

Long Term Finance Highlights

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Developing Economies' Long-Term Financing Shortfall

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Since the global financial crisis, “banking” has practically become a swear word. But, while banks undoubtedly have the capacity to inflict serious damage on economies and livelihoods, a well-run financial system can offer significant benefits. A growing body of evidence, highlighted in the World Bank Group’s recent Global Financial Development Report, shows that financial institutions and markets have a profound influence on economic development, poverty alleviation, and the stability of economies worldwide, and that a pragmatic assessment of the state’s role in finance is warranted.

On the surface, the most unusual feature of the ongoing financial crisis is that developed economies have been affected much more strongly and directly than developing economies, many of which have learned from previous crises, put their fiscal houses in order, made progress on structural reforms, and improved supervision and regulation.

But this distinction misses the larger point: the quality of policy matters much more than the level of economic development. Some financial systems in developed economies – for example, in Australia, Canada, and Singapore – have shown remarkable resilience, while others have gotten into trouble.

At the same time, the focus on financial reform in developed economies, while warranted, has contributed to complacency in developing economies. For example, many are facing their own version of the “too big to fail” problem – which the crisis reinforced – but have done little to address it.

Moreover, measures taken during the crisis may have helped to mitigate financial contagion, but some do not support robust long-term development of the sector. Many developing economies weathered the crisis at the cost of massive direct state intervention, while their financial sectors lack breadth and access.

The financial crisis has had a particularly profound impact on the supply of finance at longer maturities. To some extent, this is understandable, given the focus on short-term liquidity and capital flows. But the sharply decreased availability of longer-term funding is heightening financial-sector vulnerabilities.

While developing economies’ share of the global economy has risen from roughly one-third to one-half over the last decade, developed economies continue to dominate the supply of long-term funding. The mismatch between the time horizon of available funding and that of investors and entrepreneurs, particularly those in developing economies, is a source of vulnerability that acts as an impediment to growth.

Several factors have diminished investors’ willingness to extend long-term credit. The financial crisis reduced private financiers’ risk appetite, making long-term exposures unappealing.

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Net private capital flows, particularly to developing economies, have become more volatile.

Private capital, which accounts for more than 90% of capital flows to developing economies, will remain the dominant source of long-term financing. But the availability of long-term capital appears to have been impaired, as traditional providers of equity to infrastructure projects, for example, have become less able or willing to invest. Financing from banks has also been constrained owing to deleveraging, particularly by European banks.

The new Basel III package of global banking reforms may increase funding costs further for some borrowers, while reducing the availability of finance, especially for longer-term debt. Institutional investors, such as pension funds and life-insurance companies, with more than \$70 trillion in assets, are a major additional source of long-term capital. While such investment in long-term productive assets like infrastructure is essential to generating the income that these investors demand, less than 1% of pension-fund assets are allocated directly to infrastructure projects.

Meanwhile, net savings in developing economies are increasing, and low yields in developed economies are providing an incentive for investors to channel more resources to productive investment in these countries. Recently, several banks have been able to issue long-term bonds at affordable rates.

Another promising development is the growth of local-currency bond markets. These markets can become a strong source of financing for longer-term domestic investment, including in infrastructure, thereby reducing currency risk for borrowers and investors. But strong and sustainable development of these markets cannot occur without institutional and regulatory reforms that ensure an attractive environment, as well as capacity-building in both the public and private sectors to facilitate further market development.

Investors' willingness to make capital available over the longer term for infrastructure development, job creation, and economic growth depends on their perceptions of various kinds of risk. Policymakers can manage these perceptions by improving public-sector governance, ensuring sound macroeconomic management, promoting a transparent and supportive legal framework for private-sector activity, building debt-management capacity, and protecting investors from expropriation.

Moving away from a one-size-fits-all approach to financial reform means committing the time and effort needed to understand the political economy, as well as establishing partnerships with representatives from government, civil society, and the private sector. Such tailored solutions are essential to bolstering economic performance in developed and developing economies alike.

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