Lecture 3: Financial Markets and Development

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Financial Development

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- Reduce credit constraints on investors
- Enable the transfer of funds to individuals with better investment opportunities.

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$$\log c(t) + E_t \log c(t+1)$$

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$$1)\ q \text{ with certainty}$$

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$$Q > q$$

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- Fixed cost $\xi > 0$ of participating to the market for risky assets

Financial Development and Growth (cont'd)

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- $V^F > V^N$:

$$W > W^* = \frac{\xi}{1-(q/Q)^{\beta/(1+\beta)}}$$

Financial Development and Growth (cont'd)

Dynamics in Equilibrium

- Individuals using the market for risky assets

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- Inverse U-shaped relation between growth and inequalities (Kuznet effect)

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Financial Development and Growth (cont'd)

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- Rajan and Zingales (1998) show that lack of financial development has particularly negative effects on sectors that have greater external borrowing needs
- Jayaratne and Strahan (1996) document how banking deregulation that increased competition in US financial markets led to more rapid financial and economic growth within the United States.

$$\max_{c_t} \sum_{t=0}^{\infty} \beta^t u(c_t)$$

$$c_t + s_t \leq y_t$$

$$y_t = f(s_{t-1}); y_0 = \omega$$

- For any ω, convergence to a Unique steady state c^*, y^*, s^*

Credit Market Imperfection and capital Investments

A "convex" world

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$$c_t + s_t \leq y_t$$

$$y_t = f(s_{t-1}); y_0 = \omega$$

- For any ω, convergence to a Unique steady state c^*, y^*, s^*
- Initial inequalities do not matter

Credit Market Imperfection and Human capital Investments (Galor and Zeira 1993)

The model

- Individuals Utility

$$\max_{c(t),b(t)} (1-\delta)\log c_i(t) + \delta \log b_i(t)$$

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- **Imperfect Credit markets**: Lending rate r , borrowing rate i; $i > r$ (Costs of monitoring necessary to induce agents to pay back the loans)

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- **Imperfect Credit markets**: Lending rate r , borrowing rate i; $i > r$ (Costs of monitoring necessary to induce agents to pay back the loans)
- Assume

$$w^s - h(1+r) > (2+r)w^u$$

(With wealth $x > h$ it is always profitable to invest in human capital)

Credit Market Imperfection and Human capital Investments (cont'd)

Analysis

- if $x < h$

$$
\begin{aligned}
U_s(x) &= log(w^s - (1+i)(h-x)) + log(1-\delta)^{1-\delta}\delta^{\delta} \\
U_u(x) &= log((1+r)(w^u + x) + w^u) + log(1-\delta)^{1-\delta}\delta^{\delta}
\end{aligned}
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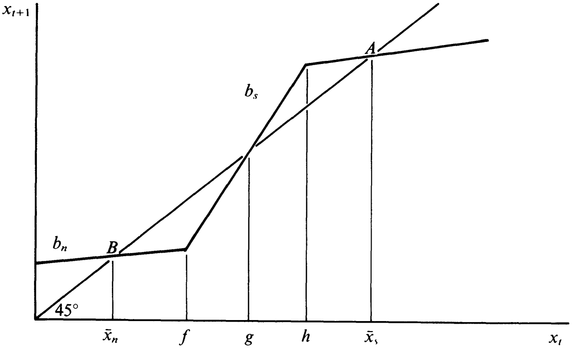
- $U_s(x) > U_u(x)$

$$x > f \equiv \frac{(2+r)w^u + (1+i)h - w_s}{1-r}$$

Credit Market Imperfection and Human capital Investments (cont'd)

Analysis

$$x_{t+1} = \begin{cases} b^u(x_t) = \delta((1+r)(w^u + x_t) + w^u) & x_t < f \\ b^s(x_t) = \delta(w^s + (1+i)(x_t - h)) & f \le x_t < h \\ b^s(x_t) = \delta(w^s + (1+r)(x_t - h)) & x_t \ge h \end{cases}$$



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Main results

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- Poor individuals with $x < g$ converge to x_n
- Rich individuals converge to x_r
- An economy initially poor stay poor in the long run: Initial Wealth distribution matters

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- Proto (2006) the effect on rental prices

Finance and Development

Summary

- Positive effect of Financial Markets on Development due to better risk diversification opportunities

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- Imperfect Credit markets and poverty affect access to rentable investments and growth