009/jan/22/banking-sector-banks-nationalisation and
© Limping towards nationalisation by John Adams Investors Chronicle 22-1-2009
http://www.investorschronicle.co.uk/MarketsAndSectors/Sectors/article/20090122/1640ce14-e6fb-11dd-bc23-00144f2af8e8/Limping-towards-nationalisation.jsp

(a) Using **Fig. 1**, compare the performance of RBS shares with that of the FTSE 100 between March 2008 and February 2009. [5]

(b) With the assistance of a demand and supply diagram, explain the **main** cause of:

(i) the collapse in the price of RBS shares (Source 1, para 1) [5]

(ii) the fall in the FTSE 100 (Source 1, para 2) [5]

(c) Examine the likely impact of the Lloyds and HBOS merger on the UK banking market. [10]

(d) Critically examine the case for the full nationalisation of the UK banking industry. [15]

Essays:

Answer **one** from **Questions 2, 3 or 4**.

2 Price discrimination can never be justified.

(a) Explain why some firms charge different prices to different groups of consumers for the same product. [15]

(b) Evaluate the view that price discrimination should be outlawed to protect vulnerable consumers. [25]

3 Perfect competition is an unrealistic ideal.

(a) Explain why, in theory, perfectly competitive markets result in an efficient allocation of resources. [15]

(b) Critically examine the view that government competition policy should try to make markets contestable, rather than competitive. [25]

4 “Big is beautiful” is the new business motto

(a) Explain the impact of economies and diseconomies of scale upon a firm’s long-run average cost curve. [15]

(b) Critically examine the view that advances in modern technology and improvements in management techniques mean that firms can continue to grow in size without experiencing diseconomies of scale. [25]

THIS IS THE END OF THE QUESTION PAPER
