Financial Market Failure

# Starter: Recap Question

**Instructions:** Test yourself with the below quick question

What are the six roles of financial markets?

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What is meant by a market failure?

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What types of market failure do you know? Can you explain them?

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| Note Space: |

# Presentation 1 – Intro to Financial Market Failure

Complete the activities below so as to have a complete set of notes:

**Definition:** *Market Failure*

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**Technique:** *Analysing Failure in Financial Markets* ***-*** *A Three-Step Process*

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**Key Notes:** *Sources of Failure in Financial Markets*

* Externalities
* Asymmetric Information
* Moral hazard
* Market Rigging
* Speculation & Market Bubbles

# Presentation 2 – Sources of Financial Market Failure

Complete the activities below so as to have a complete set of notes:

**Definition:** *Externalities (recap)*

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Actions in financial markets can impact third parties in other markets who are not part of the transaction.

*Example*

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## Video Task: Bailouts

A person with his eyes closed

Description automatically generated with medium confidence**Instructions:** Watch the video via the link below and answer the questions

<https://www.youtube.com/watch?v=Bu2wNKlVRzE>

**Questions:**

What is the externality at the heart of the financial crash and bailout?

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Which role of the financial market does the financial crash and bailout impact and why?

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What are the consequences on the macroeconomy of this impact?

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**Definition:** *Asymmetric Information (recap)*

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One problem with the financial sector is that financial institutions often have more knowledge compared to their customers , both consumers and other institutions.

This means they can sell them products that they do not need, are cheaper elsewhere or are riskier than the buyer realises.

*Example*

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## Video Task: CDOs & Jenga

**Instructions:** Watch the video via the link below and answer the questions

<https://www.youtube.com/watch?v=3hG4X5iTK8M>

**Questions:**

What is the asymmetric information at the heart of the CDOs?

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Which role of the financial market does the asymmetric information impact and why?

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What are the consequences on the macroeconomy of this impact?

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**Definition:** *Moral Hazard (recap)*

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It can manifest in financial markets where individual workers take adverse risk in order to increase their salary.

Any problems they cause will be the problem of the company and not the problem of the individual, the worst that can happen is to lose their job whilst the company may lose millions of pounds.

*Example*

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A person smiling at the camera

Description automatically generated with low confidenceMoral Hazard can also occur as whole financial institutions may take excessive risk because they know the central bank is the ‘lender of last resort’ and so will not allow them to fail because of the impact it would have on the economy.

## Video Task: Mortgage Brokers

**Instructions:** Watch the video via the link below and answer the questions

<https://www.youtube.com/watch?v=H-XINT-hL5I>

**Questions:**

What is the moral hazard at the heart of the mortgage brokers’ profession?

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Which role of the financial market does the moral hazard impact and why?

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What are the consequences on the macroeconomy of this impact?

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**Definition:** *Speculation*

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**Definition:** *Market Bubbles*

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Market bubbles are caused by mass speculative herding behaviour (“mania”).

Investors see the price of an asset is rising and so decide to purchase this asset as they believe the price will continue to rise and will profit them in the future.

Agents use their savings and use loans to buy something because other people think it is worth something, not because they want to consume the financial instrument.

This leads to prices becoming excessively high, well above the intrinsic value of the asset, and eventually enough investors decide that the price will fall, so they sell their assets and panic sets in, causing mass selling.

When a bubble bursts, there is a fall in demand for the asset, hence its price will fall leading to a negative wealth effect for all who held the asset, reducing AD.

Furthermore, banks can be left with huge loans that will not be repaid in full, harming access to credit in future.

*Examples:*

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## Diagram, engineering drawing Description automatically generatedA couple of men walking down a street in front of houses Description automatically generated with low confidenceVideo Task: What Causes a Housing Bubble

**Instructions:** Watch the video via the link below and answer the questions

<https://www.investopedia.com/articles/07/housing_bubble.asp>

**Questions:**

What is the bubble at the heart of the American housing market?

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When the bubble bursts, which role of the financial market does this impact and why?

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What are the consequences on the macroeconomy of this impact?

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**Definition:** *Market Rigging*

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As a result, a suboptimal quantity of a financial product will be traded as these firms care for their own welfare rather than their customers or society.

*Possible ways collusion manifests in financial markets*

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## A person wearing sunglasses Description automatically generated with medium confidenceVideo Task: Ratings Agencies

**Instructions:** Watch the video via the link below and answer the questions

<https://www.youtube.com/watch?v=Kj2W_EqKzuw>

**Questions:**

What is market rigging at the heart of the ratings agencies?

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Which role of financial markets does the marker rigging impact and why?

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What are the consequences on the macroeconomy of this impact?

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# Diagram Description automatically generatedExtension Video: Tulip Mania

**Instructions:**

* Watch the Video
* Answer the questions
* Discuss your answers as a class

**Video**

<https://www.youtube.com/watch?v=I5ZR0jMlxX0>

**Questions**

What causes market bubbles?

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What caused the bubble in Tulip prices?

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What were the impacts when this bubble burst?

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What caused the “DotCom” bubble?

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What were the impacts when this bubble burst?

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What recent bubbles have been seen recently?

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# Assignment

**Data Response (Section B)**

Text, letter

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Text, letter

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Discuss whether providing substantial government financial support to banks is the best policy response during a financial crisis.

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| **Planning Grid: Aim = 4 paragraphs - 2 KAA points (9); 2 Eval points (6)** | |
| **KAA Point 1 = signpost key point** |  |
| Application |  |
| Main concept & diagram |  |
| **Eval Point 1 = relate to your earlier point & re-read the title** |  |
| Context / evidence |  |
| **KAA Point 2 = signpost key point** |  |
| Application |  |
| Main concept & diagram |  |
| **Eval Point 2 = relate to your earlier point & re-read the title** |  |
| Context / evidence |  |

**Question:** Discuss whether providing substantial government financial support to banks is the best policy response during a financial crisis. (15)