OCR – A Level Economics

Component 2 – Macroeconomics

10. The financial sector

Revision Notes

Contents

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10.1 Money and interest rates

The functions of money

With specialisation, a person or firm do not produce everything they need themselves, so they need a way to trade. The earliest form of exchange was **barter** (trading goods directly), but it had some major issues. To solve these, **money** was developed, which serves four main functions:

1. **Medium of Exchange:** Money can be used to buy and sell anything, and everyone accepts it. Barter only worked if both parties wanted what the other had (called a "double co-incidence of wants"). With money, you can trade for what you need without this hassle.
2. **Measure of Value:** Money makes it easy to compare the value of different things, like a cupboard versus a t-shirt. It also puts a value on services and labour, making it clear what things are worth.
3. **Store of Value:** Money keeps its value over time, so you can save it and use it later. However, there is inflation, so this isn't always true.
4. **Method for Deferred Payment:** Money allows people to buy now and pay later (credit or loans). This only works because money holds its value over time.

10.1 Money and interest rates

Characteristics of money

Back in the day, people traded all sorts of things (gold, seashells, even shiny stones) to get what they needed. But for something to truly **work as money**, it has to have certain characteristics.

1. Scarce

Money should be **limited in supply**, or it'll lose its value.
If everyone could pick pounds off trees like leaves, money wouldn't be worth anything.
Economists call this the principle of **scarcity** (rare things are more valuable.)

2. Acceptable

Money needs to be something that **everyone agrees to use**.
If people don't trust or recognize it, it can't work as a **medium of exchange**
Think: You wouldn't buy a sandwich with a bottle cap.

3. Hard to Fake

If money is **easy to copy**, it's game over.
We need money that's tough to forge (with watermarks, holograms, and fancy ink) to keep it secure and **trustworthy**.

4. Durable

Money should **last a long time** without falling apart.
Coins and polymer notes are tough enough to survive many hands and pockets.

5. Portable

Money must be **easy to carry around**.
Imagine trying to buy coffee using sacks of rice or gold bars, not very practical.

6. Divisible

Good money can be **split into smaller parts**, like coins or notes of different values.
Example: If a chocolate bar costs £1 and you only have a £5 note, you should get £4 back and maybe change in coins.

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10.1 Money and interest rates

The money supply

The **money supply** is just a fancy term for the total amount of money available in an economy. But money isn't just what jingles in your pocket, it includes several different things.

Notes and Coins

These are the physical bits of money (paper notes and metal coins) that you carry in your wallet. 💡Fun fact: They make up **only about 2%** of the total money supply in the UK. So, money is mostly... not money you can touch.

🏦 **Bank Accounts**

Most of us keep our money in **bank current accounts,** these are super convenient for things like:

- Using your debit card at a shop
- Taking cash out of an ATM
- Paying bills online or via direct debit

This money still counts as part of the money supply because it can be spent almost instantly.

🚫 **Typical Mistake**

A lot of people think there's a bar of gold sitting in the Bank of England for every pound in your bank account.
🚨 Not true. We left the gold standard behind ages ago. Today's money isn't backed by gold; it's backed by trust in the system.

10.1 Money and interest rates

The money supply

🏢 **What about Savings & Building Societies?**

- **Savings accounts** may also be counted as money, but some of them make it harder to access your cash quickly.
- **Building societies** are like banks – they hold your deposits and help you pay or borrow money. Many big banks actually started off as building societies.

📈 **Other Financial Assets**

There are things that *feel* like money (such as **shares**, **bonds**, and **treasury bills)** because they can be sold for cash. But they're **not quite money**, because:

- They aren't always easy to turn into cash without losing value
- They may take time to sell

So, economists usually don't count them in the main money supply... but they do keep an eye on them.

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The money supply

📊 **Narrow vs Broad Money – What's the Difference?**

To make things easier, economists split money into two main groups:

1. Narrow Money

This includes:

- Notes and coins
- Bank and building society accounts that you can access easily (like your current account)
- 🛍️ This is the money you can spend right now!

2. Broad Money

This includes:

- Everything in narrow money
- Plus, savings accounts and other deposits held at banks and building societies

🏢 This shows a fuller picture of all the money that exists in the economy, even if it's not always ready to spend immediately.

🧠 **Why Does This Matter?**

Central banks (like the Bank of England) use this info to:

- Judge how much spending and borrowing might happen
- Decide whether to raise or cut rates
- Manage inflation and economic growth

10.1 Money and interest rates

The money supply

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10.1 Money and interest rates

The quantity theory of money

Ever wondered what causes inflation? One classic explanation comes from something called the **Quantity Theory of Money**. It all starts with a famous formula by economist **Irving Fisher**, called the **Fisher equation of exchange**:

M × V = P × Q

Where:

- **M** = Money supply (how much money is in the economy)
- **V** = **Velocity of circulation** – how often each unit of money is used to buy goods/services over a year
- **P** = Average **price level** (think of this like the average cost of things, measured by something like the CPI)
- **Q** = Real output – the amount of stuff we produce (also called real national income or real GDP)

This equation shows that the amount of money multiplied by how often it's spent equals the total value of goods and services sold in the economy.

🧠 **What Do Monetarists Say?**

Monetarist economists (like Milton Friedman) built on this theory and took it further:

- They believed **V** (velocity) stays more or less **constant** over time.
- They also said **Q** (real output) tends to grow steadily – not too fast, not too slow.

So, if **V and Q are steady**, then any change in **M (money supply)** must affect **P (prices)**.

🧨 Translation? Printing lots of money = higher prices = **inflation**.

This led to the idea that inflation happens not because people are spending too much or because of rising costs, but simply because **too much money is chasing too few goods**.

10.1 Money and interest rates

The quantity theory of money

💬 **So, Why Did It Matter?**

This idea became huge in the 1980s, especially under governments that tried to fight inflation by controlling the **money supply**. They thought: "If we can limit how much money is in the system, we can control inflation."

One of the biggest supporters of this theory was **Milton Friedman**, who even won a **Nobel Prize**. He believed inflation is always a **monetary phenomenon,** basically, if you want to stop prices from rising, stop printing money like there's no tomorrow.

🤔 **What Happened to This Idea?**

By the late 1980s, things changed:

- Governments found it **really difficult to control the money supply**.
- Plus, **velocity (V)** didn't stay as constant as people thought, it changed depending on interest rates, confidence, and other factors.

So, while the theory still has its place in economics, it's no longer the go-to method for tackling inflation.

📝 **In a Nutshell:**

- Too much money in the economy → prices go up.
- Control the money supply = control inflation (in theory).
- But in real life? It's messier than the maths.

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10.1 Money and interest rates

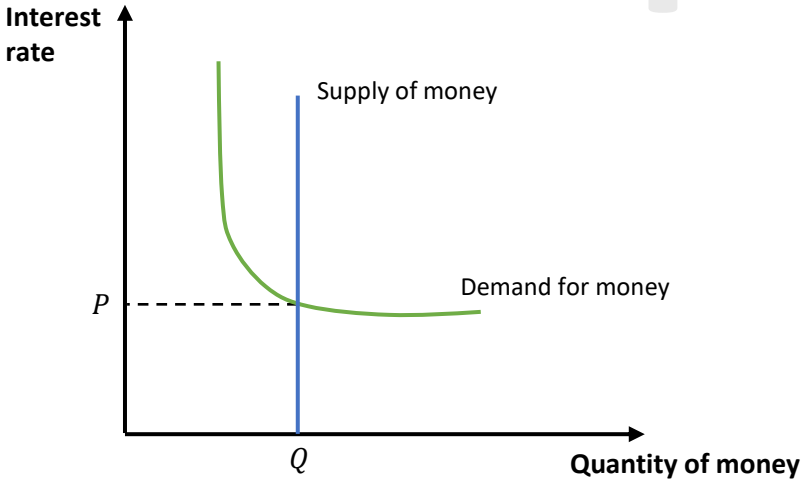
The determination of interest rates

The **interest rate** is basically the "price of money"; what you pay to borrow money or what you earn when you save it.

It's determined by the **demand for money** (how much people and businesses want to borrow/spend) and the **supply of money** (how much money the central bank makes available).

- At the point where **supply of money = demand for money**, we get the equilibrium interest rate.
- If the interest rate goes higher than this, people borrow less and save more, so demand falls.
- If the interest rate is lower, people want to borrow more and save less, so demand rises.

Think of it like an auction: the "price" (interest rate) adjusts until the amount of money people want matches the amount available.



10.1 Money and interest rates

The determination of interest rates

Liquidity Trap

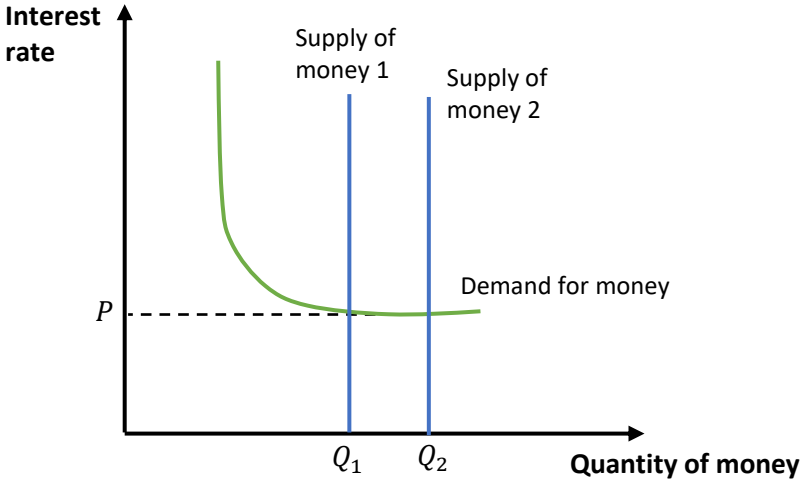
A **liquidity trap** happens when interest rates are already super low, but people still don't want to borrow or spend.

For example:

- Imagine interest rates are close to 0%, but people are worried about the future (like in a financial crisis). Instead of spending or investing, they just **hoard cash under the mattress** (or in a savings account).
- In this situation, even if the central bank pumps more money into the system, interest rates don't fall further, and people don't spend more.

This means **monetary policy (changing interest rates) stops working**.

Example: After the 2008 financial crisis, and again during COVID-19, many economies like the US, UK, and Japan hit this trap; central banks set interest rates near zero, but growth and spending were still sluggish.



10.1 Money and interest rates

The determination of interest rates

The relationship between inflation and nominal interest rates

- **Inflation** = the general rise in prices over time (your money buys less than before).
- **Nominal interest rate** = the "headline" interest rate set by banks or the central bank; the rate you see on loans, mortgages, or savings accounts.

📈 **When interest rates are high:**

- Saving becomes more attractive 💰 (because you earn more interest on your money).
- Borrowing becomes expensive 💳 (higher repayments on loans or mortgages).
- As a result, people save more and spend less, which cools down the economy and reduces inflation.

Example: If a bank offers 6% interest on savings, you're more likely to stash money away rather than splurge on a new car.

📉 **When interest rates are low:**

- Saving becomes less rewarding 🐌 (you earn very little interest).
- Borrowing becomes cheap 🏢 (loans and mortgages cost less).
- This encourages people and businesses to borrow, spend, and invest; boosting economic growth.

Example: If mortgage rates fall from 5% to 1%, more families might buy houses, and firms might borrow to expand their businesses.

10.1 Money and interest rates

The determination of interest rates

Real-life example:

- During the **2008 financial crisis**, the UK cut its interest rate to a historic low of **0.5%** (and it stayed there for years). The idea was to encourage borrowing and spending to kickstart the economy. Even when inflation later rose, rates stayed low to keep growth alive.

✨ In short:

- High interest rates = good for saving, bad for borrowing → helps fight inflation.
- Low interest rates = bad for saving, good for borrowing → boosts spending and growth.

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10.2 The financial sector

The role of the financial sector

Financial markets are like the engine room of the economy; they keep money flowing between people, businesses, and governments. They help move money from those who *have* it (savers) to those who *need* it (borrowers or investors).

Some well-known examples of financial markets are the **stock market** (where people buy and sell shares) and the **bond market** (where governments and companies borrow money from investors). Keep role of the financial markets include:

1. To Help People Save Money

Financial markets give people and businesses a safe place to store their extra cash. Think of savings accounts or government bonds. When you put money in the bank, the bank pays you **interest;** basically, a small reward for letting them hold your money.

2. To Lend Money to People and Businesses

Need a loan to buy a house or open a new café? Financial markets help with that.
They move money from savers to borrowers. The funds can be used for **consumption** (like buying a car) or **investment** (like building a new office).

3. To Make Buying and Selling Easier

Ever wonder how businesses in different parts of the world trade so easily? Financial markets help with this too.
They provide systems (like payment platforms and currency exchanges) so that **buyers and sellers** can do business and transfer money, even across borders.

10.2 The financial sector

The role of the financial sector

4. To Help with Currency and Commodity Trades

Financial markets also deal with **currencies** (like dollars, euros, yen) and **commodities** (like wheat, oil, and gold).

- **Currency markets** let people swap one currency for another (useful for travel or international trade).
- **Forward contracts** let people lock in a price for something now but agree to pay and deliver it later (kind of like booking concert tickets early to avoid a price hike).

This can help protect people from big price swings, but it can also lead to risky **speculation** (betting on future prices to make a profit).

5. To Trade Shares (Equities)

Equity markets, also known as **stock markets**, are where people buy and sell **shares** (small parts of companies).
When you buy a share, you own a tiny piece of that business.

- Businesses use this to raise money to grow.
- Investors buy shares hoping to earn **dividends** (a slice of the profits) or sell them later for more than they paid.

It's like being part-owner of your favourite company and getting paid if it does well.

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10.2 The financial sector

The financial markets

Financial markets are like giant matchmaking services, but, instead of people, they match **money**. They help shift cash from people who have **more money than they need right now** (like savers or investors) to people or businesses who need money to **spend, grow, or invest**.

These markets now operate all over the world, connecting individuals, companies, and governments from different countries.

There are **three main types of financial markets**:

- **The Money Market**
- **The Capital Market**
- **The Foreign Exchange Market**

💷 The Money Market

This market handles **short-term borrowing and lending,** we're talking anywhere from a few hours to a few months.

It's used by:

- **Governments** (e.g. borrowing via Treasury Bills)
- **Banks** (lending money to each other overnight)
- **Firms and individuals** needing short-term loans

📝 Think of the money market like a short-term loan shop, great for quick fixes, not for long-term needs.

10.2 The financial sector

The financial markets

📈 The Capital Market

This market is all about **longer-term finance** – usually more than a year.

It's where companies and governments **raise funds** for big projects by issuing:

- **Shares (equity)** – ownership in companies
- **Bonds (debt)** – long-term IOUs with interest

The capital market has **two parts**:

🔷 Primary Market

This is the "new stuff" market. It's where **new shares and bonds** are created and sold for the **first time**.
Example: When a company does an **IPO (Initial Public Offering)** and sells shares to the public for the first time.

🔷 Secondary Market

This is the "secondhand" market. It's where people buy and sell **existing** shares or bonds.
Example: Stock exchanges like the **London Stock Exchange** or **NASDAQ**.

Why it matters: The secondary market keeps money moving and gives investors the confidence they can sell assets when needed.

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10.2 The financial sector

The financial markets

The Foreign Exchange Market (Forex)

Whenever someone travels abroad, shops online from another country, or invests overseas; **currencies must be exchanged**.

This market deals with **buying and selling currencies** and operates 24/7 around the globe.

There are **two types of Forex trades**:

Spot Market

- You exchange currencies **on the spot;** instantly, at the current exchange rate.

Forward Market

- You agree today to exchange currencies **at a future date**, at a rate you lock in now. Handy for managing risk if the currency moves.

Both markets involve **speculation** where traders try to make profits from future changes in currency values.

10.2 The financial sector

The financial markets

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10.2 The financial sector

The role of saving and investment in economic development (Harrod-Domar Model)

- **Saving**: money that households don't spend but put aside for the future (e.g., in banks).
- **Investment**: using those savings to buy capital goods (like machines, roads, schools) that increase future production.
- **Capital accumulation**: building up physical and human capital (factories, tools, education, training) to boost productivity.

🌎 Why saving matters for development

In many developing countries, wealth is limited. People often spend everything they earn on **basic needs** like food, water, and shelter. This means fewer savings are left over, so less money is available for **investment** in things like factories, infrastructure, or technology.

Example: If farmers in a poor village can only afford to eat and keep the lights on, they can't save to buy better equipment. Without that investment, productivity stays low, trapping them in poverty.

📊 Africa vs Middle-Income Countries

- In Africa, the saving rate is about **17%**.
- In middle-income countries, it's around **31%**.

This gap matters. Lower savings mean higher borrowing costs. Governments and businesses in Africa face more expensive loans, making it harder to fund new projects like power plants or schools.

10.2 The financial sector

The role of saving and investment in economic development (Harrod-Domar Model)

🔧 The Harrod-Domar Model

This model says that **growth = savings ÷ capital-output ratio**.

- The **capital-output ratio** shows how much extra capital (machines, factories, etc.) is needed to produce one extra unit of output.
- If a country saves more 💷, or if it uses its capital more efficiently ⚙️, then growth increases.

Example: If saving increases, banks have more funds to lend. Businesses can borrow to buy tractors, which means more crops are produced → higher GDP → economic growth 🚀.

⚠️ Limitations of the model

- It's not all sunshine and rainbows:
- Some countries have a **low propensity to save** (people spend most of their income just to survive).
- A weak or corrupt **financial system** may mean savings don't actually get turned into productive investments.
- **Workforce inefficiency** (poor education, lack of training) means that even with capital, productivity stays low.

🤔 The Paradox of Thrift

Here's the twist: if everyone saves too much and spends too little, total demand in the economy falls (AD decreases). That means fewer sales for businesses, less investment, and slower growth. So, saving is good, but only if it turns into productive investment.

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10.2 The financial sector

Microfinance

📖 What is microfinance?

Microfinance means giving very small loans (often just £50–£500) to people who don't have access to traditional banks. These borrowers are usually low-income individuals who need money to start or grow tiny businesses.

Instead of being trapped with loan sharks charging massive interest, they get fairer loans, which can help them build independence.

🌍 How it helps development

- **Reducing poverty traps**: Farmers in Peru can borrow money for tools or irrigation, which means they depend less on unpredictable crop yields.
- **Creating jobs**: Since the money often goes to small businesses (known as SMEs [Small and Medium Enterprises]), it can stimulate local employment.
- **Boosting incomes**: A woman in rural Kenya might borrow £100 to buy chickens. She sells eggs at the local market, earns a steady income, and uses that money to send her kids to school.
- **Empowering women** 👩👵: Globally, most microfinance borrowers are women. In Nepal, women have used loans to set up tailoring businesses, giving them more financial independence.

10.2 The financial sector

Microfinance

✅ Advantages

- Gives financial independence to people who would otherwise be excluded from the banking system.
- Cuts people off from **loan sharks**, who charge sky-high interest.
- Can create a **multiplier effect;** when one person invests and earns, they spend more, which benefits the whole community.

⚠️ But there are problems…

- Not all loans are used for business. For example, in some villages in Cambodia, loans are used to pay for weddings or urgent healthcare, which doesn't boost future income.
- High repayment pressure 😰: Borrowers usually need to repay weekly, and if their business fails, the debt becomes a burden.
- Success rates can be low. In Tamil Nadu, India, less than 2% of microenterprises funded by loans were still running after a few years.

10.2 The financial sector

The role of the financial sector in promoting economic development

The **financial sector** is basically the backbone of an economy; it includes banks, stock markets, insurance companies, and even government borrowing. Think of it as the "circulatory system" of money, making sure funds flow to where they're most needed. Here's how it helps economies grow:

💰 1. Encourages Saving (and Investment)

- Banks and savings institutions allow people and businesses to **save money safely**.
- These savings don't just sit around; they're turned into loans for businesses to expand or for consumers to buy homes.
- Example: A bakery saves profits in a bank → the bank lends this money to a tech start-up → both grow, boosting the economy.

🏢 2. Helps Manage the Economy

- The financial sector supports **fiscal policy** (government spending and taxes) and **monetary policy** (interest rates and money supply).
- For example, if inflation is high, central banks can increase interest rates to reduce spending and cool things down.

📈 3. Provides Capital for Businesses

- **Stock markets** let companies raise money by selling shares.
- Example: Apple sells shares to raise billions, which it then invests in new iPhones, jobs, and innovation.
- This provides businesses with the fuel they need to grow.

10.2 The financial sector

The role of the financial sector in promoting economic development

💳 4. Enables Borrowing (with a Catch ⚠️)

- Loans and credit cards allow firms to invest and expand and let consumers buy homes or cars.
- Example: A farmer in Brazil can borrow to buy better equipment, leading to higher crop yields.
- BUT: High-interest loans can cause dangerous debt traps if borrowing isn't managed wisely (think payday loans).

🏛️ 5. Supports Government Funding

- Governments raise money by selling **bonds** (IOUs to investors).
- Short-term bonds help cover immediate spending, while long-term bonds can finance big projects like roads, hospitals, or green energy.
- Example: The UK government issues bonds to fund NHS projects.

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10.3 Financial regulation

Main functions of a central bank

Central Banks are the **guardians of the financial system**. They help keep the economy running smoothly, protect your savings, and even play a part in how expensive your shopping trip feels each month.

Let's look into their 4 main roles:

1. 💰 Implementation of Monetary Policy

Monetary policy means managing interest rates and the money supply to keep things like inflation, unemployment, and growth under control.

- If prices are rising too fast (**inflation**), the central bank can raise interest rates to slow things down.
- If the economy is slowing down, it can lower rates to encourage borrowing and spending.

🧠 **Example:** If the central bank like the Bank of England (BoE) increases interest rates, your loan becomes more expensive but saving money earns you more interest. That's monetary policy in action. During COVID-19, like the BoE cut interest rates to near 0% to keep money flowing.

2. 🏛 Banker to the Government

The government has its own massive "bank account" with the central bank. This bank:

- Manages all **tax income and government spending** (like paying teachers or NHS staff).
- Holds **foreign currency reserves** and even **gold**.
- May lend money to the government by buying its bonds (aka public debt).

10.3 Financial regulation

Main functions of a central bank

3. 🏢 Banker to the Banks – Lender of Last Resort

Commercial banks (like HSBC or Barclays) can get into trouble if they suddenly don't have enough cash; this is called a **liquidity problem**.

Luckily, the central bank is their **backup plan**.

- It can lend money to keep banks afloat.
- It stops one bank's failure from causing a domino effect and crashing the entire system.

Why this matters:
If a big bank fails, it could cause chaos as people might lose savings, businesses could collapse, and confidence in the system would drop like a stone.

📉 **Example:** In the 2007-08 Financial Crisis, central banks stepped in to stop banks from collapsing when their mortgage-backed assets lost value.

4. 🛡 Role in Regulation of the Banking Industry

The financial system can be risky if left unmonitored. Central banks **set rules to stop dodgy behaviour**, protect consumers, and avoid another crisis.

They watch over:

- How much money banks must keep in reserve (**liquidity ratios**)
- Banning scammy or super risky products
- Stopping **market rigging**
- Ensuring fair access to loans and banking services

One big tool:
They use **reserve ratios** [rules on how much money banks must keep in reserve (and not lend out)].

- **Higher ratio = less money flowing in the economy**
- **Lower ratio = more money flowing**

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10.3 Financial regulation

The Bank of England and the money supply

The **money supply** = all the money circulating in the economy (notes, coins, and bank deposits).
If the money supply grows too fast, it can cause **inflation** (prices rising quickly). If it shrinks too much, it can signal an economic slowdown or even a recession.

The **Bank of England** can't directly control every pound in circulation, but it *can* influence it through tools like interest rates. Lower interest rates usually make borrowing more attractive (people and businesses take out loans, spend more), while higher rates slow borrowing and spending.

Aside from changing rates, the Bank also has other tricks up its sleeve to keep the economy stable and encourage growth. Let's discuss them 👇

💷 **Quantitative Easing (QE) – AKA "Boosting the Economy When Rates are Stuck"**

Definition: Quantitative easing is when the Bank of England creates new money to buy government bonds or other assets from investors.

Why do it?

- It gives investors extra cash, which they might spend on other investments, like buying company shares or lending to businesses.
- It makes borrowing cheaper and encourages spending.

Example:
The Bank buys £50 billion worth of bonds from insurance companies. Those companies use the cash to help fund a massive renewable energy project, hiring thousands of workers and boosting spending in the economy.

Fun fact: QE was introduced in the UK in 2009 after the financial crisis, when interest rates were already super low and couldn't be cut much further.

10.3 Financial regulation

The Bank of England and the money supply

💡 **Funding for Lending Scheme (FLS) – "Helping Banks Help You"**

Definition: A scheme launched in 2012 to make it easier for banks to lend money to people and businesses.

How it works:

- Banks swap assets (like loans they've made) with the Bank of England for **Treasury bills** (safe, short-term government IOUs).
- Treasury bills can be used to borrow more money cheaply from other markets.

Why it matters:

- Cheaper funding for banks = more incentive to lend at low rates.
- Helps boost business activity and consumer spending.

Example: If a bank can borrow at 0.5% instead of 3%, it might offer small business loans at 2% instead of 5%, encouraging more businesses to invest and grow.

📣 **Forward Guidance – "Telling the Future… Sort Of"**

Definition: When the Bank of England tells everyone what it *plans* to do with interest rates in the future, to help guide borrowing and investment decisions.

Why it matters:

- If people know rates will stay low, they might be more confident about taking a mortgage or investing in their business.
- It reduces uncertainty, which encourages spending.

Example: The Bank says, "We won't raise interest rates for at least 18 months." A tech company hears this and decides it's the perfect time to take out a loan to build a new office, knowing repayments will stay manageable for a while.

10.3 Financial regulation

Regulation of the financial system in the UK

Why regulate at all?
Think of the financial system like a busy motorway. Without traffic rules, you'd have chaos, accidents, and some seriously grumpy drivers. In finance, *regulation* means creating rules to make sure banks, insurers, and investment firms don't take dangerous risks that could cause massive problems for the economy.

In the past, a lack of strong rules led to risky loans, bad investments, and huge losses for banks. After financial disasters (like the 2008 crisis), the UK decided to step up its game. The **Bank of England** now keeps a closer eye on the financial world to ensure:

- **Financial stability** — keeping the system steady and safe.
- **Protection** for everyday people — making sure your savings aren't in danger because of someone else's bad gamble.

The Key Players in UK Financial Regulation:

1. The Prudential Regulation Authority (PRA)

The PRA is like the safety inspector for banks, insurance companies, and co-ops. Its main job? Make sure these organisations are strong enough to survive tough times and don't go bankrupt.

How they do it:

- Set rules banks must follow (like keeping enough money aside for emergencies).
- Check regularly that these rules are followed.

Example:
Imagine a large UK bank starts lending too much to risky tech start-ups. The PRA might step in and say,
"Hey, slow down! Keep more backup cash so you don't collapse if those start-ups fail." After the 2008 crash, the PRA told some banks to sell parts of their business, cut costs, and reduce risky loans.

10.3 Financial regulation

Regulation of the financial system in the UK

2. The Financial Policy Committee (FPC)

The FPC is like the economy's "big picture" safety net. It spots problems in the financial system and tries to fix them before they get serious.

How they do it:

- Run **stress tests** on banks (like a financial fire drill) to check they can survive big economic shocks, for example, a sudden fall in house prices.
- Set rules on how much people can borrow, based on their income, to stop things like housing bubbles.

Example:
If house prices are rising too fast and people are taking massive mortgages they can't afford, the FPC might say, "Banks, you can only lend up to 4.5 times a person's salary, let's cool things down."

3. The Financial Conduct Authority (FCA)

The FCA is the referee of the UK's financial markets. It makes sure companies treat customers fairly, don't mislead people, and follow the rules.

How they do it:

- Investigate dodgy behaviour by banks, insurance companies, and investment firms.
- Fine companies or force changes if they're not playing fair.

Example:
If an investment app promised "guaranteed profits" but was actually just gambling with people's money, the FCA could step in, shut it down, and get customers their money back.
In one real case, they ordered a payday loan company to refund millions to borrowers it had overcharged.

10.3 Financial regulation

Why a bank might fail

Banks, like people, can make mistakes. But when they do, the consequences can be huge, not just for them, but for the whole economy. Here are some common reasons why banks hit trouble:

1. High-Risk Loans 🎯

When a bank hands out too many risky loans (money lent to people or businesses that may not be able to pay it back), it's like playing financial roulette.

Example: Imagine a bank giving lots of loans to new businesses with no proven track record, hoping they'll all succeed. If many fail, the bank is left with unpaid debts.

- A real-world example was **Lehman Brothers** in the U.S., which invested heavily in risky mortgages before the 2008 crash. When borrowers couldn't pay, Lehman collapsed.
- This can cause a **"run on the bank",** when customers panic and rush to withdraw their money, worried the bank might go under.

2. Asymmetric Information 🤔

This happens when one side of a deal knows much more than the other and uses it to their advantage. In banking, sellers of financial products often have more knowledge than buyers.

Example:

- A bank might sell complex investment products that sound safe but are actually very risky and customers wouldn't know until it's too late.
- In the 2008 crisis, banks bundled risky home loans and sold them as "safe" investments. Investors didn't realise how risky they actually were until the market collapsed.

10.3 Financial regulation

Why a bank might fail

3. Breaking the Rules 📜

Banks must follow strict regulations, like rules on preventing fraud, money laundering, and interest rate manipulation. Ignoring these rules can mean heavy fines or even closure.

Example: Suppose a bank doesn't check where large deposits come from. If that money turns out to be linked to illegal activities, the bank can be in serious trouble.

- In 2012, **Standard Chartered Bank** was fined for failing to follow anti–money laundering laws when dealing with certain foreign transactions.

4. Speculation & Market Bubbles 📈

If there's too much easy money floating around, people and banks may invest in risky assets, pushing prices up beyond their real value. This creates **bubbles**, which eventually burst.

Example: Before the dot-com crash (2000), banks pumped money into internet companies with no profits and when reality hit, stock prices collapsed.

- Bubbles can also form in housing, cryptocurrencies, or even collectibles like rare trading cards.

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10.3 Financial regulation

Liquidity and capital ratios

Back in 2007, the world had a big financial mess (a.k.a. the global financial crisis). One major lesson we learned? Banks can't just take wild risks without having a safety net.
Now, banks must meet *capital* and *liquidity* requirements, basically, prove they have enough resources to survive sudden money problems (think of it like carrying an umbrella just in case a storm hits ⚡).

💧 **Liquidity Ratio – Your "Rainy Day" Readiness**

Definition: The liquidity ratio measures how easily a bank can get its hands on cash to cover short-term needs.
It compares what the bank *could quickly turn into cash* (like cash in the vault or money in very safe investments) to what it *owes soon* (like customer withdrawals).

💡 **Example:** Imagine you run a café. You have £1,000 in your cash register and £2,000 worth of milk, coffee, and sugar in stock (easy to sell if needed). If you owe your suppliers £2,500 next week, your liquidity ratio tells you whether you can pay them without borrowing money.

✅ A higher liquidity ratio = the bank is more ready for sudden "cash now" situations.

💎 **Capital Ratio – The Bank's Safety Cushion**

Definition: The capital ratio measures how much of a bank's own money (profits, reserves, or money raised from selling shares) it has compared to how much it has lent out or invested.

💡 **Example:** If your friend borrows your bike, you'd feel safer if you have a spare bike at home. That spare is your *capital cushion*. In banking, it means if loans go bad, the bank has its own funds to absorb the losses without collapsing.

✅ A higher capital ratio = the bank can handle more bad-loan "oopsies" without needing a bailout.

10.3 Financial regulation

Moral hazard

Definition: *Moral hazard* is when someone takes bigger risks because they know someone else will bail them out if things go wrong.

Since 2008's financial crisis 💣, moral hazard has been on the rise in the banking world. Why? Because governments keep stepping in to save struggling banks 🏢 when they're about to fail (for example, RBS in the UK).

Here's what happens:

- 🏢 **"Too big to fail"** – Big banks know they're so important that the government can't let them collapse. So, if they take wild risks and lose, taxpayers end up picking up the tab 💸.
- 🦹 **Questionable comeback** – After being bailed out, some banks go back to making super-risky investments, kind of like a student who crams at the last minute, barely passes, and then repeats the same bad study habits.
- 📊 **Investor hype gone wrong** – These false success stories got people excited, drove up stock prices temporarily, and made some investors rich… until the truth came out. Then prices crashed, and a lot of everyday people lost serious money 💔.

💡 **Everyday example:**
Picture your friend borrowing your brand-new skateboard 🛹. They decide to try a crazy stunt because they know if it breaks, *you* will replace it. That's moral hazard, risking big when you're not the one paying for the damage.

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10.3 Financial regulation

Systemic risk

Definition: *Systemic risk* is the danger that problems in one part of the financial system spread like dominoes 🁣🁣🁣, knocking everything over. It's not just one bank or company struggling, it's the *entire* financial sector feeling the pain.

💥 **How it happens:**
After a long period of economic growth, people can get a little too confident and start making risky investments; think housing bubbles or overpriced tech stocks. Banks often help fuel this by lending money for those risky bets.

When the bubble bursts 💣:

- Banks may suffer **liquidity problems** (fancy term for "we're short on cash") and become less willing to lend.
- Businesses and households can't borrow easily, which means less spending, less hiring, and higher unemployment 📉.
- Confidence in the economy drops, leading to even less borrowing and spending, a vicious cycle.

Key point: Financial instability and economic instability are tightly linked like tangled earbuds 🎧, it's hard to tell where one starts and the other ends.

✅ **Solution:** Stronger regulation can help prevent a crisis from spreading. But… regulation has its own headaches (see below).

10.3 Financial regulation

Systemic risk

🏛 **Issues with Regulation – Good Intentions, Tricky Results**

Regulation is like adding safety rules to a playground. It makes things safer, but it can also slow down the fun.

The challenges:

- 🌎 **Jobs may move overseas** – Tough rules can push financial services to countries with looser regulations.
- 💸 **Penalties need to be meaningful** – Fines or punishments must be strong enough to keep banks in line, or they'll just shrug them off.
- ⏳ **It's time-consuming and costly** – Designing, enforcing, and monitoring regulations takes a lot of planning, money, and people.
- 📉 **Less lending = slower economy** – If banks have stricter rules and lend less, fewer people buy homes, start businesses, or expand companies.
- 🥷 **Unexpected side effects** – Over-regulation can push risky activities into the "shadow banking" sector (unregulated financial operations), where it's harder to monitor.

💡 **Everyday analogy:**
Systemic risk is like a power outage ⚡ in a city (one failure can black out everything. Regulation is the electrician fixing the wiring) necessary, but sometimes the repairs slow things down or make people look for unofficial, riskier power sources.

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10.3 Financial regulation

International institutions and non-government organisations (NGOs)

🌍 The World Bank

The **World Bank** was set up after World War II (at the 1944 Bretton Woods Conference) to help rebuild countries devastated by war. Today, its mission is to reduce poverty and support **long-term development** by helping countries grow stronger over time, not just get quick fixes.

What does the World Bank actually do?

- 🏗️ **Infrastructure**: One of its biggest roles is helping countries build vital things like roads, bridges, schools, hospitals and energy systems. For example, it supported electricity access expansion in Ethiopia.
- ⚙️ **Policy advice**: It gives advice to governments on how to improve their economies. This includes encouraging **economic reform** (changing how the economy works to be more efficient or fairer) and **trade liberalisation** (removing trade barriers like tariffs to allow easier trade with other countries).
- 💷 **Reconstruction loans**: When countries are hit by war or major disasters, the World Bank steps in to help them rebuild. For example, it helped Ukraine fund emergency repairs to infrastructure damaged by conflict.
- 🌱 **Development loans**: It lends money to **developing countries** to help improve their economies and living standards. This could be anything from funding education projects in Malawi to water sanitation in Bangladesh.

10.3 Financial regulation

International institutions and non-government organisations (NGOs)

💰 International Monetary Fund (IMF)

The **IMF** (International Monetary Fund) was created in 1944 at the Bretton Woods Conference, just like the World Bank. But here's the twist: while the World Bank focuses on long-term development, the IMF is more like a global financial firefighter. Its main job is to make sure **exchange rate systems** (how currencies are exchanged between countries) run smoothly and that global financial stability is protected.

🛠️ What does the IMF actually do?

- 🧭 **Keeps the world's finances stable**
The IMF's top goal is to make sure countries can trade and invest with each other smoothly. They help prevent financial chaos across borders.
- 💱 **Watches over exchange rates and payments between countries**
When countries buy and sell with each other, they need to exchange currencies. The IMF helps manage these systems, so countries don't fall into crisis.
- 🧯 **Helps countries in financial trouble**
If a country runs out of foreign currency and can't afford to pay for imports (like fuel or food), the IMF can lend money. This helps solve a **balance of payments** problem (when a country spends more abroad than it earns).
- 👀 **Monitors what's going on in the world economy**
This is called **surveillance**. The IMF keeps an eye on what governments are doing with their money and gives advice if things look risky, like too much debt or out-of-control inflation.

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International institutions and non-government organisations (NGOs)

💙 **NGOs (Non-Governmental Organisations)**

NGOs are organisations that are **independent of governments** and are usually **not-for-profit**. They're often set up by volunteers or charitable groups to help solve problems or improve people's lives, without trying to make money.

🧰 **What Do They Do?**

- **Direct Help on the Ground**: NGOs can jump in to provide real, practical support like building schools, digging wells, or running health clinics. For example, **WaterAid** works to bring clean water to rural villages in Malawi, and **BRAC** (a large NGO from Bangladesh) supports education and microfinance around the world.
- **Act as Pressure Groups**: Some NGOs try to influence governments by raising awareness and lobbying for better development policies. Think of groups like **Greenpeace** pushing for climate action or **Save the Children** advocating for child rights.

🚧 **What Are the Challenges?**

- **They Can't Do It All**: One big criticism is that NGOs **can't fix everything alone**. Big, structural problems (like reforming an education system or building nationwide healthcare) usually need **government-level action**.
- **Political Tensions**: Some NGOs are seen as having **anti-capitalist views**, meaning they may challenge the role of big global players like the **World Bank**, **IMF**, or **WTO**. This can cause tension because some people believe that free markets and capitalism are the best path to development while others think they cause inequality.

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International institutions and non-government organisations (NGOs)

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