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The Pursuit of Economic Development

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Abstract

The article poses the question of what is economic development and how it should be pursued. In the aftermath of the Cyprus bail-in and the blanket approach of the Government to attract foreign investment the author reminds that failed projects do not promote the cause of sustainable economic development. The point is also made that although cost benefit analysis and risk analysis can indicate viable capital investment projects (public and private), one should bear in mind that a developmental project should be both viable financially (from the Owner's and Bank's perspective) but also from the point of view of the Economy. Special concessions, subsidies, relaxations and tax exemptions made by a Government over-eager to attract foreign investment may indeed make a financially viable project non-viable from the Economy's perspective. In order to successfully accelerate the pace of economic development, three areas of focus are suggested to take measures for so as to: 1) institutionalise and enhance the credit risk assessment of commercial banks, 2) set up a Development Bank to source and position new long term loan funds and lead the way in the financing of major projects in the economy, 3) create the capability of Government to have independent expert advise on the structuring, evaluation and financing of public sector and Public-Private-Partnership (PPP) projects.

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1 Economic Development and Cost-Benefit Analysis

Economics is about using economic resources to maximise the utility of a society. In order to move an economy closer to that optimum point of economic welfare it is necessary to employ capital and labour and other factors of production such as land closer to their most efficient uses. However, to successfully accelerate the pace of economic development, in addition to increasing the levels of employment and attaining high efficiencies for the factors of economic production, it is also necessary to yield a good return on capital. This in effect means that a project scrutinised through a cost-benefit analysis test should have positive net present value (where the projected net cash flow discounted at the opportunity cost of capital is greater than zero). The methodology of cost benefit analysis for capital investment projects is well documented[2] and is applied worldwide successfully for over 50 years.

2 Risk Analysis and Project Financing

Moreover, because with any new project the outcome is by definition uncertain it is also desirable to evaluate the impact of alternative possible scenarios in light of the risks that are intrinsic to the project and ask whether there is the capability to overcome them. In other words any new investment project should have a manageable risk profile and the decision whether to undertake (and finance it) should depend on the outcome of this risk analysis[3]. If the project risks are properly identified and measured it is often possible to seek and find suitable solutions to mitigate and manage it among the different stakeholders of the project. The table below outlines the typical risks that a project is subject to and which must be assessed before the capital investment and finance decision is taken[4]:

[2]Harberger, Arnold C., and Glenn P. Jenkins 2000, Jenkins, G.P., 1998
[3]For the methodology of Risk Analysis in Investment Appraisal see Savvides, S C. 1994
[4]For an exposition on Analysing and providing for Market Risk in Project Evaluation see Savvides, S C. 2000

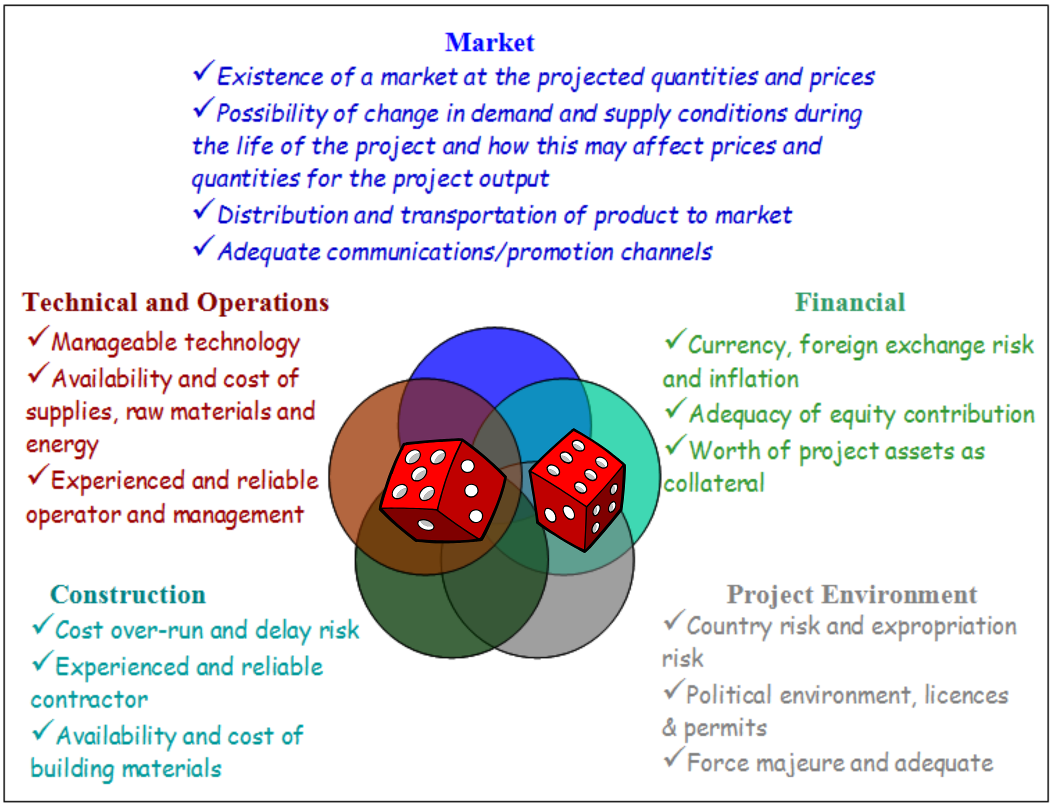

Figure 1: Sources of Project Risk

A proper and thoughtful appraisal of a proposed business plan seen through the prism of a sound financial model that accommodates for risk analysis will reveal and gauge a number of inherent risks which can be charted along the projected life of the project and most importantly from the point of view of the lending bank indicate how these may affect loan disbursements and loan service during the repayment period[5] (see Figure 2)[6].

[5]For complete case-studies that include financial, economic and risk analysis see: Andreas Andreou, Glenn Jenkins, Savvakis C. Savvides and 1990 and Andreas Andreou, Glenn Jenkins, Savvakis C. Savvides. 1991.
[6]Source: Savvides, S C. 2011

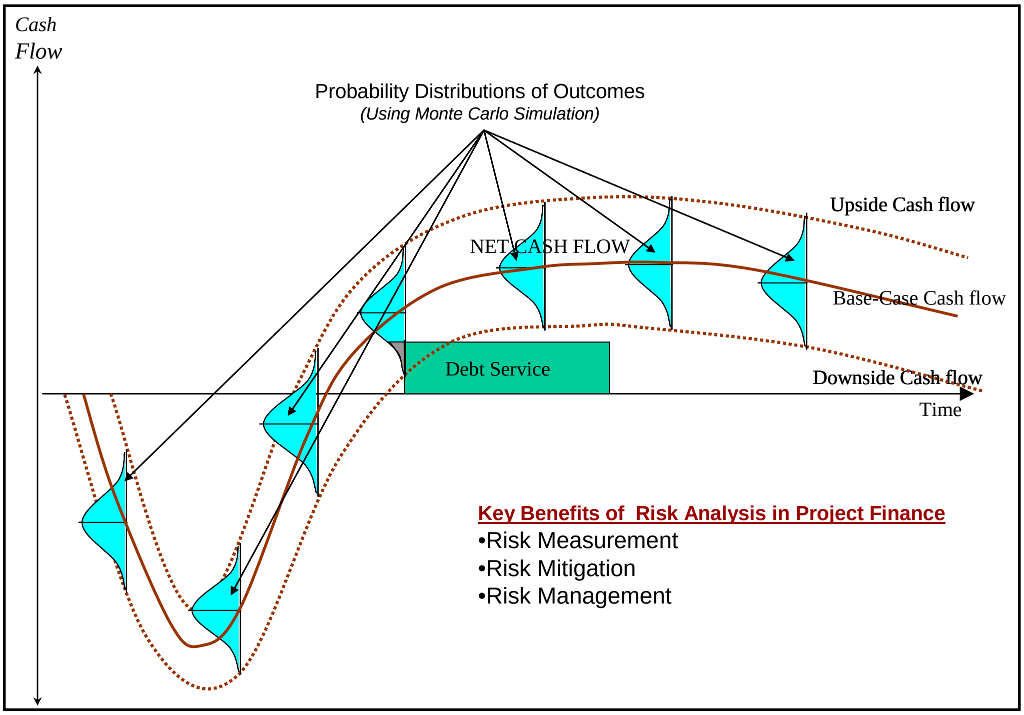

Figure 2: Risk Analysis on Projected Cash Flow

Sustainable economic development therefore can only be attained if capital investment and financing is directed towards funding the most viable and ergo competitive projects. Real economic development comes from building on solid grounds and from funding projects which add net customer value and are cost effective. Only viable and competitive projects promote the cause of economic development. This holds true for both foreign and local investment projects. An investment in a project which is likely to foreclose before its expected life span or that is likely to be unable to repay its loans only drags the economy even further into recession.

3 Project Stakeholder Analysis

The cash flow projections of any investment project should be looked at with respect to its different project stakeholders[7]; the "Owner" of the project which includes the loans and other inflows and outflows relating to the owners of the project, the "Banker" (or Total Investment view) where it is assumed that the project is all equity financed in order to show how good the project is in supporting the repayment of its obligations (including the loans it may wish to raise), and last but not least, the "Economy's View" where the basic cash flow is adapted and the prices adjusted to reflect the net benefits and costs arising to the Economy in general. Economic value (which is the building block of

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[7] Jenkins, G.P., 1998.

economic development) occurs when the net present value arising from the costs and benefits cash flow of a project from the Economy's perspective is positive.

Economic development therefore stems from investing and funding economically viable projects. It does not come about because a foreign or local investor is persuaded, or "bribed", to invest in a project he would never have invested in without the special concessions, subsidies, relaxations and tax exemptions that may have been made by an uninformed and over-eager government to attract foreign investment. This happens time and again where a public sector concession authority does not understand the distinction between an economically viable vis-à-vis a financially plausible from the Owner's point of view investment project. Non-viable investment projects inevitably only drag the economy even further into recession.

4 Conclusion

The requirement to identify, appraise and finance developmentally strong projects is even greater when there is a crying need for restructuring in order to get the economy out of recession. In such circumstances, a Government should be ready to make the necessary reforms and put in place those mechanisms necessary to facilitate this critical process for spearheading economic development. These may include the better regulation of banks so as to focus on their core savings and lending activities and the retraining/reorganisation necessary to enhance their capability to assess credit risk for restructuring existing loans[8] and for granting new ones. It may also consider the creation of a Reconstruction and Development Bank to take steps so as to secure and position long term funds and lead the way in the financing of major projects in the economy in a new development initiative. Last but not least, the Government should create its own capability so as to have independent expert advice on the structuring, evaluation and financing of public sector and Public-Private-Partnership (PPP) projects and for managing the project development and procurement process. Without a competent and totally independent professional body (such as a National Advisory and Finance Agency) it is practically impossible to ensure that the public is receiving value for money from a privatisation or a PPP project. Indeed, a newly created Development Bank in the model of the German KFW Bank can serve both as a lender to industry and as advisor to the Government on Public Sector and PPP projects. In the final analysis the Government should understand that economic development is best served when capital investment, whether from the Public or Private sector, is directed towards projects which are economically viable for the country under free market competitive conditions.

[8]Savvides, S C. 2011

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