Discussion on
"Enterpreneurship, Financiership, and Selection
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Questions

- How financial markets outcome are determined if the supply of funds are determined by agents who decide not to demand any funds?

Answer

- Benchmark: supply of funds is unlimited
  - Those who should have not become entrepreneurs may choose to become one.
- Supply of funds limited by the supply of no entrepreneurs.
  - The number of those who should have not become entrepreneurs is less than in the benchmark case.

How is the question approached?

Build a simple micro finance model

- Potential entrepreneurs endowed with
  - projects of size I
  - with funds $A < I$

- Fraction h of projects is of high return, the remaining fraction is of low return

$$p_H R_H > I > p_L R_L$$

with $R_L > R_H$

- Perfectly competitive financial markets where entrepreneurs may borrow $I - A$ to carry out their projects

- What agents do?

  1. In the presence of outsider investors
     - Invest in your own project
     - Invest in storage
  2. In the absence of outsider investors
     - Invest in your own project
     - Invest in someone else's project
     - Invest in storage

Main results

1. In the presence of outsider investors
   - some bad projects are carried out if A is low enough
   - financial markets may collapse if A is too low

2. In the absence of outsider investors
   - some bad projects are carried out if A is low enough but to a lesser extent than in the presence of outside investors
   - financial markets may still collapse if A is too low
   - Overall: equilibrium more likely to be efficient without outside finance than without it

Simple intuition

- Opportunity cost of being an entrepreneur
  - Outside finance: return on storage
  - No outside finance: storage or being a financier

$\Rightarrow$ the opportunity cost of being an entrepreneur cannot be higher in a regime with outside finance than with no outside finance at similar A

$\Rightarrow$ entrepreneurs with bad projects are more likely to face higher opportunity cost in a regime with no outside finance than with outside finance

Comments

Comment 1

- It is nice to see general equilibrium like effects in micro finance models.

Comment 2

- Efficiency in the model versus empirical indicators of efficiency

- Often used indicator for financial market efficiency
  - Difference between loan rate and deposit rate

- Consider the case: all agents with good project and some agents with bad project are entrepreneurs.
  - Lower A implies higher difference between loan rate and deposit rate in the model.
  - But: lower A leads to agents with bad project to drop out from entrepreneurship which improves efficiency.

- Should the difference between loan rate and deposit rate not be used as indicator of efficiency in the financial markets?

Comment 3

- What does the paper says about financial liberalization?
  - It may result loss of efficiency at a medium level of A (the pool of potential entrepreneurs is unchanged)

- It seems consistent with unhappy experiences with financial liberalization of many middle income countries in the 80s and 90s
  "Goodby financial repression, hallo financial crash"

- But:

  1. financial liberalization often changes the pool of potential entrepreneurs with good project (FDI)
  2. there is evidence that economies closed off from international capital flows are doing worse on average than those who are not independent of income level