Edexcel (B) Economics A-level

Theme 4: Making Markets Work

4.5 Risk and the Financial Sector

4.5.1 Risks and uncertainty

Notes

The difference between risk and uncertainty

Risks are a quantifiable probability of damage, loss or injury occurring. Banks face risks when lending capital. The capital might not be paid back, which would result in a loss for the bank.

There is also a risk that the return on an investment will be less than the expected return.

The market imposes a risk, since general trade can influence interest rates and exchange rates, which then impacts several countries across the globe.

Uncertainty considers a situation which may or may not happen, but the probability of each outcome is not known.

The impact of shocks

Shocks are defined as unforeseen changes which impact the economy. Shocks could be caused by humans or natural disasters. A recent example of a major shock was the 2008 Global Financial Crisis. This impacted the economy for many years, and it was caused by risks taken by banks.

Exchange rate risk and forward markets

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.

The role of insurance in business

Insurance is designed to reduce the risks of decisions. People and firms take out insurance policies and pay a premium. The premium is the price paid to cover a risk. Firms might include the price of an insurance premium in their costs, which will help protect them against huge losses.