Lecture 15

Financial Policy

(Based on Chapter 13 of Perkins et al.)

Autumn 2004

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Recap

- Money
  - Role
  - Money supply

- Monetary policy
  - Short versus long run
  - Inflation
    - Seigniorage
  - Policy instruments
    - Open versus closed economy

Financial Repression

- Definition (McKinnon-Shaw)
  - Interest rate controls
  - Directed credit
  - High reserve requirements
  - Capital controls

- Consequence
  - Low real interest rate
    - Reduction in savings
      - Implications for financial deepening
    - Sub-optimal allocation of savings

Policy Options

- Traditional view
  - Liberalise interest rates
    - Higher savings
    - Better allocation of capital

- Modern view
  - Restructure financial sector
    - Lower intermediation costs
    - Risk pooling
    - Efficient collection and dissemination of information
    - Maturity transformation

Pitfalls

- Liberalisation of interest rates
  - Jump in real interest rate
    - Corporate bankruptcy
      - Fragility of the banking system

- Liberalisation of capital flows
  - “Hot” money flows
    - Currency crisis
    - Economic collapse

- Liberalisation of credit markets
  - Lower profit margins
    - Risk taking behaviour
    - “Too big to fail” strategies

Banking and Currency Crises ... 1

- Causality from banking to currency crises.

  - Capitalisation.
    - E.g., Bulgaria.
    - Currency devaluation as an optimal policy response to a bank run.

  - Redistribution of assets from domestic banks to foreign banks.
    - E.g., Mexico.
    - Capital account convertibility.

Banking and Currency Crises … 2

- Causality from currency to banking crises.
  - Speculative attacks on currency when banks use deposits to speculate in the currency market.
  - Increase in interest rate as a policy response.
    - E.g., Hong Kong

Banking and Currency Crises … 3

- Joint occurrence.
  - Illiquidity.
  - Joint consequence of consumption boom financed by bank credit and foreign borrowing.

Policy Response

- Prudential regulations
  - Capital requirement
    - Risk taking behaviour
  - Writing off bad assets
  - Marking assets to market
    - Off balance sheet activities

- Proposed
  - Risk weighted premium for deposit insurance

- Debated
  - New global financial architecture

Equity Markets

- Advantage
  - Price reflects all information about a company.
    - Efficient market hypothesis.
  - Relatively low transactions cost.

- Issues
  - Bubbles
    - “Soft landing” if legal.
    - Prosecute if source of funding is illegal.
  - Insider trading
    - Violation of laws.

Sequencing of Financial Reforms

- Overall
  - Macroeconomic
    - Low inflation, low fiscal deficit
  - Real sector
    - Trade liberalisation, privatisation, labour market flexibility
  - Effective system of supervision

- Financial sector
  - Domestic
    - Interest rate
    - Credit controls
    - Monetary policy instruments (debt market)
  - Capital account of balance of payments

Rural Credit Markets …. 1

- Default risk
  - Assumptions
    - *q* proportion of borrowers default.
    - No interest is paid on defaulted loans.
    - Interest rate = i
    - Loan amount = L
  - Returns on lending
    - $(1 + i)(1 – q)L - L$

Rural Credit Markets …. 2

- Effective interest rate
  - $d = [(1 + i)(1 – q)L – L]/L$
  - $d = (1 + i)(1 – q) - 1$
- Problem
  - if $q > 0$ then $d < i$
- Arbitrage
  - d equals urban interest rate
    - i is very high

Rural Credit Markets …. 3

- Monopoly lender
  - Demand for loans
    - $L(i)$, $L' < 0$
  - Inverse demand
    - $i(L)$, $i' < 0$
  - Cost
    - r
  - Profit
    - $\max L.i(L) – r.L$
  - First order condition
    - $r = i(L) + L.i'(L)$