

Market Failure in the Financial Sector

Financial markets experience market failure when the free market leads to an inefficient allocation of resources.

The 2008 Global Financial Crisis highlighted how problems within individual financial institutions can spread through an interconnected global financial system.

The main causes of market failure in the financial sector are:

- Asymmetric information
- Externalities
- Moral hazard
- Speculation and market bubbles
- Market rigging

Asymmetric Information

Asymmetric information occurs when one party in a transaction has more information than the other.

This is common in financial markets because financial products can be complex and difficult for consumers to fully understand, giving sellers an information advantage.

For example, in 2008, complex CDOs were packaged and given top-tier AAA ratings, meaning rating agencies had far more information about their true risk than buyers (Watch the movie “The Big Short” , great movie to understand the 2008 financial crisis)

Externalities

Financial institutions are highly interconnected with each other and the wider economy. Therefore, risky behaviour or the failure of one financial institution can impose significant costs on third parties.

Systemic Risk

Systemic risk occurs when problems within one financial institution spread through the financial system and potentially damage the wider economy.

For example, if one bank cannot repay money it owes another bank, the second bank loses revenue and may also experience financial difficulties.

Bank failure → banks become more cautious and reduce lending → firms find it harder to borrow → investment falls → aggregate demand falls → real GDP falls and unemployment rises.

Consumers may also lose confidence in the banking system. If households fear losing their deposits, or actually lose some of their wealth following a bank failure, consumption may fall due to a negative wealth effect.

Lower investment + lower consumption → fall in AD → lower real GDP + higher unemployment + lower inflation.

For example, Northern Rock collapsed in 2007 → fear spread through the banking system → lending between banks fell → other banks faced financial difficulties → the wider financial system became unstable.

Moral Hazard

Moral hazard occurs when protection against a risk encourages an individual or firm to take greater risks because they do not expect to face the full consequences if things go wrong.

Before the 2008 financial crisis, some banks engaged in risky activities such as investing in high-risk financial assets. One reason was that large banks may have expected governments to intervene if their failure threatened the wider financial system.

Expectation of a government bailout → banks expect some losses to be absorbed by the government → cost of taking risks falls → banks take greater risks → probability of financial instability increases.

This is linked to the idea that some banks are “**too big to fail**” because allowing them to collapse could cause severe damage to the wider financial system.

“Privatise the profits, socialise the losses.” The criticism is that when banks' risks pay off, shareholders and executives collect the rewards. But when those risks cause huge losses, the government steps in and the public bears the cost.

Following the financial crisis, regulators developed alternatives to traditional bailouts. For example, shareholders may be required to absorb losses while the bank continues operating or is transferred to another owner.

Speculation and Market Bubbles

Speculation occurs when investors buy an asset because they expect its price to rise in the future, allowing them to sell it later for a profit.

Higher expected future prices → investors buy the asset → demand increases → asset price rises → rising prices attract more investors → price may rise above its fundamental value.

A **market bubble** occurs when an asset's price rises significantly above its underlying or fundamental value.

Eventually, investors may realise the asset is overpriced → investors begin selling → supply increases rapidly → confidence falls → more investors sell → asset prices collapse.

This is known as the **bubble bursting**.

2008 Housing Market

Before the 2008 financial crisis, rising house prices encouraged greater mortgage lending and speculation in property. Banks increasingly provided mortgages to higher-risk borrowers because house prices were expected to continue rising.

Borrowers defaulted on mortgages → mortgage-related assets fell in value → investor confidence collapsed → asset prices fell → housing bubble burst → banks holding these assets suffered major losses.

Market Rigging

Market rigging occurs when participants manipulate financial markets, such as interest rates or exchange rates, in order to benefit themselves.

For example, banks or traders may coordinate their behaviour to manipulate a benchmark rate and increase their profits. This is fraudulent but can be difficult for regulators to detect unless evidence emerges, such as through a whistleblower.

LIBOR Scandal

LIBOR was a benchmark interest rate used in many financial transactions, including short-term borrowing between banks.

Some traders were convicted of manipulating LIBOR for financial gain. This meant the interest rate used to price financial transactions did not accurately reflect market conditions.

Market rigging → prices or interest rates become distorted → resources are misallocated → some market participants gain at the expense of others → financial markets become less efficient.