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In favour of the transformation of capitalism in Europe
Challenges and strategies for long-term financing

An Exit Strategy for the European Union and the Role of Long Term Investors

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The Effects of the Crisis on EU Public Finance

According to a recent report by the International Monetary Fund, the financial crisis will have a significant impact on the public finance of most countries throughout the world.

The debt/GDP ratios of the "advanced economies" within the G-20 will be at 101.8% of GDP in 2009 and could reach 121.7% in 2014 (see Table next slide).

The public debts of advanced economies are expected to expand the most, while those of the emerging countries should remain broadly stable at around 30% of GDP.

The former include: Japan (from 218% in 2009 to 245% in 2014), Italy (from 115.3% to 128.5%), the United States (from 84.8% to 108%), Germany (from 78.7% to 89.3%), France (from 78% to 96.3%) and the United Kingdom (from 68.7% to 98.3%).

And the latter: China (from 20.2% to 20%), Brazil (from 68.5% to 58.8%), India (from 84.7% to 78.6%), Mexico (from 47.8% to 44.3%) and Russia (unchanged at 7.2%).

Taking a long-term view, the debt/GDP ratios of countries with mature economies in 2050 could, if no major decisions are taken, even exceed 250%.

The Effects of the Crisis on EU Public Finance

	2007 (Pre-Crisis)	2009	2010	2014
EU-27	58,6	65,4	67,1	n.d.
Germany	63,4	78,8	84,5	89,3
France	63,8	78	85,4	96,3
UK	44,1	68,7	81,7	98,3
Italy	103,5	115,8	120,1	128,5
Japan	187,7	218,6	227	245,6
USA	61,9	84,8	93,6	108,2
Brazil	66,8	68,5	65,9	58,8
Argentina	67,9	60,5	58,1	46,4
Mexico	38,2	47,8	47,9	44,3
Russia	7,4	7,2	7,7	7,2
China	20,2	20,2	22,2	20
India	80,5	78,7	84,5	89,3
Advanced G-20 Economies	78,2	98,8	106,7	118,4
Emerging G-20 Economies	37,4	36,9	39,6	36,2
G-20 Countries	62	75,1	80,2	85,9

Source: IMF (November 2009).

The Effects of the Crisis on EU Public Finance

The state of European public finance is therefore under unprecedented stress.

In the short term, public budgets will have to face the cost of public interventions in the financial systems and the negative effects of the recession.

In the longer term, the cost of social expenditures, especially in pensions and health systems, in a society which is experiencing a rapid shift towards an older population, will put an heavy burden on the European fiscal framework.

The adjustment required for the next ten years to the EU-27 Member Countries is estimated by the IMF in 1,5% of GDP (either by cuts in public expenditures or by raising taxes).

How to Reduce Public Debt to GDP Ratios?

As we know, Public Debt to GPD ratios may be reduced thank to:

- Inflation
- Primary Surpluses
- Fostering Growth

The Effects of Inflation on EU Public Finance and Economic and Social Systems

The first route is not advisable, and in any event the ECB would do everything it can to counter it. However, at the global level (especially in the United States, which has a much more “flexible” monetary policy), we cannot rule out the possibility that higher inflation might be used to help deflating the debt balloon generated during the crisis.

It has been recently estimated (Rogoff) that with 6% inflation over the next five years the average ratio of government debt to GDP of the advanced economies could fall by 8-9 points, compared with the baseline scenario (inflation at 2%).

Obviously, double-digit inflation would have a significantly different impact. The experience of the 1970ss teaches us the harm which may come if such a path is taken.

In fact, it has been proved that high inflation:

- seriously distorts the allocation of resources,
- reduces the rate of economic growth,
- hits the poorest citizens the hardest,
- creates social and political instability,
- once unleashed is hard to contain and its negative effects are difficult to predict.

Price stability must therefore be maintained and central banks should do everything they can to ensure it.

Structural reforms of public expenditures and tax systems

The second option to reduce public debts is to carry on a major long term adjustment based on “real” structural reforms on the public expenditures and tax systems (like reform of the welfare state, fighting tax evasion, fiscal federalism and, generally, more compulsive rules on local expenditure’s responsibilities).

So the reforms forced by budget constraints are going to be a necessity but they may turn out to be also an opportunity.

Though necessary, they are not going to be sufficient. In fact, in the past 15 years they have given a modest contribution to deficit/debts reduction: they have supported and moreover “substituted” by one-off and/or creative accounting measures (as shown in the next slide)

The Effects of "One-Off Measures" and/or "Creative Accounting" in EU Public Finance Adjustments since 1992

It has been proved that most of the adjustments carried by EU Member States, since the Maastrichjt Treaty came into action (1992), have been based on one-off measures and/or so-called "Fiscal Gimmiks" or "Creative Accounting" without structural impact on government finances. They include:

- Capital Injections and Recapitalization
- Special Dividends
- Asset Sales (Privatization and Corporatization)
- Securitization
- Quasi-Fiscal Activities
- "Off-Budget" Items and Infrastructure Spending
- Tax Amnesties
- Cash/accrual effects on primary expenditures
- Other "window dressing" operations

But today we need a greater contribution by positive structural primary balances also because there is no more room for such one-off measures.

The Positive Effects of Growth in EU Public Finance

Increasing the average rate of GDP growth is the most desirable solution to reduce public debt to GDP ratios, but it is also not easy to achieve.

Countries with mature economies have had modest, if not stagnant, rates of economic growth (in the last 15 years, growth has not exceeded 2% per year, while in the 30 years prior to that, growth was around 5%).

The much vaunted reforms to liberalize markets, boost competition and give free-market forces more room have not yet achieved the desired results.

Nevertheless, growth is a strong ally in the fight against the debt. For example, with debt equal to 100% of GDP, an annual 1% year increase in growth (assuming constant public spending and a tax burden of 40%) could reduce the debt/GDP ratio by 28 percentage points over 10 years.

One feasible way to stimulate growth is to channel major flows of long-term capital in European initiatives with strong "positive externalities" for the economic system, for the environment and for social cohesion, in sectors such as energy, climate change, transport, R&D, human capital, TLC, and the like. Investments that can make a significant contribution to growth, while using the least amount of public resources possible.

The Strenghts of Euroland

•Historical high European households' savings' rates.

•The European Union's and Euro - thanks to the results of the Stability and Growth Pact and the ECB's rigorous anti-inflation policy – has a strong reputation on the global markets.

•Moreover, financial capital surplus countries (especially in emerging economies with low public debts such as China, Singapore, Russia, Arab Gulf Countries, India, Brazil, Mexico) may find Euro denominated investments attractive (also as a way to diversify their dollar denominated investment products).

Therefore Euro denominated long term instruments to finance EU strategic investments may find in European households' savings and global markets the resources needed (outside the national public budgets).

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EU Denominated Financial Instruments will be competitive in the global financial markets of the future

Europe appears to be in a good position to increase its leverage to attract capital from the global markets and thereby finance policies that involve long-term investment in infrastructure projects (transportation, energy, telecommunications).

European infrastructure projects will have to (and should) seek financing from private European or non-European capital and non-EU public capital rather than rely on the unlikely prospect of receiving funding from government budgets.

The Demand for Infrastructure in the EU-27

The demand for infrastructure in Europe is huge.

The overall cost of the Trans-European Transport Network (TEN-T) still to be financed has been assessed at around €500 million by 2020. Priority projects alone will cost an estimated €270 billion until 2020:

The overall cost investments in Energy and Climate Change is estimated in over 2,500 billion by 2020. It includes energy infrastructure (electricity transmission, gas pipelines, and in liquefied natural gas terminals), energy generation, renewable energies (solar, wind power, biomass) and environment systems and infrastructures.

The Future Supply and Demand for Long Term Investments

How can Europe attract financial resources from European private investors and extra European private/public investors for financing strategic European projects in the fields of innovation, infrastructures, human capital, renewable energies, TLC, biotechnologies, notwithstanding their long term and moderate (not speculative) IRR?

EU should build up on a wide range of attractive instruments:

- **fiscal incentives and special regulatory and accounting rules for long term investments with strong "positive externalities";**
- **a class of new financial instruments to finance long term projects/initiatives with moderate (non speculative) yield but with a low risk profile thank their issuers' high institutional standing/reputation;**
- **by promoting the action of a selected class of special long term investors with special public endorsement and/or guarantees, collecting private financial resources.**

A definition of a New Class of Investors

The Financial Institutions which may be "eligible" to be considered as Long Term Investors are, first of all, the institutions owned by public, semi-public or non-profit entities (States, Local Authorities, Banking Foundations, and the like):

- **they do not seek speculative IRR or strong capital gains (also thank to the structure of their balance sheets which enable them to retain assets in their portfolios in times of crisis thus playing a counter-cyclical role in the financial markets);**
- **they are able to spread risks between generations;**
- **and finally have, generally, a clear social responsibility in their missions.**

This allows them to "accept" non speculative returns on their investments, as well as the willingness and the capacity to keep in their books long term assets and liabilities.

Other institutional financial investors, such as large pension funds, insurance companies, Italian Banking Foundations, non-profit institutions, development banks and SWFs, may also be considered Long Term Investors if they decide to allocate some or most of their assets in that same type of investments.

New Instruments for Financing Long Term European Strategic Investments

- EU Equity Funds
- EU Project Bonds
- EU Debt
- EU Guarantee Schemes and, generally, “credit enhancement” initiatives

The “Marguerite Fund”

The “2020 European Fund for Energy, Climate Change and Infrastructure (Marguerite)” is a pan-European equity fund for investment in energy, climate change and infrastructure. It has been set up few days ago by:

European Commission
European Investment Bank (EIB)
Caisse des Dépôts et Consignations (CDC - France)
Cassa Depositi e Prestiti (CdP - Italy)
KfW Bankengruppe (KfW - Germany)
Instituto de Crédito Oficial (ICO - Spain)
Powszechna Kasa Oszczędności Bank Polski (PKO - Poland)
British Treasury (through UK Partnership)

It was endorsed in December 2008 by ECOFIN and the European Council as a key measure of the European Economic Recovery Plan (EERP).

The “Marguerite Fund” Development Role of the Fund

The Fund will fullfill a clear policy role by the following means:

• Investments to focus on sectors/projects with solid IRR and satisfactory Economic Rates of Return (ERR)

• Focus on Greenfield projects in priority energy and infrastructure sectors as identified by the Fund as well as the Commission the Core Sponsors and other investors (TEN-T, TEN-E and particularly interconnectors, gas storage and LNGs, Renewable energies, including, distribution and hybrid transport systems);

• Fund will be an investment vehicle for long term institutional investors from both the public and private sectors.

The “Marguerite Fund” - Philosophy

The Fund will be “market oriented” but it will be characterized by three main features which would make it a quite “unique” instrument in the European financial landscape of Private Equity Funds:

•it will seek "non speculative returns";

•it will have Long Term horizon in its investments;

•it will have an institutional endorsement by the European Commission.

A similar initiative in the area of the Union for the Mediterranean has been taken with the creation of the Equity Fund InfraMed, by a joint initiative of CDC and CDP (the EIB).

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The “Marguerite Fund” - Size

The expected total fund size is EUR 1.5 billion.

It is estimated that over the next few years, thanks to its multiplier and support effect for private funds, the Fund will be able to mobilise investments on the order of €30 billion-€50 billion in the European energy and infrastructure sectors.

The Fund will mainly invest in equity stakes, but it will also have associated debt facilities managed directly by each individual institution.

These additional facilities could potentially mobilize many billions of euros in additional resources.

The “Marguerite Network”
A “European Super Fund for Growth”
Future Perspectives

The Marguerite Fund is one of the first examples of “reinforced cooperation” in the European financial sector (the first was the Euro).

It can be viewed as the first “product” turned out by a new “laboratory”.

If successful, it could become the prototype for a “family of European Funds for Growth” to support the market in financing the ambitious objectives of the Lisbon Agenda.

EU Project Bonds
A Potential Institutional New Bond Market

Another financial instrument, that may be a more cost efficient alternative to debt financing, is issuing Project Bonds.

Transport and energy project bonds may be an interesting long term investment opportunity for institutional investors such as pension funds, insurance companies, SWFs, and households.

The Project Bonds may be sponsored by the “Marguerite Network”.

The Network guaranteed Project Bond would be issued by the project company.

In other words the investors in such bonds would primarily assume the Network risk.

EU Project Bonds
A Potential Institutional New Bond Market

The “reputation premium”, which may come from the EU endorsement and by the “high standing” of the long term institutions involved, as project sponsors, may:

•decrease the cost of financing,

•increase the credit ratings of the bonds,

•creating an asset class which may attract large institutional investors (by matching their own liabilities – long term, fixed income) and medium size European (retail) households’ savings.

Moreover, thank to well prepared projects, financing could be contracted directly from the financial market, without a need to appear in the accounts of the Governments.

Eurobonds

Issuing Eurobonds, that is issuing European sovereign debt, is another possibility to create a class of European bonds which may be attractive to global investors.

The rationale behind the Eurobond Proposal is well known:

•The European Union needs to attract, as much resources as possible, from the global markets to finance its strategic investments;

•Such investments are key to the making of Europe as one of the most advanced area of the world in terms of knowledge, technology, environment, culture, social cohesion and civilization.

In the coming future, global markets are going to experience an impressive growth in the supply of financial assets from the emerging economies. There is going to be a competition among regions of the world to attract that investments. The USA, thank to the strength of the dollar, has been able to borrow from all other countries of the world, to finance its growth.

Why Europe should not start to do the same?

Eurobonds
A “Sovereign Union Bond Market”
The potential size

The market for US federal government securities is around \$2,500 billion. The equivalent sovereign European debt would be around 13.5% of the European Union's GDP.

This is a relatively modest portion of the total public debt of the EU-27 member states is estimated to rise to 72% in 2009 and 79.4% in 2010. Nevertheless, this is a sufficient portion for making truly significant strategic investments.

Incentives for Long Term Investments

For strengthening the contribution of Long Term Investors a new regulatory framework is needed, including ad hoc systems of incentives:

in the accounting standards

prudential principles

taxation systems

corporate governance

As proposed by the de Larosière Group Report on Financial Regulation and Supervision.

Regulatory and Accounting Rules
The problem of the mark to market

Accounting rules should be adapted in order to make it possible to value a long-term investment based on a weighting for its market value, while also taking into account the value of its future cash flow over the long term.

These should, at least, reflect long-term investors specific business model.

The accounting and prudential treatment of financial assets giving priority to their marked to market value is standing in the way of long-term investment. Not only is long term investment not enough promoted, but current rules incite Long Term Investors to adopt short termist behaviours.

Due to the mark to market rule, the contingencies affecting the value of these investments over the short term are having repercussions over time on the financial statements - higher earnings volatility and additional solvency requirements -, although the actual horizon for these investments goes beyond that for the publication of the accounts.

Regulatory and Accounting Rules
The problem of the mark to market

The mark to market accounting rules introduced with the IAS also for typical long term investors such as Pension Funds and Insurance Companies did not allow in their ALM for any distinction between short term and long term investments.

Regulatory and accounting experts are now trying to introduce accounting criteria that distinguish between different temporal durations/matching of liabilities and investments.

Also the theory of finance is looking for new dynamic risk management models for these long term type of investors.

For instance, a Pension Fund efficient system of ALM should be able to match the value of different investments with the demographics of its associates. Similarly for a Life Insurance Company.

Fiscal Incentives for Long Term Investments

From a fiscal policy point of view, we may even think of introducing special *ad hoc* incentives for financial products and for firms which invest in the long term initiatives of general national or European public interest, on the lines of the fiscal incentives granted to the US Project Bonds recently launched by the American Administration Stimulus Plan.

The fiscal incentives may go directly in favour of the investors. This may trigger arbitrage effects. However, this is exactly what the incentive is trying to achieve, that is to make it more convenient for investors to hold long term rather that short term and speculative investments. This is the same logic behind the fiscal disincentive that a buyer of a real estate asset has in selling back it before a reasonable period of time which does not allow for a speculative operation (usually 3-5 years).

Fiscal Incentives for Long Term Investments

The fiscal incentive may also be in favour of financial institutions which decide to be hold part or all of their assets as long time investments. The fiscal incentive in this case would go to the type of investor.

The fiscal incentive may also go, not to the type of investor, but to the type investments. Some investments may be eligible to be long term investments if they have certain specific characteristics. The characteristics may regard the financial structure of the investments, which then relates to a long term type of project. Then types of projects and sectors may also become specific characteristics which make them eligible for special type of fiscal incentives.

In short, there are different possibilities which should be explored to create a system of fiscal incentives as part of a policy that Governments may decide to pursue to support and stimulate long term investments, because these type if investments or of investors in their activity give a contribution for the production of “positive externalities” for the economy and for society as a whole.

Why Europe

We have been speaking so far about Europe, though the instruments and the suggestions proposed may also be applied to the National States. But, while waiting for a global regulation, only Europe has the sufficient size to be financially attractive.

Moreover, the instruments proposed are needed for overcoming a very probable impasse in next European financial perspectives negotiations between:

- **on the one hand, the need to finance great European projects to exit from the crisis and to make the new European public and common goods (*the new Lisbon Agenda*);**
- **on the other hand, the difficulty, exacerbated by the crisis, to finance those project through the increase of Europe's own resources or new common European recipes.**