

# Capital Availability and System Perspectives



- Three frameworks for addressing capital systematically
  - Capital market imperfections
  - Ecosystem approach
  - Capital absorption framework
- Role of class, gender and race in capital markets
- Implications for economic development finance
- Dual practice framework
- Detroit and the three frameworks

# Market Imperfections in Theory



- Theory: “perfect” competitive markets allocate capital to the most productive users
- What are the requirements for “perfect” markets?
- Imperfections and capital supply gaps occur when these conditions do not hold
- Political and policy case for development finance is based on perfecting markets
  - Better productivity and economic growth
  - Social benefits

# Capital Markets in Practice



- Capital markets: set of institutions that accumulate and channel savings to households, businesses and governments and provide a return to suppliers of capital
- Institutional structure and operation of capital markets shape supply gaps
- “Public” vs. “Private” capital markets
  - What are the difference in how these markets work?
  - What market imperfections result?

# Capital Markets: Recent Trends



- Increased role of public markets & fewer assets held or originated by depositories
  - Mortgage banks, brokers, pension funds, mutual funds
  - Global securitization and role of secondary markets
  - Separate origin, ownership & management of assets
- Systemic market and regulatory failures during financial crises
- Bank consolidation and growth in venture capital increased intermediary and transaction sizes
- Automation of business lending (credit scoring)
- Growth of “fringe” & predatory financial services in low-income and minority neighborhoods

# Race/class/gender and Capital Availability



- History of disparity in access to capital/exclusionary policies
  - FHA mortgage policies
  - Red-lining of low-income neighborhoods
  - Segregated financial institutions and networks
- Inequality in income, wealth, & education limits access to informal and formal capital
- Institutionalized discrimination in financial institutions & products serving communities
  - Nexus of residential & financial segregation
  - Sub-prime loans 3X more likely in low-income area; 5X more likely in black neighborhoods, independent of income
- Racial disparities in lending decisions and pricing remain after 30 years of legal & regulatory changes

# Economic Development Implications



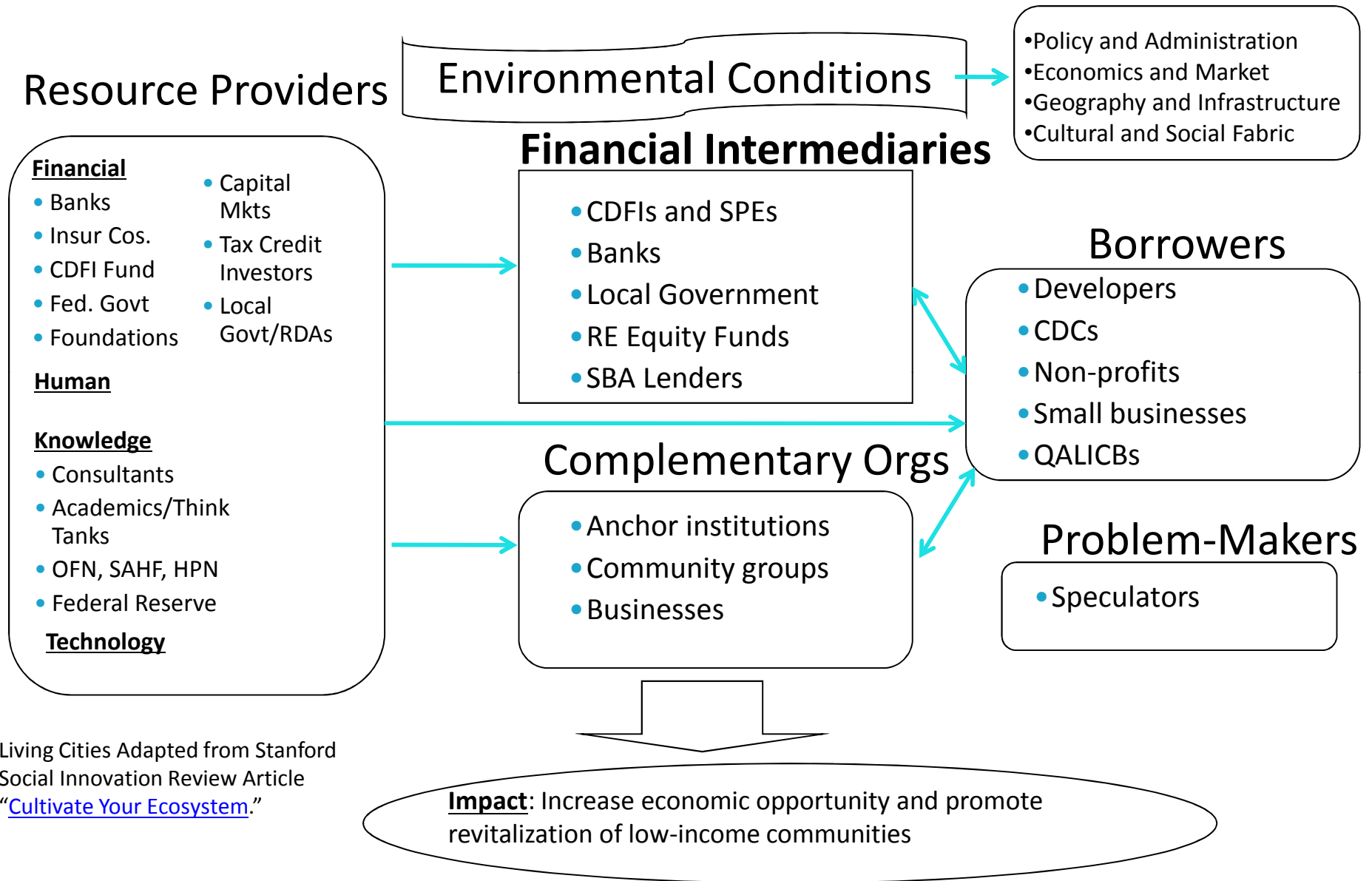
- Common capital supply gaps from market imperfections:
  - Lack of institutional equity for most small businesses
  - Limited availability of small commercial loans
  - Limited availability of long term debt
  - Capital access disparity: geography, wealth, race & gender
  - High level of risk aversion in post-crisis environment
- Private intermediaries are key capital sources for community economic development
- Understand how market, regulatory and financial sector factors shape regional capital supply by private sector
- Expand supply of small amounts and higher risk capital
- Proactive strategies to address class/race/gender biases

# Ecosystem View of Capital Markets



- “Ecosystem” of players and environmental forces affect capital markets
- Ecosystems vary across regions & cities
- Tool to gain deeper understanding of the local/regional capital market conditions and to formulate policies and strategies
- Focuses attention on factors beyond capital markets that influence capital supply and using them to change how markets work

# Finance Ecosystem



Living Cities Adapted from Stanford Social Innovation Review Article "[Cultivate Your Ecosystem.](#)"



# Capital Absorption Framework



- Living Cities’ response to observed gaps in capital absorption capacity:
  - “the ability...to make effective use of different forms of capital to provide needed goods and services to underserved communities”
- Community development investment (CDI) entails many sectors: housing, health, education, arts & culture, economic development, financial services, etc.
- Functional view of finance system:
  - Five functions seen as critical to effective CDI

"Community Investment Functions" graphic from Page 5 of Wood, David, Katie Grace, Robin Hacke, and John Moon. "[The Capital Absorption Capacity of Places: A Research Agenda and Framework.](#)" Cambridge, MA: Living Cities and the Initiative for Responsible Investment at Harvard University (2012) has been removed due to copyright concerns.

# Dual Practice Plus Approach



- Perfect conventional capital markets
  - Risk sharing tools and policies
  - Bank and financial sector regulation
  - Addressing information and transaction costs
- Create alternative financial institutions
  - Revolving loan funds
  - Venture capital funds
  - CDFIs
  - Micro-enterprise Funds
- Address larger system and functional barriers to effective and equitable capital deployment

# Detroit through 3 Frameworks



- Capital markets imperfections in Detroit?
- Observations on the economic development finance ecosystem?
- Insights in how effectively the capital absorption functions work?

MIT OpenCourseWare  
<https://ocw.mit.edu>

11.437 Financing Economic Development  
Fall 2016

For information about citing these materials or our Terms of Use, visit: <https://ocw.mit.edu/terms>.