Finance and Growth

Issues of International Finance and Development in the Mediterranean Area

- Theories and Concepts of International Finance and Development
- Exchange Rate Policy in European Union and MENA Countries
- Finance, Economic Growth, and Development
- European Capital Flows in Southern Mediterranean Countries

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What is Finance?

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Credit Constraints, Inequality, and Growth

Introduction

What is finance?

The study of how money is managed

The actual process of acquiring needed funds

Institutions: banks, stock markets, etc.
Instruments: loans, shares, other securities

Why could finance matter for growth?

- Firms need finance in order to **invest**, especially if they do not have cash
- E.g. more loans or more efficient banks allows firms to **invest** more
- Investment -> economic growth

Functions of the financial sector

1. Produces information ex ante about possible investments and allocate capital
2. Monitor investments and exert corporate governance after providing finance
3. Facilitate the trading, diversification, and management of risk
4. Mobilize and pool savings
5. Ease the exchange of goods and services

How well does the financial sector provide these functions

Financial development:

Bank- versus market-based finance

1. Producing information and allocating capital

There are large costs associated with:

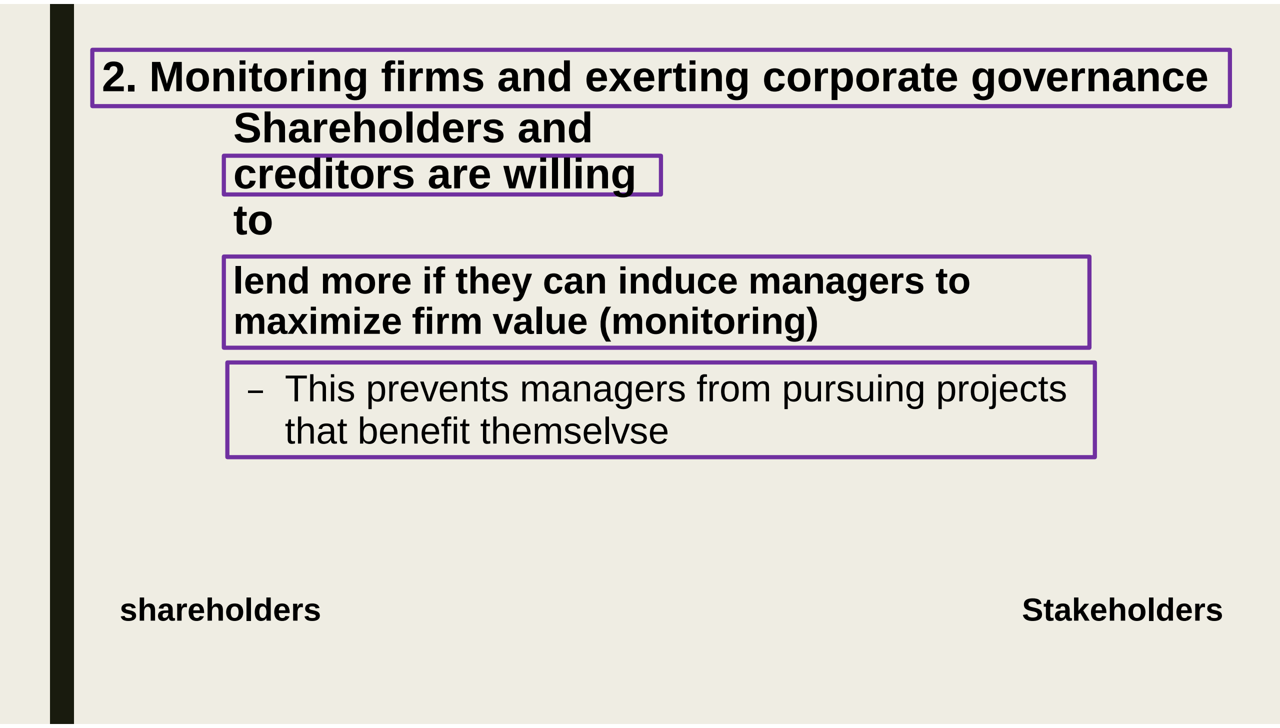
evaluating firms, managers, and market conditions

Individual savers may not have the ability to

collect, process, and produce information on possible investments

THEN, high information costs may prevent capital from flowing to its highest value use

➢ Financial intermediaries may reduce the costs of acquiring and processing information and thereby improve resource allocation



2. Monitoring firms and exerting corporate governance

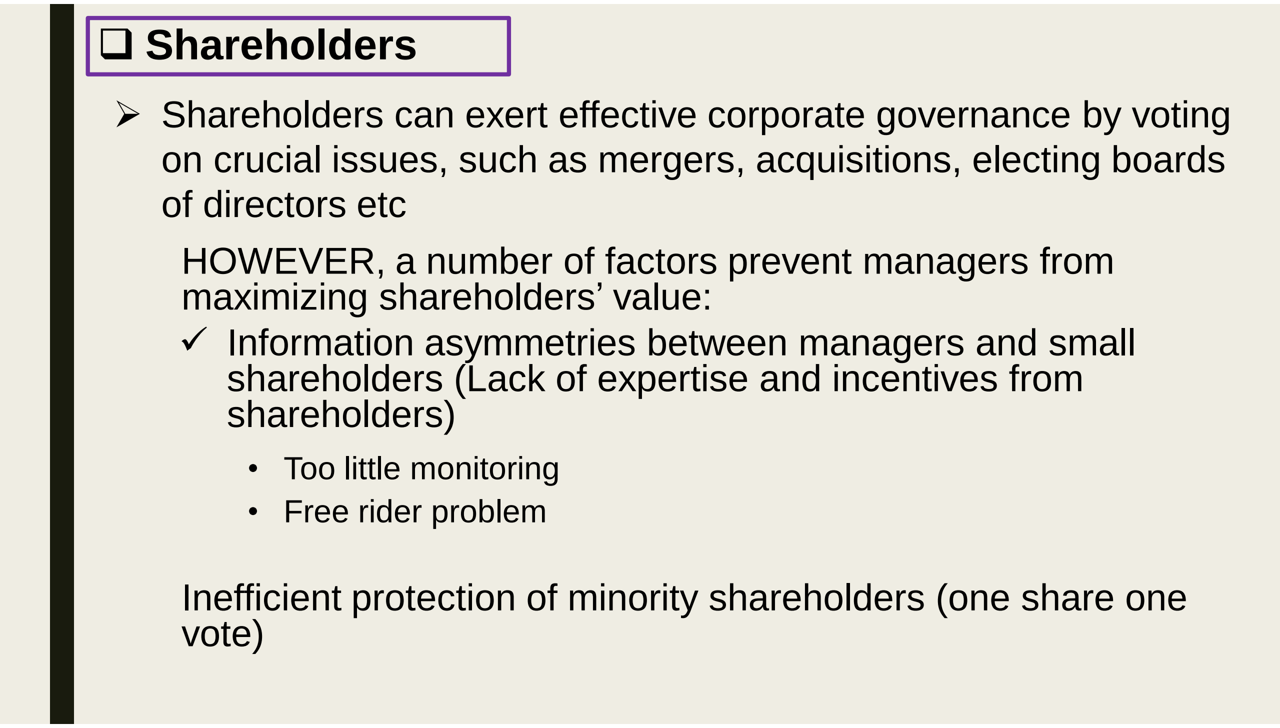
Shareholders and creditors are willing to

lend more if they can induce managers to maximize firm value (monitoring)

- This prevents managers from pursuing projects that benefit themselvse

shareholders

Stakeholders



❑ Shareholders

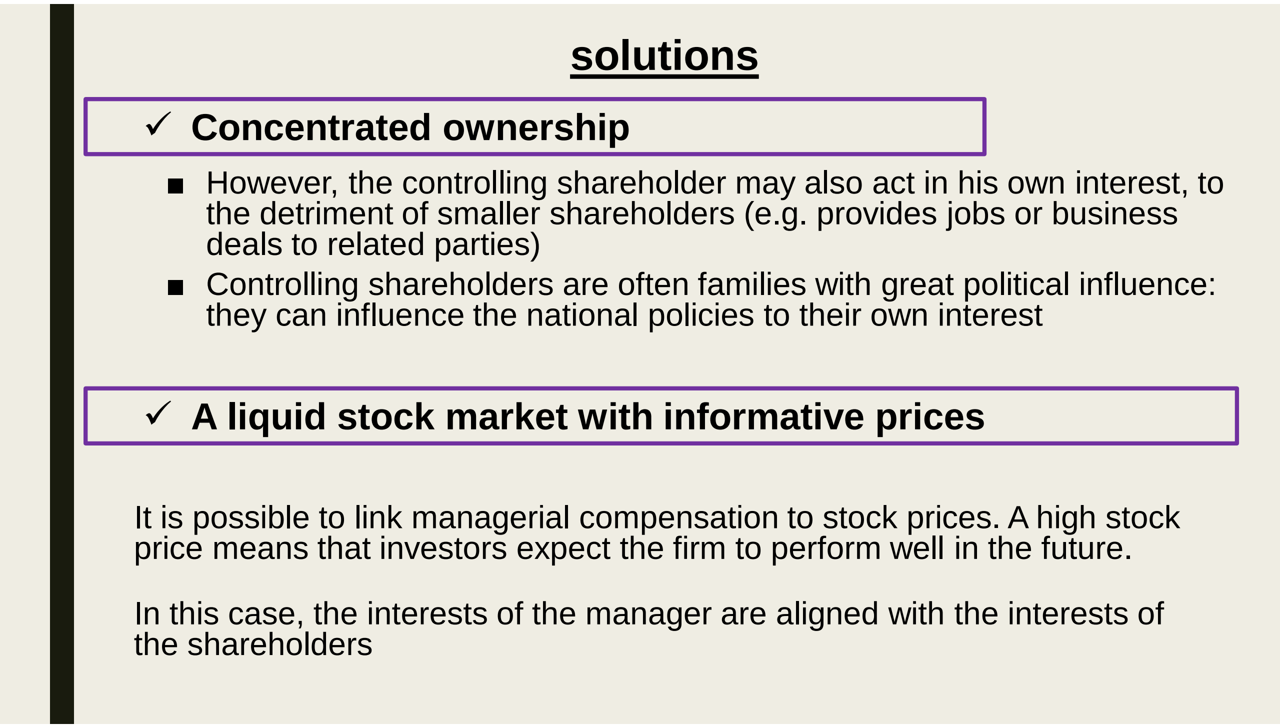
➢ Shareholders can exert effective corporate governance by voting on crucial issues, such as mergers, acquisitions, electing boards of directors etc

HOWEVER, a number of factors prevent managers from maximizing shareholders’ value:

✓ Information asymmetries between managers and small shareholders (Lack of expertise and incentives from shareholders)

- Too little monitoring
- Free rider problem

Inefficient protection of minority shareholders (one share one vote)



solutions

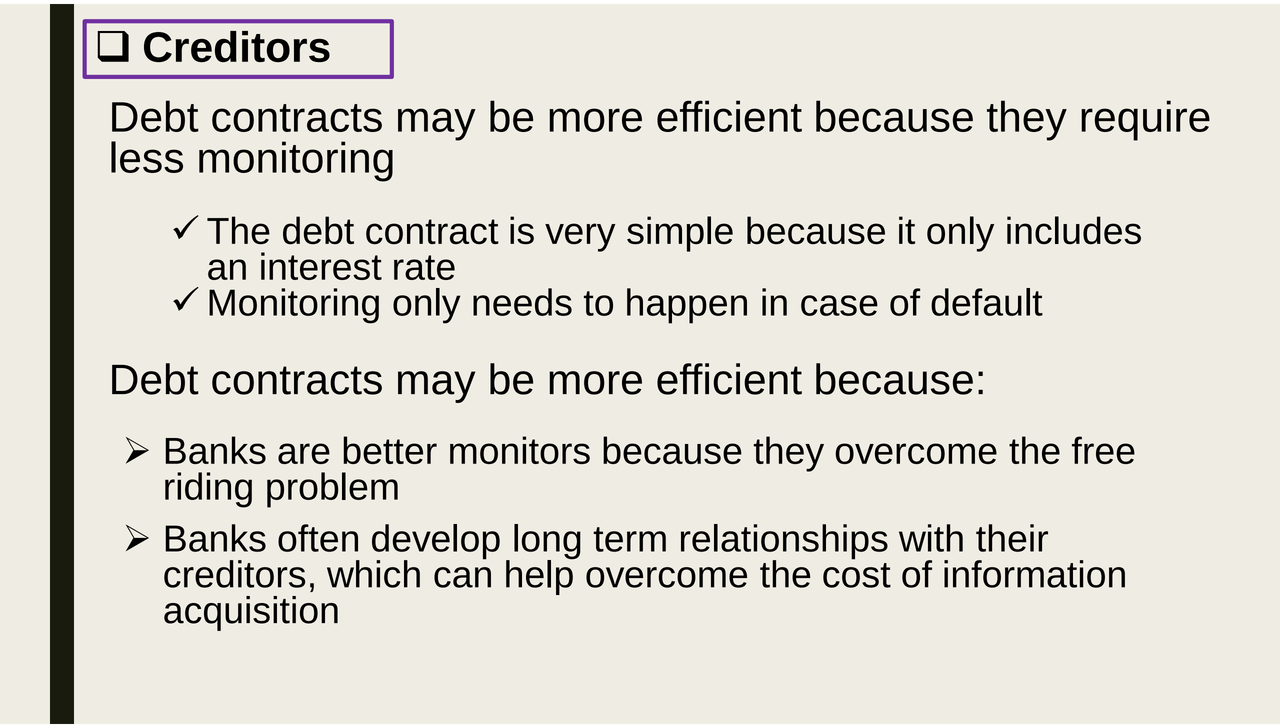
✓ **Concentrated ownership**

- However, the controlling shareholder may also act in his own interest, to the detriment of smaller shareholders (e.g. provides jobs or business deals to related parties)
- Controlling shareholders are often families with great political influence: they can influence the national policies to their own interest

✓ **A liquid stock market with informative prices**

It is possible to link managerial compensation to stock prices. A high stock price means that investors expect the firm to perform well in the future.

In this case, the interests of the manager are aligned with the interests of the shareholders



❑ Creditors

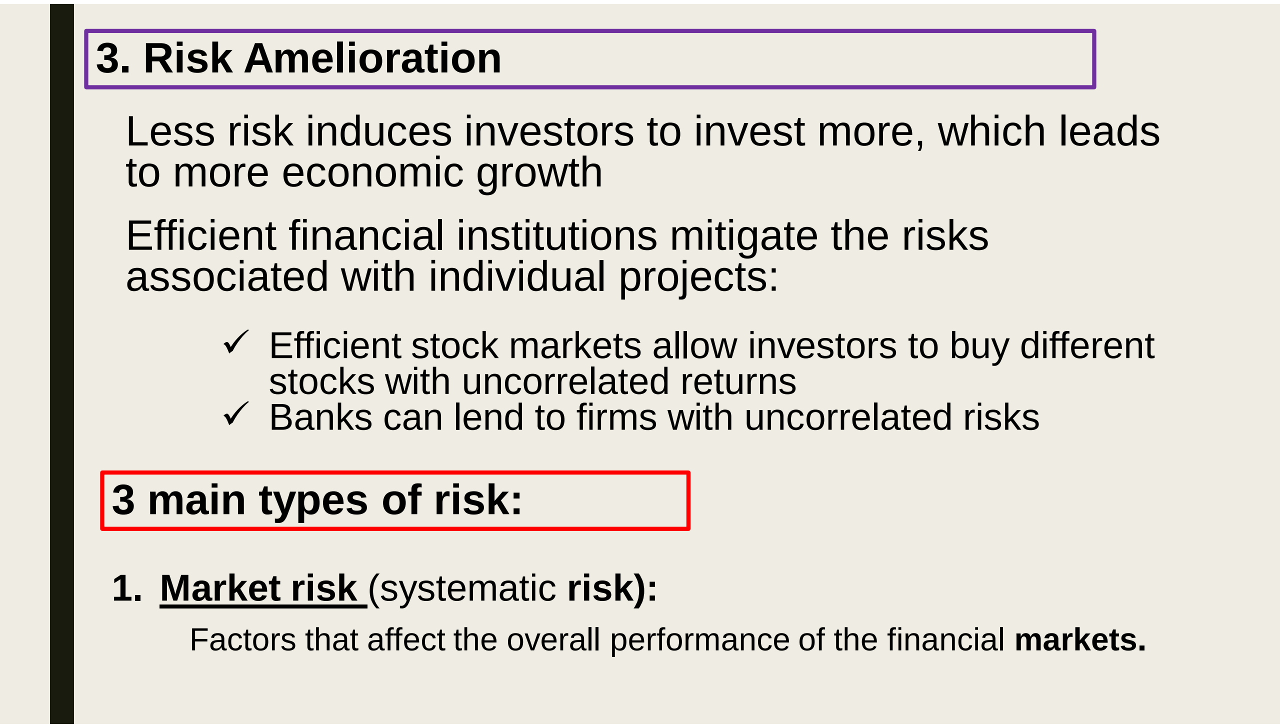
Debt contracts may be more efficient because they require less monitoring

✓ The debt contract is very simple because it only includes an interest rate
✓ Monitoring only needs to happen in case of default

Debt contracts may be more efficient because:

➢ Banks are better monitors because they overcome the free riding problem

➢ Banks often develop long term relationships with their creditors, which can help overcome the cost of information acquisition



3. Risk Amelioration

Less risk induces investors to invest more, which leads to more economic growth

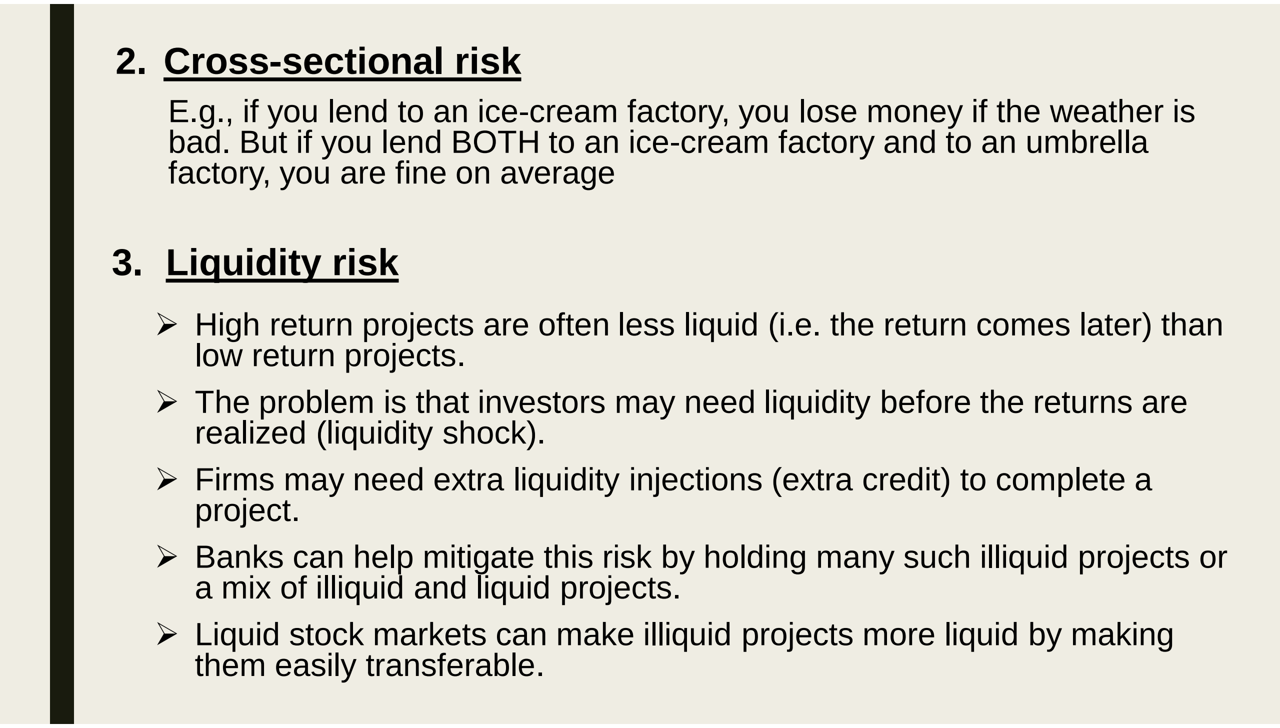
Efficient financial institutions mitigate the risks associated with individual projects:

- ✓ Efficient stock markets allow investors to buy different stocks with uncorrelated returns
- ✓ Banks can lend to firms with uncorrelated risks

3 main types of risk:

1. **Market risk** (systematic **risk):**

   Factors that affect the overall performance of the financial **markets.**



2. **Cross-sectional risk**

   E.g., if you lend to an ice-cream factory, you lose money if the weather is bad. But if you lend BOTH to an ice-cream factory and to an umbrella factory, you are fine on average

3. **Liquidity risk**

   - ➢ High return projects are often less liquid (i.e. the return comes later) than low return projects.
   - ➢ The problem is that investors may need liquidity before the returns are realized (liquidity shock).
   - ➢ Firms may need extra liquidity injections (extra credit) to complete a project.
   - ➢ Banks can help mitigate this risk by holding many such illiquid projects or a mix of illiquid and liquid projects.
   - ➢ Liquid stock markets can make illiquid projects more liquid by making them easily transferable.

4. Pooling of savings

- Financial intermediaries mobilize savings.
- It overcomes the transaction costs associated with collecting savings from different individuals
- This function is useful in the case of large indivisible projects
- It also helps investors hold diversified portfolios

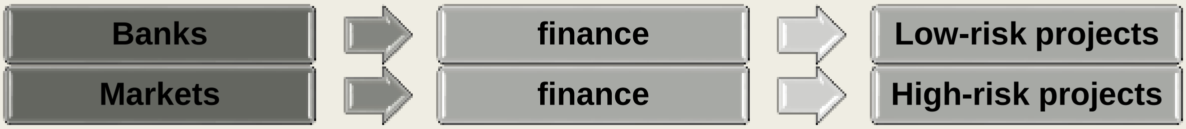
5. Easing Exchange

- Economic growth requiers higher specialization (Adam Smith) which requires more transactions
- Problem: Transaction costs
- Financial institutions can help in reducing these transaction costs:
  - E.g. credit card or bank transfers, rather than payment in cash

Bank- and Market-Based Finance

- It does not matter whether finance comes from banks or markets
- Bank and market-based finance are **complementary**:
  - the availability of both systems may spur competition to provide finance
  - Each system may be more appropriate for a certain type of firms:

e.g.



Banks → finance → Low-risk projects

Markets → finance → High-risk projects

Notes on Bank-Based Finance

Banks can extract rents from firms because they have a lot of private information

In case of debt renegotiation or liquidity injection, banks have a lot of bargaining power and can extract more of the future **profits** of the firms

➡ This may reduce the effort extended by firms to undertake **innovative business**

Banks may be more risk averse

This is why Banks favor conservative and slow growth strategies

Banks solve the free rider problem

They have greater incentives to search for information on **valuable projects**

They **don't** have to **display the information** they collected, so they can take advantage of this monoplistic position.

✓ By contrast, private information collection by market participants is immediately revealed in **the stock price**.

Banks	Stock Market
A Money market	Capital Market
Raise funds- Short term	Raise funds- Long term
Indirect Finance	Direct Finance
Certificate of Deposit	Shares and Bonds
Provide interest rate	Provide coupon rate
Provide loan	Raising equity capital
Low Risk-Projects	High Risk-Projects
To fulfill short term credit needs of the business	To fulfill long term credit needs of the business
Private information is not disclosed	Private information is revealed in the stock price

Credit Constraints, Inequality, and Growth

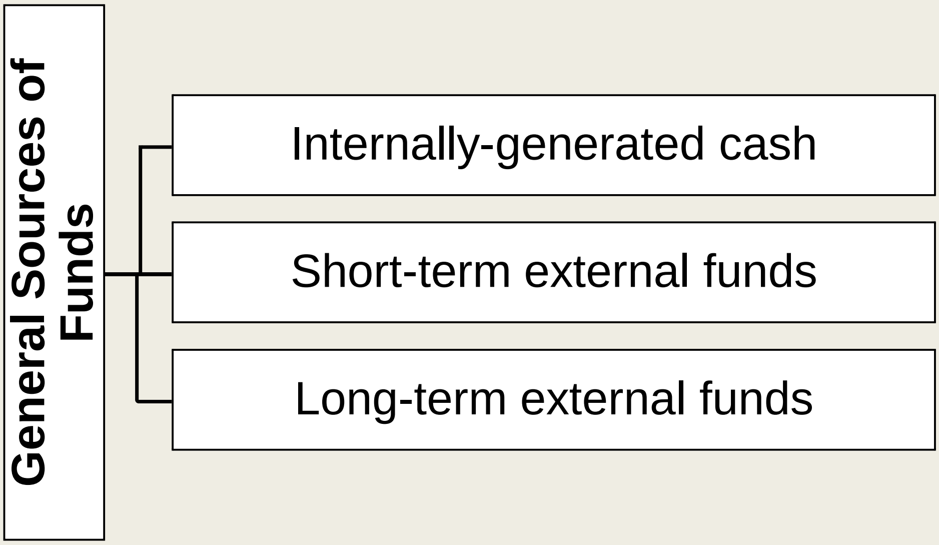
- It is empirically observable that **inequality** harms **economic growth** because:

  it implies more redistribution and thus less investment.

- But if inequality is the consequence of **credit constraints.** by reducing them,

  the equal distribution of wealth could have positive effect on growth.

Corporate Sources and Uses of funds



General Sources of Funds

Internally-generated cash

Short-term external funds

Long-term external funds

a financial center (IFC)

London

New York

Singapore

Hong Kong

Tokyo

Prerequisites to be a financial center

1. Political stability
2. Minimal government interventions
3. Legal infrastructure
4. Financial infrastructure

Breaking News

Egypt expects to raise $4 billion in Eurobond sale

Egypt will sell $4 billion of Eurobonds in three tranches, raising twice as much as targeted when it began a roadshow last week.

Bankers said the issue was likely to comprise $1.75 billion of five-year bonds yielding 6.125 percent, $1 billion of 10-year bonds paying a yield of 7.50 percent and $1.25 billion of 30-year bonds yielding 8.50 percent.

Initial marketing had pointed to yields of 6.375-6.625 percent, 7.625-7.875 percent, and 8.625-8.875 percent respectively. The tighter pricing is a vote of confidence from foreign investors the country has sought to lure back following a 2011 uprising that drove them away.

The country of over 90 million has been seeking a variety of funding sources, from development loans to foreign grants and aid, to plug its financing needs as it struggles with an acute dollar shortage that has hampered its ability to import.

Euromarkets

These can broadly be classified as

Eurocurrency

Eurobond

Eurocurrency

A Eurocurrency is a **freely convertible currency** deposited in a bank located in a country which is not the native country of the currency.

The Eurocurrency market consists of banks (called Eurobanks) that accept deposits and make loans in foreign currencies.

Definition: the Eurocurrency market

The **market for deposits** placed under **a regulatory regime different** than the regulations applied to deposits used to execute **domestic transactions**.

Countries that allow eurocurrency usually set up special regulations to permit “Eurocurrency deposits” on domestic institutions.

Example

US$ deposits outside the United States, UK£ deposits outside the United Kingdom, and so forth.

Eurobond

The Eurobond is a **special type of bond** issued in a currency which is **different** from the currency of the country or the market in which the bond is issued.

These types of bonds are also known as external bonds.

Example

- Eurobond are categorized by the currency in which they are denominated.
- Eurobond are usually offered at fixed interest rates, offering a clear fixed-payment debt structure for the issuer (in the short and long term.

Who Issues Eurobond?

1- Private Organizations

2- International Syndicates

3- Governments

For example

- ✓ A U.K.-based company can issue Eurodollar bond in Japan, (which is denominated in US dollar)
- ✓ An international financial syndicate can issue Euroyen bonds in Singapore, (which are denominated in Japanese yen).

Official Development Assistance (ODA)

Definition

The DAC (OECD- Development Assistance Committee) defines ODA as:

“Those flows to:
- Countries on the DAC-List of ODA Recipients

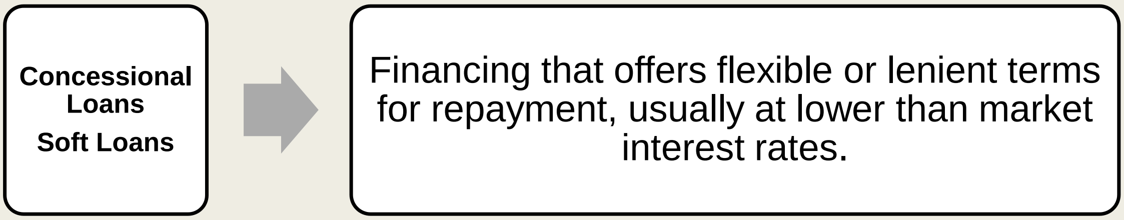
Those flows that have the following characteristics:

1. **Provided by official agencies**, including state and local governments, or by their executive agencies;

2. Each transaction of which:

a. is administered with the promotion of the **economic development and welfare of developing countries**.

b. is **concessional in character (**soft loans).



Concessional Loans

Soft Loans

Financing that offers flexible or lenient terms for repayment, usually at lower than market interest rates.

Coverage of ODA

The boundary of ODA has been carefully delineated in many fields, including:

1. Exclusion of Military aid

No military equipment or services are reportable as ODA. Anti-terrorism activities are also excluded. However, the cost of using donors' armed forces to deliver humanitarian aid is eligible.

2. Peacekeeping

Most peacekeeping expenditures are excluded in line with the exclusion of military costs. **However**, some closely-defined developmental relevant activities within peacekeeping operations are included.

3. Nuclear energy

Reportable as ODA, provided it is for civilian purposes.

4. Cultural programs

Eligible as ODA if they build the cultural capacities of recipient countries, **but** activities to promote the donors’ image, are excluded.

5. Civil police work

Expenditure on police training is reportable as ODA, unless the training relates to paramilitary functions such as counter-insurgency work or intelligence gathering on terrorism. The supply of the donor’s police services to control civil disobedience is not reportable.

6. Assistance to refugees

Assistance to refugees in developing countries is reportable as ODA. Temporary assistance to refugees from developing countries arriving in donor countries is reportable as ODA during the first 12 months of stay, and all costs associated with eventual repatriation to the developing country of origin are also reportable.

7. Research

Only research directly relevant to the problems of developing countries may be counted as ODA.

Examples: Research into tropical diseases.

Note that: the costs may still be counted as ODA if the research is carried out in a developed country.

Example

In **2014-2016** EU's assistance to Egypt under the ENP focused on three priority sectors:

- Poverty Alleviation, Local Socio-Economic Development and Social Protection;
- Governance, Transparency and Business Environment;
- Quality of Life and Environment.

The **European Neighborhood Policy** (ENP)

It is a foreign relations developmental policy, which seeks to govern the EU's relations with 16 of the EU's closest Eastern and Southern Neighbors.

- **The South:** Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestine, Syria and Tunisia
- **The East:** Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine.

Exchange Rate Regimes

Exchange Rate -Definition

The price of a nation’s currency in terms of another currency

There are two approaches to express the exchange rate:

The price of a unit of foreign currency is expressed in terms of the domestic currency.

The price of a unit of domestic currency is expressed in terms of the foreign currency.

a base currency vs. a counter currency

Example, US$1 = EGP16.5 (Here the base currency is the US dollar and the counter currency is the Egyptian pound)

Note that:

Most exchange rates use the US dollar as the base currency and other currencies as the counter currency.

Classifying Exchange rate regimes

Fixed Exchange Rate **Flexible Exchange Rate**

Fixed Exchange Rate

Advantages

- Provide a nominal anchor for monetary policy
- Reduce transactions costs and exchange rate risk

Disadvantages

- Loss of monetary policy autonomy
- Loss of exchange rate as a shock absorber
- Danger of speculative attacks by currency holders

Flexible Exchange Rate

Advantages

- Monetary Policy independence (discretionary policy)
- Automatic adjustment to trade shocks

Disadvantages

- Exchange rate uncertainty
- Need to find a less obvious anchor (→Consequences for inflation)
- Danger of speculative bubbles represented in inflationary trends.

The Impossibility Trinity

A country must give up one of three goals:

1. Exchange rate stability
2. Monetary Independence
3. Financial Market Integration (absence of capital control)

Common Currency

Definition

a system of money shared by two or more countries.

Advantages of a Common Currency

- **Reduction in exchange rate risk**
  - Eliminates the risk of exchange rate variability, which increases capital market stability
- **Reduction in transactions costs**
  - There is no exchange of currencies among members, so transaction costs are reduced

Disadvantages of a Common Currency

- **Loss of independent monetary policy**
  - With a common currency monetary policy is the same in all countries because there is **one** money supply and **one** central bank
- **Loss of national symbol**
  - Losing a national currency may be a loss of national identity or heritage

Optimal Currency Areas

- **An optimal currency area is** a group of countries suitable to adopt a common currency without significantly jeopardizing domestic policy goals.

Criteria for optimal currency areas:

- ✓ Similar composition of industries
- ✓ Significant mobility for factors of production (labor and capital)
- ✓ Diversified economies

Thank you