1. General introduction

The main objective of this book is to examine why the policy of financial liberalization and, for that matter, the policy of financial intervention, were unable to achieve the respective goals sought by each policy. An important question is why execution of the policy of financial liberalization led to financial crisis, while intervention either adversely affected the performance of the financial sector or brought fragility into the system (without their respective objectives necessarily being fulfilled). Policy prescribers by their nature always take a defensive role. There is a saying in India that if you do not know how to dance then blame the floor. Without exception policy prescribers did just that, i.e. they blamed the macroeconomic environment or corruption and nepotism when either policy failed to live up to its promises. There is no doubt, despite this colloquial Indian saying, that the uneven or rough surface of the floor can adversely affect the performance of the dancer, but when there remains a possibility that the floor can be adversely affected by the dance performance, then it is necessary to examine the floor in order to decide whether such a performance can be carried out on it.

The failure of economic policies in relation to the financial system perhaps arose from the fact that the policy makers did not give adequate attention to understanding how the system operates and why it operates the way it does. This problem perhaps arises from our overriding objective of studying economics with a view as to how to improve the economic well-being of all members of society. Consequently, we often place a greater effort on identifying the problem than on examining why such problems arise, and then search for a system or a policy that satisfies our moral conviction. The problem that arises from this way of formulating a policy is that the policy is formulated in the presence of an incomplete understanding in relation to how the market operates. Both past and present policies relating to our financial system, especially on the issue of credit rationing, suffer from this problem.
The issue of credit rationing is perhaps one of the most controversial areas in the literature on economic theory. The origin of this controversy principally arises owing to a conventional claim in economic theory that it is market forces that determine the price, and it is the price that governs the allocation of resources. This means in the case of the loan market it is the interest rate that should govern the allocation of loans, i.e. credit. Contrary to this claim, it is observed that in the case of the loan market this is not necessarily so. In fact, it is observed that in this case preferential treatment among its potential clients is a regular part of its standard practice. In short, in this market, price alone does not always clear the market. For example, it has long been noted that small firms, small farms, lower socio-economic groups and firms seeking to invest in venture capital without the backing of a large firm or assets, do not have the first claim on the banks’ preference. This problem has been observed in developed as well as in developing countries.¹ The question is why is this so? As banks are the major contributors in the loan market, this book will mainly deal with the banks’ lending problems.

It is now recognized that this market operates differently compared with those where the delivery of, and payment for, goods and services take place simultaneously. In the case of the loan market, the advance- ment and payment of loans do not take place simultaneously, which means an element of both risk and uncertainty enters into such transactions, and may give the impression that perhaps small firms, small farms, lower socio-economic groups and firms seeking to invest in venture capital, offer a higher risk compared with other borrowers. As a result they may have less access to the banks’ lending market. But the puzzling problem is that observation reveals that banks do not always attempt to avoid risk and uncertainty. In fact, it is not altogether too uncommon for banks to engage in speculative activity. For example, a buoyant economy is normally accompanied by a surge in bank lending, where much of the loan capital is engaged in speculative activity. For example, a buoyant economy is normally accompanied by a surge in bank lending, where much of the loan capital is engaged in speculative activity. These are short-term loans, which the borrowers use to purchase assets in anticipation that they will make a windfall gain on changes in the price of assets. Thus a collapse of the asset prices causes instability in the banking system, as the banks incur bad debts. The speculation is not confined to expected changes in the price of assets or equity but also extends to expected changes in commodity prices. The 1982–83 financial crisis in Latin America was largely followed by a fall in commodity prices. This form of involvement in the speculative market by banks not only often becomes a hindrance to the development of the industrial
sector when they advance large loans for speculative activities during boom periods, but is believed to have caused financial crises.\textsuperscript{2}

In addition to this, there exists no hard evidence to suggest that the default rate of those groups of borrowers who have been denied loans by the banks, is high. In fact, contrary to this, the fragmentary evidence that does exist indeed suggests that their default rate is low. For example, in the county of Cleveland, UK, it was observed that those who had been denied loans by the banks received loans from the informal sector at a much higher interest rate, yet their default rate was much lower compared with the firms who received loans from the banks (Storey, 1982). Similarly Raj (1979) noted in the case of India that the Rural Credit Survey, which was conducted by the Reserve Bank of India in 1951–52, reported that only 10 percent or less of the total amount of loans advanced were found to be doubtful. In recent years a similar situation has also been observed, for example in the case of Bangladesh, where commercial banks refused loans to lower socio-economic groups. For this reason Professor Yunus established the Bangladesh Grameen Bank in 1983, which exclusively offers loans to the ‘have nots’. This bank’s interest rate is not low, yet the default rate is less than 2 percent (Ghatak, 1995). The Bangladesh Grameen Bank has now lent $1 billion to over two million borrowers. Also, Wydick (1999) noted that similar kinds of institutions were established in various sectors of the developing nations following the Bangladesh Grameen Bank’s experience, for example in Bolivia, the Dominican Republic, Ghana, Guatemala, Nepal, Nigeria, the Philippines, Thailand, and Zimbabwe, and in all of these cases it was found that the repayment rate on loans approached 100 percent. Furthermore, in the case of Australia there were two independent studies conducted by Juttner and Bird (1976) and Renfrew et al. (1985), where both noted that small businesses had a particular problem in gaining access to the trading banks’ loan market, while having easier access to the finance companies’ loan market. This problem principally arose owing to their smaller asset value (Renfrew et al., 1985). Also small businesses often did not accept the banks’ loan capital because the terms and conditions for obtaining such loans were not acceptable to them. In fact what is remarkable about these studies is that none of the authors found that the denial of loans to these borrowers arose from the possibility of a higher default rate, but principally from the fact that they were either unable or unwilling to meet the banks’ terms and conditions for obtaining loans. The principal problem was that they had assets of lower value.\textsuperscript{3}
But there exists overwhelming evidence to suggest that they pay a far higher interest rate on average than those who have normal access to the banks’ loan market. For example, it was revealed that in the USA, small businesses had to pay 3 to 6 percent more than the prime rate on borrowed capital from the bank (Thomson and Leyden, 1982). In Japan, small or medium sized firms had to pay 50 percent more interest on borrowed capital than the large firms (Caves and Uekusa, 1976). In the case of developing countries there are no available data on the cost of borrowing for small enterprises, prior to the introduction of various government-sponsored schemes. This may be because they had access neither to the banks nor to the private moneylenders, but mostly relied on their own savings with the remainder coming from their friends and relatives.

The reference to high interest rates is only made in relation to the rural credit market where the existence of a high and dispersed interest rate has been observed. The interest rate that has been observed not only varies from country to country, but the puzzling feature of this market is that it also varies between and within regions, and in particular depends on the borrowers’ and lenders’ relationship and the purpose of the loan. For example, Nisbet (1967) found in rural Chile the interest rate is often 360 percent, while Griffin (1974) found the interest rate in rural areas varies from 0 to 200 percent from one region to another in the Philippines. Similarly, in the case of India, Bhaduri (1973) and Prasad (1974) found in certain regions such as in West Bengal and Bihar that the interest rate is very high, while Bardhan and Rudra (1978) and Rudra (1992), who has done a more comprehensive study of this issue, found that the interest rate, although high, is not universally as high as that found by Bhaduri and Prasad. More interestingly they found the interest rate varied from 0 to 50 percent. In my own study (1997), I found the annual interest rate varied from 30 to 50 percent. Similarly, a recent study by Smith et al. (1999) also found in the Sindh province of Pakistan that the annual interest rate on average varied from 40 to 80 percent. The puzzling feature of this variation in the interest rate and the complications under which this market operates were not well understood in the past, and will be discussed with reference to India.4

What is important for our context is to recognize that these borrowers often have to pay a much higher interest rate than those who have access to the formal loan market. It is these borrowers’ lesser access to the formal loan market and their payment of higher interest rates that not only concern the governments of developed nations but cause serious problems for developing nations.
In the case of developed nations this concern principally arises for the two following reasons: one is pure economic necessity, and the other is the democratic aspiration that individuals must have a choice as to how they wish to pursue their livelihood. Both of these are important in their own right. The importance of the first issue principally arises from the fact that by the late 1960s it was becoming increasingly clear that GDP growth rate was no longer simultaneously followed by employment growth rate. In other words, employment growth rate was falling behind GDP growth rate. This trend started even prior to the Second World War, and was eloquently captured by Robinson (1931) in two observations he made. One was Ford’s reorganization of his factory floor in 1921, which allowed him to reduce the number of workers employed daily for the production of each car from sixteen to nine. The second example was a German potash firm which, without altering its level of output, reduced the number of workers from 50,000 to 20,000 between 1923 and 1927.5

However the speed of this trend was nowhere near that which was observed during the post-war years. This was largely due to rapid technological change. This change also started to segregate the labour market to a greater extent than that observed in the early 20th century. For those labourers who have a basic education and are technologically skilled, their demand in the job market continues to rise, while the demand for uneducated and unskilled labourers continues to fall. Furthermore, governments can no longer rely on large corporations to solve the unemployment problem, as they are the principal beneficiaries of this technological change. In recent years, it has also been observed that in the corporate world, the price of shares principally follows cost-cutting exercises, and this means that one cannot expect cooperation from the corporate sector for unemployment reduction programmes. Therefore, small business is seen as the engine of employment growth, in particular for the unskilled labour force. This is mainly because it is the small business sector in general which uses less advanced technology compared with its larger counterparts. Thus the growth in small businesses and the growth of the self-employed has become an important vehicle to solve part of the unemployment problem, especially for the unskilled labour force. But, as stated above, this growth has been hindered by their lack of access to the formal loan market and by the fact that they often have to pay higher interest rates per unit of loan compared with those who do have access to this market. This in turn reduces their net profit rate, thereby limiting their incentive to hire more labour. Furthermore, it has been increasingly recognized that this
sector’s instability principally arises from its frequent cash shortage problems, which can only be remedied by improving its access to the formal loan market.

The second issue that has concerned the governments of developed nations is that the foundation of democratic society rests on (among other things) the alternative choices that a society can offer to its individual members. In the economic context this means the society must offer its individual members a choice from various alternative means of survival. Restricted access to the loan market for a certain section of society means the members of that section have one less option than members of other sections. This conflicts with the philosophy on which the ideals of democracy rest.

In the case of developing nations, their problems are somewhat more acute than those of developed nations. The developing nations that used to be colonies of the developed nations, received their independence shortly after the Second World War, mainly as a result of their rising nationalism, and had a big task to develop their respective nations. This task was magnified by the fact that the momentum of sweeping nationalism rested on big promises that were made at that time by their respective leaders. The promise was that independence would allow them to use their nation’s resources, which previously had been siphoned off by their colonial masters, for their own development. In other words, these resources then could be used to improve the living conditions of all people, especially those who otherwise would continue to live in extreme poverty. This means the enlargement of the entitlement set is necessary for people specifically from the poorer section of the community, without which the meaning of independence carries little weight, and in fact loses any relevance for them.

These countries therefore are first required either to develop or to improve the necessary infrastructure, which is the prerequisite for the development of the industrial, as well as the rural, sectors. Development of both of these sectors has been considered to be the founding pillar on which it is possible to enlarge the entitlement set for the people concerned. Development of the industrial, as well as the rural, sectors requires long-term loans for investment in fixed capital; and to improve the living conditions of the general masses, loans also have to be allocated to small farmers, small enterprises and artisans. This means the financial sector has a very important role to play.

The financial sector’s main role therefore was to mobilize the nation’s savings and to allocate these savings to the productive areas of
the economy that were considered necessary for the nation’s development. In the absence of a well-developed stock market and non-banking financial institutions (NBFI), banks were considered to be the main players for fulfilling such tasks. The commercial banks that were operating at that time, mainly advanced loans to the trade-oriented part of the economy and specialized in the provision of short-term or working capital loans, mostly in the form of cash-credit and overdraft facilities (against the hypothecation of marketable tangible assets). They offered loans neither to small enterprises nor to the rural sector. They were mainly operating in urban and industrial locations, their size of operation was small, and therefore they neither had the means nor the willingness to extend the large and long-term loans that were necessary for industrial development. Furthermore, a large part of the financial or money market remained outside the orbit of the formal market. This means these commercial banks first had to bring this market within the orbit of the formal money market, so that much of the nation’s savings could be brought under its control.

The situation that is described above suggests that some degree of intervention is required in the operation of the financial markets in both developed and developing countries. But the nature and the level of intervention differs considerably in both. This difference principally arises because developing countries want to bypass the necessary evolutionary stages that developed countries have undergone. Thus in the developed countries, intervention took the form of correcting some of the defects that were thought to have arisen from market imperfection whereas, in the developing countries, the intervention took the form of reshaping and developing their financial markets, with the aim that the banks would assist the nation in fulfilling its development objectives. In order to closely study the impact of this form of intervention in developing countries, we will confine our investigation to the cases of India and South Korea.

Accordingly, in the case of developed countries, for example in the USA, the Securities Exchange Act of 1934 gave power to the Federal Reserve System to regulate lending for stock market speculation. Similarly in 1946, the Bank of England Act introduced selective credit controls in order to ensure that a certain amount of credit would be allocated to industry and trade. The different types of regulations that have been adopted by different countries may have followed from their respective historical experiences and needs, but the important point to note here is that regulations were adopted in order to ensure that a
certain amount of credit was allocated for productive purposes, thereby limiting the flow of credit that otherwise would have been engaged in speculative activity. In the case of small businesses, small farms and lower socio-economic groups, loan guarantee schemes and the ceiling on interest rates were introduced in order to ensure that these groups of borrowers received bank loans at a cheaper rate.

In the case of developing nations, the magnitude of the intervention was on a larger scale. There was a need for intervention to both allocate loanable funds to selective sectors and under-privileged groups, and also to mobilize nations’ savings that otherwise would remain either in the hands of the informal sector or in an unproductive form. Accordingly, in order to mobilize higher levels of savings, for example in India, banks were often encouraged to open branch facilities outside the metropolitan area, while in other countries, such as South Korea, the interest rate on deposits was raised to a very high level. In order to allocate loans for long-term projects, industrial banks, along with other institutions, were developed, while in order to provide credit to the rural sector, a variety of rural banks were established. Furthermore, when it was recognized that commercial banks were reluctant to cooperate fully with the respective governments, banks were nationalized, for example in India and South Korea. In addition to that, a quota system was introduced for the provision of loans in India in order to ensure that the priority sector received a certain percentage of loans. The priority sector comprised the rural sector and small borrowers. In South Korea, banks were nationalized and a discriminatory interest rate policy was introduced in order to ensure that their priority sectors (largely composed of export and export-related sectors) received loans at a cheaper rate. Furthermore, in the case of South Korea, the government often used a variety of coercive devices in order to ensure that loans were not provided to its least preferred sectors of the economy. The advancement of loans for speculative purposes was discouraged by both of these nations.

The main objective of the regulations that were introduced in the developed countries, was to protect their depositors’ funds from the excesses of banks’ speculative activities, and to fulfil the respective government’s social objectives. In the case of developing countries, intervention took the form of fulfilling governments’ economic and social objectives.

But adequate attention was not given to the issue that the fulfilment of social objectives may not be easily reconciled with the banks’ principal objective of maximizing their own profitability. This is a conflict
which will often emerge between the maximization of individual profit and the maximization of social benefit; in other words, as a result of a divergence between the private return and the social return. This is an issue, which although extremely important, largely falls outside the scope of this book. But the question still arises, whether these policies were formulated on the basis of any theoretical investigation of why banks are reluctant to offer loans to some groups of borrowers while they quite readily offer loans even to those who use such funds for speculative activity. In other words, why do rational profit maximizing bankers use a discriminatory lending policy?

In the absence of such analysis, the impact of these interventions on the banking sector and the difficulty that they may cause the monetary authority, were not foreseen. The effect of these interventions, as banks were then prohibited by regulation from advancing loans to certain areas of economic activity, was to create the opportunity for new institutions to form in order to capture that end of the loan market. This in turn caused banks' share of the loan market to fall, thereby also affecting the effectiveness of the traditional tools that had been used by the monetary authority in the past to control the money supply. This was mainly because these new institutions were not subject to the same regulations as the banks. Consequently, this caused a convergence of interest between commercial banks and the monetary authority and raised some serious concerns about the negative aspect of these regulations. Furthermore, policies that were implemented in order to promote the access of smaller borrowers to the loan market at a cheaper rate, largely remained ineffective and often adversely affected whatever limited access they may have had to this loan market in the past. Some serious doubts were also raised, in particular about the merits of the ceiling on interest rates as a vehicle to provide loans to these borrowers at a cheaper rate. In the case of developing nations, the intervention adversely affected the banking sector's performance, with no appreciable improvement being observed in the smaller borrowers' access to the formal loan market.

The ineffectiveness of these interventions and their adverse impact on the banking sector led one country after another to deregulate its financial sector. The view was taken that government intervention itself distorts the determination of the price of loans, thereby adversely affecting not only the allocation of loans but also savings. Accordingly, it is argued that in the absence of intervention, market forces will determine the interest rate, which in turn will govern the allocation of loans. There
is no doubt that the intervention produced an unsatisfactory result. But the recent experience of financial crisis in the various developing nations and the large number of bank failures in developed countries also raise doubts about the merits of the liberalization policy. The issue of regulation or intervention arose again in order to prevent financial crisis, as it similarly emerged (and was undertaken) following the Great Depression. The important issue that arose from these experiences is that both policies, i.e. the policy of intervention and the policy of liberalization, were implemented with the objective of improving all borrowers’ access to the loan market, specially those who are engaged in the productive aspect of the economy. In this respect both have failed, as neither of these policies was able to improve borrowers’ access to the loan market in any sustainable manner. Thus the question is, where did they go wrong?

In order to address this issue, we need to examine why the interest rate alone does not clear the loan market. In other words, the question is, when two individuals or firms are prepared to pay the price, why does one receive the loan as demanded, while the other either receives less than what he/she demanded or is denied a loan altogether by banks? To put it more precisely, why do banks ration credit to some borrowers while meeting the demand of others? An analysis of this may allow us to understand why financial liberalization, and for that matter, the form of intervention that has been implemented in the past, were unable to improve all borrowers’ access to the loan market, irrespective of their size.

In order to study these issues, the remainder of this book is divided into six chapters. In Chapter 2 we critically examine the existing literature on credit rationing with the specific intention of finding out whether this literature can shed some light on the above issue, i.e. why banks ration credit to some borrowers while they quite willingly meet the demands of others. It will be argued that despite its enormity and richness, this literature is somewhat limited in its ability to assist in the investigation of this specific issue. This is mainly because the existing literature investigates the rationing phenomenon that may have arisen due to particular circumstances in a specific situation. For example, authors investigate why the ceiling on interest rates causes banks to ration credit to some borrowers, or why the supply of loans is not monotonically related to the interest rate. Thus the investigation is confined within a specific context, and has not been extended to an examination of whether rationing is a generalized feature of the operation of this
market; for example, when banks deny loans to some, why they quite willingly advance loans to others, even when they know that these borrowers may use such funds for speculative purposes. In other words, this literature has not investigated the rationing phenomenon by taking into account both aspects of banks’ behaviour, i.e. by taking account of the character of the entire market’s operation. In other words, why is it that for some groups of borrowers in the loan market banks appear to not be concerned about the risk and uncertainty, while for other groups they seem to be unwilling to take any risk and uncertainty? Furthermore, there is the question of, when banks deny loans to borrowers, why these borrowers receive loans from other lenders. The theoretical argument is at odds with this reality, as it argues that denial of loans to some borrowers by a bank provides a signal (or information) to other lending institutions about the risk aspect of those borrowers, and argues as a result these borrowers would not receive loans from other lenders. But the observations by Juttner and Bird (1976) and Storey (1982) reveal that those who were denied loans by banks indeed received loans from other finance companies. In fact, a variety of private lending institutions have been developed to capture this end of the market. An example is the Bangladesh Grameen Bank. This issue becomes even more complicated in the context of the rural credit market where we find that the poorest borrowers who have been denied loans by all lenders, including banks, receive loans from their own landlords. Why is this so? In the absence of an investigation of these issues our understanding of the rationing phenomenon to some extent remains incomplete.

In Chapter 3 we explore how the loan market operates in the presence of uncertainty. The foundation of conventional theory is rested on the certainty assumption. In such a theory there is no room for uncertainty. Thus when the issue of uncertainty, or for that matter expectation, has arisen following Keynes (1936), it has been addressed within the framework of what is referred to as ‘certainty equivalence’. ‘Certainty equivalence’ in its crudest form is defined as a situation when an agent (i.e. an entrepreneur) acts as if his or her expectation is true (or certain), although this expectation is formed from a bundle of vague and various possibilities. In the statistical sense, this means the agent undertakes his/her decision exclusively on the basis of a forecast with an absolute conviction that this forecast is true. The ‘certainty equivalence’ therefore refers to the situation where the agent acts on the assumption that the probable proposition is true. This in turn eliminates the difference in the behaviour of the agent that might have emerged when undertaking a
decision based on the expectation that something may happen as opposed to the expectation something will definitely (or certainly) happen. In other words, by definition the agent rules out the possibility that his/her probable proposition may not be true, a consideration of which may make the agent alter his/her decision either by modifying it or by postponing it until obtaining further information. Thus with the assumption of ‘certainty equivalence’, the need for consideration of a possible change in the agent’s behaviour is arrested. This in turn may reduce the obligation to reconsider our theoretical argument and its conclusion, but in the process it limits understanding of the way this market operates, thereby opening up the possibility of producing a policy which may become counter-productive, as has happened in the past. The problem with the replacement of information symmetry with information uncertainty, is that it changes the character of the operation of that market.

It is argued in this chapter that other than price, there are two additional factors that play a crucial role in the operation of this market, namely the credit standard and credit risk. The question is, why is this so? It is argued that when the payment remains uncertain, promises to pay alone cannot clear the loan market. Lenders introduce the credit standard in order to ensure that, should the borrowers default on loans, there remains some other means to enable lenders to recoup their loan capital, without which this market breaks down. The issue of credit risk principally arises here, owing to the fact that in the competitive atmosphere in which this market operates, lenders are not able, in all circumstances, to secure their loans by the credit standard. The credit risk therefore refers to that portion of the loan which is not secured by the credit standard, so that, should the borrower default on a loan, that is the portion of the loan that will not be recouped from the proceeds of the credit standard. It is the variation in the credit standard implemented by the respective lenders which causes the variation in access of different groups of borrowers to the loan market. Now once our theoretical understanding of the nature of the operation of this market has been formulated, we are then in a position to investigate what went wrong with the policy of financial liberalization, and for that matter, with the policy of intervention that was adopted in the past.

In Chapter 4 we investigate the theoretical foundation on which financial liberalization rests. We then introduce the concept of the credit standard into this model to examine whether the same result can be obtained as the policy prescribes. Our analysis suggests that instead of
bringing efficiency to the operation of this market, there is a good possibility that theoretically this policy can bring financial crisis. This means some form of intervention will be required in the operation of this market.

In Chapters 5 and 6, with this in mind, we investigate the types of intervention that have taken place in South Korea and India. We chose South Korea and India, as opposed to any other countries, for specific reasons. The level of intervention that has taken place in these two countries is roughly similar. The governments of both heavily intervened not only in the operation of the financial market, but also in their industrial and rural sectors. However, there is a subtle difference between India and South Korea, in the specificity of their intervention in the operation of the financial market. In India, while the emphasis was on providing cheaper credit to small enterprises and to the rural sector, in South Korea the emphasis was on providing credit to specific government-selected industries. The result of these interventions on the performance of the economy remained quite modest for India but robust for South Korea. In both cases, intervention in the operation of the financial sector made this sector fragile and in these two chapters, we examine the intervention in order to understand the factors that caused this fragility. This may allow governments of the respective countries, as well as those of other countries, to avoid such forms of intervention, with such adverse consequences, in the future.

In Chapter 7 we present the conclusion.

NOTES


3. See Basu (1989) for further details on this issue.
4. See Basu (1997) for more on this issue.

5. Against these observations Robinson wrote (1931, p. 3), ‘So long as the curing of the consequent unemployment remains imperfect, the gains of efficiency are worthless . . . since the leisure is given not to those who wish to enjoy it, but to those who would prefer to be occupied.’

6. See Basu (1986) for further details on this issue.

7. Entitlement set refers to the individual’s command over goods and services. This is defined as the set of all possible combinations of goods and services that an individual can legally obtain by using the resources of his/her endowment set (where resources include both tangible assets, such as land, other assets, income, and intangibles such as knowledge and skill, labour power, or being a member of a particular community). See Sen (1981) and Osmani (1995) for more on this issue. Thus by enlargement of the entitlement set we mean an increase in the availability of a combination of goods and services as well as an increase in an individual’s own endowment set, so that each individual will have a higher command over goods and services.

8. See Sayers (1960a) for further details. See also Hawtrey (1944) on the issue of credit controls.

9. For example, in the case of Australia, the New South Wales and Victorian state governments have established loan guarantee schemes since 1978. The Commonwealth Development Bank, prior to its privatization, used to be one of the major sources of providing long-term loans to small businesses for the purchase of plant and equipment (Johns et al., 1983). In the UK, the government decided to stand as a direct guarantor for small businesses, anticipating that this would ease the capital availability problem. In addition, the government directly provided some financial help to small firms to purchase machinery, and also introduced a Business Start-up Scheme (Basu, 1986). In the USA, the Small Business Administration (a government-sponsored organization) also provided 70 percent guarantees for small businesses to ease their capital availability problems (Report of the President, 1982). Similarly, the Japanese government developed certain government-affiliated organizations to provide cheaper, as well as long-term, loans. They also provided loans in order to update the small manufacturing sector, so that small manufacturers could keep pace with modernization (MITI, 1983). See Basu (1986) for further details.

10. This is the general view expressed in the Campbell Committee’s Report (1981); a similar view was also expressed earlier in the Bolton Committee’s Report (1972). See also Smith (1776) who considered the detrimental impact of the ceiling in the context of usury.


12. See Krishnaswamy et al. (1987) and Little et al. (1987) on the above issue.

13. For the Latin American financial crisis see Diaz-Alejandro (1985). For a detailed account of bank failure see Goodhart (1995) and for the Australian financial crisis see Basu (1994). Furthermore, the recent financial crisis in Asia is another example of the failure of such a policy; see Miskin (1999), Arestis and Glickman (2002) and Basu (2002).

14. It is this argument that was put forward by Blinder and Stiglitz (1983) in order to explain how monetary policy works.

15. Of course, it would be extremely imprudent not to mention that Keynes himself was partly responsible for the development of the above framework and this is clear in his writing. As he wrote (1936, p. 24), ‘By his [the entrepreneur’s] expectation of proceeds I mean, therefore, that expectation of proceeds which if it were held with certainty, would lead to the same behaviour as does the bundle of vague and more various possibilities which actually makes up his state of expectation when he reaches his decision.’ See Hart (1949) and Robinson (1980) for more on this issue.
16. See Hart (1949) for more on this issue. Even in the modern era, theoretical argument also proceeds by replacing uncertainty with the assumption of ‘certainty equivalence’. For example, in the asymmetric information literature, the strategic interplays between agents are formulated by assuming agents are rational, and their prior probability distribution and their utility function are common knowledge (Brandenburger and Dekel, 1990). Alternatively as Milgrom and Roberts (1987, p. 184) write, ‘the probability distribution over the particular private information of the various players could be common knowledge’. Essentially it amounts to redefining the game in such a way that each agent knows the probability distribution of the variable which is uncertain. Thus the game whose outcome is supposed to be uncertain has been transformed or re-arranged in such a manner that the absence of information is replaced with complete information about the probability distribution. See also Harshanyi (1967–68).

17. For a further explanation of credit standard and credit risk see Chapter 3.