# Credit booms: implications for the public and the private sector

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# The big question:

What are the consequences of lending booms?

# Refining the question

- What kinds of effects of lending booms?
- Political economy effects
  - Delay  inevitable fiscal adjustments
  - Allow “bad” politicians to be entrenched in office
- Financial effects
  - Cause origination incentives to deteriorate.
  - What is the point of generating good assets when the market pays the same for a good and a bad asset?
- What both effects have in common: a kind of hysteresis
  - A temporary shock (capital inflow, lending boom) can have permanent effects (changed political landscape, changed asset composition)

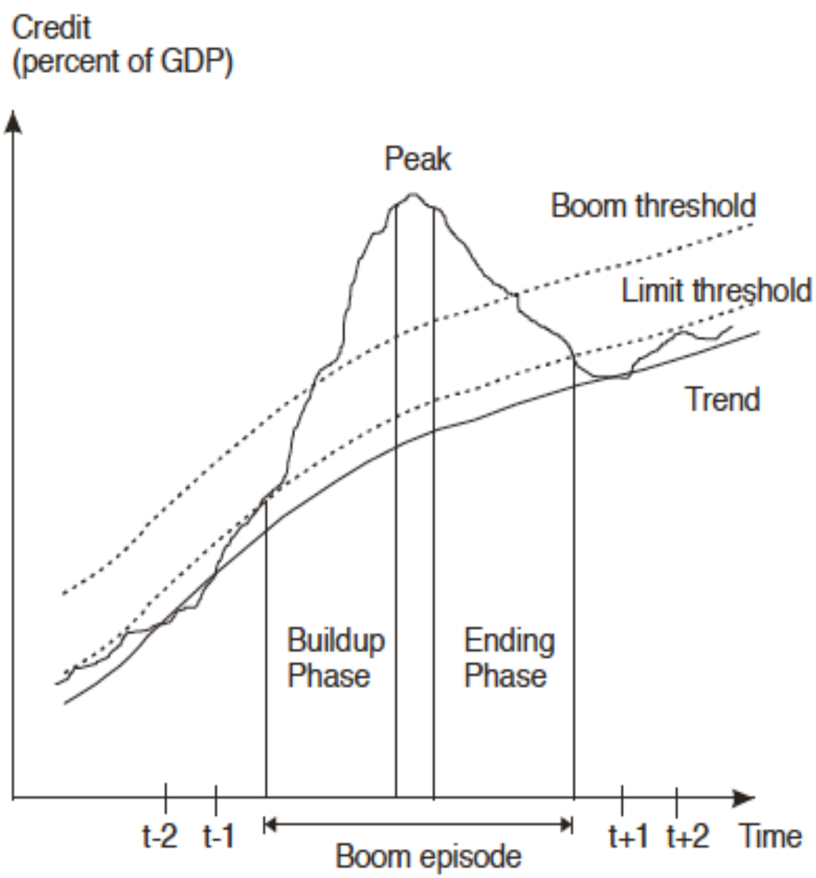
# General comments

- Nice paper, which touches a key topic for economic policymaking.
- I like the analysis and find most of the conclusions very plausible
- What do I plan to do?
  - Add context and put the results in that context
  - Express some theoretical doubts and quibbles
  - Explore policy implications and policy alternatives

# A little context…

- Complaints:
  - Paper written as though lending booms had begun around 2005 some place in the middle of the Iberian peninsula
- Many earlier episodes on CA deficits, K inflows, lending booms, asset inflation, relative price distortions
  - Latin America in the late 1970s and early 1980s
  - Emerging Asia in the run-up to the 1997 crisis
  - Many emerging nations in the early 2000s and again since 2010
- In all of those episodes, lessons about
  - Stylized facts: macro fundamentals around lending boom episode
  - Asset price inflation, increased financial vulnerabilities
  - Political economy effects: fiscal populism, delayed adjustment

# Gourinchas, Valdés and Landerretche (2001)




- Lending booms typically
  - Are associated with CA deficits and K inflows
  - Increase investment & consumption (sometimes)
  - Appreciate the real exchange rate & asset prices
  - (Weakly) increase vulnerability to banking & balance of payments crises
  - Deteriorate the budget balance (political economy)

# Political economy effects

- Delayed reforms
- Entrenched politicians

- Focus on the first

# Do lending booms delay reform?

- "Credit booms can potentially have two opposing effects on political economy games."
- "On the one hand they can relax constraints and postpone resolution of the attrition game."
- "On the other they can facilitate the issuance of debt to share with future generations the transitional costs associated with reform."
- "At least in the case of the first global liquidity phase, some countries in the Eurozone periphery avoided necessary reforms and simply levered to delay the inevitable."

# Why a political economy explanation?

- It is not enough to “be able” to postpone adjustment.
- If postponing is collectively inefficient, then one must have a political economy story as to why the government “wants” to postpone adjustment: Alesina and Drazen (1991); Velasco (1999).
- There is a large empirical literature on whether “crises” accelerate stabilization & adjustment. Drazen and Grilli (1993); Casella  and Eichengreen (1996); Drazen and Easterly (2001).
- Here we are have the inverse case: do “booms” cause delayed adjustment?

# Booms, crises and reform

- Theoretical literature: crises do accelerate adjustment
  - Shorten attrition game
  - Make it harder to defect from cooperative policies.
  - Caveat: results are sensitive to the political economy process assumed in each paper
- Caveat: this does not mean crises are good for welfare, or that booms are bad for welfare
  - Boom increases ST consumption, but shortens the period during which high consumption is feasible. Net effect?
- Empirical literature: not clear crises cause reform
  - Depends how you define crises (inflation, output, CA, BOP)

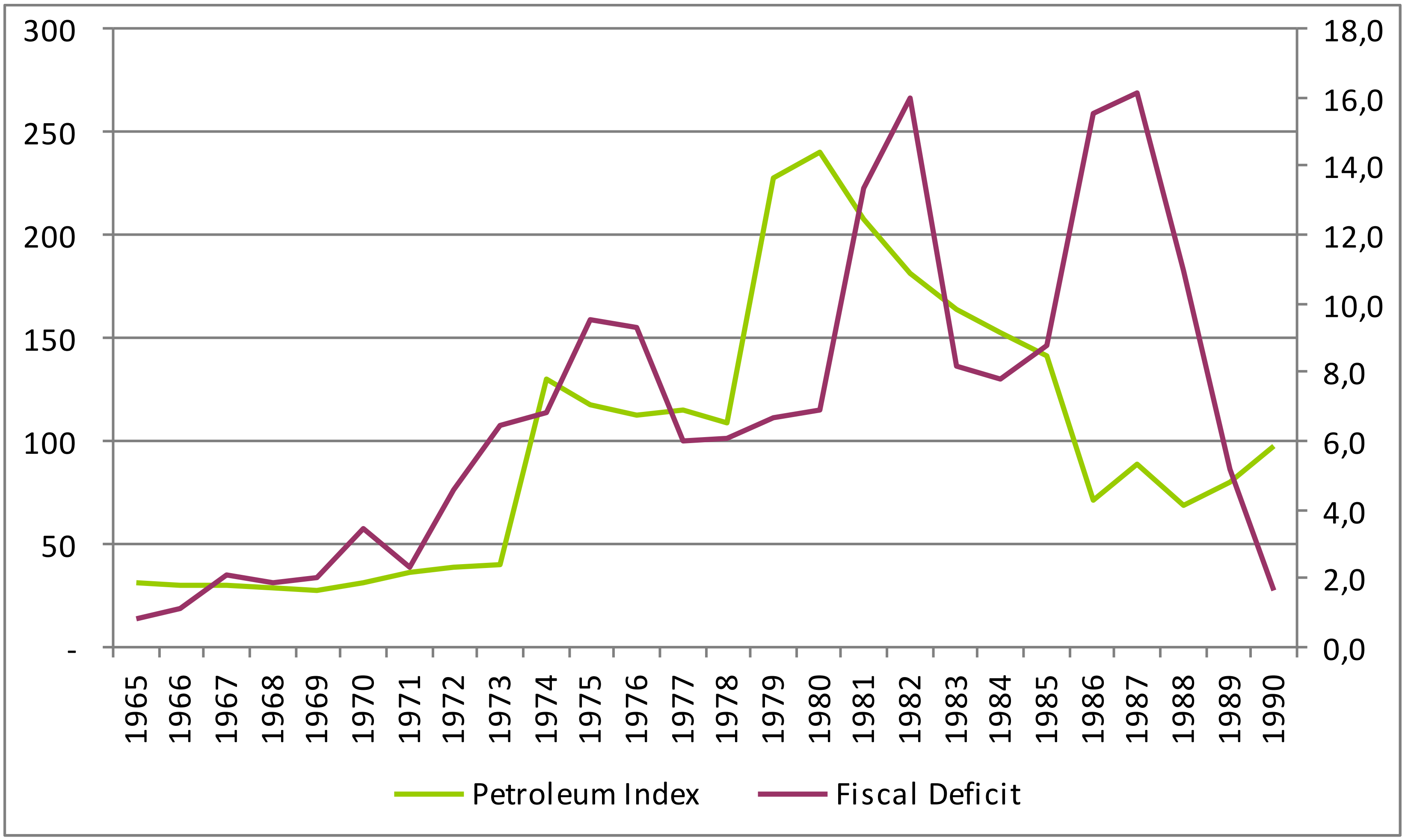
# Needed…

- Needed: a detailed theoretical model linking
  - The type of boom (e.g. lending boom, others)
  - The type of reform needed
  - The precise political economy mechanism at work
- Tano tells me he is working on this
- The type of reform needed makes a difference
  - If it is pension reform, availability of credit helps spread costs across time
  - If it is resource allocation (from NT to T) and real devaluation, almost impossible to achieve in the middle of lending boom
- Political mechanism makes a difference
  - Attrition game, coordination game, voting game (who votes?)

# Pro-cyclical fiscal policies

- The link between lending booms and delayed adjustment may be an example of a broader phenomenon: pro-cyclical fiscal policies
- Standard view: fiscal policy should be counter-cyclical. Barro (1979)
- Political economy view: "voracity effect". Tornell and Velasco (1991); Lane and Tornell (1993)
- If fiscal resources are "common pool", then equilibrium involves spending "more" in good times: pro-cyclicality
- Example: Mexico from the 1960s to the 1980s

# Fiscal pro-cyclicality: an extreme example



# Policy alternatives

- Macro-prudential regulation (and capital controls?)
- Fiscal rules
- The role of the exchange rate regime

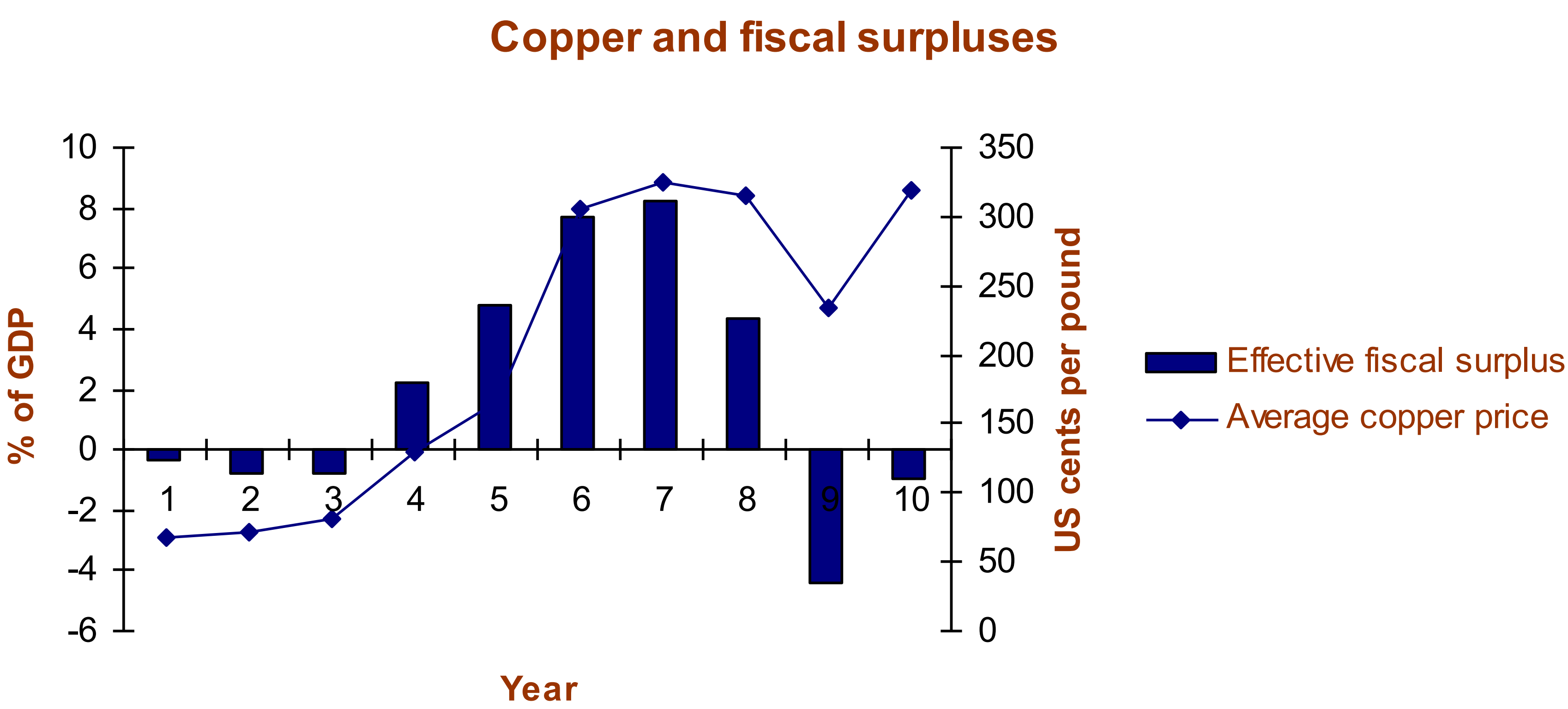
# The role of macro prudential policies

- If K inflows cause lending booms, then
  - Do away with capital inflows
  - Do away with the credit consequences of K inflows
- Reducing K inflows may require K controls. Once completely unacceptable, but increasingly OK. See Ostry, Ghosh, Habermeier, Chamon, Qureshi, and Reinhardt (2010)
- Cutting the link between K inflows and lending booms may call for tighter macro-prudential regulation. Borio (2003); Dell'Ariccia, Igan, and Laeven (2008); Turner (2010); Galati and Moessner (2011); many others
- Caveat: if government benefits politically from boom, it will oppose regulation. Key: regulatory & CB independence

# The role of fiscal rules

- If fiscal pro-cyclicality is the problem, then a fiscal rule mandating counter-cyclical or a-cyclical fiscal policies is the obvious answer.
- According to the IMF (2009), 80 countries had some kind of fiscal rule in place
  - However… back then only 8 of those rules involved "cyclical" or "structural" adjustments
  - By contrast, Eurozone today
  - Among emerging markets: Chile, Colombia, Panama, Peru
  - Mongolia, Nigeria, Kazakhstan, others
- Caveat: rule has to be enforced (in good times, which is the hard part). It must be a political economy equilibrium

# Fiscal counter-cyclicality: an example




Source: Parrado and Velasco (2010)

# The role of the exchange rate

- Conventional wisdom once upon a time: currency boards & currency unions will impose discipline and facilitate reform. Papademos (2001); Bentolila and Saint Paul (2000); Bean (1998)
- Reality: in the Eurozone, this did not happen. If anything, as the paper stresses, the opposite effect took place. See also Fernández Villaverde, Garicano and Santos (2013).
- Issue the paper does not address: what is the role of the ER regime in all of this? Do fixed rates provide discipline?
- One answer: NO. Flexible rates provide more fiscal discipline. Tornell and Velasco (1995 and 1998).
- Intuition: under flexible rates, effects of unsustainable policies on the ER and the price level show up right away

# The end