OCR Economics A-level

Macroeconomics

Topic 5: The Financial Sector

5.2 The Financial Sector

Notes

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The role of the financial sector in the real economy

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.

Explain the role of saving and investment in promoting economic development using, for example, the Harrod-Domar model

A secure and stable financial sector is required in emerging and developing economies in

order to promote economic development. This is because without a financial sector, consumers and firms cannot generate sufficient savings to make the macroeconomy stable.

In many developing countries, there is only limited wealth, which means money cannot be put aside for the future, and they can only afford to spend in the short run. Consumers have to focus on their immediate needs, including food and safe water, to ensure they can survive. Without sufficient savings, there is inadequate capital accumulation.

Africa's saving rate is around 17%, whilst the average for middle income countries is around 31%. This makes it more expensive for the African public and private sectors to get funds since they have higher borrowing costs. This impedes capital investment.

The Harrod-Domar model states that investment, saving and technological change are required in an economy for economic growth. The rate of growth increases if the savings ratio increases. This leads to increased investment and technological progress, which leads to higher productivity.

The rate of growth is calculated by the savings ratio / capital output ratio in the Harrod-Domar model. Growth increases with more saving or a small capital output ratio.

The limitations of the model are that there is a low marginal propensity to save in some countries, or that there might be a poor financial system. Funds might not lead to borrowing and investment. There could also be inefficiency in the workforce.

Moreover, the paradox of thrift could be considered. An increase in savings could lead to an increase in investment. However, an increase in savings means there is a reduction in spending, which leads to a fall AD.

Microfinance and its role in supporting economic development

Microfinance involves borrowing small amounts of money from lenders to finance enterprises. It increases the incomes of those who borrow, and can reduce their dependency on primary products. There could be a multiplier effect from the investment of the loan.

They are small loans for usually unbankable people. It allows them to break away from aid and gives borrowers financial independence. In Bangladesh, 95% of microfinance cohorts are women.

Microfinance loans detach the poor from high interest, exploitative loan sharks. They could help businesses to be set up, although the money could also be spent on immediate consumption, rather than investment. Since the money goes directly to SMEs, it can stimulate employment.

However, the data collected on microfinance loans might not be reliable if there is dishonesty regarding where the money was spent.

In Tamil Nadu, India, less than 2% of microenterprises were still operating after their establishment.

Microfinance loans have high repayment rates.

The role of the financial sector in promoting economic development:

- Financial sector facilitates saving, which provides funds for investment and enables consumers and firms to plan ahead.
- The sector helps enable control and management of the economy e.g fiscal and monetary policies
- Financial markets such as the stock market enables firms to raise capital
- The finance sector also facilitates borrowing which may encourage investment or enable business expansion. However, it is important to consider some loans have high interest repayments that could result in higher levels of debt.
- Governments are also able to raise short and long terms funds through issuing bonds or bills

The extent to which international financial markets have influenced flows of financial capital into and out of developing and emerging economies

Foreign currency gap

A foreign currency gap exists when the country is not attracting sufficient capital flows to make up for a deficit in the capital account on the balance of payments. In other words, the value of the current account deficit is larger than the value of capital inflows.

Capital flight

This is when capital and money leave the economy through investment in foreign economies. It is triggered by an economic threat, such as hyperinflation or rising tax rates. It can worsen an economic crisis and cause a currency to depreciate.

The impact of public and private sector debt on developing and emerging economies

The debt crisis emerging in the developing world threatens the fight against poverty and inequality.
Debt relief is the partial or total forgiveness of debt.

In developing countries, debt is considered to be a principal cause of poverty, since it causes human suffering and misery, and it hampers development.

With high levels of debt, financial resources are diverted from infrastructure, education and healthcare. The country's ability to pay the debt, not the size, is most important. If a country defaults on its debt, it can make it hard to borrow more money in the future.

Debt forgiveness can allow a country to import more and increase the population's standard of living. It improves government finances, so public services could be funded instead.

However, if debt is forgiven, it could encourage more borrowing in the future. Moreover, there could be corruption.