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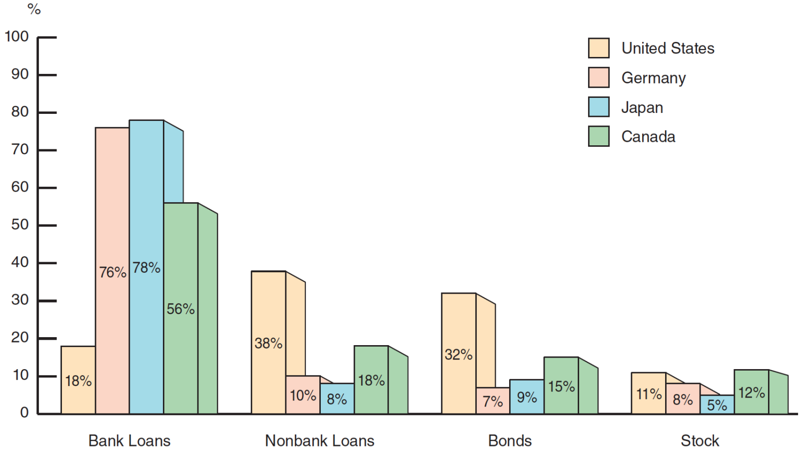
- Loan contracts typically restrict the behavior of borrowers

Sources of External Funds for Nonfinancial Businesses, 1970–2000



Transaction Costs

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High fixed cost of financial market participation

Inability to buy a diverse portfolio makes participation risky for the poor

Benefits of financial intermediaries: transaction cost reductions

- Economies of scale
  - Purchases and sales
  - Collection of information
  - Example: mutual funds

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- Reduce assymetric information problems

Asymmetric information

Problems:

- Adverse Selection
- Moral Hazard

Adverse selection (lemons problem)

1. Buyer does not know quality, so is willing to pay average value

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Result: fewer trades

Private information collection and sales

Rating agencies increase information for people who buy their services

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Free rider problem:

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- Information can be a public good
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One solution: firms cover the cost of rating their selves

Big brother is here to help

Securities and Exchange Commission: firms selling securities must submit to audits

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Success?

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Covers limited set of cases of asymmetric information

- Not mortgages
- Not commercials loans
- Not interbank loans
- Not relevant in all insurance markets

Financial intermediaries and assymetric information

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Prediction of theory: "As information about firms becomes easier to acquire, the role of banks should decrease"

Prediction of theory: larger, established firms should be more likely to finance with equity or commercial paper

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- Reduces the costs of default to the lender

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Moral hazard

Principal agent problem:

- Stakeholders are not the decision-makers and
- Monitoring of performance on a contract is difficult

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- Stockholders and managers
- Person on a date and interpreter who is in love with the date

Moral hazard solutions

Frequent audits

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- Expensive

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Venture capital firms

- Own large shares of new firms
- Firms they own are not publicly traded (*no free riding on information*)

Moral hazard solutions with debt contracts

Debt contracts produce less moral hazard than equity contracts

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- Maintain value of collateral
- Increase information
- But monitoring is costly, so free riding occurs

Financial development

Huge variations in the ease of establishing ownership of property

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Weak legal systems

- Recourse for creditors is weak
- Counterintuitive: government attempts to protect borrowers but hurts people who want to borrow

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Governments capture financial assets

- Legislate lower interest rates
- Lending quotas
- Monopoly power for public banks

Play time

1. Stocks are not the most important source of external financing for business
2. Issuing marketable debt and equity securities is not the primary method of businesses finance
3. Indirect finance is more important than direct finance
4. Financial intermediaries are the most important source of external funds for business
5. Financial markets are heavily regulated
6. Only large, established corporations have easy access to securities markets to finance their activities

Bonus: why might laws against insider trading make financial markets function less smoothly (less liquid)?