OECD FORUM 2010

Attracting Capitals from Global Markets for financing European Future Growth

Franco BASSANINI
President of Astrid Foundation
Chairman of Cassa Depositi e Prestiti

Paris
May 26, 2010
www.cassaddpp.it
www.astrid.eu - www.bassanini.eu

1. How will growth and longer term development be affected by public debt burdens? Will governments and the private sector rise to the challenge of achieving green growth?

Growth and Longer Term Development

- Public debt/GDP ratios of "advanced economies" within the G-20 peaked to 102% in 2009 and are expected to reach 122% in 2014.
- Restoring sustainable debt over the medium term will be indeed a formidable task.
- The adjustment required should be based on structural reforms of 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)
- Such a large medium long term fiscal consolidation will most probably slow down growth rates.
- ***Harvard economists Christoph Reinhart and Kenneth Rogoff have recently shown that, historically, countries with public debt/GDP ratios over 90% grew 1% less than countries with ratios under 90%.***

The Potential Contribution of Long Term Investments to Growth

- **Low growth, reducing tax revenues and increasing debt to GDP ratios, will make harder the adjustments required.**
- Therefore, together with structural reforms, sustaining long-run growth should be the first priority of policy makers. For doing so, increased investments in infrastructure and “common goods” are needed.
- Major investments in the fields of innovation, renewable energies, water networks, telecommunications and transport infrastructures are in any case required for shifting to a low-carbon economy, coping with the scarcity of natural resources, adapting to rapid urbanization and increasing competitiveness.
- These are all sectors which themselves can yield high investment returns, stimulate follow-on investment and, as a result, create growth and jobs.

Long Term Investments for a strong, balanced and sustainable growth

- In the so called “Golden Age” (1950-1973) annual growth rates in Europe exceed 5%. That made public debts levels stationary under 50% and highly sustainable.
- There are many different reasons for such a good economic performance. One of which was certainly a very high level of long term public and private investments in infrastructure .
- Investments in green Economy and in “common goods” may play the same role in the next decades.
- That would also mean to increase the quota of growth based on “commons” (which generally reduces CO_2) and decrease the one based on “consumers’ goods” (which generally increases CO_2)

Golden Rule and investments in “common goods”

- The demand in Europe for Infrastructure, Energy, Climate Change, Strategic and Urban Infrastructure in Europe is huge. It is estimated in over 3,000 bn euro in the next ten years!

- Some new form of Golden Rule (extended also to the financing of European long term investments) may perhaps be reconsidered in the new Growth and Stability Pact (GSP)

- Anyway, it is clear that the European countries will not be able to finance such investments mainly with their own budget resources as do low public debt countries (such as China, Korea, Russia, Australia, etc.)

The Public/Private "Complementary" Approach

- **We need , then to attract larger amounts of private capitals, ready to invest long term**
- But we know, from economic theory, that high public debt produce the so called "crowding out effect" of private investments
- This - I suggest - maybe avoided if the public and private sector work together building strong "complementarities" - i.e. if new forms in the relationship between the public and the private sectors should be explored
- But also **by:**
  - **Fiscal Incentives**
  - **New regulatory and accounting rules for long term investments**
  - **Incentives for PPPs and PFIs**
  - **New financial instruments (Long Term Equity Funds, Project Bonds, Guarantee Schemes)**

Long Term Investments for a strong, balanced and sustainable growth

- Policy-makers will not achieve their dual aim of restoring economic growth and preventing a repeat of the recent market meltdown unless they set in place the **right conditions to foster long-term investment**.
- The market collapse was primarily caused by two factors: An obsession with short-term priorities by investors, and a profound disconnect between financial instruments and the needs of the real economy.
- The implementation of long-term global objectives, such as infrastructure building and fighting climate change is not only an absolute necessity. It is also a means, in itself, to recovery.

2. How to restore trust and confidence in banks and the financial system? Will current discussions on financial regulation be able to respond to calls for a more solid and transparent financial sector?

Financial System Regulation

- Both U.S. and E.U. are developing measures aimed at improving stabilization of financial markets, like, for instance, centralization of derivatives exchanges through clearinghouses and emission of "European passport" for hedge funds and private equity funds operating in Europe.

- A clearer operational division between banking institutions (which focus on standard lending and borrowing activities) and securities firms (which provide intermediation in selling and buying risks) might be , in some cases, desirable.

Financial System Regulation

- Financial innovations, along with massive liquidity and low interest rates, created a huge credit expansion.

- At the same time, “interest conflicts”, asymmetric information, and supervision failures generated lack of transparency about the real quality of the assets traded in the market.

- Risky financial products like, in particular, the so-called “credit default swaps” (CDSs), “off-balance sheet” operations, and “subprime” mortgage loans produced a leverage effect on existing risks, instead of spreading them out.

Financial System Regulation

Major reforms should be targeted to:

- raise quantity and quality of capital
- limit leverage and introduce countercyclical tools
- improve structural liquidity
- harmonize the set of norms about regulatory capital
- support mandatory disclosure
- tighten the rules of "off-balance sheet" operations
- revise functioning criteria of Credit Risk Agencies (CRAs)
- avoid biases on risk business models due to accounting standards
- strengthen supervision authorities

But, as a representative of a long term financial institution (CDP) and of Long-Term Investors (LTIs) Club I will just say a few words on the reforms which are needed to reiforce long term investments.

Financial System Regulation

- The current crisis was largely caused by the short-termist behaviour of financial markets and by the disconnect between investment strategies and the needs of the real economy.

- The so-called “shareholders’ capitalism” created strong incentives to maximize short-term, rather than long-term, value. Indeed, managers of the firms were “winners” if they maximized the value of the shares, which was directly related to generous bonuses and stock options.

- The excess of liquidity - originated in the 1970s with the “petrodollars” - coupled with deregulation of financial markets and institutions, exacerbated arbitrage and short-term speculation.

Financial System Regulation

- Moreover, the “mark to market” accounting rules, applied also to typical long-term investors such as pension funds, insurance companies, sovereign wealth funds and development banks, did not permit any distinction between short-term and long-term investment values in their balance sheets.

- Regulatory and accounting experts should introduce accounting criteria distinguishing between different temporal durations/matching of liabilities and investments, as recommended by the de Larosière Report.

- Appropriate accounting rules for long-term investors would also give a substantial contribution to stabilize global financial markets and reduce short-term volatility.

3. How to ensure coherent financing for regional infrastructure – do we need a reinforced co-operation system for financing such projects?

Positive Effects of Growth in EU Member States 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.
- Reforms to liberalize markets, boost competition and cut regulatory burdens are always necessary but alone have shown not to be able of achieving the desired results as yet .
- To strengthen growth we need to channel major flows of long-term private 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. While using the least amount of public resources possible.

The Strenghts of Euroland

- Historically Europe has high households' savings' rates.

- Financial capital surplus countries (especially in low public debts emerging economies 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).

.

The “Marguerite Fund”

A first example of an EU long term financial instruments is the **“2020 European Fund for Energy, Climate Change and Infrastructure (Marguerite)”** set up recently 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)

- It is a pan-European equity fund for investment in energy, climate change and infrastructure, with a target of 1,5 bn euros and a 5 bn debt facility.
- 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 Network": a reinforced cooperation?

- The Marguerite Fund is in fact a good example of "reinforced cooperation" in the European financial sector (the first was the Euro). It could become the prototype of a "family of European Funds for Growth" to support the market in financing the objectives of the Lisbon Agenda.

- In fact, this is not a cooperation among the EU member States, but among some long term investors totally or partially owned by the States : The "Marguerite Network".

The “Marguerite Network” and its Instruments

- The Marguerite Network will launch other initiatives for financing with private capital European long term investments such as:
  - Some other Equity Funds (like InfraMed, Fond Fonds Carbone Mediterranéen),
  - Project Bonds
  - Guarantee schemes

- 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.

Long Term Investors: a New Class of Financial Institutions

- More generally speaking, long term investors may play a key role in sustaining directly and attraction capitals for strategic investments.
- 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), but also large pension funds, insurance companies, non-profit institutions, development banks and SWFs if:
  - 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 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.

Why Europe

Many of the policies and instruments proposed could be carried out also by national governments, but only Europe has the sufficient size to be financial attractive. While waiting for global regulation, only Europe can provide rules and incentives for private or public/private long term investments.

Moreover, the rules and 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.

To conclude

To conclude, Europe should use all its policy (rules and incentives) and financial instruments to involve and associate private capital in creating value for future generations, restoring fiscal stability, strengthening growth and increasing the quota of growth based on public and common goods.