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Corduneanu, Carmen and Iovu, Laura Raisa
West University from Timisoara (Romania), Faculty of Economics, Finance Department

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Carmen Corduneanu
West University of Timişoara, Faculty of Economical Sciences, Timişoara, Romania
Laura Raisa Iovu
West University of Timişoara, Faculty of Economical Sciences, Timişoara, Romania

MULTIPLYING FINANCING CHOICES THROUGH CAPITAL MARKETS

Key words: capital market, financial innovation, flexible financing decisions

ABSTRACT

Considerable evidence shows that countries with the most developed financial sectors and capital markets enjoy the strongest economic growth over the long run. The non-financial sector, small and medium sized entities can access a wider availability of more innovative and lower cost finance to aid their growth, while larger companies profit from an overall reduction in the cost of capital and a wider range of financial products. These economical agents in search of alternatives for financing their projects demand the greatest level of flexibility regarding the use of the financing instruments available and this flexibility can determine the success or failure of such a project. Capital markets also facilitate the efficient allocation of savings to where it is most productive. They allow large numbers of investors to reduce their financial risks through diversification. By spreading risk widely, they also cushion the economy against economic and financial shocks.

1. INTRODUCTION

Capital markets represent a fundamental element of the financial system of any modern economy and they play an important role in the allocation of capital within the economy. Considerable evidence shows that countries with the most developed financial sectors and capital markets enjoy the strongest economic growth over the long run. The non-financial sector, small and medium sized entities can access a wider availability of more innovative and lower cost finance to aid their growth, while larger companies profit from an overall reduction in the cost of capital and a wider range of financial products. These economical agents in search of alternatives for financing their projects demand the greatest level of flexibility regarding the use of the financing instruments available and this flexibility can determine the success or failure of such a project. Long-term finance tends to be associated with higher productivity. An active stock market and an ability to enter into long-term contracts also allow firms to grow at faster rates than they could attain by relying on internal sources of funds and short-term credit alone. Therefore public authorities responsible for economic policy as well as private sector agents who are active in the capital markets have a vested interest in capital markets that are both efficient and stable. Beside reviewing some of the theoretical framework regarding the benefits of a sound financial system upon the eonomical growth and trying to ilustrate some of the advantages offered in terms of alternative means of financing by the capital markets we tried in this paper to focus on the current situation in the European financial markets, to see whether the capital markets play or not an important role in one of its main functions, that of financing the economy.

2. THEORETICAL FRAMEWORK

Many economists have extensively investigated the relationship between finance and growth, and found that financial development has a strong, positive impact on economic growth.

For a long period of time it has been asserted that through the determinant factors of economical growth are savings and the equipment with the adequate material and human resources. This thing implies realizing some investments in infrastructure, developement and innovation, as well as in education and formation, that will improve the current level of these resources in each country, the level of productivity and therefore an increase in the GDP of the considered country. Though, there is a very important factor that influences the **level of development of the financial system** of the economy and this is **the way of financing** that generates economical growth. At a microeconomic level, **financing** has the most important role for the development of the activities of the company. Generally speaking, no matter how good is the promoted product, or the efficiency of the commercialization channels or the level of correlation between technological equipment and the human resources, if the company does not have a good financing policy, as far as concerns the liquidity, the solvability and rentability, it will end bankrupt, minimizinf all the other aspects realizes in a succesful way.

The structure of the financial systems and the way in which the countries finance their productive systems have experienced a continuos evolution. The change from a bank-based financial system to a market oriented financial system, situation that initially was noticed in anglo-saxon countries cannot be ignored because of its expansion. This distinction was for the first time noticed by Hicks (1974). While in a bank-based economy financing the economical entities is mainly realized through banks, in a market-based economy, capital markets have the role of assuring the long-term funds for financing the economy. Capital markets have a significant importance in financing the economical entities, contributing to multiplying financing choices for those with a need for financial resources.

The distinction between the two types of financial systems and the correlation with the economical development of a country has been the subject of research for many years for many economists, through them **Gerschenkron** (1962), **Goldsmith** (1969), **Levine** (2000), **Tadesse** (2000). This debate started in the context of economical growth of Germany and Great Britain at the end of the XIX century and the beginning of the XX century. Gerschenkron (1962) mentions that the bank-based financial system permitted in Germany a closer relationship between banks and industrial firms than in Great Britain. Goldsmith (1969) shows that, even the manufacturing industry has grown in a faster way in Germany than in Great Britain the economical growth rates have been recently similar, at least in the last decade of the XIX century and the beginning of the XX century. More recently, Levine (2000) builds a wide database, covering 48 countries, taking into consideration the 1980-1995 period. He gets to the conclusion that the distinction between bank-based financial systems and the market-based financial systems does not represent an important element in order to justify the potential connection between financing and economical growth. More likely, elements like the legal framework or the quality of financial services can foster the level of economical growth. An opposite opinion belongs to Tadesse (2000), in a comprehensive study covering 36 countries for the 1980-1995 period. This reflects the fact that in a country with an underdeveloped financial system, a system based mainly on the banking sector overtakes a market based financial system. A country with a well-developed financial system will benefit more from a market-based financial system.

The studies made so far had some lacks in realizing a concrete delimitation between bank-based or market-based economies and to decide which is better. Leaving this task to the empirical researchers, we can definitely conclude that developing the financial system as a whole leads to economical growth, and consequently, the capital market should represent a viable alternative to the banking system, both intermediaries must be well-developed in order to assure the effciency of the national financial system.

In this context, we can conclude that the financial system as a whole, in other words, both the banking system and the capital market, with its extremely important role in the global financial system generates economical growth. Once there have been met the requisites refering to the population income, investments in education, political stability, fiscal stability, capital account liberalization, macroeconomical stability in general, the banking sector and capital market indicators are good predictors of the savings rate, capital accumulation, productivity and of the rate of growth of the GDP.

2. RECENT TRENDS IN THE EUROPEAN FINANCIAL MARKETS REGARDING FINANCING PATTERNS

A very interesting analysis can be made by reflecting in which way the financial structure of the economies has changed over time. Therefore, we can take into consideration more countries with different levels of development. If we analyse the financial structure of the financial and economical triad (Japan, USA, EU-15), putting in comparison the year 1995 and 2005, we can notice that the financing structure differs both from one area to another, and within the same area, at different moments in time. Therefore we can easily notice from the figure below that Europe and Japan have a bank-based economy, while USA remains a market-based economy (Figure 1).

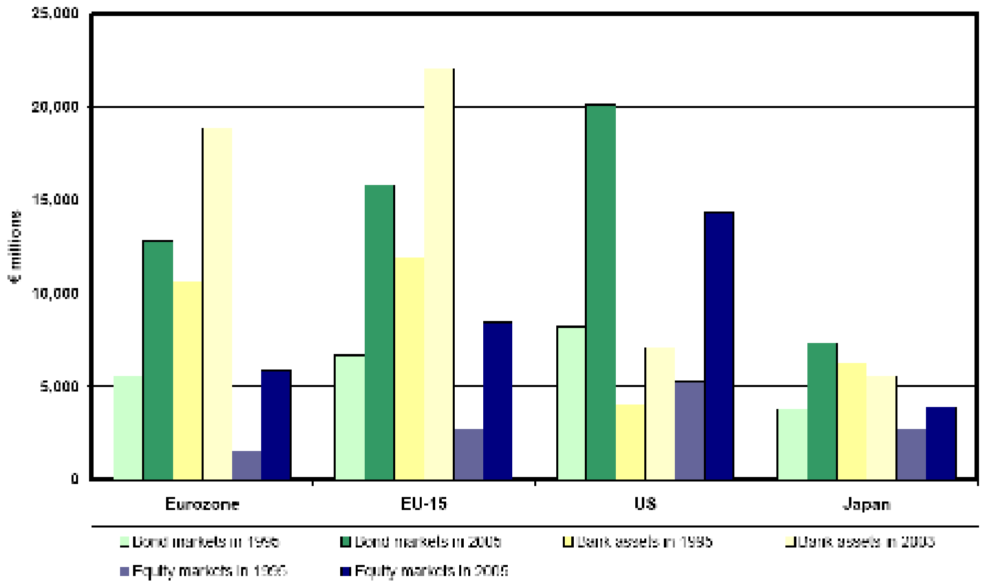

Figure 1-The dynamics of equity markets, bond markets and bank assets, Comparative situation 1995-2005 for Japan, USA and EU-15

Source: European Capital Markets Institute

It is true that the sustained disintermediation process has been visible so far on the European capital markets since the introduction of the single currency in 1999. With all these efforts, bank loans still account for an important amount of investment financing compared to the United States. More precisely, bank assets in the EU amount to nearly four times the combined value of equity capitalization across EU stock exchanges and to more than twice the value of government- and private sector-issued debt securities combined. The situation is the reverse in the United States, where the value of debt securities outstanding is more than three times, and total equity more than twice, the value of total bank assets. In absolute terms, the value of bank assets in the EU-15 is more than triple that in the United States today.

As far as concerns the financial structure of the 10 member states that adhered in may 2004, it is similar with the one of the EU-15 member states. Capital markets, although relatively developed, do not have the main role in the financial system. The difference between new and old EU member states consists in the importance of the other financial intermediaries like insurance companies, investment companies, pension funds, that in the old EU member states have a significant role, while in the new EU member states do not have a priviledged place[1]. Without any doubt, we can conclude that currently in the European Union, we have a bank-based financial system.[2]

To analyse the dynamics of the financial intermediaries at the European Union level and to see whether the intermediate financing will continue to play in the future a significant role, we must take into account the dynamics of the considered intermediaries (banking system and capital market).

Generally, the whole European financial market expanded considerably in the considered period (1992-2004) and this trend is maintaining itself presently. An extremely important thing, that can be easily noticed from the figure below is that the growth pace of the capital market, beginning with the year 1998, began to overtake the growth pace of the banking sector **(**Figure 2**).** Although the banking assets have had a constant growth rate, indicating a process of continous and more intensified financial disintermediation, the trend is clearly downward. In other words, the degree of dependency on the intermediate financing is starting to reduce its importance, emphasizing the role of the caputal markets in financing the economies.

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[1] To see Appendix 1- *Total assets of insurance companies, pension funds, investment funds in the EU-25 countries as % of GDP*

[2] To see Appendix 2 - The development of the banking sector and of the capital market in the EU-25 countries

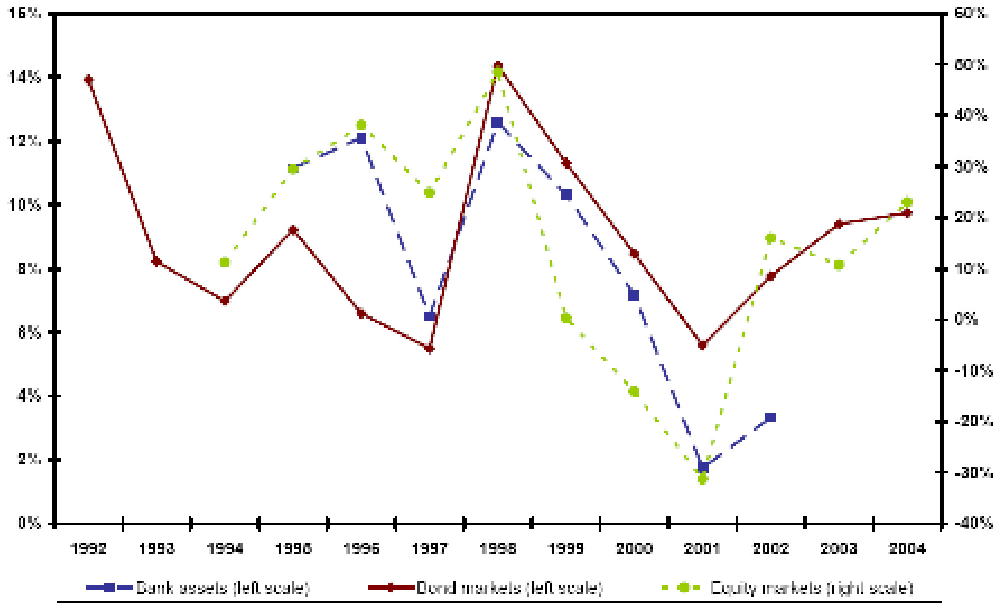

Figure 2- Growth in bank assets, bond markets and equity markets in the EU-15 (1992-2005)

Source: European Capital Markets Intitute

3. BENEFITS OF FINANCING THROUGH CAPITAL MARKET

The recent trends in the financing patterns of the European economies showed above prove that the role of financing the economy by the capital market began to increase significantly in the last years. This fact is due to the fact that the economical entities encountered with a need of financing became more confident in the advantages or benefits of entering the capital market. These entities can be either mature companies willing to obtain long-term resources for financing their productive investments or small companies that wish to transform themslves and get listed on the stock exchange, launching an IPO (initial public offering), or nevertheless, public sector or financial institutions willing to overcome their temporary deficits in the overall budget in periods of unfavourable economic development.

If we are talking about the corporate sector, the advantages of appealing to the capital market are various, the most important one consists in **taking advantage of the capital markets in order to acquire short-term, medium-term and especially long-term financing of their activities in a continuous way**. The most important objective of an IPO made by an entity from the corporate sector is the possibility of issuing securities through the capital market, in other words, getting the access to a flexible source of finances to make the management of their cash flow easier. Moreover, it is an alternative to the classic method of credit financing, and an optimum way for diversifying their resources. For benefiting entirely from this advantage, this company must mention that after the IPO, it will get listed on the stock exchange. In this way, it will enhance the possibility of attracting more available resources. Public companies will more likely get cheaper financing because of their existent market value. The potential creditors of the issuer have the possibility of comparing the accounting value of the equities with the market-value. They have the certainty of the existence of a secondary market, where they can trade these equities, in case of any financial risk. On the other hand, it is well-known the fact that the admission of one company to a stock exchange streghten its reputation among the potential investors and immediately draws an increase of the value of its equities. The international statistics show an average of 20 % increase in the value of traded stock after the entrance on the capital market of any company. On the other hand, there are some clear advantages regarding the popularity of such company, cuantified in the increased credibility in front of the creditors and suppliers.

As an economy develops, self-funding and inside funding become insufficient to finance firms that must manage complex production processes and serve broader markets. Firms must attract additional financing from external resources. Firms that are widely known can bypass information-intensive bank lending and acccess lenders directly with corporate bond funding. Nevertheless, firms with direct access to the bond market continue to fund themselves in part with bank loans because banks provide a number of other financial services.

One of the reasons why entities with need of financing would rather choose capital markets than other alternatives of financing provided by the extended money market is the *variety of number and type of financial instruments* provided by the capital market. The financial instruments are becoming more complex and sophisticated each day. There is an increased flexibility in the financing decision, when choosing between issuing equities or bonds, or between different type of these securities, according to the needs and final objectives of the borrower, based on his asset/liability management situation, regulatory constraints, financial accounting considerations or tax considerations.

When deciding on issuing bonds, the issuer has already made its decision, based on the fact that he wishes to conserve the previous voting rights or the shareholder (shareholder control) and sometimes gets cheaper resources than the one borrowed by banks (interest on bonds is tax deductible for the corporation issuing the payments). There are several more decisions to make regarding maturity, fixed/floating interest rate, the currency, asset-backed securities or not, or the possibility to use hybrids, as convertibles (a mixture between equity and debt capital, that offers lower yields, because of the potential benefits for the investors if occurs a rise in the price of the underlying stock). The issuer has a wide range of financial products from where he can choose the most adequate one. The most common changes of the classical bonds are related to giving up at fixed-interest rate, diversifying the rights given to the investors and the reimbursement manner.

What is also very important is the financial risk taken into consideration when choosing a way or other of finamcing using bonds. If we are talking about *interest rate risk*, it can be easily solved by using derivatives, the most sophisticated financial instruments encountered on the capital market typically used for hedging financial risks.

In conclusion, too much reliance on bank loans or on capital market, however, exposes a firm to excessive risk. Hence, in developed economies firms have come to rely on a portfolio of external finance that usually includes substantial equity, as well as bond or bank loan finance. Equity finance gives a firm financial flexibility in the choice of the payment of dividends-flexibility that a firm can utilize to avoid default on bank loans or bonds. Outside equity, however, involves a cost of its own: too much of it blunts the incentive of managers to run a firm efficiently because external ownership allows managers to retian only a fraction of the value they create for the firm above revenue needed to pay off fixed obligations, which include debt and fixed salaries. **Therefore, equity, bank loans and bonds generally coexist in the capital structure of modern corporate borrowers.**

As far as concerns the **Romanian firms**, although financing through capital market has become a more and more attractive way of financing their activities, we cannot say that nowadays, most of the companies would rather obtain long-term funds from the capital market than appealing to the bank loans, like it happens in most developed countries. Comparatively, in 2006 were finalized only two IPO on the capital market, in a total amount of 151,85 million lei, meanwhile the long-term financing offered by banks accumulated 2,3 billion lei[3]. However, it is expected an increase of the listed companies on the Romanian capital market, given the fact that only recently, the capital market began to develop in a significant way and from now on are met all the requisites in order to fulfill one of it's most important roles: that of financing the economy. As we can see in the further figure, the percent of market capitalization in GDP increased every year, and it is being forecasted a level of 40 billion Euro at the end of 2010.

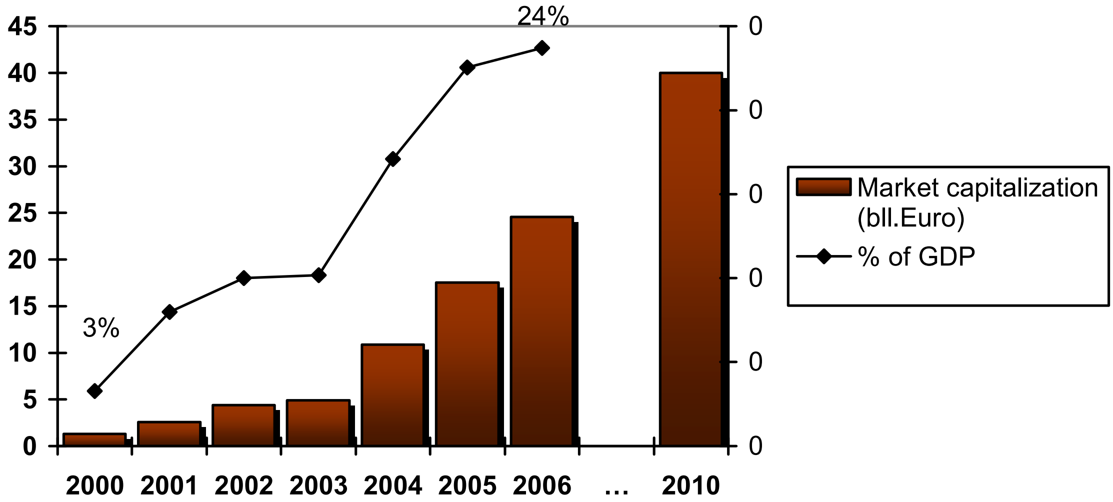

Figure 3 – Market capitalization as percent of GDP
Source: Author calculation on dates provided by BVB and INSSE

After this indicator and the one of value of transactions, the Bucharest Stock Exchange is ranking the third position in the region of Central and Eastern Europe [4]. **Therefore, there exists the premises that the Romanian stock exchange will represent an important alternative to financing in the nearest future.** It is true though that, in what concerns the bond market, it is under-developed only in comparison with the equity market, that reached a certain development, fcat easily noticed in the figure below (Figure 4).

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[3] Dobrea, C., Bara Raluca - *Firmele ocolesc transparenţa bursei şi preferă costul creditelor,* Adevărul, 28 january 2008
[4] To see Appendix 3

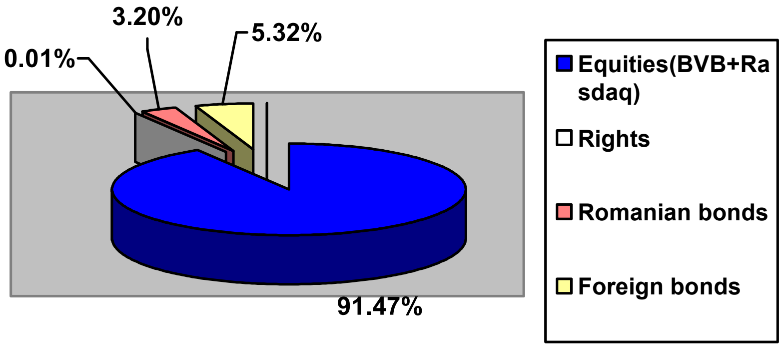

Figure 4 – Structure of market transactions (2006)
Source: Author calculation on dates provided by BVB

With a pretty devious evolution, the Romanian equities market seems to have got to a certain maturity which can lead to future quantitative, but especially qualitative growth. Regarding the bond market, Romanian capital market is characterized by an insufficient development of the bond primary market and secondary market. In 2007, at The Stock Exchange Bucharest 20 bonds were quoted, of which only 5 corporate bonds, the other 13 municipal bonds and 2 international bonds. Moreover, analyzing the value of the transactions that took place in 2006, we can see that only 8,52% of this is due to the bonds, the listed actions at BVB having a contribution of 91,47%..

4. CONCLUSIONS

In this context, we can conclude that the financial system as a whole, in other words, both the banking system and the capital market, with its extremely important role in the global financial system generates economical growth. Once there have been met the requisites refering to the population income, investments in education, political stability, fiscal stability, capital account liberalization, macroeconomical stability in general, the banking sector and capital market indicators are good predictors of the savings rate, capital accumulation, productivity and of the rate of growth of the GDP.

Companies should benefit from a developed financial market, taking into consideration not only banks, but also the alternatives provided by the capital market when looking for long-term funds to finance their activities. Too much reliance on bank loans or on capital market, however, exposes a firm to excessive risk. Hence, in developed economies firms have come to rely on a portfolio of external finance that usually includes substantial equity, as well as bond or bank loan finance. Equity finance gives a firm financial flexibility in the choice of the payment of dividends-flexibility that a firm can utilize to avoid default on bank loans or bonds. Outside equity, however, involves a cost of its own: too much of it blunts the incentive of managers to run a firm efficiently because external ownership allows managers to retian only a fraction of the value they create for the firm above revenue needed to pay off fixed obligations, which include debt and fixed salaries. **Therefore, equity, bank loans and bonds generally coexist in the capital structure of modern corporate borrowers.**

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9. www.eurocapitalmarkets.org
10. www.bvb.ro

Appendix 1

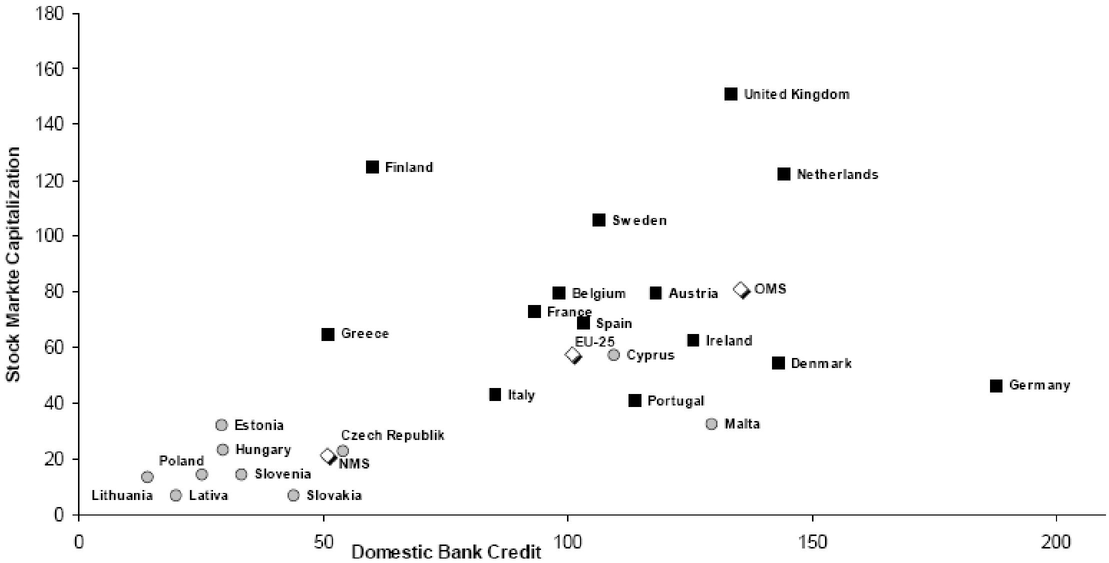
Total assets of insurance companies, pension funds and investments funds of the EU-25 as % of GDP

	Insurance companies		Pension funds		Investment funds	
	1995	**2004**	**1995**	**2004**	**1995**	**2004**
Austria	26.6	28.8	3.7	4.3	45.3	51.7
Belgium	45.5	57.7	5.7	4.1	34.1	33.4
Cyprus	-	-	-	-	-	-
Czech Republic	7.2	9.3	2.4	3.7	4.0	4.3
Denmark	53.8	63.3	23.3	192.8	21.2	39.2
Estonia	2.3	3.4	0.0	1.9	-	3.5
Finland	23.7	25.5	-	-	9.0	14.4
France	55.9	59.9	0.0	0.0	43.3	48.5
Germany	44.6	49.3	-	11.7	37.6	9.5
Greece	9.2	7.2	0.0	0.0	13.2	9.5
Hungary	4.9	4.4	4.0	6.6	5.0	5.3
Ireland	48.2	58.2	43.7	42.0	242.7	292.5
Italy	25.2	29.4	0.5	0.9	31.5	20.8
Latvia	2.2	2.0	0.2	0.4	0.2	0.5
Lithuania	1.6	2.3	0.0	0.1	-	-
Luxembourg	130.0	130.3	-	-	3.873,3	3.797,9
Malta	10.9	13.9	0.0	0.0	13.0	23.5
Netherlands	66.3	65.8	100.8	106.9	25.1	20.1
Poland	5.1	7.1	2.7	7.9	1.7	4.7
Portugal	20.6	24.6	11.5	10.7	19.8	21.9
Slovakia	5.6	7.2	-	-	-	5.0
Slovenia	6.0	8.9	0.9	2.0	11.5	8.0
Spain	21.9	24.3	6.6	7.7	23.3	24.8
Sweden	0.1	31.3	0.0	0.0	35.6	42.1
Great Britain	108.6	95.0	73.6	64.5	22.6	24.8
Average EU-25	46.6	48.3	17.6	21.9	39.6	41.0
Average EU-15	50.3	52.2	19.0	23.5	42.9	44.4
Average EU-10	5.2	6.7	2.3	5.4	2.8	4.6

Source: ECB, National Banks, Eurostat

Appendix 2

The development of the banking sector and of the capital market in the EU-25 countries



Source: ECB, National Central Banks, WDI and National Stock Exchanges

Appendix 3

The current situation of the Romanian capital market in comparison with the other states from Central and Eastern Europe, members of the European Union

Country	GDP 2006 (bll Euro)	Market capitalization (bll Euro)	Capitalization/ GDP (%)	Value of transactions 2006(mill.Euro)	Value of transactions /Capitalization 2006 (%)
Cyprus	14,5	12,3	84,5	3.343,3	27,3
Czech Republic	112,6	34,7	30,8	30.015,4	86,5
Estonia	12,8	4,6	35,7	766,5	16,8
Hungary	89,2	31,7	35,5	24.625,5	77,7
Latvia	15,5	2,0	13,1	87,7	4,3
Lithuania	23,3	7,7	33,1	1.606,7	20,8
Malta	4,8	3,4	70,9	205,1	6,0
Polond	267,4	112,8	42,2	43.235,2	38,3
Slovakia	43,9	4,2	9,6	70,1	1,7
Slovenia	29,4	11,5	39,1	1.451,5	12,6
Bulgary	24,3	7,8	32,2	1.176,0	15,0
Romania	**96,9**	**22,9**	23,7	2.801,7	**12,2**

Source: www.kmarket.ro