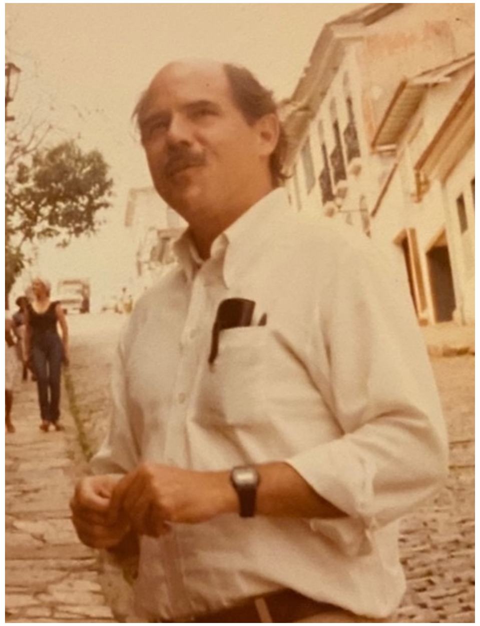
Development Policy

FINANCING DEVELOPMENT

Why is the market for credit different from the market for pork or bread?

- Goods markets are spot markets: It is easy to know what you are getting by just looking at it, and you can take it with you
- So the price of pork or bread is mainly about the quantity and quality. Supply meets demand at the market price.
- Credit is a promise to repay a certain amount of money at a future date. Unfortunately, the future is unknown.
- So credit is always rationed. *The market never clears*. There is always more demand for it than bankers are willing to supply.
- Lenders ration credit based on information that they have about borrowers



Carlos Diaz-Alejandro

Savings and Investment: The conventional story

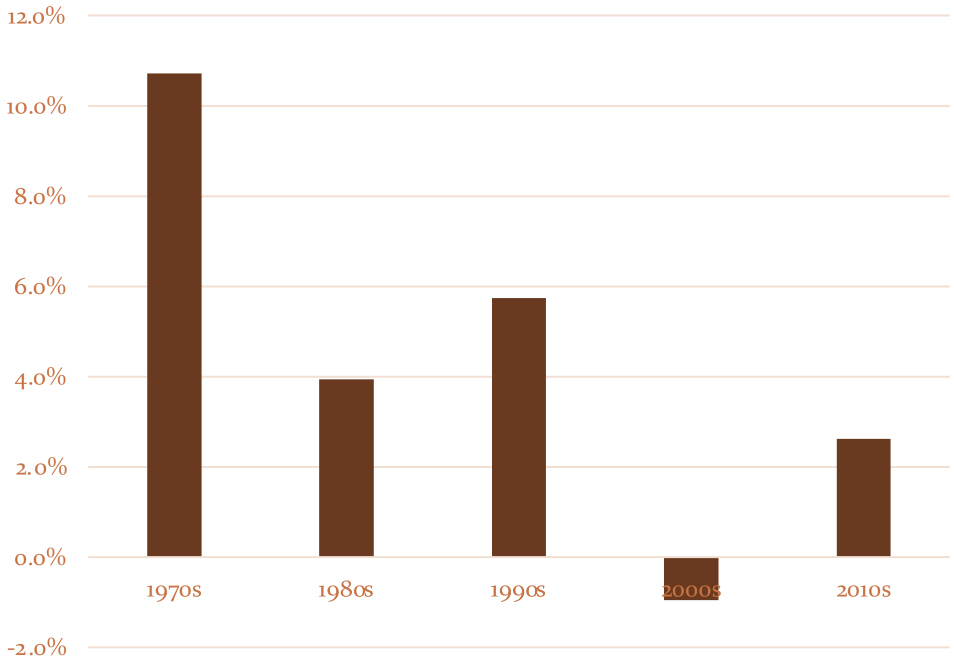
- Say's Law: Supply is always equal to demand (the economy always operates at full employment)
- If Say's Law is true, then savings always equals investment.
- Households earn income and save part of it in banks
  - Banks then loan these savings to businesses for investment
  - The equilibrium of savings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

What’s wrong with the conventional story?

- 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. So in fact it is 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)

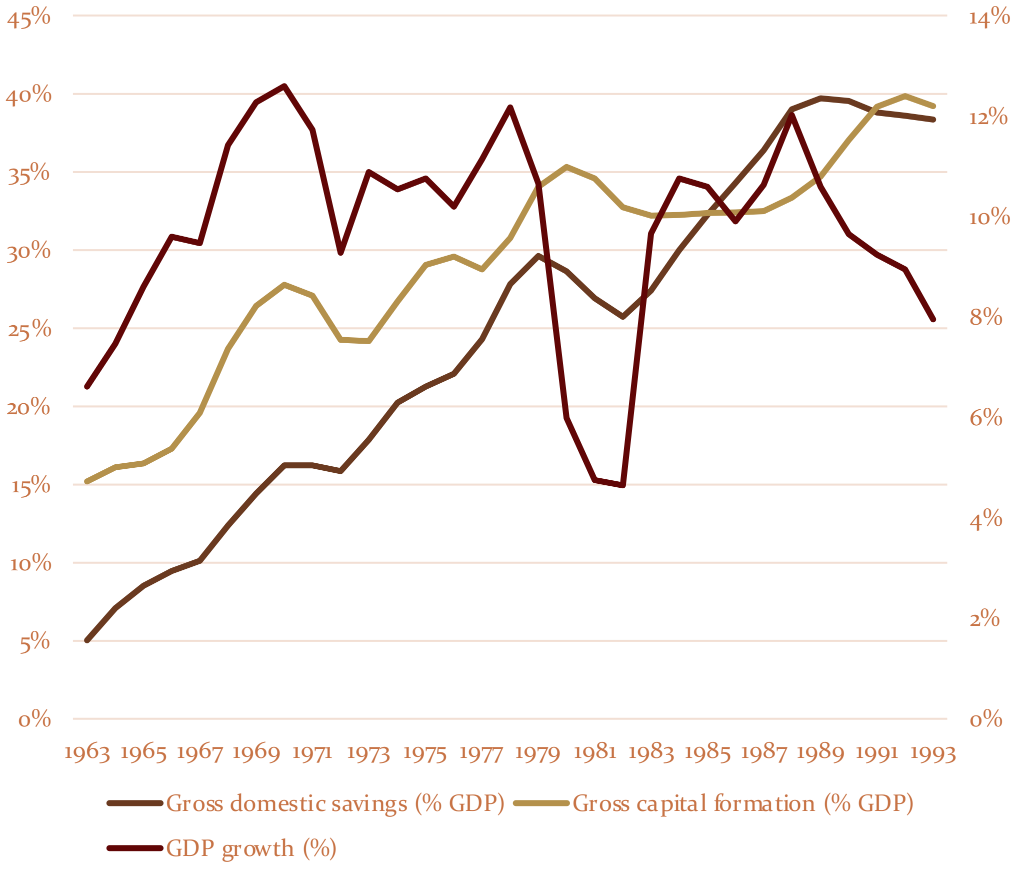
Lawrence Summers: "Secular Stagnation"

- There is a surplus of savings because the population in Europe, North America and Japan is getting older and saves too much
- Plus 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 in 1960s: no savings and low investment



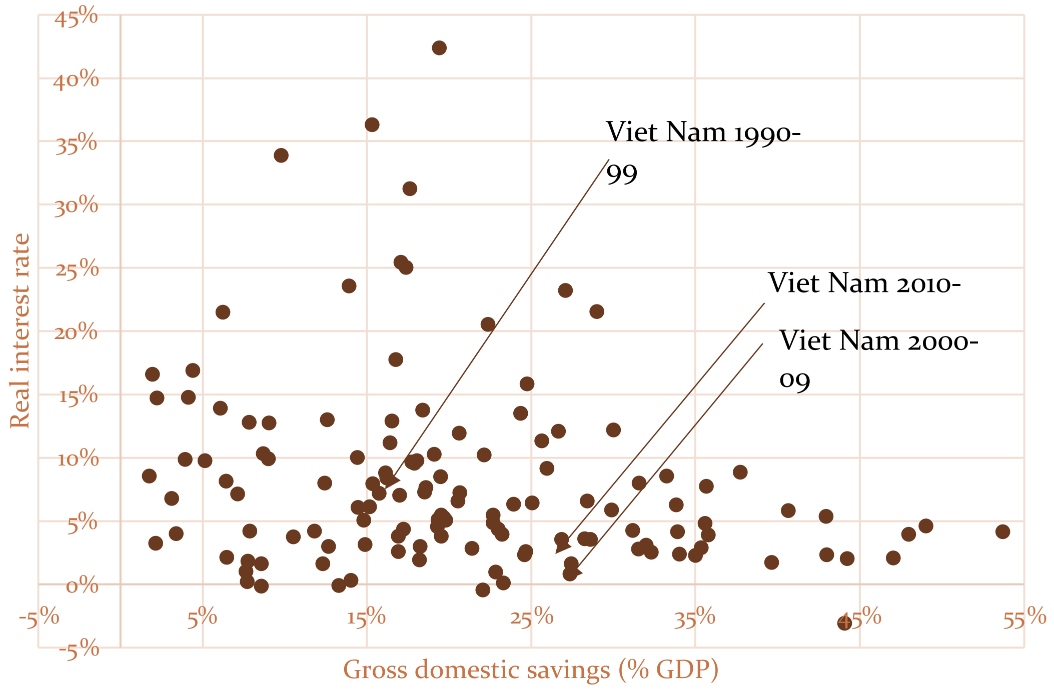
- Savings in Korea was the result of rising investment, not its cause
- Government directed credit to export industries to take advantage of foreign demand
- Main constraint on Korea was not savings, but foreign exchange (access to dollars to buy machines and inputs) and demand

Financial repression: McKinnon (1973) and Shaw (1973)

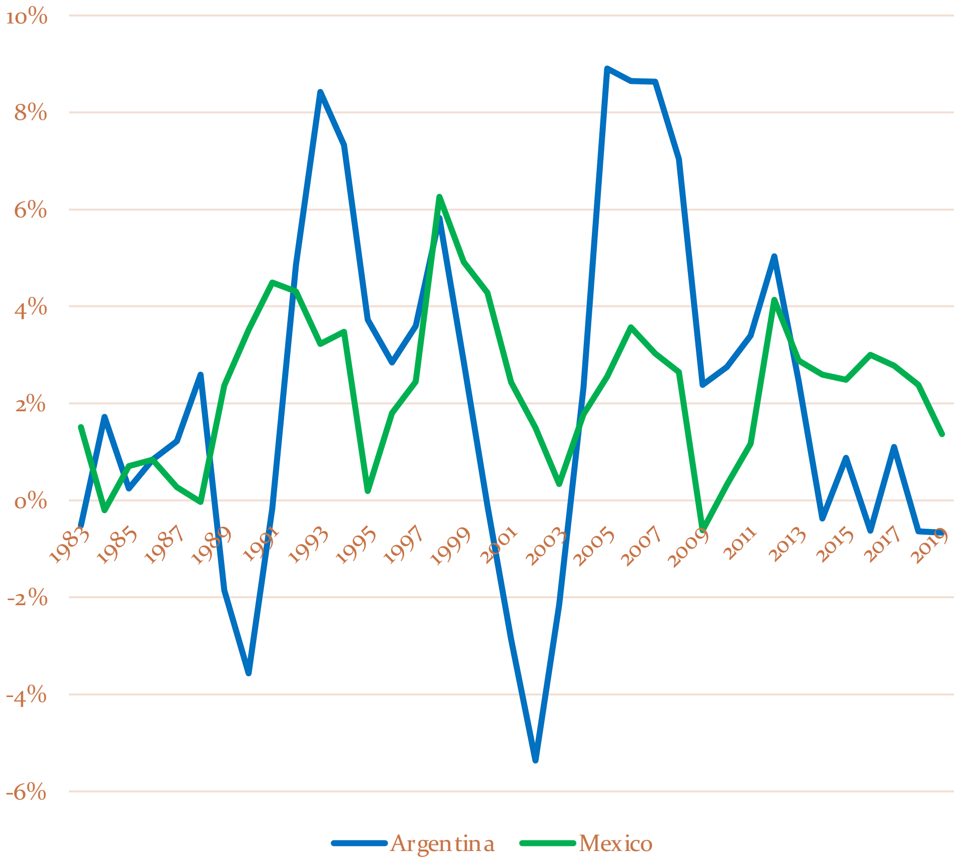
- Government controls on credit and interest rates results in "financial repression" and reduces the supply of savings for development
- The debt crisis of the 1980s gave the IMF and World Bank leverage to insist on financial liberalization as part of "structural adjustment programs" especially in Latin 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)

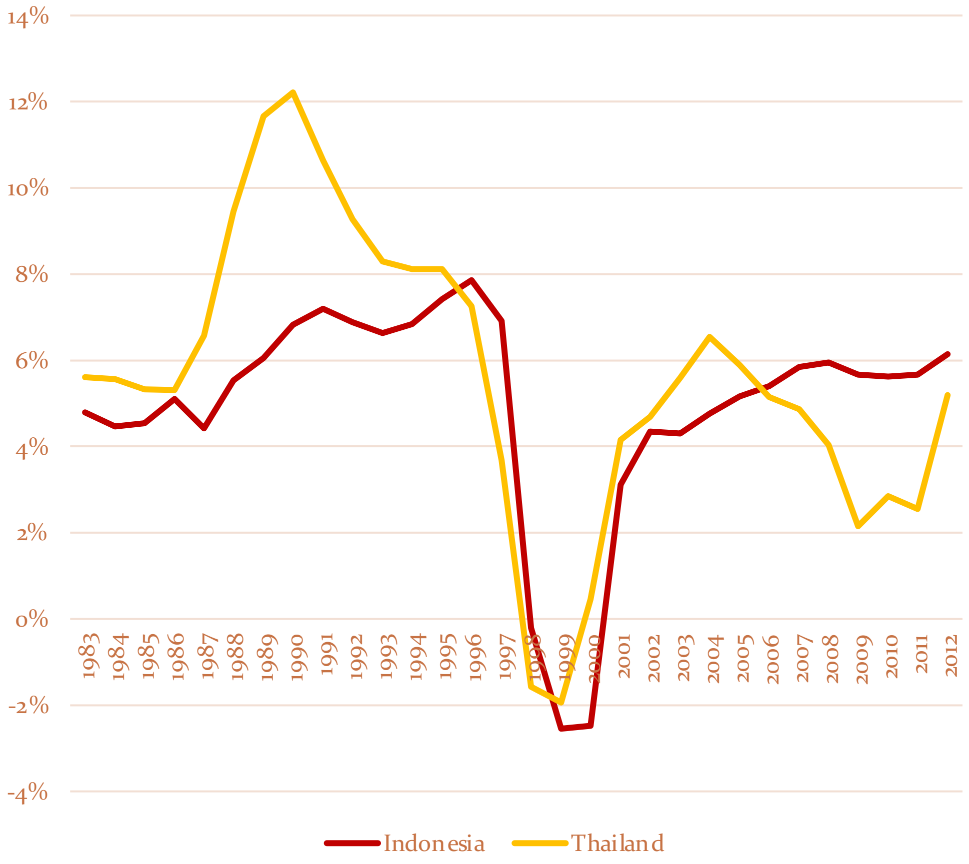
Financial liberalization from 1980s-2000s—let the market allocate credit

- Experiments attempted all of the developing world
- Savings and investment rates did not rise
- Fry 1995 – the real interest rate has no affect on savings
- But rapid increase in financial crises because too many banks allowed to open and they lent too much
- Culminating in East Asian Financial Crisis of 1998

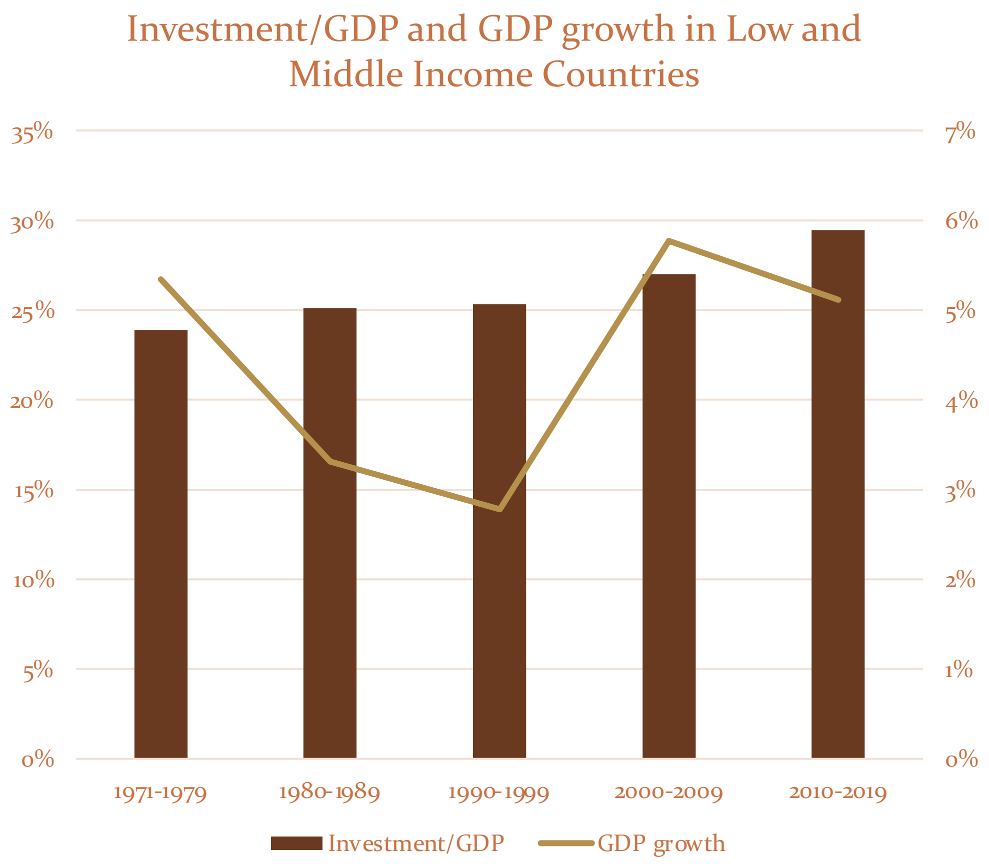


Financial crises on Latin America and Asia (gdp growth, three year moving average)





Financial liberalization did not raise growth rates



- 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

- Large capital inflows into nontradeable sector in Southeast Asian economies: Borrowing dollars to invest in property (currency mismatch)
- Scramble for assets as prices rose: land and equities
- Easy access to foreign borrowing reduced credit quality: As asset prices rises, companies have more collateral and can borrow more (tenor mismatch)
- Capital inflows led to currency overvaluation and trade deficits
- Loss of confidence led to depreciation of domestic currencies and bankruptcies as local banks and corporations would not pay back foreign loans with cheaper baht, Rupiah, won.

What is the role of finance if its not to collect savings and loan them out?

- The real function of the financial markets is 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 or mortgages, secondary bond markets, stock markets
- But most developing countries do not have liquid secondary markets, so there is shortage of long-term financing

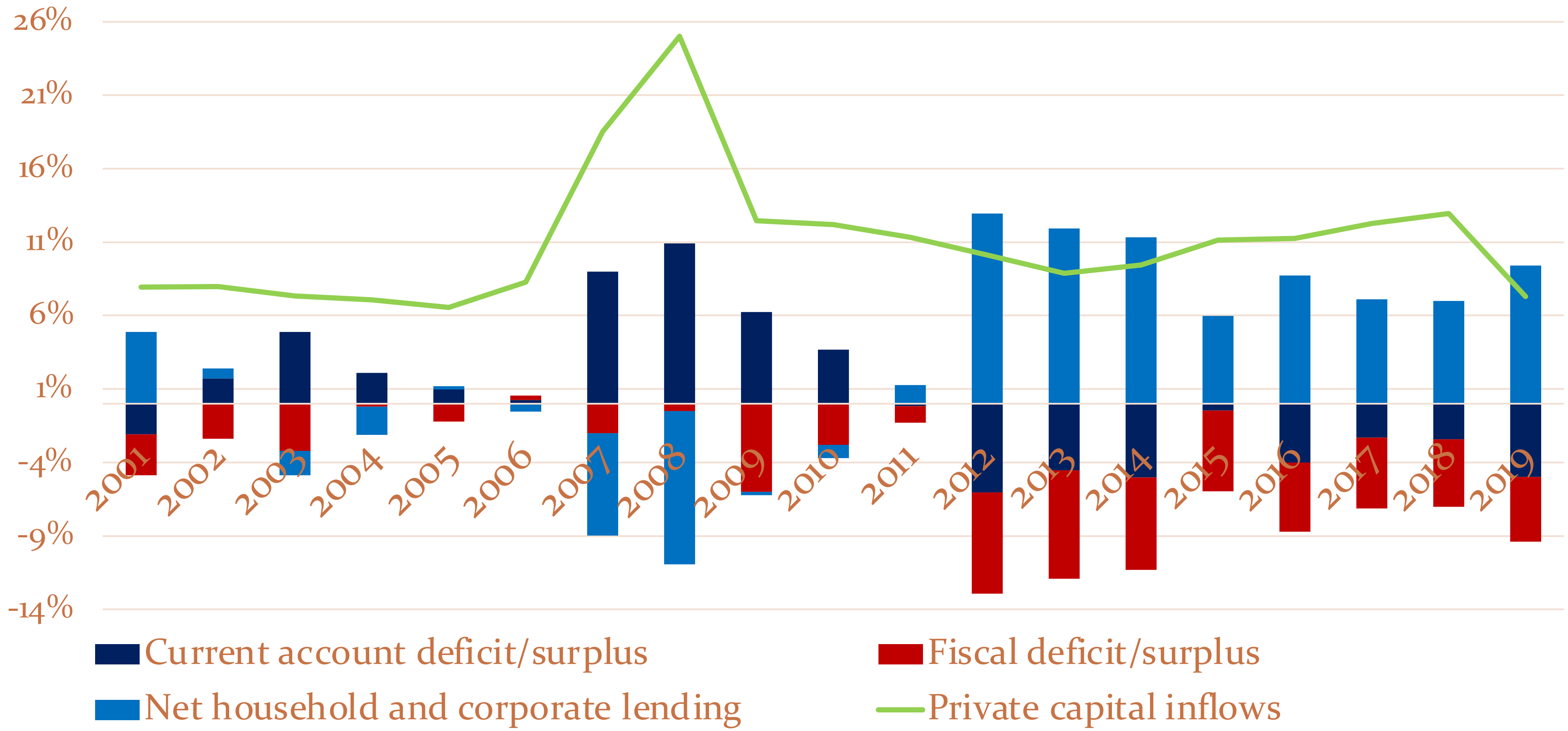
How have countries solved this problem?

- 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)

Vietnam's 2007 boom



Policy implications

- Frugal households and governments will not resolve the financing problem
- The shortage of long-term financing is endemic, especially when countries do not have liquid secondary markets
- National Development Banks and other instruments can increase the supply of long-term finance
- Reducing speculation also important to maintain macroeconomic balance