The role of financial markets in achieving a sustainable economic development process

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Objectives of the presentation

- To present the links between growth and the development of financial system (part 1)
- To discuss the advantages and drawbacks of each kind of financial system (bank versus market oriented) (part 2)
- To give elements to evaluate the case of Euromed countries (part 3)

1- The effects of financial development on Growth

There are three well known channels that link financial development to long term growth :

- It allows an increasing part of savings to be used on investment financing,
- It increases the productivity of capital in allocating savings toward the most profitable projects,
- It is supposed to increase savings

Five major functions of a financial system (1/2)

1. **To facilitate trades of goods and services**. An efficient financial system reduces information and transaction costs in trade and helps the payments.
2. **To increase saving mobilisation by an improvement of the savers confidence**.
3. **To produce information on the investment projects**. It can be difficult to obtain reliable information on the projects or on the borrowers. The financial system can reduce this issue by devoting some agents to the screening of projects.

Five major functions of a financial system (2/2)

4. **To afford a better repartition and diversification of risk**, and finally a better risk management. A higher diversification allows risk adverse people to invest in riskier projects with higher returns. In addition, a well-performing financial system reduces liquidity risk: some products used to finance risky projects can be easily converted into money.
5. **To favour the monitoring during all the investment process, and develop a corporate governance control.** In fact the financial system has to deal with two kinds of information asymmetries (see following page)

Two kinds of information asymetries: 1/Adverse selection

The **adverse selection problem**: if a lender is not able to evaluate the quality of some investment projects, he will ask for an average return. This price will be too high for the less risky projects, hence only risky projects will be financed. It can result in a significant reduction of the capital market size.

Two kinds of information asymetries: 2/ Moral hazard

Moral hazard arises because an individual or institution does not bear the full consequences of its actions. In finance, borrowers may not act prudently when they invest or spend funds.

This contingency can prevent the contract conclusion.

2- What kind of financial system to resolve these issues?

Two opposite financial systems:

- the “market oriented” system
- the “bank oriented” system.

They have advantages and drawbacks:

The Bank oriented system

- Banks are supposed to be more efficient in solving information asymmetries

- Because they produce private information, they can keep the benefice of their work. In financial markets the prices include and then disseminate all new information.
- A long term relationship allows them to practice a more efficient control.
- Banks have a comparative advantage in financing small firms, because the information extraction is harder than for big corporate.

The Market oriented system

- Markets can finance bigger projects
- The evaluation of a project is made from a larger group of persons.
- They can disseminate the risk between many agents.
- Markets show a higher reactivity to news and a better ability to reallocate quickly the funds.
- But a drawback of these qualities is the volatility of assets prices.

3- What kind of system in Euromed countries? (1/2)

Four common features in Euromed countries:

1. A predominance of small firms, most of them self-financed, and non quoted in financial markets.
2. In fact the banking system has financial resources. But banks prefer to lend to the public sector.

What kind of system in Euromed countries? (2/2)

3. Some countries like Tunisia, Morocco, Jordan or Egypt were able to lay down financial markets with respect to international standards that tend to catch up the occidental markets.
4. But with a lack of credibility and transparency these markets are still unattractive to international investors.

Some propositions

- Developing new accounting standards for corporate in order to make firms able to deliver reliable information about their financial and accounting situations.
- Banks have to develop analysis tools for credit risk.
- With more reliable information, banks could lower their lending conditions.

- The development of financial markets in emerging countries can give to international investors a way to improve their diversification.
- However, to be attractive improvements have to be made concerning market regulations, transactions security, pricing rules and financial protection for shareholders.

Conclusion (1/2)

- The improvement of financial system is probably a necessary condition for a sustainable growth in Euromed countries.
- Given the composition of the productive sector, a bank oriented system is a better choice. As a consequence the effort should be concentrated in improving the bank-firm relationships.
- The development of financial market is an important but second step. But it has to be completed carefully: the recent emerging countries experiment shows that it can be risky to develop in excess financial markets.

Conclusion (2/2)

A **sustainable** development requires:

- A financial development oriented toward intermediated finance, ie bank rather than markets
- A financial development based on financial markets with a strong regulation of international capital movements