# Edexcel Economics (A) A-level

## Theme 4: A Global Perspective

## 4.4 The Financial Sector

**Summary Notes**

## 4.4.1 Role of financial markets

Financial liquid assets are exchanged in a financial market. For example, the stock market and the bond market are two examples of financial markets.

- **To facilitate saving**

Financial markets provide somewhere for consumers and firms to store their funds. Savings are rewarded with interest payments from the bank.

- **To lend to businesses and individuals**

The transfer of funds between agents is aided by financial markets. The funds can be used for investment or consumption.

- **To facilitate the exchange of goods and services**

The transfer of real economic resources is facilitated in a financial market. Financial markets can make it easier to exchange goods and services from the physical market, by providing a way that buyers and sellers can interact and transfer funds.

- **To provide forward markets in currencies and commodities**

The currency market is another kind of financial market. They are used to trade one currency for another currency. Currencies can have speculative attacks taken on them, which can affect the value of the exchange rate.

In commodity markets, investors trade primary products, such as wheat, gold and oil. Future contracts are a method for investing in commodities. This involves buying or selling an asset with an agreed price in the present, but a delivery and payment in the future.

A forward market is an informal financial market where these contracts for future delivery are made.

- **To provide a market for equities**

Equity markets involve the trade of shares. It is also called a stock market. Equity markets provide access to capital for firms, and allow investors to own part of a market. Returns on the investment, usually in the form of dividends, are based on future performance. A dividend is a share of the firm's profits.

**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

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.

# 4.4.3 Role of central banks

The central bank manages the currency, money supply and interest rates in an economy. For example, the European Central Bank (ECB), the Bank of England and the People's Bank of China are central banks.

## Implementation of monetary policy

The central bank takes action to influence the manipulation of interest rates, the supply of money and credit, and the exchange rate.

In the UK, the Monetary Policy Committee (MPC) alters interest rates to control the supply of money. They are independent from the government, and the nine members meet each month to discuss what the rate of interest should be. Interest rates are used to help meet the government target of price stability, since it alters the cost of borrowing and reward for saving.

The bank controls the **base rate,** which ultimately controls the interest rates across the economy.

## Banker to the government

The central bank provides services to the Central Government. It collects payments to the governments and makes payments on behalf of the government. It maintains and operates deposit accounts of the government. The central bank also manages public debt and issues loans.

The Bank can also advise the government on finance, including the timing and terms of new loans.

## Banker to the banks – lender of last resort

The Bank of England is considered to be a lender of last resort. If there is no other method to increase the supply of liquidity when it is low, the Bank of England will lend money to increase the supply.

If an institution is risky or is close to collapsing, the Bank might lend to them. This is when they have no other way to borrow money.

It can protect individuals who deposit funds in a bank and might otherwise lose them. It also aims to prevent a 'run on the bank', which is when consumers withdraw their bank deposits in a panic, because they believe the bank will fail.

Usually, banks will avoid borrowing from the lender of last resort, because it is suggests the bank is experiencing a financial disaster.

## Role in regulation of the banking industry

Governments might regulate banks with regulation and guidelines. This helps to ensure the behaviour of banks is clear to institutions and individuals who conduct business with the bank.

Some economists argue that the banks have a huge influence in the economy; if they failed it would have huge consequences. Therefore, it is important to regulate the banking industry.

The UK banking industry is regulated by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The FCA regulates financial firms to ensure they are being honest to consumers and they seek to protect consumer interests. The FCA also aims to promote competition which is in the interests of consumers. The PRA promotes the safety and stability of banks, building societies, investment firms and credit unions, and ensures policyholders are protected.