Edexcel (A) Economics A-level

Theme 4: A Global Perspective

4.4 The Financial Sector

4.4.2 Market failure in the financial sector

Notes

Market failure in the financial sector was evident during the Great Recession of 2008.

Asymmetric information

Before the crash, asset prices were high and rising, and there was a boom in economic demand. There were risky bank loans and mortgages, especially in the US where government securities were backed by subprime mortgages. This means the borrowers had poor credit histories, and after house prices crashed in the US in 2006, several homeowners defaulted on their mortgages in 2007. Banks had lost huge funds, and required assistance from the government in the form of bailouts. There was asymmetric information since banks were not aware of how risky the loans were. Since the crisis, banks have become more risk averse, so there are tougher requirements to get a loan or mortgage.

Externalities

Externalities are the effects from an economic transaction on a third party who is not directly involved in the transaction.

A pecuniary externality leads to an inefficient allocation in the market, through prices rather than resources.

For example, a pecuniary externality could lead to the under provision of liquidity in the banking model. In the 2008 financial crisis, illiquidity contributed towards volatility and government intervention.

Liquidity refers to trading activity. Liquid assets are those which can be bought and sold easily.

Illiquidity refers to assets that cannot be sold easily without a loss in value. Usually, this is because there are insufficient investors willing to buy the asset.

Systematic risk in financial markets can be seen as a negative externality. Systematic risks are the risk of damage of the economy or the financial market. For example, it could be the risk of the collapse of a bank. Since this costs firms, consumers, the economy and the market, it is akin to a negative externality.

Moral hazards

A moral hazard is a situation where there is a risk that the borrower does things that the lender would not deem desirable, because it makes the borrower less likely to repay a loan. It usually occurs when there is some form of insurance for the mistake. For example, if a house is insured, a borrower might be less careful because they know any damage caused will be paid for by someone else.

Banks might take more risks if they know the Bank of England or the government can help them if things go wrong. The financial crisis has been regarded as a moral hazard, due to the degree of risk taking.

Speculation and market bubbles

A market bubble occurs when the price of an asset is predicted to rise significantly. This causes it to be traded more, and demand exceeds supply so the price rises beyond the intrinsic value. The bubble then 'bursts' when the price steeply and suddenly falls to its ordinary level. This causes panic and investors try and sell their assets.

It results in a loss of confidence and it can lead to economic decline or a depression.

Market rigging

This is the act of firms coming together to interfere in a market, with the intention to stop it working as it is supposed to, so that the firms can gain an unfair advantage.

The Libor Scandal is an example of this. It was discovered that banks were inflating or deflating their interest rates to make a profit from trade or to make them seem more financially reliable.

Loans such as mortgages, student loans and other financial products use Libor as a reference rate. This means that manipulating the rate, as the banks were doing, can negatively affect consumers and the financial market.