

MACQUARIE UNIVERSITY



Division of Economic and Financial Studies

UNIT OUTLINE

2004

ECON335

THE ECONOMICS OF FINANCIAL INSTITUTIONS

- Contents:*
1. Course Overview
 2. Enquiries
 3. Course timetable
 4. Assessment
 5. Lecture topics
 6. Text book
 7. Reading list
 8. In-Class Essay

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Lecturer-in-charge

ECON 335: ECONOMICS OF FINANCIAL INSTITUTIONS

I. COURSE OVERVIEW

Banking and finance institutions today have evolved into complex organisms that play a centrally important role in the modern economy. The management of financial corporations is a highly specialised task with many unique aspects. And the success (or failure) of banks carries the potential for significant ramifications in the markets for goods, services and labour across the wider macroeconomy.

This course:

- outlines the structure of the Australian finance industry
- studies the evolution of the payments system and the issues it raises
- analyses the risks of banking and how to manage them effectively
- examines banking theory, especially performance and productivity
- examines the role financial institutions can play in a country's development
- puts these in the context of official supervision and surveillance.

The course is designed to equip those who will work in banking, securities or government.

II. ENQUIRIES

The teaching staff in ECON 335 are:

Sean Turnell	(C5C Rm 380; Tel: 9850 8493)	Weeks 1-2, 9-13
Kim Hawtrey	(C5C Rm 392; Tel: 9850-8504)	Weeks 3-8

If you have general enquiries about the course, contact the Lecturer-in-charge (Sean Turnell). For specific enquiries about course notes, lectures, etc., contact the relevant lecturer for each part of the course. If the lecturer is not immediately available, it is best to leave a message with your name and telephone number so that staff can contact you. Students can receive help with study skills, lecture content, essay resources, assessment, etc.

III. COURSE TIMETABLE

Students attend three classroom hours per week, comprising **lectures** using a mix of theory and practical applications, delivered in Second Semester in the following session:

Friday 3 - 6 p.m., E7B Mason Theatre

Students are expected to attend the full quota of lectures; all the material covered in class is examinable.

IV. ASSESSMENT

Quiz (10%)

All students are required to sit a within-semester 'Quiz' to be held during the week 6 lecture slot. The Quiz will be in multiple choice format, and will be based on the material given in lectures in weeks 3 to 5.

Essay (20%)

All students are required to complete an essay (on the set topic – see p.7) **in class, on Friday 22 October (Week 10)**. Completing the essay, on this day and in class, is compulsory. Normal exam conditions will apply.

Exam (70%)

The final examination will consist of essay-type questions.

V. LECTURE TOPICS: OVERVIEW

Lecturer:

WEEK: 1.	Introduction and Survey of Global Financial Institutions	Turnell
2.	The Evolution and Rationale of Financial Institutions	Turnell
3.	How Socially Responsible are Banks?	Hawtrey
4.	Alternative Banking: Is it Feasible?	Hawtrey
5.	Why do Banks Fail?	Hawtrey
6.	Do Financial Services Make us Happier?/(QUIZ)	Hawtrey
7.	What is Merchant Banking?	Hawtrey
8.	Does the Funds Management Industry Earn its Keep?	Hawtrey
9.	Financial Market Consolidation	Turnell
10.	In Class Essay	
11.	Supervision I: Central Banking	Turnell
12.	Supervision II: Capital Adequacy and Regulation	Turnell

VI. USEFUL REFERENCES

There is **no** set text-book for Econ 335. Students should consult the following list of useful references, other references as indicated in lectures, and other sources.

(a) Australian

Saunders, A. and H. Lange (1996), *Financial Institutions Management: A Modern Perspective*, Sydney: Irwin.

Valentine, T, Ford, G. and Copp, R. (2003), *Financial Markets and Institutions in Australia*, Sydney: Pearson Education Australia.

McGrath, M. and C. Viney (2003), *Financial Institutions, Instruments and Markets*, 4th ed., Sydney: McGraw Hill.

Lewis, M.K. and R.H. Wallace, eds. (1997), *The Australian Financial System*, Melbourne: Longman Cheshire (2nd edition).

(b) International

Cornett, M. & A. Saunders (1999) *Fundamentals of Financial Institutions Management*, Boston: Irwin.

Koch, T.W. (1995), *Bank Management*, 3rd ed., Fort Worth: Dryden Press.

Sinkey, J.F. (2002), *Commercial Bank Financial Management*, 5th ed., Macmillan.

VII. READING LIST BY LECTURE TOPIC

1 & 2. Introduction and Survey/The Evolution and Rationale of Financial Institutions

Role of financial intermediaries
 Changing pattern of financial institutions
 History of banking
 Commercial banking in Australia

*Saunders, A. and H. Lange (1996), Chs. 1, 2 and 3.

*Valentine, T., Ford, G. and R. Copp (2003), Ch. 4.

*Allen, F. and Santomero, A. (1998), 'The theory of financial intermediation', *Journal of Banking and Finance*, vol.21, pp.1461-1485.

*Allen, F. and Santomero, A. (2001), 'What do financial intermediaries do?', *Journal of Banking and Finance*, vol.25, pp.271-294.

Australian Prudential Regulatory Authority Website, www.apra.gov.au.

Edey, M. and B. Gray (1996), "The Evolving Structure of the Australian Financial System", in M. Edey, ed. (1996), *The Future of the Financial System*, Sydney: Reserve Bank of Australia.

Financial System Inquiry (1997), *Financial System Inquiry Final Report*, Canberra: AGPS. (The Wallis Report), Chs. 1 - 4, 14.

Galbraith, J.K. (1995), *Money: Whence it Came, Where it Went*, 2nd Edn., London, Penguin Books.

*McGrath, M. and C. Viney (2003), Chs. 1, 2, 3.

Reserve Bank of Australia Website, www.rba.gov.au.

*Scholtens, B. and van Wensveen, D. (2000), 'A critique on the theory of financial intermediation', *Journal of Banking and Finance*, vol.24, pp.1243-1251.

Sinkey, J.F. (2003), Ch.1.

9. Financial Market Consolidation/Change

Berger, A.N., Demsetz, R.S. and Strahan, P.E. (1999), 'The consolidation of the financial services industry: Causes, consequences, and implications for the future', *Journal of Banking and Finance*, vol.23, pp.135-194.

Cetorelli, N. (2001), 'Competition among banks: Good or bad?', *Economic Perspectives* (Federal Reserve Bank of Chicago), pp.38-49.

De Nicolo, G. and Kwast, M.L. (2002), 'Systemic risk and financial consolidation: Are they related?', *Journal of Banking and Finance*, vol.26, no.5 (May), pp. 861-880.

Hogan, W.P. (1999), 'The future of banking: A survey', *The Economic Record*, vol.75, no.231, pp.417-427.

Llewellyn, D.T. (1996), 'Banking in the 21st Century: The transformation of an industry', *The Future of the Financial System*, Reserve Bank of Australia 1996 Conference Volume (available at RBA website, www.rba.gov.au).

Prowse, S. (1996), 'Alternative models of financial system development', *The Future of the Financial System*, Reserve Bank of Australia 1996 Conference Volume (available at RBA website, www.rba.gov.au).

11. Supervision I: Central Banking

Bank for International Settlements (BIS), website, www.bis.org

Fraser, B.W. (1994), 'Central bank independence: What does it mean?', *Reserve Bank of Australia Bulletin*, December 1994.

Latter, T. (1997), 'Causes and management of banking crises', *Bank of England Handbook on Central Banking No.12*, available at Bank of England website, www.bankofengland.co.uk

Turnell, S.R. (2000), *Establishing an East Timorese National Currency via a Currency Board*, Macquarie Economics Research Papers, no.2/2000.

See also 'Mark Bernkopf's Central Banking Resource Centre', <http://patriot.net/~bernkopf/>.

12. Supervision II: Capital Adequacy and Regulation

*Valentine, T., Ford, G. and R. Copp (2003), Ch.6.

* McGrath, M. and Viney, C. (2003), pp.63-83.

Australian Prudential Regulatory Authority (APRA), website, www.apra.gov.au

Basle Committee on Banking Supervision (1987), *International Convergence of Capital Measurement and Capital Standards*, www.bis.org/publ/bcbs04A.pdf

Basle Committee on Banking Supervision 2001, *Overview of the New Basle Capital Adequacy Accord*, www.bis.org/publ/bcbsca02.pdf

Commonwealth of Australia (1997), *Financial System Inquiry, Final Report* (Wallis Report). This report is available on the website of the Australian Treasury, www.treasury.gov.au

Commonwealth of Australia (2002), *Options for Improving the Safety of Superannuation*, Draft Recommendations of the Superannuation Working Group, 4 March 2002. This report is available on the website of the Australian Treasury, www.treasury.gov.au

13. Financial Institutions and Economic Development

Todaro, M.P. (2000), *Economic Development* (Chapter 17), New York, Addison-Wesley.

De Soto, H. (2000), *The Mystery of Capital*, London, Bantam Press. A nice summary of De Soto's arguments (by De Soto himself) is published in the IMF's *Finance and Development* journal, available online at <<http://www.imf.org/external/pubs/ft/fandd/2001/03/desoto.htm>>.

Holden, P. and Propoenko, V. (2001), 'Financial development and poverty alleviation: Issues and policy implications for developing and transition countries', *IMF Working Paper*, October, WP/01/160 (This paper is available on the IMF website, www.imf.org).

World Bank (2002), *World Development Report 2002, Building Institutions for Markets*, World Bank, Washington D.C. (This report is available on the World Bank website, www.worldbank.org).

VIII. ESSAY TOPIC

On Friday, 22 October 2004, students in Econ 335 will be required to attend the normally scheduled lecture in order to complete the Class Essay. The topic is outlined below, together with the readings required to write it. These readings are sufficient to answer the question and they are to be consulted, read and understood, prior to the class in which the essay is to be written. Neither the readings, nor any other material, can be consulted during the time allotted for writing the essay, and for which normal University exam conditions will apply. These conditions include the provision of relevant ID. The essay is to be written in the exam booklet provided.

Time allotted for writing the essay is one (1) hour. The essay will be marked as an 'exam essay' and, as such, you will not be required to provide references, footnotes and other such accoutrements of a 'take home' essay. On the other hand, it must be stressed that the essay should be written in a 'formal' way, and marks will accrue for such attributes as quality of expression, writing style, strength and logic of argument, and so on.

The topic:

On 9 June 2004 the Group of Eight leading industrial nations (the 'G8') announced a series of initiatives designed to reduce global poverty and inequality. These initiatives, collectively labelled the 'G8 Action Plan on Poverty: Applying the Power of Entrepreneurship to the Eradication of Poverty', posited a substantial role for financial institutions. Specifically, what have become known as Microfinance Institutions (MFIs) were seen as crucial. The following is an extract from the 9 June Press Release of the G8:

Expanding Access to Microfinance for Entrepreneurs

Entrepreneurs, no matter how small, need access to capital. Microfinance programs have provided small amounts of capital to entrepreneurs for many years -- benefiting women in particular. Sustainable microfinance can be a key component in creating sound financial market structures in

the worlds poorest countries. It is often the first step in launching SMEs, the beginning of what should be a continuum of credit access necessary to support the maturation of companies in developing countries. In anticipation of the UN-designated international year of micro-credit in 2005, G8 countries will work with the World Bank-based Consultative Group to Assist the Poor (CGAP) to launch a global market-based microfinance initiative. To assess the status and effectiveness of current microfinance programs, G8 countries will work with CGAP to promote best practices in microfinance for developing countries. We endorse the Key Principles of Microfinance, compiled by CGAP and its members and will work with CGAP on ways to;

- Focus on institutional best practices for expanding and mainstreaming sustainable microfinance.
- Develop a microfinance institution code of conduct based on CGAPs efforts to identify key principles for microfinance lending.
- Reduce barriers for growing microfinance institutions to gain access to domestic and international capital markets...
- Assist developing countries to improve their legal and institutional frameworks for microfinance so it can become sustainable and more widely available.
- Enable growing microenterprises to continue to access capital by reducing barriers for bank lending, promoting innovative bank-microfinance institutions (MFIs) linkages, and removing disincentives to business formalization.

The Question:

Using the readings below, write an essay that answers the following question:

‘What is microfinance, and in what ways do its advocates believe it will alleviate poverty? What is meant by the 'paradigm shift' in microfinance? What has been the approach to large-scale microfinance of an MFI with which you are familiar? What do you think have been the major achievements of microfinance, and what challenges does it still face?

Readings

Robinson, M.S. 2001, *The Microfinance Revolution*, Washington D.C., The World Bank: Chapters 1 and 2.

Asian Development Bank/UN, *Rejuvenating Bank Finance for Development in Asia and the Pacific*, New York, Economic and Social Commission for Asia and the Pacific, United nations.

Both of these references are available in ERIC!