

A LEVEL ECONOMICS

EXAMPLE ESSAYS

Financial Markets

VOLUME 1

with Examiner Commentary

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As Keynes said: 'When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.' (The General Theory of Employment, Interest and Money, 1936). To what extent do you agree that market failure is inevitable in financial markets? Justify your answer with reference to economic theory and evidence.

Financial markets refer to money markets, capital markets and foreign exchange markets. Market failure occurs when a market, left to its own devices, fails to achieve an efficient or equitable allocation of resources. There could be any number of reasons for this, but with financial markets, seems likely because of information failures, externalities and concentration and lack of contestability.

How prevalent are information failures in financial markets and what are the inevitable consequences? Perfect competition assumes that market participants have full information, and while this is unrealistic in practice, it means that to avoid failure, markets must function using high degrees of symmetrical information. Financial markets deal in intricate and complex products (e.g. derivatives and swaps), with differing expertise at both personal and professional levels. Innovation has meant ever-increasing choice and complexity, and where decisions are infrequent, as with mortgages, insurance products and pensions, individuals may experience bounded rationality, even where correct and complete information is available. Consumers are likely to respond by adopting heuristics (or simple rules of thumb) such as herd behaviour or loss aversion and their decisions will exhibit bias. Biased decisions can then lead to market failure. However, information is highly unlikely to be complete and is likely to be asymmetric. With insurance and mortgages, the purchaser has an advantage in that they are more aware of the risks of ill-health in the case of health insurance and understand better the likelihood of default on loans. Add in moral hazard in insurance for example, where the insured is likely to run greater risks because it is the insurance company and not them who pays in the event of loss, and market failure is highly likely, if not inevitable. At the extreme - as explained by Akerlof in his 'market for lemons' analysis - information asymmetry can result in missing markets, but in this case, is more likely to result in financial institutions charging higher insurance premiums or interest rates and/or making tougher checks. However, these too are a form of market failure. It can also be the case that sellers have an information advantage where complex products are concerned. There are frequent examples in the news of action against mis-selling, with PPI being the most notable example. Another would be sub-prime loans in the US where individuals, in many cases without regular incomes from a job, were persuaded to take out mortgages, presumably unaware of the risks if the housing market failed to expand. Arguably, purchasers were not the only parties experiencing information failure in this example. For the banks and other institutions around the world that bought the sub-prime loans bundled together with other securities, they too experienced information failure and the result was a clear case of Akerlof's missing market as these products eventually became worthless. A contributory factor was the principal-agent problem where Boards of Directors of large financial institutions delegated decision-making to individuals who possessed a monopoly of technical knowledge but with incentives that encouraged excessive risk taking. The analysis of theory and evidence suggests that information failure is a major cause of market failure in financial markets and that it is perhaps inevitable.

A punchy start, showing sound understanding of key concepts and knowledge of the types of market failure likely to occur in financial markets.

Good synoptic knowledge shown, linking financial markets to a deeper understanding of market failure, and also behavioural economics.

Derivatives, mortgages and pensions are good examples – this is required by the question and would be easy for candidates to forget to do.

The market failures are well-linked to the specific example of financial markets rather than being generic – this shows excellent understanding and is the basis of a super argument.

More examples – fantastic!

The entirety of this paragraph shows an outstanding applied grasp of information failure in its numerous forms.

In addition to information failure, financial markets also generate externalities. In markets generally, a cause of partial market failure is externalities, and it is likely that the externalities involved in financial services are sizeable. Externalities are impacts falling on third parties as a result of decisions by market participants. First, a well-functioning financial sector allows payments to be made, as it enables funds from those who wish to save to be channelled to those in need of funds, and this also allows individuals and businesses to insure and manage risk. The efficiency and effectiveness of financial markets influences short-run and long-run growth in developed countries. Indeed, an inadequate financial sector is recognised as a barrier to growth in emerging countries. Without insurance and the means to borrow, innovation and technological progress would be less and economic growth would suffer. In this sense, financial markets are associated with positive externalities. Where this is the case, a free market would partially fail, as equilibrium would be below the socially optimal outcome.

However, it is likely (and experience supports this view) that financial markets may also be associated with negative externalities. Speculative bubbles caused in part by the optimistic willingness of financial institutions to lend have led to instability that has been a major cause of fluctuations in real economic activity. Furthermore, the recent financial crisis saw initial problems at individual banks threaten the breakdown of the entire banking system due to inter-linkages and cascading failures – a process known as systemic risk. Both negative and positive externalities seem sizeable and presumably the focus of government intervention is to maximise the positive and minimise the negative. So soon after major changes in regulation have been made, it is difficult to assess the impact on externalities. There is potential for market failure from this source, but it is difficult to say if it is inevitable.

Finally, the financial sector is one characterised by a high degree of concentration, a feature which may lead to market failure. The extent to which market failure exists here depends on the conduct of the businesses in question and the scope for economies of scale and dynamic efficiencies. Economies of scale are sizeable, not on the technical side perhaps but with managerial, risk taking, financial and so on. This is a sector undergoing rapid innovation and it may be that better outcomes will be obtained from dynamic efficiencies from firms earning abnormal profit. However, there have been a number of instances of collusion – with the LIBOR scandal being a notable, but not the only example. This clearly suggests market failure. In addition, this is not an especially contestable market. While there are a reasonable number of challenger banks (including online or app-based banks) waiting to contest the market against incumbent firms, the regulatory process of approval is slow, perhaps reflecting the risk of negative externalities. It is unclear too how well the process of creative destruction will be allowed to work in this area, on which true market efficiency depends.

All markets fail to some degree, therefore the conclusion that market failure is inevitable in financial markets is valid, if not particularly interesting. Is it more inevitable than other markets? Perhaps yes. Large numbers of theoretical causes of market failure are present and there is reason to think their impact could be significant on micro and macro levels. However, in judging against real world evidence, this is a market where there is a high and increasing degree of government intervention. This in itself suggests large-scale market failure and its inevitability. Whether market failure remains after government intervention is difficult to judge at this time of change, but it is perhaps the more interesting question.

The opening sentence provides a sense of structure.

Good, accurate definitions.

Both micro and macro issues, in terms of impacts of third parties, are considered here, which is helpful given that the financial markets topic covers both micro and macro issues.

Consideration of both positive and negative externalities builds strong analysis and evaluation marks. The link to recent economic experience ensures that this is not just a theoretical essay.

The wording of this final sentence of the paragraph is closely linked to the wording of the question and suggests that the candidate is staying focused on the precise question.

Consideration of the pros and cons of market concentration again shows sound synoptic knowledge and provides an opportunity for evaluation.

This is an excellent conclusion that directly answers the question as well as providing some interesting nuance e.g. there is always market failure but the more interesting issues is its significance.