Edexcel (B) Economics A-level

Theme 4: Making Markets Work

4.5 Risk and the Financial Sector

4.5.4 The Global Financial Crisis

Notes

- The Global Financial Crisis is sometimes called The Great Recession, and it refers to the decline in world GDP in 2008-2009.
- 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 are risks involved with lending long term and borrowing short term. They might lose money on investments, and if there are insufficient funds in a vault, banks might not be able to provide depositors with money when it is demanded.
- The UK government used expansionary fiscal policy shortly after the financial crisis. VAT was cut from 17.5% to 15% in an attempt to increase consumer spending. The government received less tax revenue due to the recession, which led to an increase in government borrowing.
- UK interest rates were at 5% when the crisis had just started in 2008. When the US bank Lehman Brothers became bankrupt, the Bank of England cut the interest rates. The global recession started spreading and interest rates were cut further. By 2009, banks were unwilling to lend, unemployment soared, and firms and consumers had little confidence left.
- Eventually, interest rates were cut to the historic low of 0.5%. Since the economy was still in recession, the bank employed a programme of QE. Initially, £75bn was injected into the economy, but now £375bn has been injected.
- Since the bank is concerned about the sustainability of the UK's economic recovery, interest rates are being held low and QE is not being reduced. This is particularly because of the low inflation rates the UK has had.
- **Contributing factors:**
    - **Subprime mortgages**

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- **Moral hazard (too big to fail)**

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.

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.

- **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.

The role of banking regulation

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.

The Financial Policy Committee (FPC) regulates risk in banking and ensures the financial system is stable. It clamps down on unregulated parts and loose credit. The committee monitors overall risks to the financial system as well as regulating individual groups.