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Credit rationing and capital accumulation with investment and consumption loans revisited

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Abstract

A simple model is developed to evaluate the roles of credit rationing and government policies of financial repression in the process of capital accumulation. In the model, credit rationing on both investment and consumption loans decreases as capital accumulates but increases as the government imposes policies of financial repression to a greater extent. While a reduction in credit rationing on consumption loans impedes capital accumulation, such a reduction on investment loans facilitates it. We find that developing countries may be trapped at a low-capital-stock steady state while developed countries converge to a high-capital-stock steady state. Instead of adopting policies of financial liberalization, interestingly, this paper finds that policies of financial repression may enable developing countries to escape the development trap.

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1. Introduction

Economists have long recognized that financial markets are characterized by a wide variety of informational imperfections and have realized that such imperfections cause frictions (i.e., credit rationing) in channeling resources from savers to borrowers. Spurred

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by the development of endogenous growth models, recent literature has set up models to illustrate how asymmetric information and its consequence of credit rationing affect capital investment and economic growth. Nevertheless, two distinct conclusions emerge as this recent literature takes two different directions in examining the effects of credit rationing on capital accumulation.

The first direction of research focuses on the effects of credit rationing on loans for capital investment, showing how credit rationing impedes capital investment and thereby economic growth. Examples include [Bencivenga and Smith \(1993\)](#) and [Bose and Cothren \(1996\)](#). In a neoclassical growth model, [Bose and Cothren \(1997\)](#) further demonstrate that there is a mutual dependency between capital stock and the incidence of credit rationing, such that capital accumulation reduces the incidence of credit rationing and a reduction in credit rationing on investment loans in turn fosters capital accumulation.¹ Parallel to the role of credit rationing on investment loans, another strand of literature focuses over credit constraint on (non-productive) consumption loans. As pointed out by [Modigliani \(1986\)](#), informational imperfections in financial markets may force the economy to save more, because consumers are prohibited from borrowing as much as they want to obtain their optimal consumption profile. [Jappelli and Pagano \(1994\)](#) formally model this argument and show that an exogenously given borrowing constraint on consumption loans will increase the net resources channeled to capital investment and hence facilitate capital accumulation.²

While both strands of literature are quite insightful on the role of credit rationing in the process of capital formation, they omit the fact that investment and consumption loans are both present in reality. Such an omission may be misleading in regard to the mutual dependency between credit rationing and capital accumulation. Indeed, with the presence of both consumption and investment loans, an increase in capital stock reduces the incidence of credit rationing on both types of loans. A reduction of credit rationing on investment loans facilitates capital accumulation (as in [Bose and Cothren, 1997](#)); however, such a reduction on consumption loans impedes capital formation (as in [Jappelli and Pagano, 1994](#)). In particular, the effect from consumption loans may dominate that from investment loans for some levels of capital stock and vice versa for some other levels of capital stock.³ This implies that the mutual dependency between credit rationing and capital accumulation may be more complicated than that obtained by [Bose and Cothren \(1997\)](#). Moreover, a joint consideration of both consumption and investment loans may be able to shed light on important issues regarding a government's repression policy on financial intermediation.

¹ The co-evolution of the real and financial sectors has long been asserted by [Gurley and Shaw \(1955\)](#). For recent studies, see [Greenwood and Smith \(1997\)](#) and [Bencivenga and Smith \(1998\)](#).

² [Bayoumi \(1993\)](#) has a similar argument. [Jappelli and Pagano \(1994\)](#) find evidence supporting this argument. Moreover, a recent empirical study by [Bandiera et al. \(2000\)](#) also finds that financial reform may relax households' constraints and thereby result in a reduction in savings.

³ [Hung and Cothren \(2002\)](#) first integrate investment and consumption loans into an endogenous growth and show that any correlation between the credit market and economic growth is possible. Due to their simple structure, the issues related to capital dynamics are not examined.

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