Financial Development and Economic Growth.
Financial Crises.
FIN 204 Lecture 7.1.

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1. Financial Development and Economic Growth

2. A Theory of Financial Crises
Financial markets affect the goods and services produced. How?
Financial markets affect the goods and services produced. How?

- the more developed financial markets, the more sources of funding for firms
Financial Development and Economic Growth

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Financial Development and Economic Growth

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- various support schemes (state banks)
- setting financial disclosure standards
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Can financial markets cause problems to the production side of the economy?
What is a financial crisis?

**Financial Crisis**: Major disruptions in financial markets that are characterized by sharp declines in asset prices and the failures of many financial and nonfinancial firms.

What causes financial crises?

1. adverse selection, moral hazard
2. sharp increases in interest rates
3. increases in uncertainty
4. asset market effects on balance sheets
5. problems in the banking sector
6. government fiscal imbalances
How do these factors work?

1. Adverse selection, moral hazard:
   - If interest rates increase, those with higher risk of failure stay on the market, so those already on the market take even higher risks, leading to more failures and non-performing credits. Banks lend less.
   - Sharp increase in interest rates: Firms' and households' assets remain unchanged but their debts increase, so they invest and spend less; banks provide less credit.
   - Increases in uncertainty: Risks of failure increase, leading to lower expected profits, so banks lend less, firms demand less credit, and consumers spend less.
   - Asset market effects on balance sheets: Asset prices decline, leading to a decline in net worth (own capital), so banks lend less.
   - Problems in the banking sector: Non-performing credits increase, leading to a decline in banks' assets and net worth, which can lead to bank failures if large-scale.
   - Government fiscal imbalances: Government deficit increases sharply, so foreign investors stop buying government bonds due to increased risk of default; the government cannot repay, leading to currency (exchange rate) crisis.
1. **Adverse selection, moral hazard**: If interest rates ↑, those with higher risk of failure stay on the market ⇒

2. **Sharp ↑ in interest rates**: Firms' and households' assets remain unchanged but their debts ↑ ⇒ they invest and spend ↓; banks provide ↓ credit

3. **Increases in uncertainty**: Risks of failure ↑ ⇒ expected profits ↓ ⇒ banks lend less, firms demand less credit, consumers spend less

4. **Asset market effects on balance sheets**: Asset prices decline ⇒ net worth (own capital) declines ⇒ banks lend less

5. **Problems in the banking sector**: Non-performing credits ↑ ⇒ banks assets decline ⇒ net worth declines ⇒ (if large-scale) the bank fails

6. **Government fiscal imbalances**: Government deficit ↑ sharply ⇒ foreign investors stop buying G bonds due to ↑ risk of default ⇒ government cannot repay and defaults ⇒ currency (exchange rate) crisis
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How does a financial crisis develop?

Deterioration in Banks' Balance Sheets → Increase in Interest Rates → Stock Market Decline → Increase in Uncertainty → Adverse Selection and Moral Hazard Problems Worsen → Economic Activity Declines → Bank Panic → Adverse Selection and Moral Hazard Problems Worsen → Economic Activity Declines