ECON 335

The Economics of Financial Institutions

Semester 2, 2009

UNIT OUTLINE

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ECON 335: THE ECONOMICS OF FINANCIAL INSTITUTIONS

I. COURSE OVERVIEW

Banking and financial institutions have evolved into complex organisms that play a critical role in the modern economy. Indeed, we will argue throughout this course that few institutions matter as much as those in the financial sector – a fact that recent events in global financial markets has demonstrated only too well!

There are many ways in which the importance of financial institutions 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 growth and development. Such an idea has been around since the times of Adam Smith, but it is only relatively recently that a coherent narrative has emerged as to why this might be so. We now recognize numerous ways in which financial institutions promote growth:

- 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 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, sean.turnell@mq.edu.au)

If you have any enquiries about the course please contact me via any of the 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 5 – 8 p.m., X5B T1

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

Note that, because of ‘Conception Day’ (Friday, 19 September), there is no lecture in Week 7.

IV. ASSESSMENT

**Mid-Term Exam (40%)**

On **Friday 9 October (Week 8)** all students are required to sit for a mid-term multiple choice and essay exam.

The multiple choice component of the exam (worth 20% of the final marks) will consist of 20 questions relating to the material covered up to the end of the previous week. Normal exam conditions will apply.

The essay component of the exam (also worth 20% of the final exam) will comprise one question, and will likewise be drawn from material covered thus far in the course.

**Final Exam (60%)**
V. LECTURE TOPICS: OVERVIEW

Topic:

1. Introduction – Functions and Forms of Banking, Regulatory Overview.
2. The Theoretical Rationale of Financial Institutions.

VI. USEFUL REFERENCES

There is no set textbook for Econ 335. However, the following are useful:

(a) Australian


(b) International


VII. READING LIST BY LECTURE TOPIC

1 - 2. Introduction /Functions and Forms of Banking/The Theoretical Rationale of Financial Institutions/Regulatory Overview

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

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


3. The Management of Financial Institutions I: Liabilities Management


Hogan, *et. al*.(2004), Ch. 5.

4. The Management of Financial Institutions II: Credit Evaluation

Gup, *et.al* (2007), Ch.8.

Hogan, *et. al*.(2004), Chs. 9, 10.

5. The Management of Financial Institutions III: Commercial, Real Estate and Consumer Lending

Gup, *et.al* (2007), Chs. 9, 10.

Hogan, *et. al*.(2004), Chs. 11, 12.

Gup, et.al (2007), Ch.7.
Hogan, et. al.(2004), Ch.7.

7. The Management of Financial Institutions IV: Interest Rate Risk Management

Gup, et. al (2007), Ch.5.
Hogan, et. al (2004), Ch.4.

8. The Management of Financial Institutions VI: Off-Balance Sheet Activities

Hogan, et. al.(2004), Ch. 5.


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

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

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


12. Financial Institutions and Economic Development


13. Moneylenders, Informal and Microfinance Institutions


Muhammad Yunus’s Nobel Prize acceptance speech, see: http://nobelpeaceprize.org/eng_lect_2006b.html