



Edexcel A - A Level Economics

Theme 4 – A global perspective

4.4 The financial sector

Revision Notes

Contents

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4.4.1 Role of financial markets


What Are Financial Markets?

Financial markets are places (real or digital) where people and businesses come together to **buy and sell financial stuff** like money, shares, bonds, and foreign currencies. Think of it as a giant online shop for money-related products.

Examples of financial instruments:

- **Equities** (shares in companies)
- **Bonds** (loans to companies/governments)
- **Currencies** (like dollars, euros, yen)
- **Derivatives** (complex financial bets on future prices)

They exist to:

- Help people and businesses **borrow and save money**
- Let people **invest, speculate** (i.e. make bets on future prices), and (hopefully) make .

The 5 Key Roles of Financial Markets

1. Facilitate saving



They give people and companies a place to **store money for the future** in savings accounts, pensions, or even company shares. It lets you **move money from now to later**.

2. They lend money to individuals and businesses

When you put your money in the bank, it doesn't just sit there, banks use your savings to **lend money to other people**, so your savings can help someone else buy a house or start a business. Without loans, buying big things (like houses or equipment for businesses) would be nearly impossible. Financial markets help by giving access to **credit**, which is borrowed money.



4.4.1 Role of financial markets

- For example, a bakery might borrow money to buy a new oven 
- A student might take out a loan to pay university fees 

This speeds up **spending** (by households) and **investment** (by businesses), which helps the economy grow.

3. They facilitate the exchange of goods and services

Financial markets help with the **exchange of goods and services** by making it easier to move money between people; whether you're using a phone app like Venmo, a debit card at the grocery store, or doing a bank transfer to pay your rent.

4. They provide forward markets in currencies and commodities

Some parts of financial markets are like **crystal balls**; they let people make deals today for prices in the future. These are called **forward markets** or **futures markets**.

- For example, an airline might lock in fuel prices now to avoid paying more later if prices rise.
- This helps with **price stability** and allows investors to **speculate** (make guesses and hopefully profits) on where prices are going.

5. They provide a market for equities

Financial markets also provide a **market for equities** which just means buying and selling **shares in companies**. When you buy a share, you own a tiny piece of that company (for example, Disney or Apple).

It's a way to build **long-term wealth** or try to make quick profits (if you're into **speculation**).

4.4.2 Market failure in the financial sector

A **market failure** happens when the market doesn't work the way it should and people, businesses, or even entire economies get hurt because of it. The financial sector is full of these kinds of fails and when things go wrong here, they go **really wrong**. Just ask anyone who lived through the 2008 crash.

1. 😞 Asymmetric Information

What is it?

When one side of a deal knows way more than the other. Usually, sellers know more than buyers and that creates unfairness.

Why is this bad?

Buyers can end up making decisions without knowing the full picture.

Real-life example:

In the 2008 crisis, banks sold "safe" investments that were actually filled with risky subprime mortgages. Many buyers had no idea. It's like buying a car that looks brand new on the outside—but has a broken engine inside.

Fun fact:

Even the **regulators** (the people meant to watch over the banks) didn't know the full picture. Some banks didn't share key info, making it harder to prevent bad behaviour.

2. 🌍 Externalities

What is it?

An **externality** is a side effect of someone's actions that affects other people. It can be good (positive) or bad (negative).

In finance, it's usually negative.

Example: Investors speculating on property = house prices go up = young buyers can't afford homes. That's a **negative consumption externality**.

Imagine:

A landlord buys up ten homes in your town just to rent them on Airbnb. Rents and prices skyrocket. You're affected, even though you didn't do anything wrong.

4.4.2 Market failure in the financial sector

3. 🚨 Moral Hazard

What is it?

When someone takes more risks because they know they won't suffer the consequences.

Why does this happen?

Because they think someone else (usually the government) will **bail them out**.

Examples:

- Some bank employees gave out risky loans to earn bonuses knowing if those loans failed, the bank (not them) would take the hit. Worse: banks knew central banks would **bail them out** if they failed, so they took even more risks.
- After the 2008 crash, banks like RBS were rescued by the government. So, they took big risks again later, thinking: "Meh, we're too big to fail."

It's like if you drove recklessly because you knew your parents would pay for any tickets or damages. Risky behaviour with a safety net.

4. 📈 Speculation and Market Bubbles

What is it?

Speculation is buying stuff (like houses, stocks or Bitcoin) hoping the price will go up so you can sell it later for a profit.

A **bubble** happens when prices rise way above what things are really worth and then suddenly crash.

Why does it matter?

It creates instability and can cause people to lose a LOT of money when the bubble bursts. It can cause a financial crash.

Example: Investors pumped up the housing market by buying homes just to sell them later. Prices exploded 🚀. But when interest rates rose, demand dropped, and the bubble popped 💣 causing a wave of defaults and bank losses.

Other examples:

Think of the GameStop stock craze. Prices shot up like a rocket 🚀 then fell back to Earth 🌍.

This also happened with 💻 the dot-com bubble (1990s tech stocks) and 📱 cryptocurrencies in recent years.

4.4.2 Market failure in the financial sector

5. 🤖 Market Rigging

What is it?

This is when individuals or firms **cheat the system** by fixing prices or using secret information to get rich.

Examples:

1. Insider trading – Someone uses private information (not available to the public) to buy/sell shares before news breaks.

- 🧠 Example: An employee hears their company will announce bad news tomorrow and sells their shares today.

2. Price fixing – Banks or traders team up to set prices unfairly.

- 💣 Example: The **Libor scandal** (2008) where banks were caught manipulating interest rates to boost profits.

It's **illegal**, but often hard to prove unless someone from the inside (a **whistleblower**) speaks up.

Imagine:

A football referee secretly working for one team. That's market rigging, but with money.

4.4.2 Market failure in the financial sector

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4.4.3 Role of central banks

Key functions of central banks

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).



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Key functions of central banks

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.

4.4.3 Role of central banks

Key functions of central banks

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**



4.4.3 Role of central banks

Key functions of central banks

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