FULBRIGHT UNIVERSITY VIETNAM

FULBRIGHT SCHOOL OF PUBLIC POLICY AND MANAGEMENT

Financing development

Development Policy

Summer 2023

Why is the market for credit different from goods markets?

- Goods markets are spot markets: It is easy to know what you are getting by just looking at it, and the transaction is completed immediately.
- The price of goods reflects supply and demand at any given time. If the price is too high, you can go to another market and get goods of a similar quality.
- Credit is a *promise to repay* money at a *future date*. But future is unknown.
- So credit is always rationed. The market never clears.
- There is always more demand for credit than bankers are willing to supply.
- Lenders ration credit based on information that they have about borrowers.

Savings and Investment: The Conventional Story

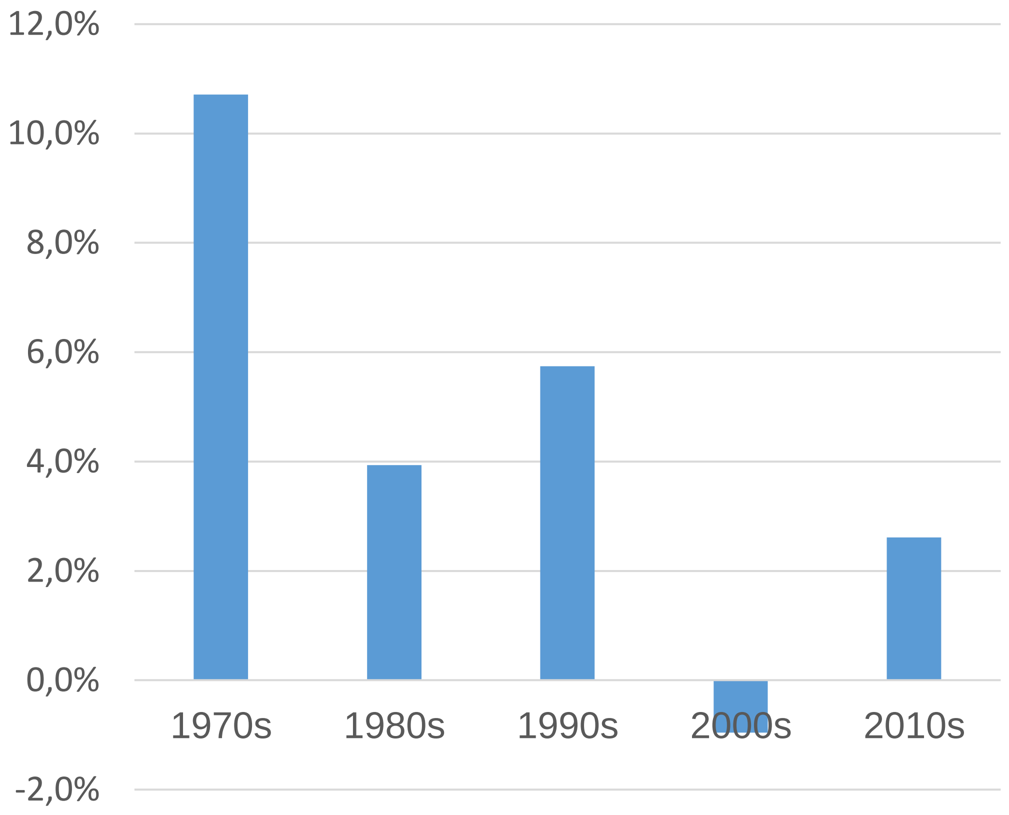
- Say’s Law: Supply is always equal to demand (the economy always operates at full employment)
- If Say’s Law is true, then savings always equals investment.
- Households earn income and save part of it in banks
  - Banks then loan these savings to businesses for investment
  - The equilibrium of savings and investment is at the real interest rate
  - The stock of savings is “loanable funds”

Finance in the real world

- Banks do not lend money already in their vaults. Banks create money (deposits) when they make loans.
  - Investors borrow money and pay wages, some of which is saved.
  - Investment that generates savings, not the other way round
  - The real interest rate is set by the central bank. It is not an equilibrium rate.
- The stock of loanable funds is not a limiting factor on financing
  - Financing is limited mostly by demand: The availability of viable, profitable projects
  - Banks also need to be able to cover their immediate obligations (pay depositors when they want to withdraw their money)

Conventional thinking: “Secular stagnation”

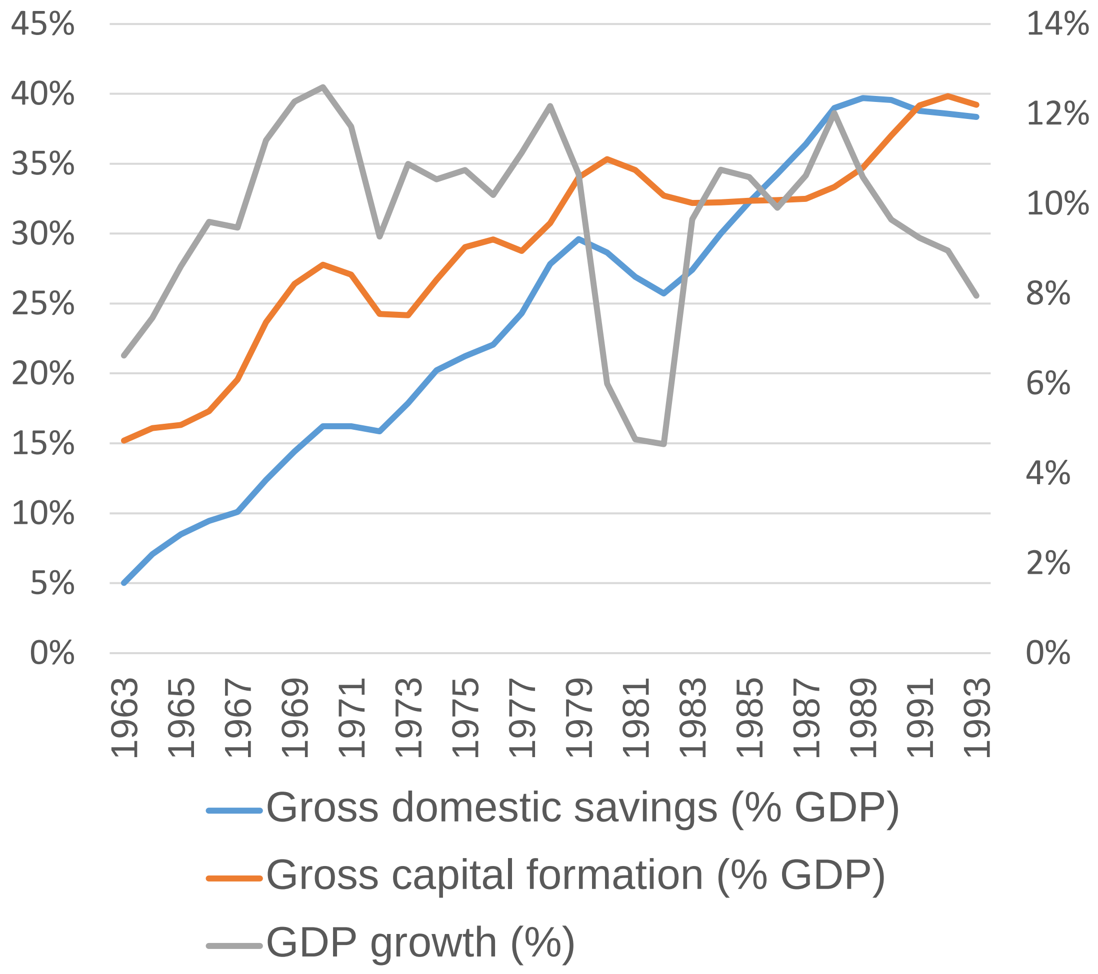
- There is a surplus of savings because the population in Europe, North America and Japan is getting older and saves too much
- New technologies are so efficient that less investment is needed
- So real interest rates will stay at historic lows
- But the problem is not savings: its not enough investment demand



US Corporate fixed investment, average annual growth (Source: OECD)

Korea as a developing country: Low savings and investment

- Savings in Korea was the result of rising investment, not its cause
- Government directed credit to export industries to take advantage of foreign demand
- Main constraint on Korea was not savings, but foreign exchange (access to dollars to buy machines and inputs) and demand

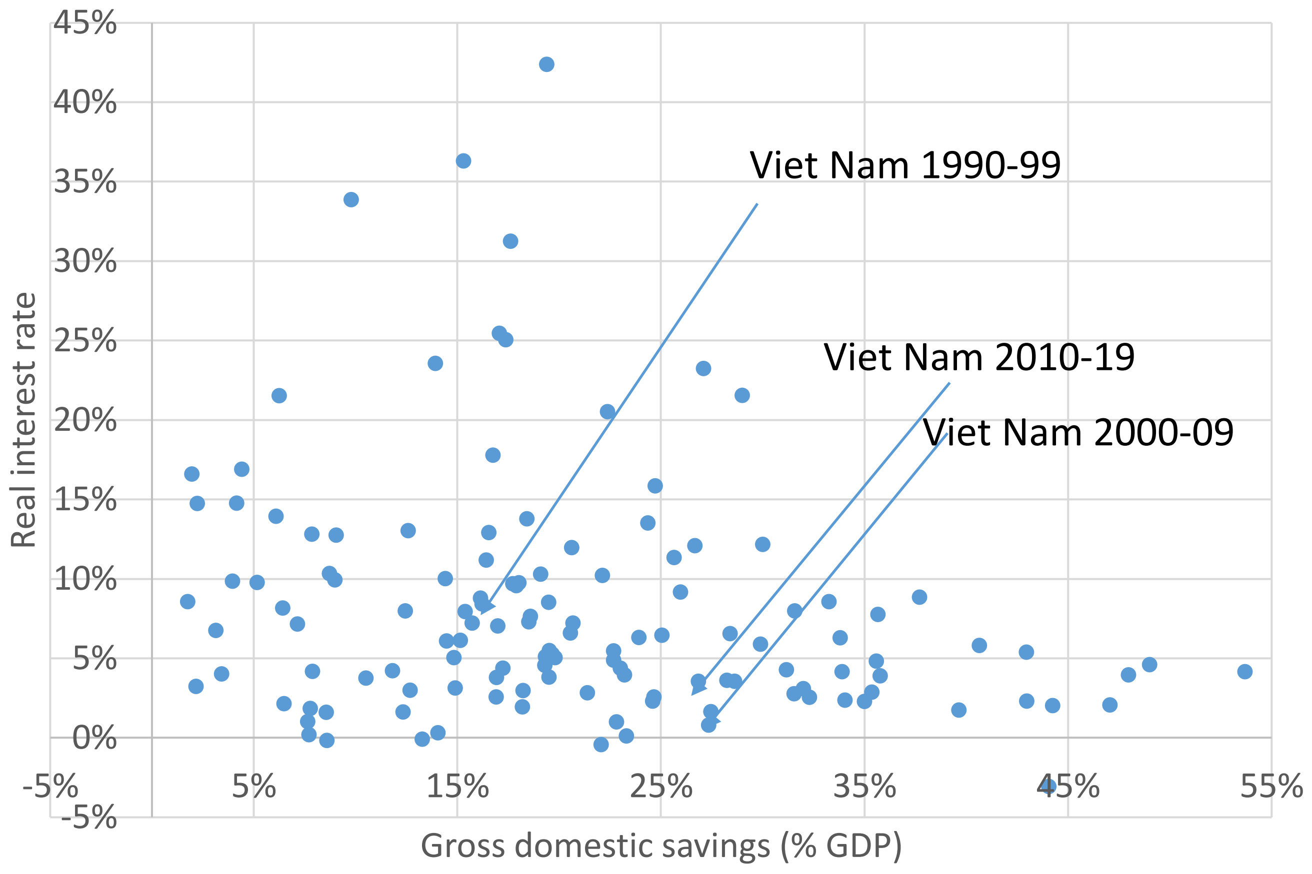


“Financial repression”: McKinnon and Shaw

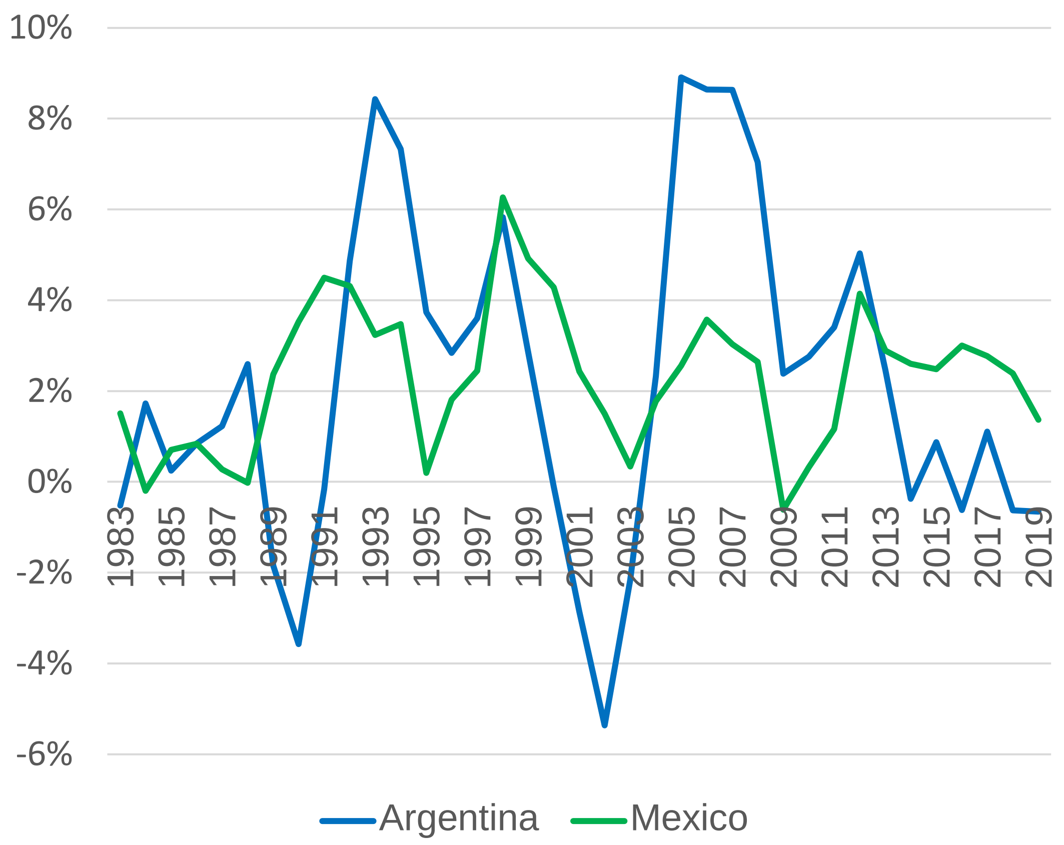
- Government controls on credit and interest rates results in “financial repression” and reduces the supply of savings for development
- The debt crisis of the 1980s gave the IMF and World Bank leverage to insist on financial liberalization as part of “structural adjustment programs” especially in Latin America.
- Privatization of state-owned commercial banks including FDI in banking sector
- Deregulation of domestic banking, including creation of new instruments and products (increasing systemic risk)

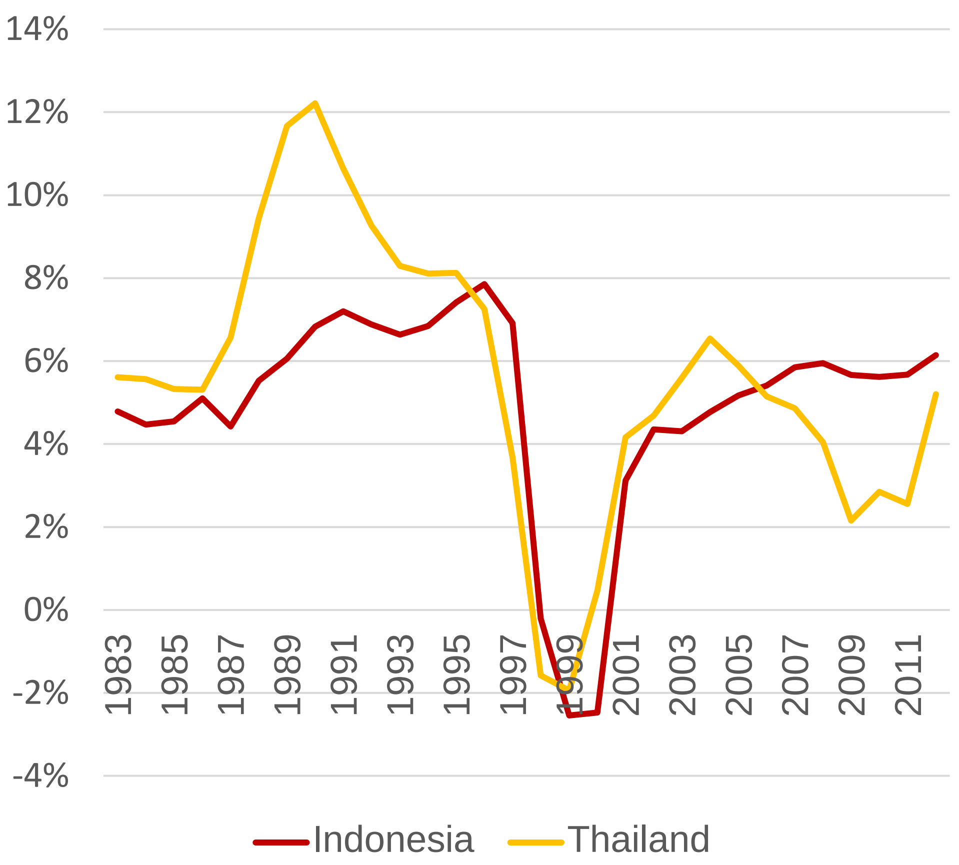
Financial liberalization, 1980-2009

- Experiments attempted across the developing world
- Savings and investment rates did not rise
- The real interest rate had no affect on savings
- Rapid increase in financial crises because too many banks allowed to open, and they lent too much money
- Culminating in East Asian Financial Crisis of 1998



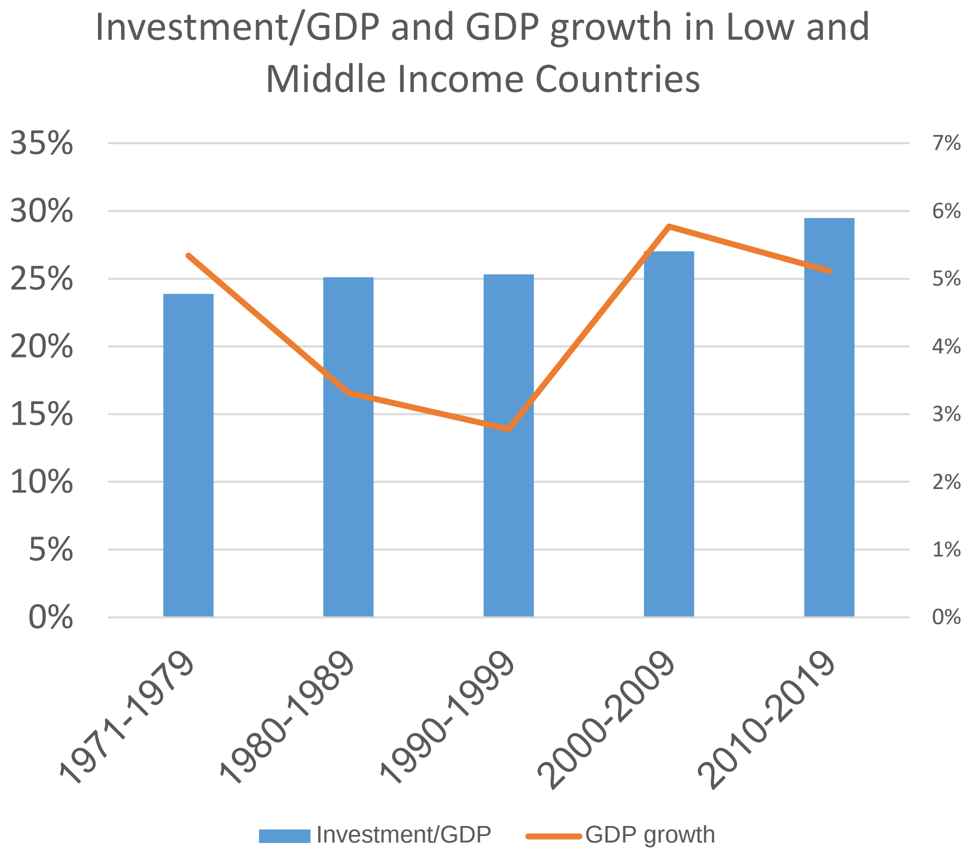
Financial crises and growth in Asia and Latin America





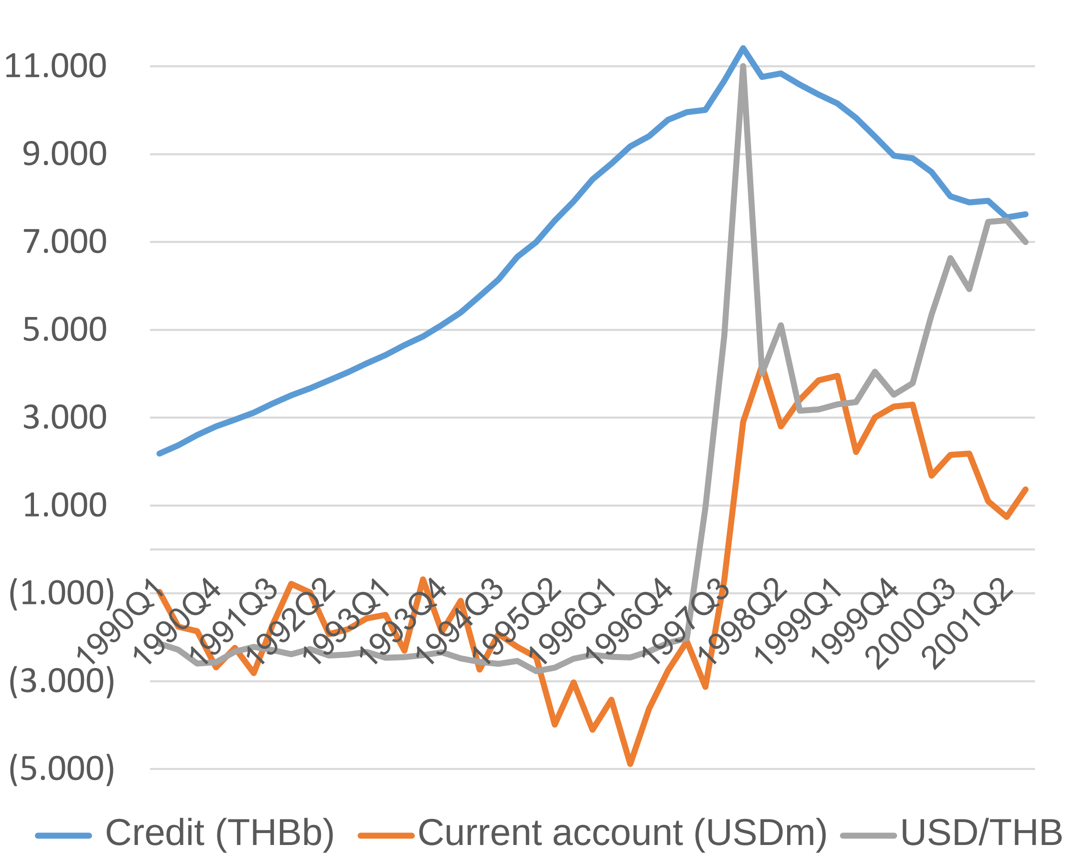
Financial liberalization failed to raise the rate of growth

- Growth slowed after financial liberalization and investment did not increase until after 2000
- Periodic financial crises reduced average growth rates in the developing world
- But the rise in investment and growth was related to relocation of manufacturing to Asia, not financial liberalization



East Asian Financial Crisis 1998

- Large capital inflows into non-tradeable sector in Southeast Asian economies: Borrowing dollars and yen to invest in property (currency mismatch)
- Easy access to foreign borrowing reduced credit quality: As asset prices rise, companies have more collateral and can borrow more.
- Capital inflows led to currency overvaluation and trade deficits.
- When Japan tightened domestic credit, the carry trade reversed.
- Loss of confidence led to depreciation of domestic currencies and bankruptcies as local banks and corporations could not pay back foreign loans with cheaper baht, Rupiah, won.



What is the proper role of finance?

- To “render long-term financing commitments sufficiently liquid to validate the commitment of resources to long term uses without requiring individual investors to make long-term financing commitments” (Jan Kregel 2014)
  - Banks have mostly short-term liabilities (deposits) so they do not want to make long term loans
  - Financial markets (secondary markets) help them make long-term obligations liquid: for example, securitization of mortgages, secondary bond markets, stock markets
- But most developing countries do not have liquid secondary markets, so there is shortage of long-term financing
- Even in advanced countries, governments intervene to create liquid secondary markets

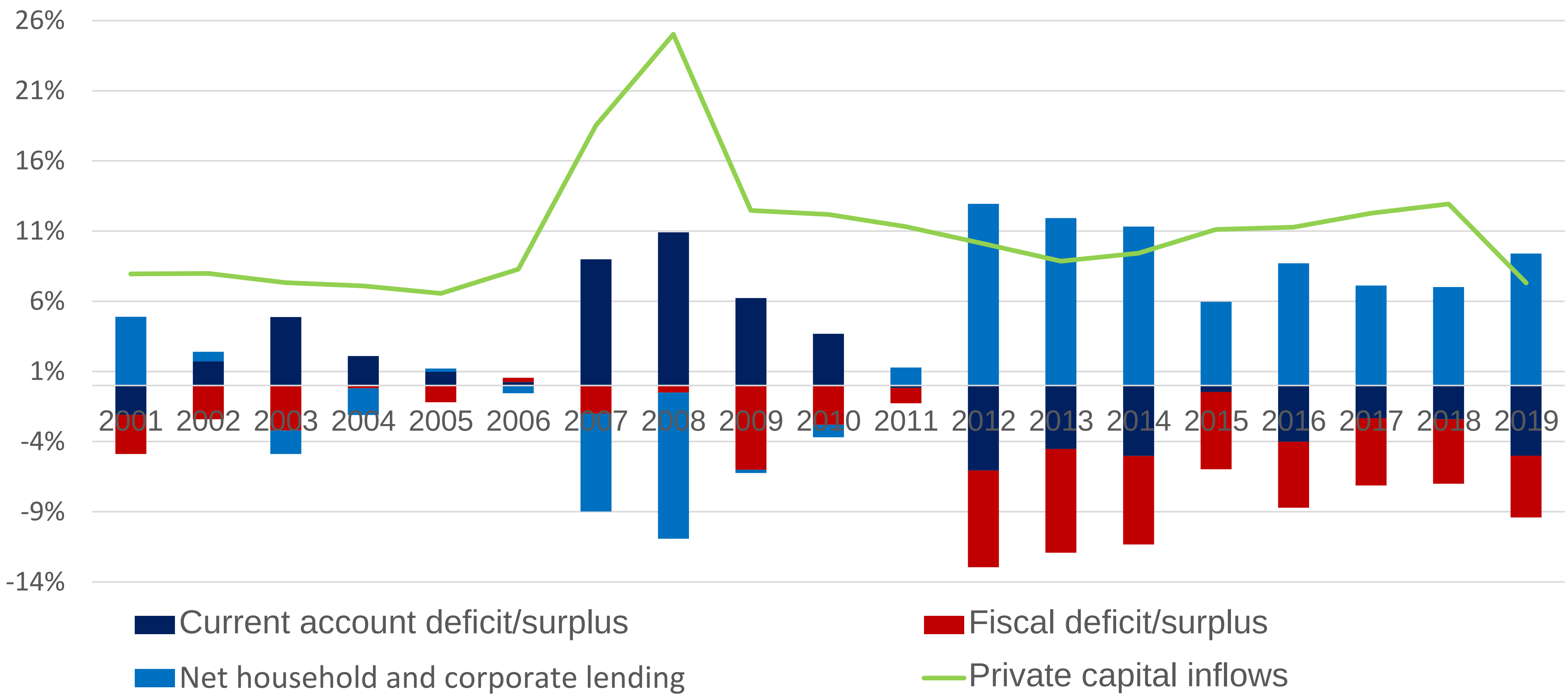
Increasing the supply of long-term finance

- Development banking (BDNES in Brazil, KfW in Germany, Korean Development Bank)
  - 250 NDBs now operating, $5 trillion in investment
  - Second tier lending, loan guarantees
  - Syndicated loans, PPP loans with technical assistance
  - Benefit: counter-cyclical lending during the Global Financial Crisis
- Fannie Mae and Freddie Mac in the US: Securitization of mortgages
- Small Business Administration in the US: Loans and equity for small businesses
- Sovereign Wealth Funds

Reducing speculation

- Channeling finance to productive projects (and away from speculative ones) is also important
- For example, 2008 capital inflows in Vietnam sparked asset bubble and overlending by banks
  - Led to inflation, massive current account deficit
  - Government had to step in to raise interest rates and cap lending
- Discouraging speculation can help
  - Property and capital gains taxes
  - Strict limits on borrowing for speculative purposes (loan to asset ratios)

Boom and bust in Vietnam



Policy implications

- The conventional approach (Say's Law) sees savings as a constraint on investment
  - Frugal households and governments solve the financing problem by generating domestic savings
  - But if supply does not always equal demand, frugal households just leads to unemployment and lower profits, which reduces savings.
- The main constraint on savings in investment: if businesses expect profits they invest, thereby generating savings.
- Most countries are constrained not by savings, but by long-term investment because financial markets and not liquid.
  - Banks and other investors will not extend credit if they cannot easily convert assets into cash.
  - National Development Banks and other instruments can increase the supply of long-term finance.
- Reducing speculation also important to maintain macroeconomic balance

Discussion questions

1. Why do credit markets behave differently from markets for normal goods and services?
2. What are the main lessons from the East Asian financial crisis that are relevant to current conditions?