

MACQUARIE UNIVERSITY



Division of Economic and Financial Studies

UNIT OUTLINE

2008

ECON335

THE ECONOMICS OF FINANCIAL INSTITUTIONS

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Assoc. Professor Sean Turnell
Lecturer-in-charge

ECON 335: THE ECONOMICS OF FINANCIAL INSTITUTIONS

I. COURSE OVERVIEW

Banking and financial institutions have evolved into complex organisms that play a centrally important role in the modern economy. Indeed, we will argue throughout this course that few institutions matter as much as those in the financial sector.

There are many ways in which this is apparent – but let us start by taking matters back to fundamentals in asserting that financial institutions play a critical role in a country's economic development. Such an idea has been around since the times of Adam Smith, but it is only in relatively recent times that a coherent narrative has emerged as to why this might be so. We now recognize numerous ways in which financial institutions promote development:

- Financial institutions mobilise a country's savings (its surplus above subsistence), and channel those savings into their most productive uses.
- Financial institutions create the media of exchange through which we conduct economic activity beyond simple barter. This allows specialisation – the very source of the 'wealth of nations' identified by Smith in 1776.
- Financial institutions create credit. Credit permits economic expansion in response to developments in the 'real' economy (technical progress) which might otherwise be stymied by a barter or a purely commodity monetary system.
- Financial institutions aggregate funds for investment in amounts larger than that which would be allowed by the savings of single individuals. This allows greater economies of scale, but it also reduces the risk of investment to particular individuals, and thereby encourages innovation.
- Financial institutions, by providing a safe vehicle for savings and by advancing personal credit, allow individuals to 'smooth' consumption and better insure themselves against unexpected events.
- Finally (though this list is far from exhaustive), and so long as they are not distorted through inappropriate government intervention, the 'prices' determined by financial institutions (such as interest rates) act as critical 'signals' conveying information – to policy makers, to investors, to everyone.

Of course, the management of financial institutions is a highly specialised task with many singular aspects. Regarding the latter, it is important to recall that (unlike most other enterprises) financial institutions create products that are almost wholly intangible. Because of this they are uniquely dependent upon trust, and those other pillars of civilisation that we take for granted except when they are absent. It is no coincidence that countries with sound financial institutions are those countries possessing the attributes otherwise necessary for a well-functioning economy and society. Finally, the success (or failure) of financial institutions carries the potential for significant ramifications in the markets for goods, services and labour across the wider macroeconomy.

In Econ 335 we will:

- outline the structure of the Australian and global financial sectors
- analyse the risks of banking and how to manage them effectively
- examine financial intermediation theory

- examine the rise of the funds management industry
- examine the role financial institutions can play in a country's economic development
- examine developments at the cutting-edge of financial institutions practice
- put all of these in the context of official supervision and surveillance.

The course is designed to equip those who will work in banking, securities or government – and, indeed, anyone who wishes to understand the modern world.

II. ENQUIRIES

Sean Turnell (E4A Rm 426; Tel: 9850 8493, sturnell@efs.mq.edu.au)

If you have *any* enquiries about the course please contact me via any of the media above.

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., X5B T1

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

IV. ASSESSMENT

Mid-Term Exam (20%)

On **Friday 19 September (Week 7)** all students are required to sit for a mid-term multiple choice exam. The exam will consist of 20 questions relating to the material covered up to the end of the previous week. Normal exam conditions will apply.

Essay (30%)

All students are required to complete an essay (on the set topic – see p.7) **in class, on Friday 10 October (Week 8)**. Completing the essay, on this day and in class, is compulsory. Normal exam conditions will apply.

Final Exam (50%)

The final examination will consist of essay-type questions.

V. LECTURE TOPICS: OVERVIEW

- Topic:
1. Introduction/Functions and Forms of Banking
 2. The Rationale and Evolution of Financial Institutions.
 3. The Evolution of Financial Institutions/Bank Regulatory Environment.
 4. Interest Rate Risk Management
 5. Securities Portfolio Management
 6. Credit Evaluation.
 7. Commercial, Real Estate and Consumer Lending.
 8. Liquidity and Capital Management
 9. Liabilities Management/Off Balance Sheet Activities.
 10. Wider Financial Services: Insurance, Wealth Management
 11. Financial Market Consolidation
 12. Financial Institutions and Economic Development

VI. USEFUL REFERENCES

The textbook for Econ 335 is:

Gup, B.E., Avram, K. *et.al.*, (2007) *Commercial Banking: The Management of Risk*, Melbourne: John Wiley & Sons Australia.

In addition to our main text, students might find the following list of references to be useful.

(a) Australian

Hogan, W. *et al*, (2004), *Management of Financial Institutions*, 2nd edn, Melbourne: John Wiley & Sons.

Hunt, B. and Terry, C. (2005), *Financial Institutions and Markets*, 4th Edn, Melbourne: Thomson.

Saunders, A. and Lange, H. (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.

(b) International

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

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

VII. READING LIST BY LECTURE TOPIC

1 - 3. Introduction /Functions and Forms of Banking/The Evolution and Rationale of Financial Institutions/Bank Regulatory Environment

Gup, *et. al* (2007), Ch.1, 2.

Hogan, *et. al* (2004), Ch.1.

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.

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.

4. Interest Rate Risk Management

Gup, *et. al* (2007), Ch.5.

Hogan, *et. al* (2004), Ch.4.

5. Securities Portfolio Management

Gup, *et.al* (2007), Ch.7.

Hogan, *et. al.*(2004), Ch.7.

6. Credit Evaluation

Gup, *et.al* (2007), Ch.8.
Hogan, *et. al.*(2004), Chs. 9, 10.

7. Commercial, Real Estate and Commercial Lending

Gup, *et.al* (2007), Chs. 9, 10.
Hogan, *et. al.*(2004), Chs. 11, 12.

8. Liquidity and Capital Management

Gup, *et.al* (2007), Chs. 11, 12.
Hogan, *et. al.*(2004), Chs. 6, 8.

9. Liabilities Management/OBS

Gup, *et.al* (2007), Chs. 13, 14.
Hogan, *et. al.*(2004), Ch. 5.

10. Wider Financial Services - Funds Management and Insurance

Gup, *et. al* (2007), Ch.15, 16.
Hunt, B. and Terry, C. (2005), Ch. 5.
APRA website, www.apra.gov.au

11. Financial Market Consolidation

Gup, *et. al* (2007), Chs 3, 4.
Hogan, *et. al.* (2004), Ch.1.

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.

12. Financial Institutions and Economic Development

Todaro, M.P. (2003), *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, 10 October 2008, 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 90 minutes. 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:

In 2006, Muhammad Yunus and the Grameen Bank were jointly awarded the Nobel Peace Prize. This award, the citation for which is immediately below (and is also at: http://nobelpeaceprize.org/eng_lau_announce2006.html), was given because of their contributions to microfinance (microcredit). Microfinance is the subject of our in-class essay:

THE NOBEL PEACE PRIZE FOR 2006

The Norwegian Nobel Committee has decided to award the Nobel Peace Prize for 2006, divided into two equal parts, to **Muhammad Yunus** and **Grameen Bank** for their efforts to create economic and social development from below. Lasting peace can not be achieved unless large population groups find ways in which to break out of poverty. Micro-credit is one such means. Development from below also serves to advance democracy and human rights.

Muhammad Yunus has shown himself to be a leader who has managed to translate visions into practical action for the benefit of millions of people, not only in Bangladesh, but also in many other countries. Loans to poor people without any financial security had appeared to be an impossible idea. From modest beginnings three decades ago, Yunus has, first and foremost through Grameen Bank, developed micro-credit into an ever more important instrument in the struggle against poverty. Grameen Bank has been a source of ideas and models for the many institutions in the field of micro-credit that have sprung up around the world.

Every single individual on earth has both the potential and the right to live a decent life. Across cultures and civilizations, Yunus and Grameen Bank have shown that even the poorest of the poor can work to bring about their own development.

Micro-credit has proved to be an important liberating force in societies where women in particular have to struggle against repressive social and economic conditions. Economic growth and political democracy can not achieve their full potential unless the female half of humanity participates on an equal footing with the male.

Yunus's long-term vision is to eliminate poverty in the world. That vision can not be realised by means of micro-credit alone. But Muhammad Yunus and Grameen Bank have shown that, in the continuing efforts to achieve it, micro-credit must play a major part.

Oslo, 13 October 2006

The precise question will be revealed on 10 October – but in order to answer it, you'll need to know:

- What microfinance is.
- The key principles of microfinance
- How microfinance potentially helps the poor
- Savings and microfinance.
- Some of the challenges and/or weaknesses of microfinance?

Readings

The following documents from the World Bank-sponsored 'Consultative Group to Assist the Poorest' (CGAP) are ideal:

<http://www.cgap.org/about/microfinance.html>

<http://www.cgap.org/keyprinciples.html>

<http://www.cgap.org/about/faq08.html>

http://www.cgap.org/docs/FocusNote_24.html

Another good broad source is:

Sengupta, R. and Aubuchon, C. 2008, 'The Microfinance revolution: An Overview', *Federal Reserve Bank of St. Louis Review*, January/February, pp.9-30. This is available online at:

<http://research.stlouisfed.org/publications/review/>

For more on the award of the Nobel Peace Prize in 2006, and Muhammad Yunus's acceptance speech, see:

http://nobelpeaceprize.org/eng_lect_2006b.html