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Market Failure in the Financial Sector

GCE A-LEVEL & IB ECONOMICS

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Lesson Structure

Market Failure in the Financial Sector

- Asymmetric Information
- Moral Hazard
- Speculation and Market Bubbles
- Externalities
- Market Rigging

Asymmetric Information

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Asymmetric information is a situation where where one party has less information than the other in a transaction.

In this situation, the informed party is unlikely to disclose all information to maximize their own interests.

An example of this is the second-hand car market shown in this video:

https://www.youtube.com/watch?v=sXPXpJ5vMnU

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Asymmetric Information

In the context of financial markets, sellers of risky financial assets (e.g. banks) tend to have more information than buyers (e.g. retirees) as they created the financial product. As a result, consumers are taken advantage off when they do not fully understand the risks involved in the investment.

This lack of information leads to inefficient markets and market failure.

Moral Hazard

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Moral Hazard is the situation when a person/business takes more risk to benefit themselves, knowing a 3rd party will bear the cost when things fail.

Banks are comfortable taking excessive amounts of risky loans to maximize profits in the crisis as they know the government will bail them out as a lender of last resort when they fail. The same can apply to bankers within financial institutions, or even countries in the Eurozone.

A common life example is what I do after getting my AppleCare – I would take more risks with my Macbook knowing that I will be protected.

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Speculation & Market Bubbles

What is a Market Bubble? It occurs when...

- There is excessive confidence in investments or assets (e.g. stock prices, house prices), especially the belief which they will continue to increase in price
- Because of that belief, investors keep buying the asset/stock and pushes the price up even further. Eventually the price becomes high that it far exceeds the asset's (house or stock's) actual value or intrinsic worth
- As a result, people stop investing as they can no longer sell the asset at a higher price than what they bought for, and the price of that asset crashes

Examples: 2008 US Subprime Mortgage crisis, Dutch tulip craze, dot-com bubble
https://www.youtube.com/watch?v=Zr3FcXeDZFc

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Speculation & Market Bubbles

What would happen when a market bubble bursts?

- The price of the underlying asset decreases significantly
- As a large number of investors may have borrowed funds to buy those investment products, their debt may now worth more than the investments they own (e.g. your mortgage value can be greater than what your house is worth after the housing bubble collapse)
- This will lead to bankruptcy for many individuals or institutions (e.g. government bailout of banks) involved
- Depending on size of bubble, huge reduction in consumption and investment in the economy due to lack of business & consumer confidence, and their capacity to spend

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Potential Causes of Market Bubbles

Excessive Liquidity

- This refers to how easy it is for consumers/investors to borrow. The more funds/credit/liquidity that they have access to, the bigger their purchasing power for investment assets like stocks and housing, thus pushing the price of these assets up.

Irrational Behaviour

- **Herding Behaviour** – This is when individuals "follow the crowd" like a herd of cows. In this case, we may tend to invest in particular products because our friends and family all do it and believe it will increase in price such that you would not want to miss out.

- **Greater Fool Theory** – This is the irrational belief that there will always be someone who will buy your investment product from you, despite you may already have bought it at a high price. As a result, you would believe you can still gain from your investment, with the buyer being the "greater fool"

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Externalities

As you would expect, the fallout of a financial crisis can lead to significant negative externalities. It can cause negative impacts to individuals who were not involved in causing the crisis. Due to the decrease in AD, some impacts may include:

- A loss in GDP in the economy due to the potential economic downturn caused by the crisis

- A reduction in business profits, sales and investment as consumption decreases, and potential bankruptcy for companies

- Fall in household incomes due to potential unemployment if companies fail, hence purchasing power and living standards

- A tightening of credit provided by banks causing long term investment to decrease

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Externalities – Chain of Reasoning

Positive externality (e.g. for developing countries):

Presence of financial sector → Ease of transactions → higher availability of credit/liquidity for businesses to borrow → Higher investment by businesses to expand → positively affect third parties through employment and higher income/living standards

Negative externality (financial crisis):

Financial sector failure → Excessive risk undertaken by banks → Banks default → credit crunch (reduction in liquidity/credit availability) → higher cost to borrow with lower investment/consumption → reduction in AD → negatively affect third parties by lower employment and incomes

Also banks need to be bailed out → opportunity cost of taxpayers' money → less goods/services provided by the government → negatively affects society/third parties

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Market-Rigging (e.g. collusion)

Read this article: https://www.bbc.co.uk/news/business-19199683

- Market-rigging is when firms act together to manipulate normal operation of the market for their own profits.

- Can occur in many forms in financial markets (including the provision of false/fraudulent information in the market for interest rates, sharing confidential client information to gain an unfair advantage in the exchange market etc.)

- Banks are heavily fined after the discovery, but does this matter if their gains from market rigging may significantly outweigh the expected risks and costs of being caught?