

Chapter 38 The financial sector

Answers to Knowledge checks

- 38.1** Investment is important because it allows firms to expand their productive capacity, which then feeds economic growth.
- 38.2** The costs involved here are known as the ‘shoe-leather costs’ of inflation, which were discussed in Chapter 15.
- 38.3** Commodity prices may show volatility over time because of unstable supply (if harvests vary from year to year) or because of unstable demand conditions (if the demand for inputs varies with the business cycle).
- 38.4** The lack of capital means that productivity will be low, which in turn means that wages will be low.
- 38.5** The key issue is whether the borrowed funds are used effectively to stimulate productive investment, or they improve efficiency by enhancing a country’s infrastructure. In the past, funds have not always been used effectively, resulting in a build-up of debt that in many cases became unsustainable.

Answers to Exercises and Case studies

Exercise 38.1

In tackling this question, you need to consider the benefits and costs of accepting alternative forms of flows of financial capital, as each of them offer benefits but also may have a downside. The key flows are foreign direct investment, overseas assistance and borrowing on international markets.

Exercise 38.2

Market failure in rural credit markets has been a problem for many less developed countries.

People in the rural areas may need to undertake small-scale borrowing, but may not have access to the formal financial institutions such as banks. This is partly because the commercial banks do not find it profitable to establish branch banks in rural areas, and even if they did they would find it difficult to distinguish between low and high-risk borrowers. This is because there is information asymmetry, with the banks having less knowledge about potential borrowers. The lack of sound property rights may mean that potential borrowers are not able to provide collateral against loans. The result is that an informal financial sector grows up to cater for rural markets. Local moneylenders have better information about borrowers than the formal institutions, but may also have local monopoly power. This may lead to large differentials in interest rates between the formal and informal sectors.

Microfinance schemes have been developed to try to overcome these problems, with success in some countries.

Exercise 38.3

In order to promote economic growth and human development, it is imperative that funds can be channelled to productive uses. This requires financial markets. In thinking about this question you need to identify the impediments that may prevent the efficient and effective use of resources.

Case study 38.1

Access to finance

- a Developing countries face many challenges in mobilising savings, not least the fact that so many people must survive on very low incomes. Furthermore, even if people were able to save, if they do not have access to formal financial institutions, they are unable to allow potential borrowers to mobilise their savings. In this respect, financial markets fail to act as a channel by which investors can borrow available savings.
- b The lack of secure property rights inhibits borrowing. A poor household or small enterprise that cannot prove it has property rights over the land it owns is unable to provide collateral that would allow a bank to provide funds for investment. The formal financial institutions do not have the local knowledge about potential borrowers, so are reluctant to lend without some form of collateral or credit rating.
- c Improving the supply of rural credit is a major challenge for many developing countries. Extending the coverage of the banking system is one possible approach, but difficult to implement, although one option is to allow banks to set up new branches in profitable locations only if they also open new branches in less accessible places (India tried this approach with some success). Building a system of secure property rights is even more difficult. Microfinance has proved successful in some areas, but banks with a less credible reputation than Grameen have struggled to survive without subsidies from non-governmental organisations or from government.

Answers to end-of-chapter questions

A Multiple-choice questions

- 1 d. To facilitate taxation
- 2 d. A high level of competition in developing countries' financial markets

B Knowledge and understanding questions

- 3 The role of savings may include:
 - Individuals need to undertake saving, and businesses and individuals need to be able to borrow. It is through financial markets that savings can be mobilised for the investment.
 - Individuals (and firms) wish to save for various reasons. It may be that a household needs to accumulate funds for future spending. This may partly depend upon where an individual is in the life cycle. When young, there may be a need to save in order to have a deposit on a house. Savings may also be needed to support people in retirement. The financial sector offers opportunities for people to earn a return through saving, and therefore have funds for later purposes. At current rates of interest, the returns may not provide a strong incentive for this.

The role of investment may include:

- The other side of the coin is that firms — and households — wish to borrow. Financial markets therefore provide opportunities to obtain loans. This was seen in the circular flow model, where the savings behaviour of households enables firms to borrow in order to finance their investment.

Explained the role of savings AND investment in promoting economic development	4 marks
One role explained AND one role identified	3 marks
Identified the role of savings AND investment in promoting economic development	2 marks
Identified the role of savings OR investment in promoting economic development	1 mark

- 4** The Harrod–Domar model is an attempt to determine how equilibrium could be achieved in a growing economy.

An economy can remain in equilibrium through time only if it grows at a particular rate. This unique stable growth path depends on the savings ratio and the productivity of capital. Any deviation from this path will cause the economy to become unstable. The model emphasises the importance of savings in the process of economic growth, and led to the conclusion that a country seeking economic growth must first increase its flow of savings.

Savings are crucial in enabling investment to be undertaken — always remembering that some investment will have to be used to replace existing capital that has worn out. Investment then enables capital to accumulate and technology to be improved. The accumulation of capital leads to an increase in output and incomes, which leads to a further flow of savings, and the cycle begins again.

A full explanation of the Harrod–Domar model	3 marks
A partial explanation of the Harrod–Domar model	2 marks
Identification of the elements of the Harrod–Domar model	1 mark

C Stimulus response question

- 5 a** Microfinance are schemes that provide finance for small-scale projects in less developed countries (LDCs). Needs may include:

- Informal borrowing often has high interest rates in LDCs
- A lack of credit information about individuals in LDCs
- Insecure property rights in developing countries

An explanation of microfinance in LDCs	up to 2 marks
An explanation of the need for microfinance in LDCs	up to 2 marks

b

AO1 Knowledge	1 mark
AO2 Application	1 mark
AO3 Analysis	5 marks
AO4 Evaluation	5 marks

Knowledge (1 mark) is likely to include:

- Financial sector

Application (1 mark) is likely to include:

- Application to promoting economic development

Analysis (5 marks) is likely to include:

Analysis of possible reasons for the financial sector in promoting economic development, for example:

- To provide facilities for savings
- To provide facilities to borrow

- To facilitate investment

Evaluation (5 marks) is likely to include:

- Evaluation that the financial sector is not important in promoting economic development
- Evaluation that other factors may be more important in promoting economic development

A judgement of the importance of the financial sector in promoting economic development

D Essay question

6

AO1 Knowledge	6 marks
AO2 Application	6 marks
AO3 Analysis	6 marks
AO4 Evaluation	7 marks

Knowledge (6 marks) likely to include:

- The financial sector
- Developing economies

Application (6 marks) is likely to include:

- Application to economic growth in developing countries

Analysis (6 marks) is likely to include:

Analysis of the benefits of a developed financial sector, for example:

- To provide facilities for savings
- To provide facilities to borrow
- To facilitate investment

Evaluation (7 marks) is likely to include:

- Evaluation that the benefits of a developed financial sector may not be applicable for economic growth in a developing country
- Evaluation of the costs of a developed financial sector to a developing country
- Evaluation of other, more important, systems required for economic growth in a developing country

A judgement of the importance of a developed financial system in achieving economic growth in a developing country