Addressing the Gaps & Challenges of Long Term Finance

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Outline

- Spectrum
- Linkages
- Trade-offs
- Observations

Spectrum

- Long-term finance → Investment (public & private)
- At firm level:
  - Tendency to match maturity of assets and liabilities is well established → it obviates liquidity/refinancing risks.
  - Maturity (tenor) mismatch → instability/ volatility

Menu of appropriate investment funding:

- Official debt flow
- Bank lending
- Capital markets
- Private Equity
- Foreign Direct Investment

Spectrum – The known Constraints

1. Official debt flow

- Conventional multilateral and bilateral lenders – concessional debt
- Commercial debt – the pursuit of complementarity and diversification
- Local versus Foreign – the “original sin” problem
- Stock issue (for Uganda = 34% of GDP equivalent; 27% GDP equivalent in NPV terms)
- Flow issue – projected revenue and/or exports towards debt service

<u>Spectrum – The known Constraints</u>

- **2**. **<u>Bank lending</u> →** (a) Balance Sheets structure: liabilities dominated by short-term-deposits; assets consequently dominated by short term-loans.

  (b) Greater availability of long-term debt finance → reduced firm volatility (i.e. availability of long-term finance mitigates liquidity or refinancing risk (*Demirgüç-Kunt et. al.; 2016*)

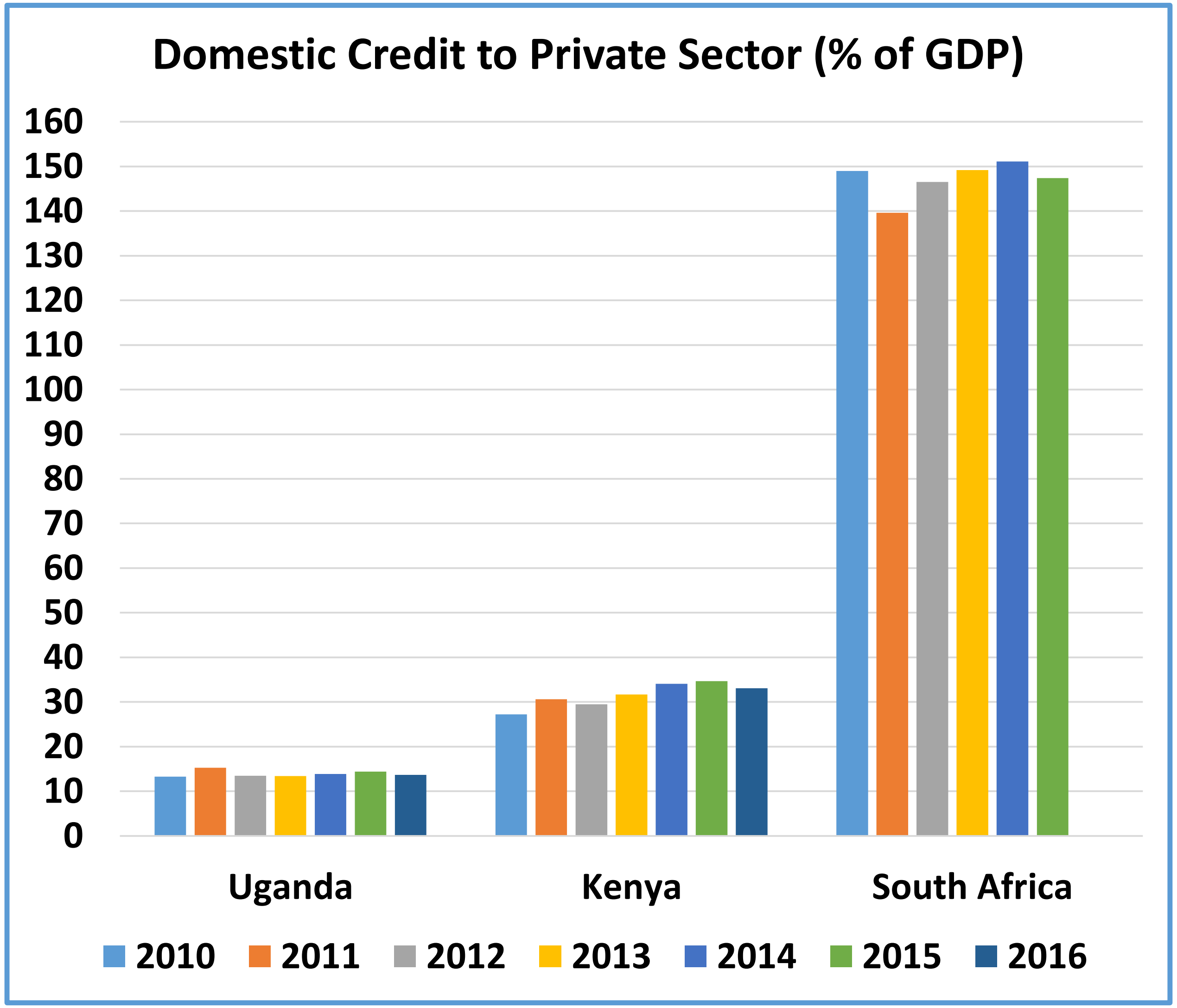
  (c) *Long-term debt = f(financial debt; ε)*

Spectrum – The known Constraints

- 2. **Bank lending** → Financial depth (one of the proxies = credit to private sector (% of GDP)

  - The **menu** of funding sources depending on the level of sophistication:

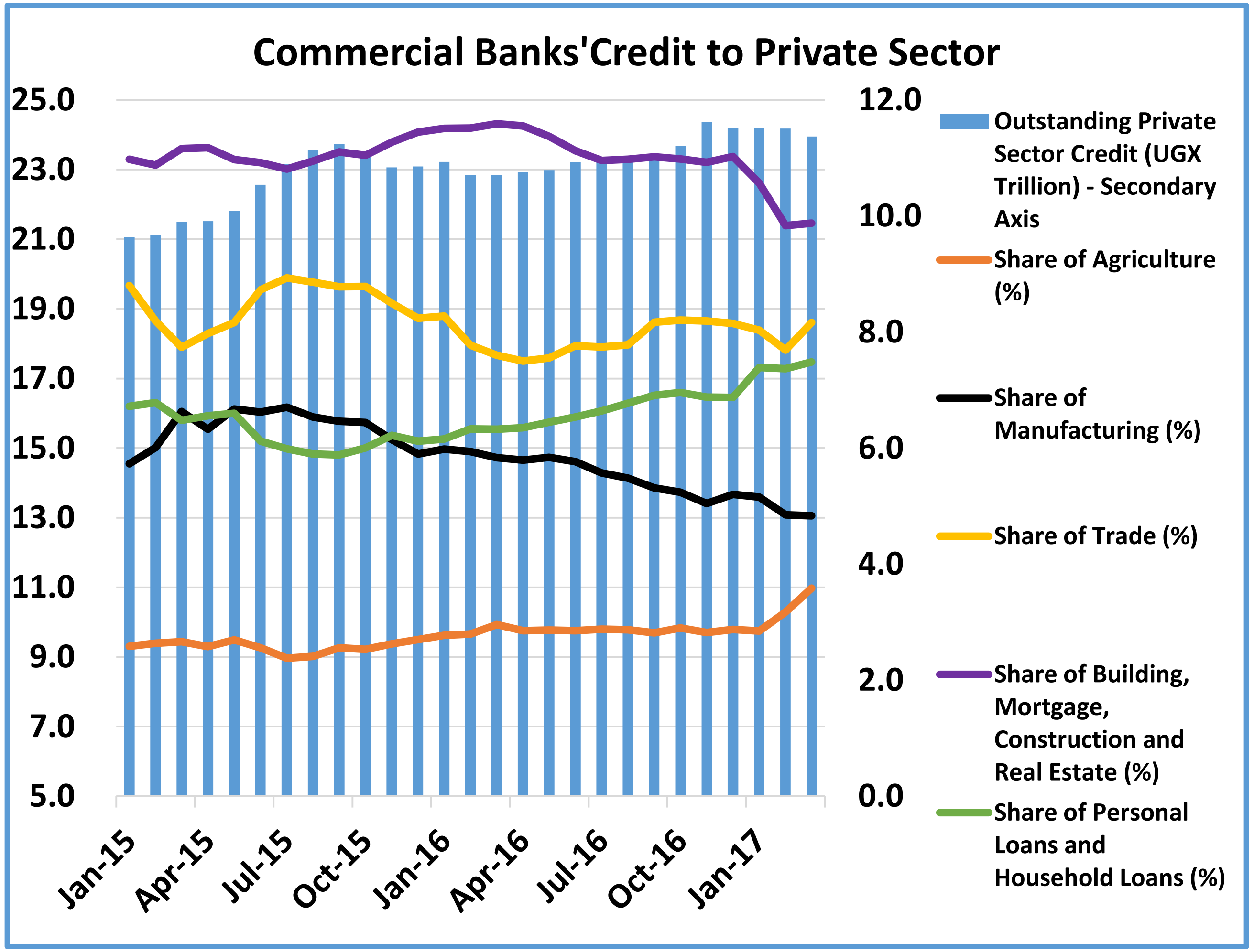
    - Deposits
    - Equity
    - Wholesale funding
    - Long-term unsecured bonds
    - Covered bonds
    - Asset-backed securities (ABC)

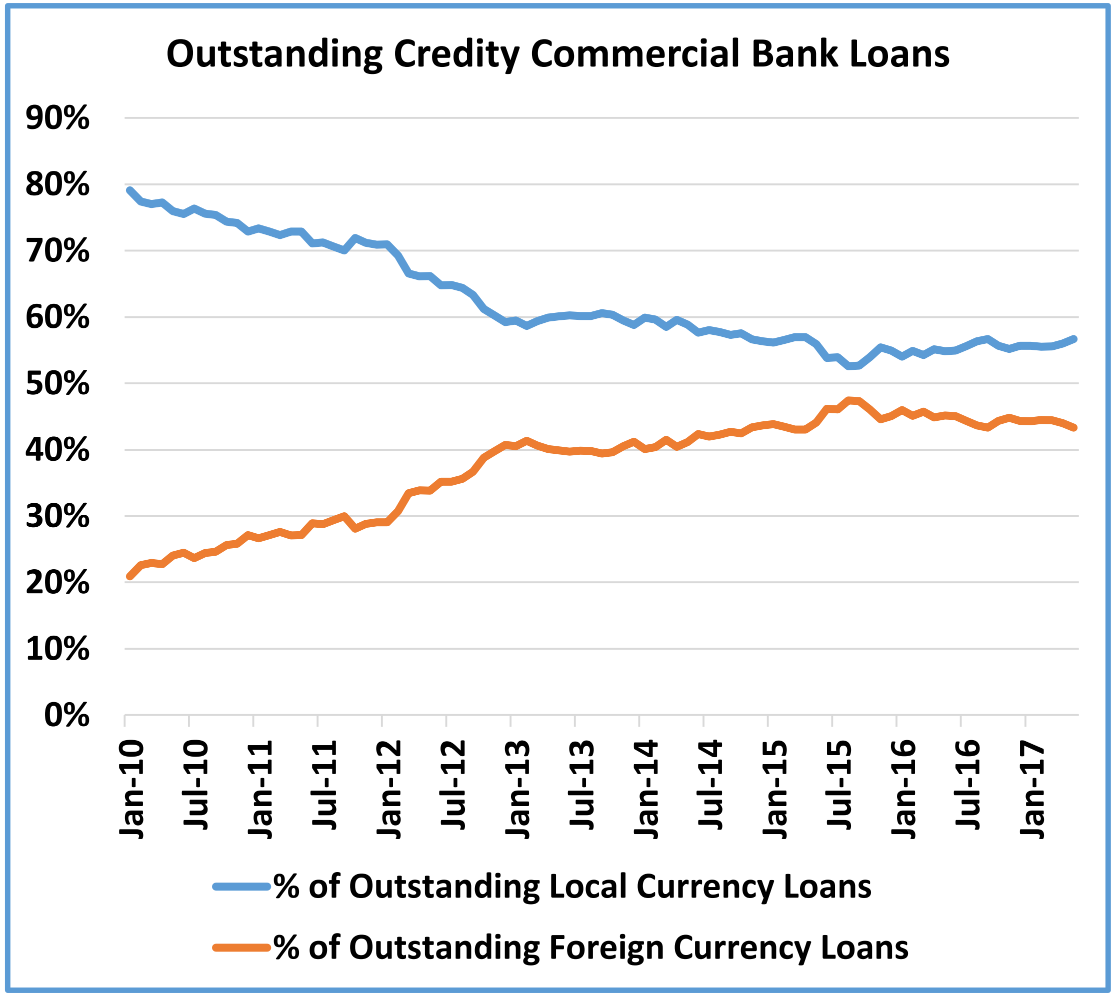


Source: World Bank

Spectrum – The known Constraints

- **2. <u>Bank lending</u>** → State of the local credit market = consumption-heavy; increasingly outward-leaning.





Source: Bank of Uganda

Spectrum – The known Constraints

- **3**. **Capital Markets** → (a) Bond market development is linked to reduced firm volatility (*Demirgüç-Kunt et. al.; 2016*). But…

  (b) A lot of that depends on the depth of the market. World Bank Data → Market Capitalisation of Listed Firms (% of GDP) – South Africa (over 300%), Kenya (about 40%), Uganda (nearly 30%); Nigeria (below 10%)
- **4**. **Private Equity** → (a) Increasing global prominence; but are we feeling it?

  (b) seeking high risk but high return enterprises (the cost issue)
- **5. Foreign Direct Investments** → (a) **Quantum** – necessary but not sufficient

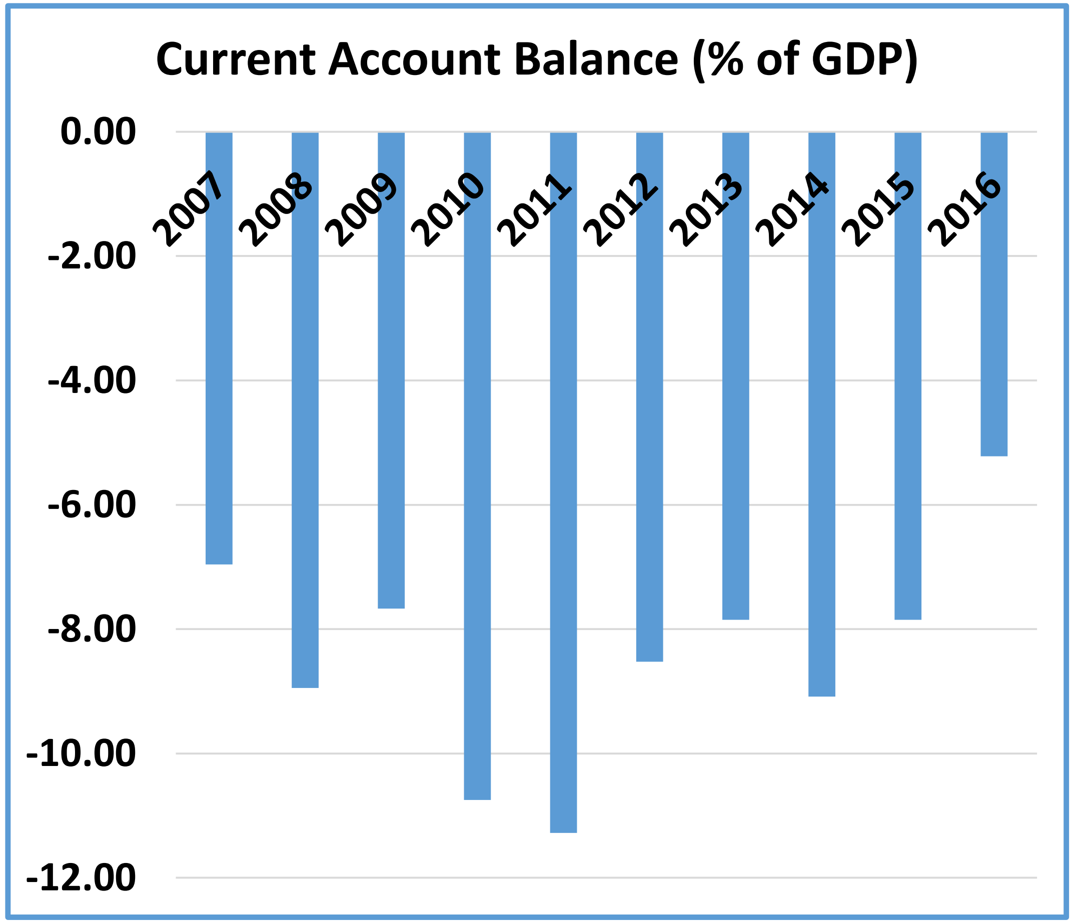
  (b) **Quality** – whether it is (i) resource seeking (ii) consumption promoting.

Linkages

1. **Macro-level linkages**

(a) When Gross Domestic Savings are less than Domestic Investment Requirements:

- Import savings to fill the domestic savings gap;
- Ensure that the imported savings are not destabilising (*fiscal approach versus the monetary approach to Balance of Payments debate*)



Source: Bank of Uganda

Linkages

2. Banks – Capital Markets Linkages

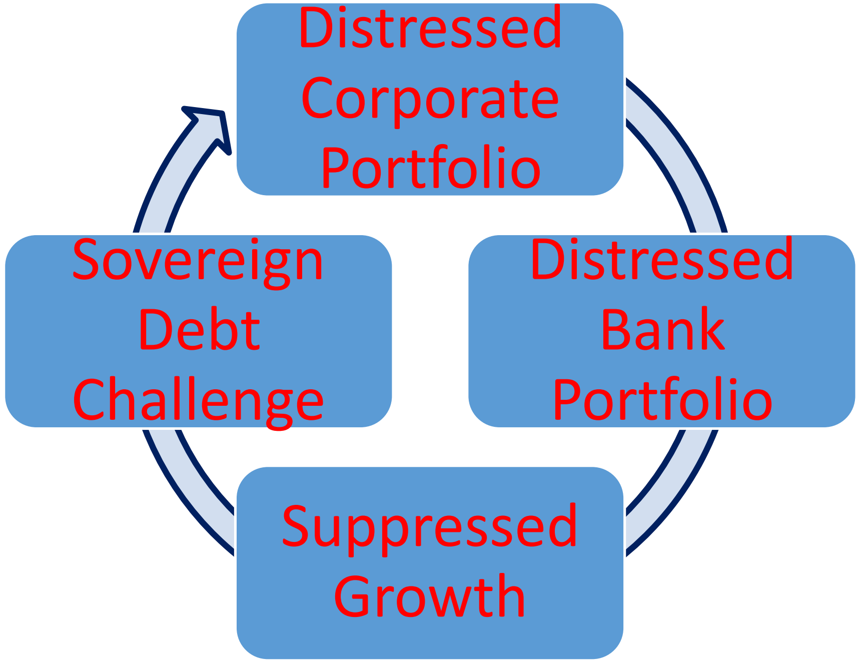
- The traditional view on “banks versus markets”.
  - *Presupposes either banks or markets, develops at the expense of the other.*
  - *As a result, regulators have tried to find a balance between the two*.
- Increasingly, evidence is pointing towards a two-way nexus (*Song & Thakor, 2010*); closer home (the case of Kenya), evidence of co-evolution confirmed (*Osoro & Osano, 2014*)

Linkages

2. Sovereign – Market Linkages

- Government Issuance – dual objective of resource mobilisation and market development.
  - 15-year paper; yield curve development – next stage will be to see longer-term and frequent issuance of corporate paper
- The link between overall interest rate of long-term funds and public debt maturity:
  - Recent studies confirm that: increasing public debt maturity lowers interest rates, especially in economies with higher average inflation and debt (*Sakalauskatie, et. al. 2017*)

Trade-offs – (1) The Vicious Cycles



Trade-offs – (2) Market Development → Crowding Out

- Sovereign Domestic Issuance ↑ = Necessary at the early stages of market development.
- Determine of the threshold beyond which:
  - Sovereign Domestic Issuance ↑ = Private sector Credit ↓
- If there is Private sector ↓ then:
  - Establish the channel – Price channel (yield curve) versus Quantity Channel.
  - Kenyan evidence (*Chebet & Kiemo, 2017*) – (a) Quantity channel prevalent (b) **Ksh.1** lent to government leads to **15cents** reduction to private sector (c) quantity channel crowing out dissipates after 2 years.

Observations

1. If "in finance, size matters" – so-called 'systemic scale economies' hypothesis – (*Bossone and Lee, 2004*), then:

- Policy for "small financial systems" is critical;
- Such policy will entail (*Bossone, 2011*)– (a) openness to foreign players/ownership of intermediaries (b) explore regional markets at both markets and infrastructure;
- Regional integration (EAC in our case) has potential to address the obstacles to market development by alleviating diseconomies of scale; it should however be a complement rather than a substitute for local markets.

2. Banks and Capital markets have strong complementarity:

- Policies that support the co-evolution that engender the two-way nexus are critical (linkages to incorporate Insurance and pensions, which have long-term savings.

3. DFIs (local, regional and international) when they intervene directly or indirectly are at best complementary (Kenya has 5 *'struggling*' local DFIs).

4. There has to be a choice: For a problem - do you formulate a policy or create an organisation?

- Reverse Bank of India is promoting discussion on the creation of *'Wholesale and Long-term Finance Banks'*(Recently published (April 2017) Discussion Paper).

Observations

5. At a macro-level

- Promote macroeconomic and political stability,
- Improve information infrastructure,
- Strengthen legal institutions including investor protection, and
- Create a contestable banking system that is adequately supervised and regulated.

End