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EUROPEAN DEFENCE FIRMS: THE INFORMATION BARRIER ON PRIVATE FINANCE*

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Abstract

After the fall of the Berlin Wall, European governments adopted a hands-off policy towards the defence industrial base, in an attempt to increase the sector's efficiency and reactivity. In this context, one topical issue is how to motivate defence firms to apply for private rather than public finance. Since banks have no prior experience with European defence firms, a problem of asymmetric information may block this transition. The problem is analysed within the framework of a game between defence firms and banks. It is shown that the Bayesian Equilibrium might correspond to a situation where low-risk firms prefer the state-financed scheme; yet, in a perfect information set-up, the same firms would apply for bank credit. In order to facilitate the transition to private finance, the government might decide to subsidize investors who agree on financing defence firms; the state aid should be made available during a transitory learning period.

*This research has benefited from the financial support of the Observatoire Economique de la Defence (OED) within the French Ministry of Defence. The views expressed in this paper are those of the authors and do not necessarily reflect the views of the OED. The designations employed and the presentation of the material do not imply the expression of any opinion whatsoever on the part of the OED. The authors are grateful to one anonymous referee, Jean Belin, Jean-Yves Caro and Marianne Guille for their suggestions and remarks that helped them to improve the quality of the text.

Q Keyword



Information

Notes

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¹See, on the one hand, Guyot and Vranceanu (2001), Hartley (2003), Hartley and Sandler (2003), Rouas et al. (2004), The

Economist ([2005](#)).

²The average leverage ratio of US defence firms is about 35% (Goyal et al., [2002](#)).

³See also the survey by Jaffe and Stiglitz ([1990](#)).

⁴For instance, see the surveys by Rogerson ([1994](#), [1995](#)). Either the firm or the government may defect on the initial terms of the contract. The higher the market power of one of the contracting parties, the higher the probability to aim at renegotiating the contract or shirking.

⁵Adding a second risk, related to external uncertainty stemming from the randomness of the government's commitment, would not change in a significant way the main insights of the model.

⁶Actually, firms hold several overlapping projects and the class of risk is a weighted average of the risks specific to each project. Assuming that the firm may be represented by one project is tantamount to considering a firm running identical-risk projects.

⁷These operating costs come due at the end of the period. The total production cost is $K(1 + r) +$ under private finance or $K(1 + i) +$ under public finance.

⁸Under a... of the debt
at a low... ate and
public fu... the model.

⁹Since a... outside
the dom...

¹⁰If π_1 w... arating
equil... smaller or
bigger...

¹¹A pool... be put
forward...

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