**LAIKIPIA UNIVERSITY COLLEGE**

**BCOM 430, MANAGEMENT OF FINANCIAL INSTITUTIONS, CAT 1, JULY 27, 2011**

The following is a dialogue between Finance and Development (F&D) (an IMF publication) and Prof. Joseph Stiglitz, a renowned economist. Read the conversation, and based on it and issues that we have discussed in class, answer the questions that follow. The F&D questions are in bold. Stiglitz’s responses are in normal font.

***F&D:* What should be done about the financial sector?**

There is recognition that in the aftermath of the crisis we haven’t really created a more stable financial system—that, to a large extent, we’re going back to where we were before the crisis. And in some ways, things are worse. They are worse in two ways. First, we have a more concentrated banking system, especially here in the United States.

And, second, the problem of moral hazard is at a heightened level. The banks know that when push comes to shove, any bank that is very big will be rescued. So we actually have not succeeded in repairing our financial system. And the vulnerability is, in some ways, even greater. And our capacity to respond to a crisis is lessened because of the rising debt and deficits that have come as a result of the crisis itself. The implication is that we really need to get back to work to try to design a regulatory system, including making sure that we both limit the size of the too-big-to-fail banks and level the playing field

***F&D:* What would such regulation look like?**

Regulation should be global in nature. But if we cannot get a global agreement, it is necessary for countries to go ahead and protect themselves. Banks have to be organized as subsidiaries, not branches, so that each government has enough control of its own banking system. It will not be a full solution, but we will move away from the single-market concept to the realization that as long as we do not have a full global regulatory system, each country has a responsibility to its own citizens and its economy. The second important point is that cross-border flows can be very destabilizing. One of the major sources of disturbances— particularly to developing countries—are unstable, short-term capital flows, and that implies that any government wishing to try to create a more stable economy has to think very deeply about capital account management. That involves using a broad range of tools, from prudential banking regulations to exchange-rate interventions, taxes, and possibly even controls. So we are seeing a big change in the mind-set of how we think about these cross-border flows.

***F&D:* Does the IMF have a role to play?**

Oh, very much. The best way of doing the regulation is global. Because, in the absence of global rules, there is going to be regulatory arbitrage. If we want to create a stable financial system, we all have to raise our standards. That, in a sense, was the biggest lesson of the crisis—that each country pursuing its own interest does not necessarily lead to the well-being of the global economy. There is, therefore, a need for this kind of coordination

(**REF**: IMF (June, 2011). Finance and development; *Wising up to the cost of aging*. IMF Publication Services. Washington D.C.)

1. What do you understand by the term **Moral Hazard**? Explain the role that capital plays in reducing moral hazard in financial institutions. (4 mks).
2. Stiglitz argues that regulation should be global in nature. Do you agree with him? Discuss why you think regulation of the financial sector is important. (8 mks).
3. “In the absence of global rules, there is going to be regulatory arbitrage” argues Stiglitz. Explain what you understand by regulatory arbitrage, and how it arises in this case. (6 mks)
4. Mr. Stiglitz advocates that banks should be organized as subsidiaries, not branches. From the above dialogue, and from your own perspective, what are the advantages of subsidiaries over branch organization of financial institutions? (8 mks)

**GENERAL QUESTION**

1. Explain the priority in the employment of funds in a financial institution in the context of liquidity management. (4 mks)