

## Lecture 11

### Capital and Saving

(Based on Chapter 11 of Perkins et al.)

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# Recap

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- Flow of funds
  - Savings → Credit/Capital Market → Investment
- Theories of household saving
  - Life cycle hypothesis
  - Permanent income hypothesis
  - Duesenberry hypothesis
- Government saving
- Corporate saving

# Foreign Savings

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- Sources
  - Investment by foreign entities
    - Direct investment
      - Multinational enterprises
    - Portfolio investment
  - Loans
    - Sovereign
      - Multilateral
        - IMF, World Bank
      - Consortium
        - Paris Club, London Club
    - Private
  - Aid
    - World Bank etc.
    - ODA, USAID etc.

# Foreign Direct Investment

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- Why do firms invest in other countries?
  - Resource
  - Market access
  
- How does a multinational choose a country for investment?
  
- Relative importance of capital and technology.
  - Spillover
    - Skills
    - Business “best” practices
    - Technology
    - Export

# Portfolio Investment

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- Financial instruments
  - Equity
  - Bonds
    - Government
    - Corporate
  
- Risks
  - South East Asian crisis
  
- Tobin tax

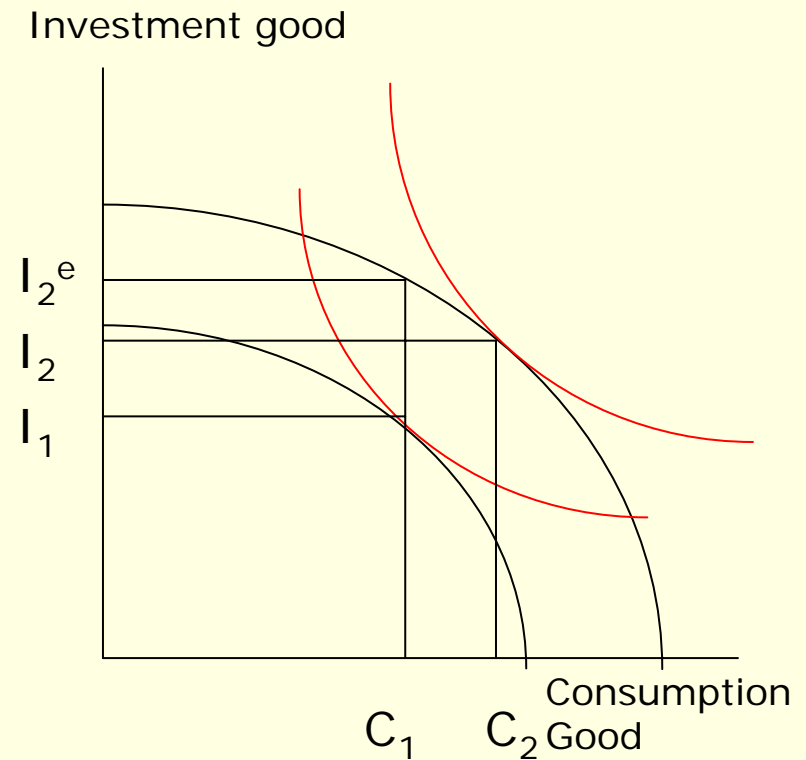
# Aid and Development

## ■ Problems

- Low impact on large countries.
- Part of aid not invested.

## ■ Solution

- Targeted aid
- Technical assistance
- Conditionality



# Foreign Debt

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## ■ Issues

- Illiquidity versus insolvency
- Currency for repayment
- Contract enforcement
  - Rescheduling and “haircuts”
    - Mexico (1982), Russia (1998), Argentina (2003)

## ■ Options facing lenders

- Future loans
  - Bargaining power: Russia (1918) versus Nicaragua (1979)
- Trade
- Military intervention
  - France and Belgium’s intervention in Germany (1923)

# Simple Model .... 1

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- Two periods
- Credit in period 1
  - $L$
- Repayment in period 2
  - $(1 + i)L$
- Penalty in the event of default
  - $b(L)$
  - $b'(L) > 0$ ,  $b(L)$  concave,  $b(0) = 0$



# Simple Model .... 2

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- Borrower's consumption in the absence of credit
  - $(C_1^0, C_2^0)$
- Utility functions
  - $U^R = U(C_1^0 + L, C_2^0 - (1 + i)L)$
  - $U^D = U(C_1^0 + L, C_2^0 - b(L))$
  - $U^0 = U(C_1^0, C_2^0)$

# Simple Model .... 3

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- Conditions for repayment

- $b(L) \geq (1 + i)L$  [1]

- $U(C_1^0 + L, C_2^0 - (1 + i)L) \geq U^0$  [2]

- Lender's problem

- $\max (i - r)L$

- sub to [1] and [2]

- Choice variables:  $\{i, L\}$

# Simple Model .... 4

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- Condition [1] likely to bind before condition [2].
- Lender's problem restated
  - $\max b(L) - (1 + r)L$
- First order condition
  - $b'(L) = (1 + r)$
- Solution
  - $L^*$
  - $i^* = [b(L^*)/L^*] - 1$