Discussion of “Credit Booms: Implications for the Public and Private Sector”

Broad Message

- Liquidity/credit affects incentives
  - To reform/maintain fiscal prudence in countries.
  - To originate good quality securities.
- Negative effects of too much liquidity/credit.
- Could lead to deterioration of governance institutions/market integrity.

Part I: Liquidity and Reform

- Why entry into Euro did not help periphery?
  - Budget constraint relaxed because of capital flows
  - Could pay off opponents to reform but ended up postponing reform
    - Pension reform in Greece
    - Social transfers in Portugal
  - Why?
    - No way of committing to long term compensation?
    - Compensation too high given pain of needed reform?

Examples

- Credit flows also mask incompetence (of elected officials), and even allows them to gain control of independent agencies.
  - Spain and Cajas and local political interests
  - Parallels to sub-prime in the United States
- Some fundamentals can help tell a convincing story
  - Demographics and house prices

Counter-example: Germany

- Germany
  - German unification placed great strains on fiscal.
  - Demographics poor.
  - There was no alternative to Hartz reforms
  - Accession to Euro did not help in expanding access to funds!
- Role of reunification at wrong exchange rate
  - Who bore brunt of reforms?
- Role of strong demand in rest of Europe.

Part II: Liquidity and origination

- More liquidity (advent of uninformed) can push some informed to seek new markets where returns are better.
- But if too many uninformed, yields get compressed across markets, and incentive to seek information falls.
- Example: Origination of sub-prime mortgages over time.

Liquidity and Institutions

- Aid and growth
- Borrowing in a time of ample liquidity and borrowing in a time of scarce liquidity (Diamond, Hu, and Rajan (2014))
  - Asset based lending
  - Cash flow based lending
- Why a change in the liquidity environment has large effects.

Bottom line

- Big idea:
- Free cash flow theory of (deteriorating) governance
- Why? Triumph of hope over experience? Short horizons? Rigidities and rational bets?
- Probably should be (and is?) multiple papers.
- Recommended to all.