

# UKS33142

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## **International banking and investment**

## **Section 1**

### **Q1.**

#### **Introduction:**

In any financial institution, it is extremely crucial when they face any financial failure due to various reasons such as recession, stock exchanges, and inflation. Most importantly the inability of financial institutions who failed to obtain information related to financial crises as well as creditworthiness from borrowers creates adverse selection and moral hazard. On the contrary, it has also been shown that the presence of different marketers for which there creates confusion as different perspective and information on the market is present. Therefore, it becomes extremely crucial to maintain moral hazards as general increases in uncertainty create various problems.

#### **Impact of Uncertainty on the financial institution**

Intermediator in any financial institution plays a pivotal role to ensure financial stability. However, uncertainty indicates the lack of knowledge of which financial institution faces various problems in their financial system. One of the major uncertainty in financial institutions is inflation. As high inflation leads to a higher rate of interest the profitability of financial institutions has been affected extremely. Therefore, it becomes extremely hard for institutions to borrow money or lend money as the interest rate is too high (Caglayan and Xu, 2019). On the contrary, inflation in the economy also lowers the money supply from various resources for which the profitability of the financial institution becomes extremely low and sometimes due to this they also can not return borrowed money on time as well. Therefore, the financial institution has to face various volatility. On the other hand, uncertainty also happens when investors and financial professionals can not provide proper knowledge and also can not analyse the present and future market trends properly.

Sometimes changes in stock prices and exchange rates fluctuate which becomes extremely crucial for institutions as it creates uncertainty for investors. During the pandemic, it was clearly shown that due to the high exchange rates overseas investors of financial institutions have faced various problems.

It has also been found that changes in macroeconomic policies are also one of the reasons for uncertainty which has been faced by financial institutions when government make changes in direct and indirect taxes and also in exchange rates. Therefore, sometimes when central

bodies change monetary policies different financial institutions face problems in their profit and growth as well.

Political instability is also one of the main causes of uncertainty which also affect the monetary transactions and also the profitability and investments extremely. It holds back businesses and hiring employees due to financial instability and unsure of the future economy as well. Therefore, uncertainty creates risk for financial institutions for this reason investors hold back their investment and also can not evaluate the future market trends more accurately.

#### **Adverse selection in a financial institution**

Adverse selection refers to the situation when one party has enough information whereas the other parties do not obtain much information which creates a conflict in financial institutions about their products or services. In most circumstances, in financial institutions, sellers obtain more information whereas buyers most of the time lack information which leads them to high risk in the future. Therefore, it can be said that it is the case of asymmetric information. Thus, adverse selection more in tends to cause uncertainty and vice versa uncertainty is also the reason for increased adverse selection. Due to this asymmetric information, most financial institutions that have faced major failures become vulnerable and tend to have more non-public information about their own assets and monetary issues (Ioannidou *et al.*, 2022).

The unavailability of information is one of the reasons for the failure of major financial institutions which affects adverse selection as well. Due to the lack of knowledge investors become extremely volatile and can not make any decisions if it will be right to invest or not. On the contrary, it has also been found that due to this reason, they also become extremely uncertain about solvency and also about borrowers as well.

Another important aspect of uncertainty which leads to adverse selection is the deterioration of market confidence in financial institutions. As a consequence of uncertainty, most investors have been losing their faith in financial institutions. Investors and other parties related to financial institutions become more sceptical due to increased risk factors and an unstable economy (Madeira, 2023). They feel that it can affect their profit and they can not make more money from them as well.

#### **Reason for moral hazards due to uncertainty in a financial institution**

Moral Hazards are one the significant areas for financial institutions as well as individuals. It also refers to the risk factors when one party is not having good faith in another or else provides them with misleading information about assets, investments, liabilities and also

about creditworthiness. On the contrary, moral hazards also describe the process of parties who take unusual risks to make a profit at any cost. Therefore, it is extremely volatile and explains that failures due to the uncertainty of financial institutions contribute greatly to moral hazards. Moral hazards present when both parties have come to an agreement and on which they can gain more profit or opportunities (Lipsy and Lee, 2019). On the contrary, it has also been found that when borrowers fail to provide their creditworthiness means when lenders give a loan without having any proper details and information about their credit and personal details which directly causes moral hazards for them.

On the other hand, bailout expectations are also one of the major trigger points for having more expectations from the government when they face any financial crisis and have face legal issues as well. Thus, these expectations lead to moral hazards as they need to engage more high-risk factors. Moral hazards also refer to situations where a party miss the incentive to protect the financial risk from happening (Wyplosz, 2020). Another important aspect which causes moral hazards in a financial institution is that most of the time they think that they are at less risk as if anything happens they can be backed up by the government. This type of distorted incentive and expectation is the major cause of moral hazards.

## **Q2.**

### **Critical discussion of the tools available to address international financial contagion**

Financial contagion is one of the significant aspects which refers to the spread of a financial crisis from one market to another which can be both internationally and also domestically. Financial contagion affects labour, goods and services, and capital goods which are being used by the market in their monetary transactions in their financial systems (Mitsloan.mit.edu, 2023). Therefore, this can be said that if a financial crisis happens in one market on the contrary, other markets will be affected by the crisis and strong markets can safeguard against economic fluctuation whereas weak markets can increase negative impact more efficiently.

#### ***Risk assessments methods:***

Financial contagion mainly occurred due to interconnectedness between domestic and international markets. Therefore, having risk assessment tools which can quantify the risks beforehand will help markets and businesses to plan out mitigation strategies. Value-at-risk is one of the vital tools in risk assessments which helps the financial institution to understand

the potential impact more closely to reduce financial contagion and also to establish financial stability as well.

***Central bank policy:***

Another important aspect is to abide by central bank policies for international engagements which will help to reduce the impact of financial contagion. The policies of the central bank provide the provision of liquidity prices as it helps to stabilize the prices (McPhilemy and Moschella, 2019). On the contrary, these rules and policies also help them to understand market trends and economic fluctuation more conveniently. These policies also can help to stabilize the interest rates as well which will be extremely helpful to mitigate financial contagion. Therefore, these macroeconomic policies help to make financial stability by optimizing the exchange rate to sustain growth.

***Government supportive framework:***

Another important aspect which can help to reduce financial contagion is to have support from the government. While facing financial contagion in international markets financial institutions or policymakers need to have more funding to overcome the crisis. The government provides capital investments which can help them to overcome this contagion on the contrary, the government also helps to make guaranteed bank debt issuance which helps them to have more time to pay. This support from the government helps to make stability in the economy. On the other hand, these types of capital investments are also lower in interest which helps to reduce the financial crisis more effectively.

***Contingency plan and market surveillance:***

The contingency plan will help to reduce financial contagion internationally by measuring risk factors beforehand and also by acknowledging the market stress. Government and regulatory bodies need to make strategies which will help them to manage and reduce crises more effectively (Aragón *et al.*, 2022). On the contrary, by making market surveillance with the help of new advanced technology will also be an extremely useful tool. As this will help to measure real-time data and algorithms about the financial trends and economic changes that are happening. This will be extremely viable and helpful to measure risk beforehand to mitigate issues as soon as possible.

The organizations such as the central banks and the governments of the country use these practices to protect their economy from financial contagiousness. International monetary and trade organizations also use these activities to protect different economies from different financial contagiousness.

The above-mentioned methods have been effective to handle the issue of financial contagiousness effectively. The risk assessment has helped to assess the risk well in before and prepare the solution and the mitigation measures are commendable efforts to counter the financial contagiousness. The proactiveness of the central bank in this regard to the financial contagiousness is also commendable efforts by the central bank to address the issue resulting from the financial contagiousness. The central bank adjusting the different rates to protect the economy from financial contagiousness is also helpful to contain the negative implication of financial contagiousness. In containing the financial contagiousness the role and the proactivity of the governments is also vital. The governments will the help of their policy-making can support the central bank to devise tools and techniques to save the economy from the financial contagiousness (Ahrens and Ferry, 2020). Governments making investments in capital investment and also making efforts for debt issuance will also decrease the changes of the financial contagiousness in an economy. The contingency plan prepared by the government and the market surveillance done by the government bodies will be helpful in identifying the key factors which can result in financial contagiousness.

#### **Gap in intereternal financial artitecture**

However, there is some gap identified in the practices of the government and the central banks to handle this crucial issue which will be explored in this part -

#### **Private sector involvement -**

The private sector of the countries has grown manifold and is operating in the globalized world consequently the private sector can be integrated to handle the issues related to the financial contagiousness which are complex. The private sector will be the biggest sector which will be affected by the financial contagiousness consequently the private sector must be integrated into this to make the decisions more effective. A gap exists in countries where the private sector is considered less important and stringent laws are put on the private sector. However, this needs to change in terms of financial contingency as the participation of the private sector can be helpful to address the issue faced by the economies in terms of financial contingency.

**Financial standards and regulations -** In view of such financial contingency the standards of financial conduct and the regulations of the central bank and the government has to be changed so that such crisis do not occur in the economy (La *et al.*, 2020). These financial contingencies such as the recession of 2007-2008 the advent of the covid-19, terrorism and other disasters have continuously weakened the economic standards and have challenged the traditional adjustments of the financial system. Consequently, the financial systems and the

regulations have to be changed and augmented the financial systems to increase the efficiency of the financial standards and regulations of the economic system. Efforts have to be made to decrease the financial volatility of the economies by increasing the efficiency of financial regulations and financial standards.



## Section 2

### Q4.

Answer

**Concept** - Quantitative easing and qualitative easing are the policies in the hand <sup>1</sup> of the central bank to stabilize the economy. Qualitative easing <sup>2</sup> is the policy that is exercised by the bank in which during troubled times tries to buy liquid securities from the open market to increase the bank balance which will result in a reduction of the interest rates and the money supply will ultimately increase which will be favour condition in the times of the recession in an economy. The increase in the money supply will bring more into the hand of the customers and the demands of different goods and services will increase which stimulate the economy in recession. This is one of the monetary policies that is being employed by the central banks of a particular country when the interest rates of the country hover near zero and the economic activity has stopped. However, there are negative implications that are also there for qualitative easing as by exercising qualitative easing the country can face situations like inflation and the creation of more assets which are not required in such conditions of the country resulting in a situation called an assets bubble (Koeda 2019).

***Application of the qualitative easing by the federal reserve bank at the time of the financial crisis (2007/2008).***

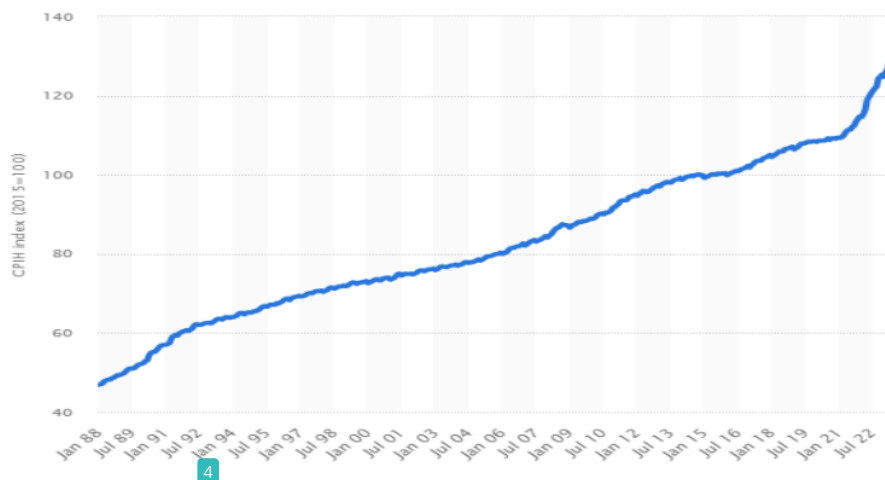
During this time the federal reserve bank strategies to buy the smaller assets from the open market. These securities are normally not bought by the big banks. These smaller assets in the form of government securities or treasury securities are generally brought by the general people of the country. However, the federal bank purchasing these smaller assets, for example, the government treasury left ample money in the hands of the investors and no avenue to invest consequently that money got circulated in the economy and boosted the demand for the goods and services in the economy which helped the country to come out of the crisis of 2007/2008 (de et al., 2023). The government also tried to buy out the long-term assets in the markets which has led to their downward trend and the investors were left with less option to invest but to spend their money. According to the policy of qualitative easing the bank also tried to provide loans at low rates to increase the money in hand to the customers which will impact in buying behaviour of the customer and also result in the country coming out of the recession. This buying behaviour of the federal reserve bank of all the assets from the market has also resulted in an increase in its assets retention from 891 billion USD to 4.5 trillion USD

***Application of the qualitative easing by the ECB at the time of the financial crisis (2007/2008)***

<sup>3</sup> During the crisis of 2008, the ECB acted swiftly with the help of the other member and made different efforts such as changing the bank rate to pump more money into the economy. Consequently, these steps helped the stagnant economy to be revived from the crisis. The ECB has taken the role of the last lender to lend money to businesses and people requiring money in the crisis time of 2007 and 2008. This injection of money into the economy through quantitative easing helped the ECB to revive the economy successfully. The ECB has lent also in foreign currency also lent money against 'other assets' and also allowed foreign

currency swaps. As observed in March 2009 the issue of the crisis was handed by the ECB however the lending of the bank due to qualitative easing has contracted the balance sheets of the bank in terms of the lending it had made against the treasuries and the securities. In the first and second phases of the qualitative easing, the US dollar and the US bonds were also brought by the ECB to inject more liquidity into the system. With the exercise of qualitative easing, the balance sheets holding has increased for the central bank however liquidity was injected into the economy as planned (Cecrdlova 2021).

#### **Application of the qualitative easing by the Bank of England at the time of the financial crisis (2007/2008)**



**Figure 1 - The effect of the Qualitative easing of the Bank of England on the consumer pricing index of the UK**

(Source - Statista.com.2023)

Bank of England also took steps as per the quantitative easing to increase the demand for goods and stimulated the economy which had become stagnant. The Bank of England aims at food ease of the monetary policy at the time of this time of crisis. With the use of qualitative easing at the time of the crisis the balance sheet of the Bank of England also increased to a significant level which shows the contribution of the Bank of England in managing the crisis of 2007 and 2008 when the Bank of England was also buying the different assets from the customers and the market to increase the liquidity in the UK's Economy. During this crisis, the fall of the Lehmann brothers happened which affected the liquidity of the banks of the UK the Bank of England tried to increase the liquidity of the banking systems by the use the qualitative easing. Here also The Bank of England also brought a large number of treasury bills and tried to decrease the interest rates of the treasury bills on the other hand which tried to inject liquidity into the banking system of England. With the exercise of the qualitative easing the Bank of England brought about 75 billion GBP of assets in increase the balance sheet of the bank (Breedon *et al.*, 2012).

#### **Evaluation of Quantitative Easing**

Quantitive easing is a monetary policy that is used in different countries to handle different kinds of financial crises. At the time of the credit crush in an economy, quantitative easing is

used successfully to increase the flow of money in the economy and raise the demand for goods and services which increases the economic activity of a country. However, there are some shortcomings of this monetary policy (Laséen 2023). One of the shortcomings is it leads to inflation. Consequently, its long terms benefits should be checked further. However, it is an important tool against all the contemporary tools to make an economy come out of a recession try situation.

## **Q6**

The policymakers are more concerned about the forecasted and expected inflation rates and their prepared or plan for the future and the implications of their decisions normally take some time or lag to implement in the economy consequently, the policymakers as more concerned with the forecasted and the expected values of the inflation. This is also according to Taylor's rules of setting interests. As Taylor has provided a mechanism to check the expected rate of inflation and adjust the current rate of interest according to consequently the policy maker normally concerned and check the expected inflation rates which will be helpful in mending or changing the short-term interest rates in order to match the inflation rates as per the forecast provided by the Taylor rule in setting interests.

### ***Justifications***

The primary aim of the policymaker is the keep the interest rates and inflation rates and employment rates under check in the present times to develop a favourable atmosphere for the country to grow. To adjust all other present rates as discussed the central bank used the forecasted inflation rates as an anchor and guides the other bank rates. The inflation rates forecasted values which are considered as the anchors are also used to check the monetary policy and keep it in check which will be favourable for the country. The forecasted inflation rate of the country also helps to keep the prices of the different items under control. The expected inflation rates also help the policymaker to adjust the current inflation rates and the policymakers also enhance their communications with other stakeholders to adjust the macroeconomic implication of the expected inflation rates (Sköld and Tesfay 2020). There is another reason for this practice is that the viewing the current inflation rates the policy-making body can make temporary adjustments and short-term planning in terms of monetary policies. However, the expected or forecasted value of inflation will be helpful in taking long terms decisions regarding monetary policy and fiscal policy which will be more helpful to the economy of the country. The policymaker can be in a better position by keeping the long-term forecasts of inflation to adjust the demand factors in the economy and supply factors in the economy. The inflation forecasts are helpful in managing the expectation of the people, government and also the policymakers (Rudd 2022). The policymaker also takes these inflation rates as indicators of future trends of inflation consequently the policymakers take more interest in them (Niu and Harvey, 2022). The future expectations and the forecast of inflation sometimes affect the customer's behaviour in terms of buying and selling which exerts pressure on the economy consequently the central bank keeps track of the inflation rates and controls the rates accordingly which helps the economy to function smoothly. For example, the increase in the inflation rates makes the household increase the buying of the essentials from the market in the present times which will result in a situation of high demand and short supply in the market. This

shows that the expectation of future inflations leads to behaviour of the panic buying in customers which affects the economy at the present time. Consequently the policy maker adjust the interest rates accordingly to manage the implication of the expected inflation. The forecast of inflation is also done to protect the economy and the economic interests of the people in terms of economic shocks. The policymakers feel that inflation expectations have a positive relationship with the unemployment rate and the wages of the employees consequently policymakers take an interest in the forecasts of the inflation (Rudd 2022). The increase in the prices of the goods in future due to an increase in the projection of inflation will require a greater influx of money to increase the wages of the people to manage the price rise due to inflation. The expectation of the inflations is also an indicator of the health of the economy and will help the companies to stay informed while taking important monetary and fiscal policies. The expectation of inflation will also provide a clear picture of the risks associated with the price rise and they also can take action with the help of its stakeholders such as the government to manage those risks effectively. The customer's expectations and the consumer's behaviours can also be forecasted with the help of an inflation forecast which will provide ample time to manage the inflation which will also control the expectation of the customers and their behaviour. The inflation forecast will also enable to manage of the consumer price index of the country which will manage the costs of all household projects and services prices.

#### ***Taylor's rule in setting interests***

Taylor's rule establishes a relationship between the expected inflation expected economic growth and the interest rates. Consequently, a change in the expected inflation will change the economic growth and the interest rates of the economy to keep the economy stable (Brand and Mazelis, 2019). The Taylor rule was proposed by Taylor as a fixed monetary policy however the modern-day economist is using the Taylor rule for more use in their policy making. The Taylor rule created an interconnectedness between the federal policy instruments and the change in the interest rates of the policymaker. As per Taylor's rule, the difference between the expected inflation and the forecasted inflation lies in the Gross domestic product of an economy. This rule was proposed by John Taylor in 1993. According to the Taylor rule an equilibrium in the fund rates has been set above the annual inflation rate and any change in the expected inflation rates will change the equilibrium of the fund rates by adjusting all the interest rates according to the expected inflation rate (Levrero 2022).

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