Bruce Smith on Financial Intermediation and Development

comments by David K. Levine

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The Historical and Intellectual Background

- first wave of the freshwater revolution – criticized by the saltwater school for naive models without frictions
- second wave of the freshwater revolution – led by Bruce Smith, a graduate of a saltwater school
- the second wave introduces serious market frictions – and the intellectual debate is over
The Intermediation Story Everyone Agrees On

I have useful machines: do I

➢ keep them in my basement to sell if I need to buy something?
➢ lend them out to other people to use in production?

intermediation allows me to do both

the devil is in the details
**Bruce’s trademarks**

- a comprehensive theory
- dynamic general equilibrium models – generally OG
- frictions: Diamond/Dybvig taste shocks, locational shocks
- the heart of these models are shocks that can be insured only by holding money

Bruce didn’t have much patience with elaborate theories of money – we know what money is and what it does: he wanted to understand the consequences
Unique Features of Developing Countries

- the need to monetize deficit, i.e. the depend on the inflation tax
- less well organized financial markets, so money plays a greater role


Growth Theory


“Financial Intermediation and Endogenous Growth”
Edward Elgar Publishing.)

lead article in the Special Issue: The Econometrics of Financial Markets, May,
1991

- intermediaries allow the shifting of savings from unproductive money
to productive capital
- technically combines OG model with endogenous growth model
- how the introduction of intermediaries enhances growth
“Deficits, Inflation, and the Banking System in Developing Countries: the Optimal Degree of Financial Repression”


- financial “repression” in development hinders the development of a banking sector, keeping interest rates high and impeding development
- repression = high reserve requirements and/or deposit interest rate ceilings
- what if it is necessary to monetize a sustained deficit?
- efficiency of inflation tax improved by “repression”
- studies output/taxation efficiency tradeoff
➢ liberalization may simply shift resources from “informal” to “formal” sector without increasing investment (but in the GE setting, this does improve efficiency) (structuralist critique)

➢ steady state with binding reserve requirement

➢ “developing” country – does not have many financial markets; has an informal sector

➢ when reserve requirements are set optimally reductions in government spending should be accompanied by liberalization
“The Effects of Open Market Operations in a Model of Intermediation and Growth”

- spatial separation and limited communication creates a role for banks
- specifically, random reallocation of traders between locations forces them to hold money which is the only portable asset
- reserve ratio increasing in the nominal interest rate
- tight money (=increase in bond to money ratio) can lead to multiple steady states, indeterminacy and oscillations; raises interest, inflation and reduces long-run output
Argentina and the Contemporary Message

- Neumeyer: the fundamentals were good, including the deficit
- drastic steps to curb the deficit
- currency board originally introduced to cure high inflation – tied Argentina to tight US money policy
- combined with liberal banking rules
- worked well in Hong Kong – but HK much higher income and much more highly developed financial markets
- according to Bruce: should lead to indeterminacy and oscillations, restrain growth
- instead of a modest expansionary policy combined with some repression, had tight money with liberal banking
- perhaps it is not too late to follow Bruce’s advice?