

## Lecture 14

### Financial Policy

(Based on Chapter 13 of Perkins et al.)

Autumn 2004

Sumon Bhaumik

# Concepts

---

- Financial system
  - Bank of England/Federal Reserve Bank
  - Financial Services Authority
  - Securities and Exchange Commission
  
- Financial policy
  - Monetary Policy
    - Exchange rate policy
  - Credit Policy
  - Development of capital markets

# Money

---

- Role
  - Unit of measurement
  - Medium of exchange
    - Financial innovation
      - Cheques, credit cards etc
  - Store of value
    - Financial instruments
      - Structured products
  
- Money supply
  - $M1 = \text{currency} + \text{demand deposits}$
  - $M2 = M1 + \text{time deposits}$
  - $M3 = M2 + \text{savings with specialised financial institutions}$

# Financial Intermediation

---

- Old view
  - Mobilise savings for investors
  
- Contemporary view
  - Monitoring
    - Informational asymmetry
  - Risk management
    - Portfolio diversification
      - Minimisation of “non-systematic” risk

# Stabilisation

---

- Inflation
  - Wage-price spiral
  - Real interest rates
    - Real return on investments
  - Real exchange rates
  
- Types of inflation
  - Chronic
    - 25-50% per annum for 3 years or more
  - Acute
    - More than 50% for 3 years or more
  - Hyper
    - More than 200% per year

# Seigniorage .... 1

---

- Starting point
  - Nominal money balance =  $M_n$
  - Real money balance =  $M_r$
  - $M_n = M_r$
  
- Inflation rate
  - $p$  percent per annum
  
- End of the year
  - $M'_r = M_r/(1 + p)$

# Seigniorage .... 2

---

- Implicit tax

- $T = M_r - M'_r$

- Tax rate

- $t = (M_r - M'_r)/M_r = p/(1 + p)$

- Issues

- Is it a progressive tax?
  - Is there crowding out of private investment?

# Seigniorage .... 3

---

- Conditions of success
  - Government's marginal propensity to invest out of inflation tax  $\geq 1$ 
    - Little empirical support
  - Revenue elasticity of tax system  $\geq 1$ 
    - Nominal versus real
  - Marginal efficiency cost of inflation tax  $<$  Marginal efficiency cost of explicit tax
    - Efficiency loss on account of inflation tax high if inflation exceeds 2% per annum



# Investment and Inflation

---

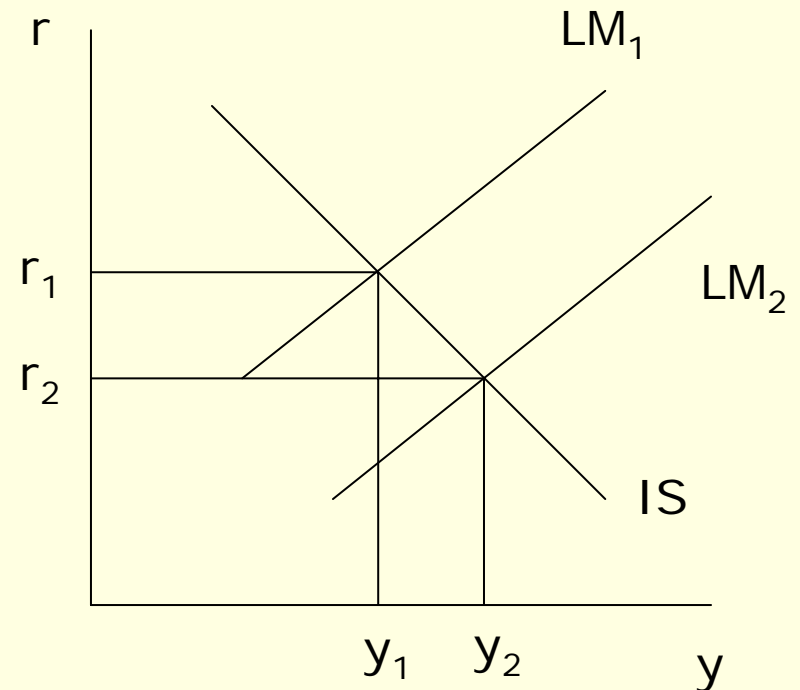
## ■ Issues

- Is an inflationary shock anticipated or unanticipated?
  - Lucas “island” parable
- Impact of inflation on risk taking.
- Impact of inflation on interest rates.
  - Are nominal interest rates rigid?
    - Impact of interest rates on savings behaviour.
      - Target savings
      - Precautionary motive
      - Alternative sources of returns on savings

# Monetary Policy .... 1

- Long run: Classical
  - Quantity theory
    - $M \times V = P \times Y$ 
      - $Y = Y^*$
      - $V$  fixed
    - $M = P \times (Y^*/V)$
    - $dM/dP = 1$

- Short run: Keynesian



# Monetary Policy .... 2

---

- Instruments
  - Open market operations
  - Reserve requirement
  - Discount rate
  - Credit ceilings
    - Government budget deficit
  
- Global practice
  - Japan
    - Easy money policy
      - Nominal interest rate near zero
  - USA, Euro-zone and UK
    - Reduction in discount rates

# Monetary Policy .... 3

---

- Complications for open economies
  - Capital inflow
    - Fixed exchange rate
      - Sterilisation
    - Floating exchange rate
  - Exchange rates
    - Export competitiveness
    - Repatriation of export proceedings
    - Foreign investment