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Optimal Sources of Financing

by

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The views expressed are those of the author and do not necessarily reflect the views of UNCTAD

Optimal Sources of Financing

(A Perspective from Low Income Country)

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Introduction

- Low income countries have needs to mobilise financial resources from domestic and external sources to finance growth and development of their economies.
- The need to do so has since become imperative given the prevalent weak or low tax effort (tax revenue as percentage of GDP), low productive base, meagre foreign exchange earnings in the wake of weak terms of trade and yawning savings – investment gaps, etc.)
- Internally, governments have raised borrowed funds through four channels:

Borrowing from the Central Bank →→ often targeted at financing government budget deficit

Issuance of Treasury securities →→ Deeping domestic debt market & budget financing

Offering long term dated debt instruments →→ deepening the market, Benchmaking for the private sector & financing infrastructure

Overdraft from Commercial Banks →→ often targeted at financing government budget deficit

Introduction

Externally, many countries have obtained credits on concessional terms from governments (bilateral) and multilateral development institutions for many years, and have set up units in their central banks and ministries of finance or semi-autonomous offices located outside of the ministry of finance, to manage such debt. Countries have also contracted export credits and developed policies and strategies to negotiate and administer such non-concessional debt. In recent years many countries have borrowed extensively on commercial terms from international banks and the international capital markets.

However, the above sources of financing involve costs and risks, making problematic the choice of the "optimal" sources of financing for specific end-use.

This presentation is targeted at considerations governing the choice of "optimal" financing sources for particular end-use.
** Although analysis such as this would require the construction of a quantitative model, the paper elects to be qualitative at this point, relying largely on **pragmatism and assumed notions of costs and risks associated with financing end-use vis – a – vis a vector of financing modes/options**.

Introduction

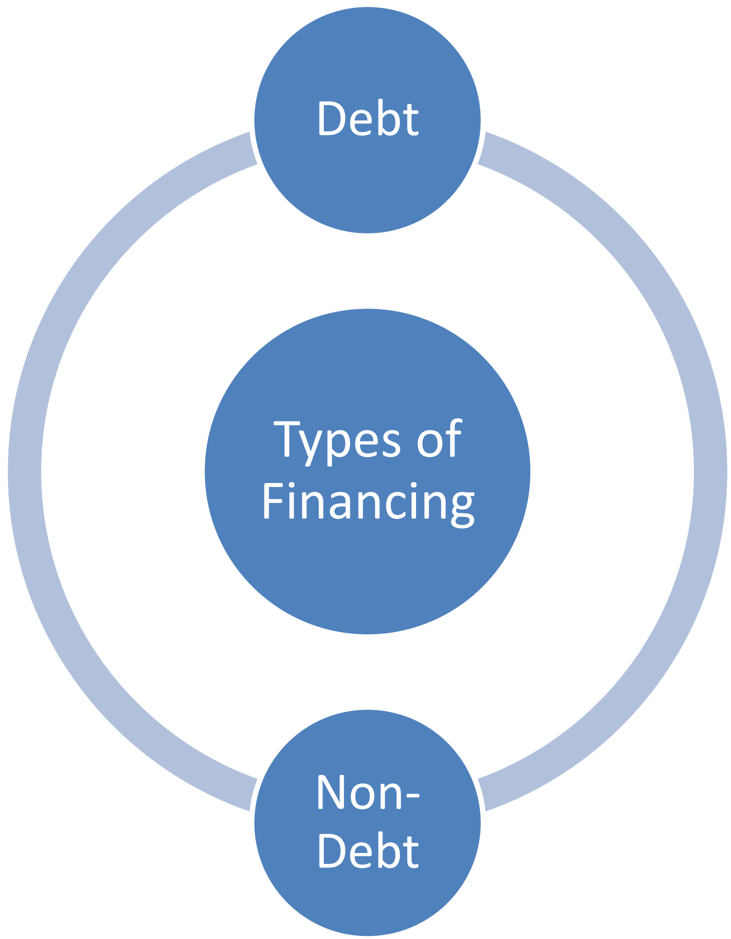
The paper seeks to articulate the **challenges/constraints involved (from low income perspective)in choosing one financing option as opposed to another leading to the identification of a number of financing sources**, at least, theoretically deemed optimal vis – a – vis the end – use.

In this regard, the analysis of the paper would **revolve around eight end-use financing choice functions formulated from the perspectives of developing countries and under some simplifying assumptions:**

- no time constraint in the mobilisation of the optimal source;
- no undue political interference; and
- existence of resource gaps: investment gap (I – S) and government deficit gap (G – T) to be financed by the current account gap (M – X): (M – X) = (I – S) + (G – T)

Types of Financing

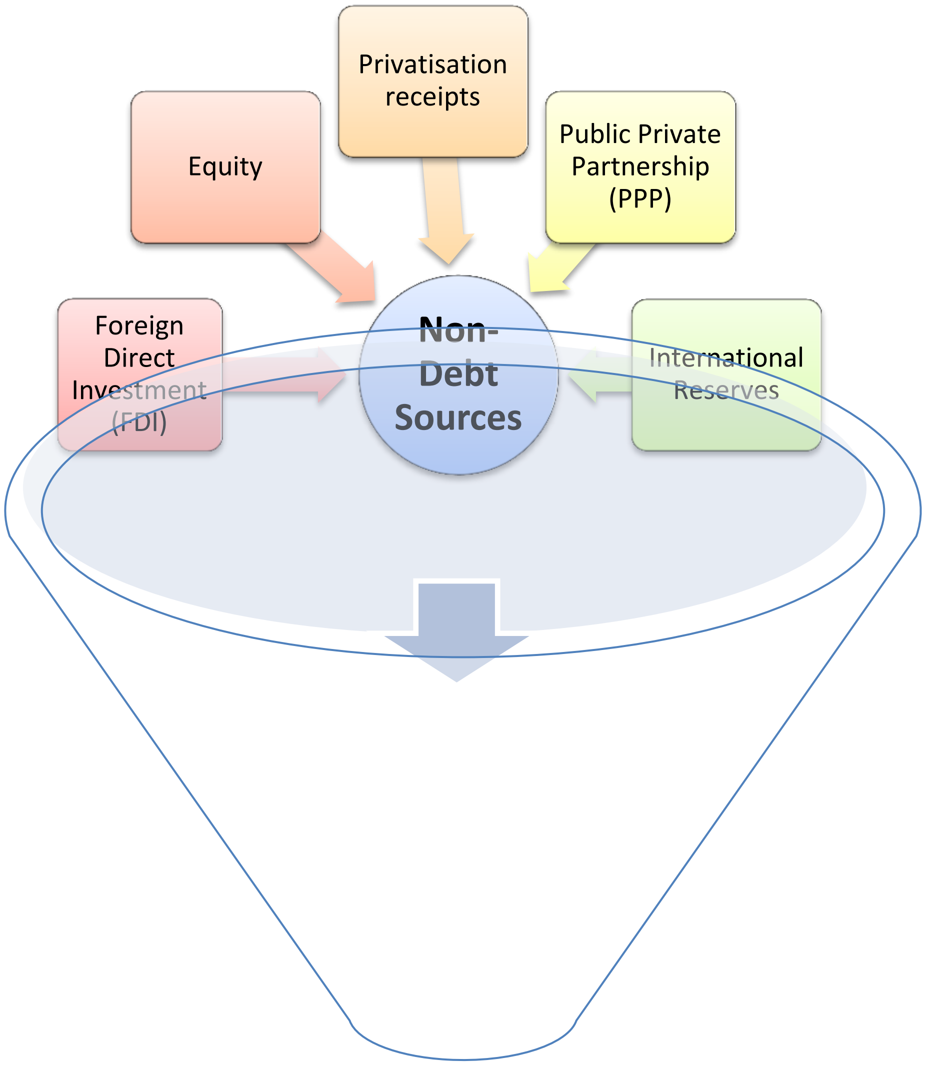
Debt and non-debt sources constitute the sources of financing in the resource – deficit low income countries.



Types of Financing - (Debt)

- **Debt Financing**
  - **Concessional loans and grants**
    - **Multilateral creditors/donors**
    - **Bilateral creditors/donors**
  - **Quasi/Non-concessional Source**
    - **Export Credits**
      - **supplies credits**
      - **buyers credits**
      - **official export credits**
    - **Multilateral Creditors & OECD & NON OECD countries**
    - **Private Flows**
      - **international bank loans & bonds (domestic and external)**
      - bank overdraft facilities

Types of Financing - (Non-Debt)



Possible end-uses and financing options

In articulating optimum combination of financing sources for an –end-use, the paper first outlines the end-uses vis – a – vis their possible financing options, in the form of end-use financing choice functions:

Optimum choice of financing (OCF)

$$OCF = f(end - use, constra\mathrm{int}s / exigency, countrycircums\tan ces).........(1)$$

$$\text{End-use} = \quad f(constraints, country\ circumstances) \quad .\ .\ .\ .\ (2)$$

Choice of financing

Possible combination of financing modes for an end – use

Cost

Exigency of end-use

Legal issues

Risk

The underlay of these determinants of choice of financing for an end – use translates into costs, risks, legal and exigency of end – use.

Possible end-uses

End Use

Financing Mode

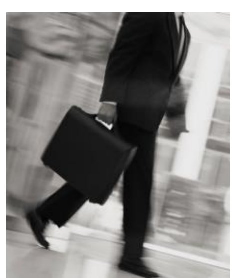
$$\text{Economic project} = f\begin{pmatrix}\text{FDI}, loans, bonds, PPP,\\ Privitisation\ receipts\end{pmatrix} \qquad \ldots . (3)$$

$$\text{infrastructure/social safety nets} = f\begin{pmatrix}\text{PPP, concessional loans,}\\ bonds, \text{FDI}, Privitisation\\ receipts, grants\end{pmatrix} \ldots . (4)$$

$$\text{Bridging finance} = f(\text{overdrafts/loans/short } term) \qquad \ldots . (5)$$

$$\text{Balance of Payments support} = f(\text{IMF facilities, SDR}) \qquad \ldots . (6)$$

$$\left\{\begin{array}{c}\text{Possible}\\ \text{combination of}\\ \text{financing}\\ \text{modes for an}\\ \text{end – use}\end{array}\right\}$$



Cost

Exigency of end-use

Legal issues

Risk

Identifying Optimal Sources of Financing

$$\text{Economic project } = f\begin{pmatrix}\text{FDI}, loans, bonds, PPP, \\ Privitisation\ receipts\end{pmatrix} \quad \ldots\ldots(3)$$

These financing modes have their characteristics.

- Grant is the best but very rear and inadequate for economic project. FDI is non-debt creating and second to grant. But it requires the need to repatriate dividends in the future. In the process of repatriation, pressure could be placed on available reserves of the country as well as on the exchange rate. These are costs to the economy although inflow of FDI could momentarily appreciate the exchange rate while creating opportunity for financing investment projects..
  - ✓ Loans and Bonds are debt creating but could be used for economically viable projects and have the advantage of financing projects chosen by the country itself – i.e. the country has flexibility in the choice of project.

Identifying Optimal Sources of Financing

- ✓ PPP in economically viable projects can be good but carries along significant contingent liabilities. In addition many low income countries lack good institutional arrangement as well as Legal framework for effective PPP arrangement.
- ✓ Privitisation receipts is limited to the availability of assets and is not continuous

$$\text{infrastructure/social safety nets} = f\begin{pmatrix} \text{PPP, concessional loans,} \\ bonds, \text{FDI}, Privitisation \\ receipts, grants \end{pmatrix} \text{ .... (4)}$$

Considering that concessional loans are characterised by high grant element and long maturity the financing mode seems to occupy one of favourable second best position after grants for infrastructure projects .

Although PPP is a good source for financing infrastructure, the hidden cost manifesting in emergence of contingent liabilities, places this financing mode in the third position after grants and concessional loans, as optimum sources of financing infrastructure/social safety nets.

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Bridging Finance

$$\text{Bridging finance} = f(\text{overdrafts/loans/short } term) \qquad \ldots . (5)$$

Sometimes, low income countries and sub-national entities are faced with temporary liquidity problem to either pay counterpart contribution or bridge the gap between donor commitments and disbursements as well as funds to pay administrative charges prior to commencement of disbursement. Bridge financing is a form of short-term loan from banks available to government to "bridge" the period until government obtains expected revenue inflow or a medium or long-term loan to replace it.

BOP Support

$$\text{Balance of Payments support} = f(\text{IMF facilities, SDR}) \qquad \ldots . (6)$$

For countries that have programme with the IMF, the Fund provides support through its concessional window in the form of Poverty Reduction and Growth Facility (PRGF) and also through the Extended Credit Facility (ECF), Supplemental Reserve Facility (SRF), etc.

Constraints to Choice of Financing Option

In the lead up to an optimum envelope of financing options for specific end – uses, the debt manager is faced with a variety of constraints.

- Some of the constraints are general in nature regardless of the nature of end–use.

- They include :-

- legal framework,
- macroeconomic conditions,
- the country's foreign policy/international econ-relations,
- Inter governmental fiscal relations constraints eg. Sub-national borrowing
- global economic conditions

Legal and Institutional Framework

Most developing countries have put in place the basic elements of a legal framework for public debt management.

Despite the legal framework the implementation of the framework is a big challenge due to weak institutions, political interference and weak capacity.

There are also challenges relating to conflicting and out dated legislations which are not in sync with current developments.

Inter-governmental Fiscal Relations/Level of Government

Central government could impose borrowing restrictions on the sub-national jurisdiction in order to maintain macroeconomic stability. This situation limits borrowing volume and sources

Country Circumstances

Individual developing country circumstances vary and could pose financing constraints. Such constraints may include the

- macroeconomic position and outlook forcing the use of operational target to fix overall external-domestic gross financing . E.g .External Debt/GDP, NDF % of GDP, NDF etc
- current stage of development especially with respect to financial markets and economic policies,
- the level and composition of the country's debt portfolio which may constrain further borrowing
- the exchange regime maintained and the degree of capital account liberalization which could inhibit capital inflows.
- the country's credit rating and general standing which may inhibit its effective negotiation of loans,
- political instability & perceptions about the governance processes.
- availability of counterpart funding as condition precedent to loan disbursement

Foreign Policy/International Economic Relations

Foreign policy could also pose challenges to effective mobilization. In some cases policy may preclude borrowing from specific country jurisdictions for strategic reasons regardless of the merits of such financing source. However, this type of constraint is few and far between.

Conclusion

The end–uses and purpose of the fund can significantly determine the optimality of borrowing. The end-use financing of economic projects, infrastructure/social safety nets, bridging finance and BOP support. In the lead up to determination of the optimal sources of financing, each end–use was related in a financing function to a vector of financing modes, taking into consideration inherent costs risks, exigency situations and a vector of other limiting constraints.

Consequently, optimal sources of financing as they relate to end–use largely vary from end–use to end–use, cognisance having been taken of possible costs, risks, exigency situation and a panoply of other constraints inhibiting the relevance or suitability of financing modes

Thus, for economic project, financing was related to loans (non-concessional) bonds, PPP, FDI and privatisation receipts, in that order.
Infrastructure/social safety nets financing was related to grants, concessional loans, PPP, bonds, FDI and privatisation receipts, in that order.
Overdrafts/loans (short-term from banks are the optimal source of bridging finance.

Thank you

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