

Lecture 15

Financial Policy

(Based on Chapter 13 of Perkins et al.)

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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
 - $\max L \cdot i(L) - r \cdot L$
 - First order condition
 - $r = i(L) + L \cdot i'(L)$

