Edexcel Economics (A) A-level

Theme 4: A Global Perspective

4.4 The Financial Sector

Detailed Notes

4.4.1 Role of financial markets

Financial markets are **where buyers and sellers can buy and trade a range of services or assets that are fundamentally monetary in nature.**

They exist for two main reasons: to meet the **demand for services**, such as saving and borrowing, from individuals, businesses and the government and **to allow speculation and financial gains**.

There are a number of **types of financial markets**: the money market which provides short term saving and lending and the capital market which provides longer term financing; foreign exchange markets; commodity markets; derivatives markets (trading financial instruments based on the values of other financial instruments) and insurance markets.

There are a range of **different financial institutions**. Retail banks provide services to households, such as the payment of direct debits, saving accounts, loans and mortgages whilst commercial banks provide services to businesses. Investment banks trade in foreign exchange, commodities, bonds, shares and derivatives for speculation purposes as well as giving advice to firms on how to raise finance and on mergers. Some smaller companies also take part in speculation. Savings vehicles exist to help individuals save, for example pension schemes, trusts, hedge funds and assurance companies, whilst insurance companies insure against a range of risks. The central bank is a financial institution that has direct responsibility to control the money supply and monetary policy, to manage the country's gold and foreign currency reserves and to issue government debt.

Role of the financial market

- One role of the financial market is to **facilitate savings**, which allows people to transfer their spending power from the present to the future. It can be done through a range of assets, such as storing money in savings account and holding stocks and shares.

- On top of this, they **lend to businesses and individuals** which allows consumption and investment. They are sometimes referred to as a financial intermediary, the step between taking money from one person to give to another since money from savings is used for investment.

- Also, they **facilitate the exchange of goods and services** by creating a payment system. Central banks print paper money, institutions process cheque transactions, companies offer credit card services and banks and bureau de changes buy and sell foreign currencies.

- Similarly, they **provide forward markets**. This is where firms are able to buy and sell in the future at a set price, for example if a farmer wants to sell the crop they are growing at a guaranteed price in a month's time. The forward market exists for commodities and in foreign exchange and helps to provide stability.

- On top of this, they provide a **market for equities**, company's shares. Issuing shares is an important way for companies to finance expansion but people would be unlikely to buy shares if they were unable to sell them on in the future. Financial markets provide the ability for shares to be sold on in the future, making the asset more appealing.

Synoptic point: The financial market is an individual market and so in this sense it is a microeconomic concept. However, it has huge implications on the macroeconomy.

4.4.2 Market failure in the financial sector

The combination of speculation and provision of genuine services means that financial markets are prone to regular crises that cause significant damage to the real economy.

Asymmetric information:

One problem with the financial sector is that financial institutions often have **more knowledge compared to their customers**, both consumers and other institutions. This means they can sell them products that they do not need, are cheaper elsewhere or are riskier than the buyer realises. <u>The Global Financial Crisis was partially caused by banks selling packages of prime and subprime mortgages, but advertising them as all prime mortgages</u>. Those buying these packages suffered from asymmetric information and it is unlikely they would have bought them if they knew the risk involved. Additionally, there can be asymmetric information between **financial institutions and regulators**. The institutions have little incentive to help regulators understand their business and this causes difficulties for the regulators so may allow institutions to undertake harmful activities.

Externalities:

There are a number of costs placed on firms, individuals and the government that **the financial market does not pay**. One example of this is the cost to the taxpayer <u>of bailing out the banks after the 2007-8 financial crisis</u>. Even higher than this, was <u>the long-term cost to the economy</u> of the crisis due to its effects on demand and growth. Moral hazard also shows some external costs.

Moral hazard:

This is where individuals **make decisions in their own best interests knowing there are potential risks**. This can happen in two main ways in the financial markets. Firstly, it will occur where individual workers take **adverse risk in order to increase their salary**. Any problems they cause will be the problem of the company and not the problem of the individual, the worst that can happen is to lose their job whilst the company may lose millions of pounds. <u>The Global Financial Crisis was caused by moral hazard, when employees sold mortgages to those who would not be unable to pay them back.</u> By selling more mortgages, they would see higher salaries and bonuses but would not see the negative effects if the loan was not repaid. On top of this, financial institutions may take excessive risk because they know the **central bank is the lender of last resort** and so will not allow them to fail because of the impact it would have on the economy.

Speculation and market bubbles:

Almost all trading in financial markets is speculative and this leads to the **creation of market bubbles**, where the price of a particular assets rises massively and then falls. They tend to occur because investors see the price of an asset is rising and so decide to purchase this asset as they believe the price will continue to rise and will profit them in the future. This leads to prices becoming excessively high and eventually enough investors decide that the price will fall, so they sell their assets and panic sets in, causing mass selling. This is known as **herding behaviour**. Moreover, the financial market has also caused market bubbles in the **housing market** by lending too much in mortgages and increasing demand for houses. When this bubble bursts, for example due to a rise in real interest rates, there is a fall in demand for houses and a negative wealth effect, reducing AD, and banks are left with loans that will not be repaid in full. Other bubbles included the <u>dot com bubble in the 1990s and the Wall Street Crash in 1929.</u>

Market rigging:

This is where a group of individuals or institutions **collude to fix prices or exchange information that will lead to gains for themselves** at the expense of other participants in the market. One example of this is **insider trading**, where an individual or institution has knowledge about something that will happen in the future that others do not know and so can buy or sell shares to make a profit. Another example is where **individuals or institutions affect the price** of a commodity, currency or asset to benefit themselves, for example large trades in a currency will shift its value and this will make a difference to individuals selling or buying assets with that currency. <u>In the Libor scandal of 2008, financial institutions were accused of fixing the London Interbank Lending Rate (LIBOR), one of the most important rates in the world.</u>

4.4.3 Role of central banks

Role of the central bank

- Firstly, the central bank **controls monetary policy** through interest rates and controlling money supply in order to keep inflation low and stable.

- It acts as a **banker to the government**. The exact nature of the services offered by the bank differs from country to country, for example the Bank of England was previously responsible for managing the national debt but this role was transferred to the Debt Management Office in 1998. They often hold the government's bank account and lend to them, holding government debt, as well as holding gold and foreign exchange reserves.

- Similarly, they act as a **bank to other banks**. Banks deposit their money within the central bank and this is often used to balance the accounts of banks at the end of each day, when banks owe each other money because cheques have been paid in by consumers etc. The most important part of this role is the fact they are a lender of last resort. If banks experience liquidity problems, they can turn to the central bank to sell their illiquid assets or to take a loan in the short term. If the bank is on the brink of collapse as its assets have fallen too far in value e.g. the financial crisis of 2007-8, then the bank can lend them money to prevent them from collapsing. Banks tend to lend to each other and so the collapse of one bank will lead to the collapse of other banks; this means that this role is important since as it allows the bank to ensure financial stability.

- Moreover, central banks in some countries **regulate the financial system**. This is important to prevent financial institutions from undertaking activities which harm consumers or engage in risky activities which would lead to collapse and to prevent systemic risk, the risk of the whole system collapsing. The financial sector plays a huge role in the economy because it impacts investment and can cause huge externalities if market failure occurs.

Financial regulation:

- Regulation can include: banning market rigging; preventing the sale of unsuitable products; maximum interest rates to prevent consumer exploitation and prevent excessively risky lending; deposit insurance to protect consumer deposits and increase stability; and liquidity ratios, when banks are forced to hold a certain percentage of liquid assets.

- There are three key bodies for financial regulation:
    - o The FPC identifies and reduces system risk and supports government economic policy (macroprudential)

- The PRA ensures competition, ensures consumers have access to services, minimises risk should a bank fail and ensures banks take responsible action. (microprudential)
- The FCA protects consumers, promotes competition and enhances the integrity of the system by preventing market rigging.