WJEC (Eduqas) Economics A-level

Macroeconomics

Topic 3: Policy Instruments

3.4 Financial stability

Notes

Evaluate 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. In the UK, the financial sector has become more important to the economy in recent years.

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.

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.

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.

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.

Why a bank might fail

- 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.

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Liquidity ratios and capital ratios and how they affect the stability of a financial institution

A liquidity ratio is used to determine how able a company is to pay off short-term obligations. The higher the ratio, the greater the safety margin of the bank. When creditors want payment, they look at liquidity ratios to decide whether the bank is a concern.

A capital ratio is a comparison between the equity capital and risk-weighted assets of a bank. A bank's financial strength is determined using this. Assets have different weightings, where physical cash has zero risk and credit carries more risk.

The recent financial crisis showed how having insufficient finance, in either capital or liquidity, can be dangerous. Another risk that comes with this is that investors might assume other banks will fail as well, which reduces confidence.