

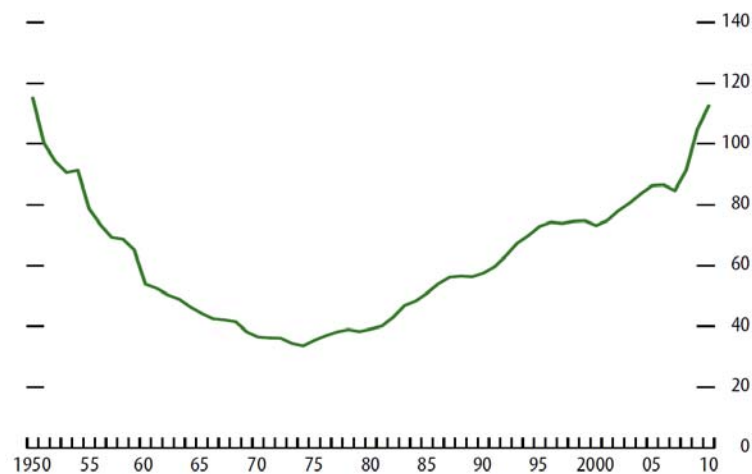
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## The Long-Term Investments in the Age of Globalisation<sup>1</sup>

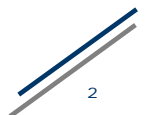
**Public finance of advanced economies is under stress. The levels of public debt of G-7 countries soared to post-war levels.**

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### Sovereign Debt to GDP (%) in the G-7



Source: IMF, *Global Financial Stability Report*, April 2010.

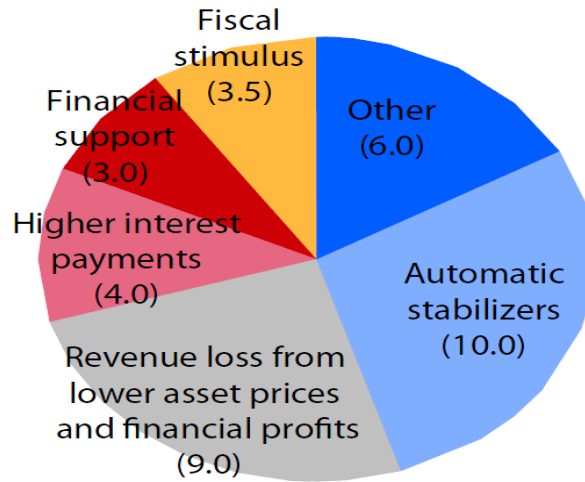


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**Public budgets are debilitated by recession, and drained by government interventions to save financial institutions and other sectors weakened by a waning economy.**

<sup>1</sup> Revised text of the Introductory speech delivered at the Second International Conference of the Long-Term Investors Club, Rome, June, 17th 2010. Edoardo Reviglio and Gianfranco Di Vaio remarkably contributed to the draft.

### Decomposition of Government Debt Increase, 2007-2014



Source: IMF, *World Economic Outlook*, April 2010.

4

### Financial Support Operations in USA, UK and Europe

	Capital injections	Guarantees	Other	Total	N. of Financial Institutions	Bought and/or Given Back	Net	N. of Financial Institutions
USA	367	1.197	97	1.662	702	402	1.260	78
UK	86	704	3	362	13	68	294	2
Europe *	188	512	25	1.156	102	117	777	9

(\*) Europe includes: Austria, Belgium, Denmark, France, Germany, Greece, Ireland, Island, Italy, Luxemburg, Holland, Portugal, Spain and Switzerland.

Source: R&S Mediobanca, May 31st 2010.

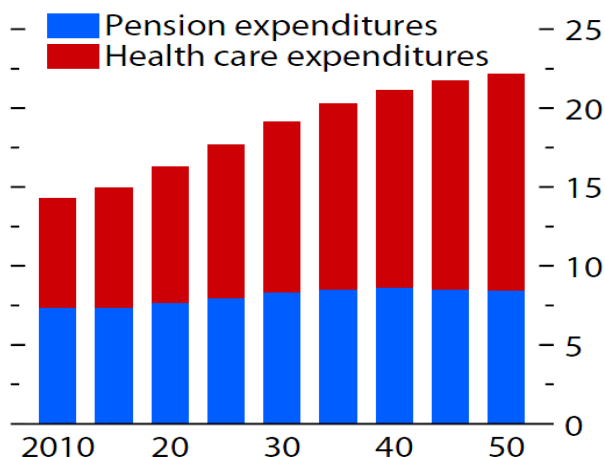


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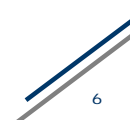
Most advanced economies need to lower their deficits and their debt substantially. Some are already experiencing strong financial market pressure to do so.

Moreover, in the coming years the debt reduction will have to face the negative effects of low growth rates and the increasing costs of the welfare state, in a society which supports a growing population of aging citizens.

## Aging-Related Spending in G20 Advanced Economies



Source: IMF, *World Economic Outlook*, April 2010.



\* \* \*

**The problem therefore is “structural” not just cyclical.**

Restoring sustainable debt over the medium term will be indeed a very challenging task.

Strong inflation could reduce public debt. But high inflation seriously distorts the allocation of resources, reduces the growth rate, hits the poorest citizens, creates social and political instability. Moreover, once unleashed, inflation is hard to contain. Then, price stability must be maintained and Central Banks should work to ensure it.

Major cuts in public spending are possible, but politically difficult. In the long term they may seriously jeopardize the political consensus of Governments.

Together with relevant but sustainable cuts in public spending, increasing the average rate of GDP growth is then the most desirable solution to reduce public debt to GDP ratios.

It is 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 to achieve the desired results as yet.

\* \* \*

**A further demand-side boost for the economy, like to the one recently enacted by the United States and Chinese governments, could represent a partial solution. Increasing investment is always crucial to foster economic growth.**

Investment in strategic sectors – like infrastructures, research and technological innovation, environment, alternative energy sourcing, biotechnologies – could foster economic growth and enhance competitiveness and productivity. These are all sectors which themselves may yield high investment returns, stimulate follow-on investment and, as a result, create growth and jobs. So, their annual contribution to the growth rate of per capita GDP might be substantial in magnitude. Moreover, these kinds of investments should play a central role in shifting European growth, increasing the quota based on “public and common goods” (which generally reduce CO2 emissions) and decreasing the quota produced by “consumer goods” (which generally increase CO2 emissions).

In fact, the demand for infrastructure, energy, climate change, strategic and urban infrastructure in Europe is very large. It is estimated at over 3,000 bn euro in the next ten years.

During the so called “Golden Age” (1950-1973) annual growth rates in Europe exceeded 5%. Public debts levels - stationary under 50% of GDP - were highly sustainable. Such strong rates of growth were possible thanks to very high level of investments in infrastructure.

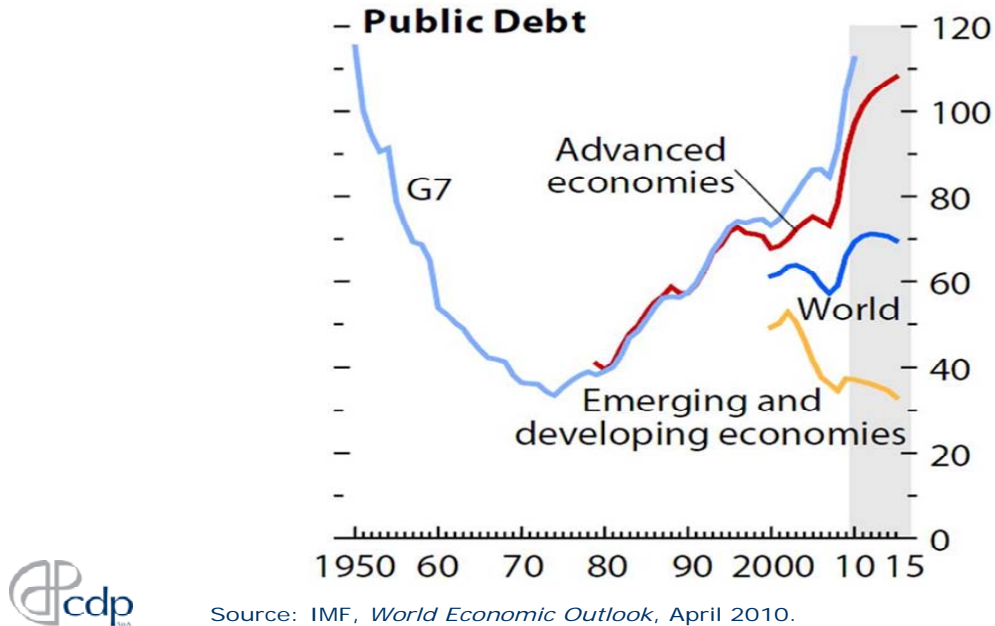
Investments in green economy may play the same role in the next decades.

\* \* \*

**Therefore: the most desirable solution to reduce EU public debt to GDP ratios and restore fiscal stability is to increase the average growth rate; a feasible way to stimulate growth is to channel major flows of long-term capital in regional and cross-border initiatives, with strong positive externalities for the economic system and social cohesion.**

But, where do we get the resources to finance such ambitious regional and cross-border programs of long term strategic investments? Increased government deficits required by the recent crisis imply that government spending cannot, under actual macroeconomic conditions, provide the desired level of investment.

It is clear that the European countries will not be able to finance such investments mainly with their own budget resources as high growth and low public debt countries (such as China, Korea, Russia, Australia) can do (and decided to do).

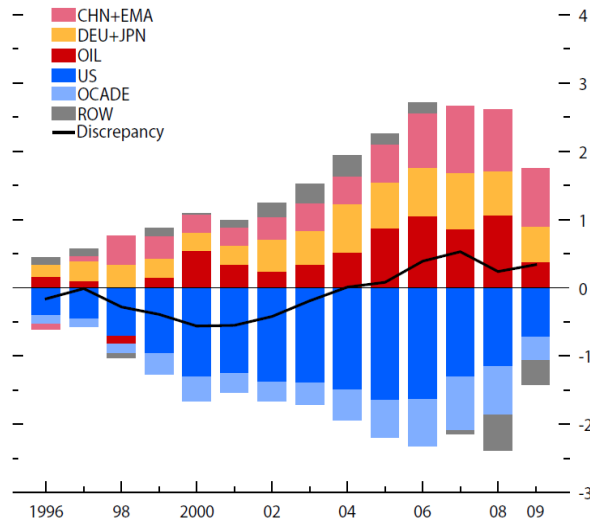
**General Government Public Debt (percentage of GDP)**

Therefore, Europe, should enact policies to raise (to attract) capital from the private sector and from extra European public and private sectors for financing European strategic investments.

Historically Europe has high household savings rates. The Household savings may be a very important asset.

With new rules, incentives and financial instruments, Euro denominated investments could become more attractive also for financial capital surplus countries searching a way to diversify their asset allocation. I think especially to low public debts emerging countries such as China, Singapore, Russia, Arab Gulf Countries, India, Brazil, Mexico, Saudi Arabia.

## Global Imbalances: Current Account Balance in Percent of World GDP<sup>1</sup>

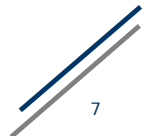


Source: IMF staff calculations.

<sup>1</sup>CHN+EMA: China, Hong Kong SAR, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, Thailand; DEU+JPN: Germany and Japan; OIL: Oil exporters; US: United States; OCADE: other current-account-deficit economies; ROW: rest of the world.



Source: IMF, *World Economic Outlook*, April 2010.

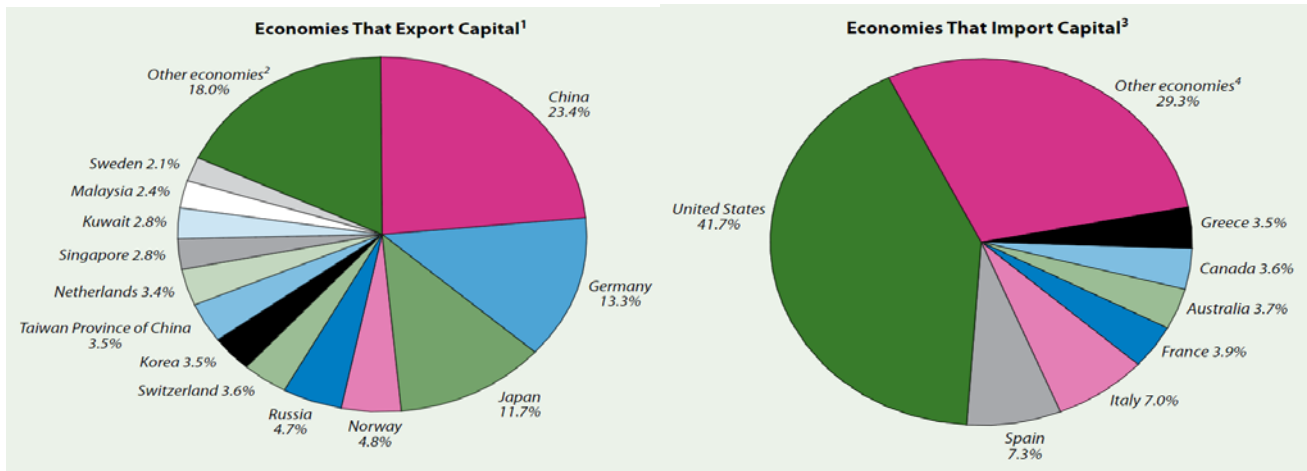


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As recently shown by OECD Economics Departments, current accounts imbalances in the next decades – to the extent that they reflect increased financial integration and a more efficient allocation of global savings - may become a source for financing long term initiatives.

Therefore Euro denominated long term instruments to finance EU strategic investments may find not only in European households' savings but also in the global markets the resources needed.

## Major Net Exporters and Importers of Capital in 2009



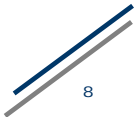
Source: IMF, World Economic Outlook database as of March 10, 2010.

<sup>1</sup> As measured by economies' current account surplus (assuming errors and omissions are part of the capital and financial accounts).

<sup>2</sup> Other economies include all economies with shares of total surplus less than 2.1 percent.

<sup>3</sup> As measured by economies' current account deficit (assuming errors and omissions are part of the capital and financial accounts).

<sup>4</sup> Other economies include all economies with shares of total deficit less than 3.5 percent.



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### How to attract this capital?

To support long term investments, public and private sector must work together to build strong “complementarities”: new forms should be explored. New rules and incentives for PPPs and PFIs and new EU endorsed financial instruments should then be introduced.

A new regulatory framework - more friendly with long term investment or, at least, not discriminatory against it - is also needed. It should involve accounting standards, prudential principles, and corporate governance, as well as “ad hoc” systems of fiscal incentives, as proposed by the de Larosière Group Report on Financial Regulation and Supervision.

As for the accounting standards, the “mark to market” principle, if applied to typical long-term investors, does not permit distinctions between short-term and long-term investment values in balance sheets. There is need to i) introduce accounting criteria that reflect long-term investors specific business model; ii) distinguish between different temporal durations/matching liabilities and investments; and ii) take into account the value of future cash flow over the long-term.

Appropriate accounting rules for long-term investors would also make a substantial contribution towards stabilising global financial markets and reducing short-term volatility.

The prudential treatment of financial assets giving priority to their mark to market value is standing in the way of long-term investment. The mark to market accounting rules applied to typical long-term investors do not incorporate in their ALM distinctions between short-term and long-term investments. Therefore, a change in the prudential principles might be recommended. 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.

\* \* \*

**I**n the last decades, the shareholder's model of corporate governance has gradually become the dominant mode of organizing listed corporations in the world.

The shareholder's model is generally characterized by a lack of social responsibility. The management is contractually linked only to the shareholders and not to the stakeholders, since managers try to maximize the value of the shares, which is directly related to their remunerations.

This model was partly responsible for the excessive “shorttermism” that characterized the managers' behaviour in the last few years. We therefore may have to rethink the foundations of such a conceptual apparatus, by rebalancing the incentives mechanisms in order to favour the long-term stakeholders' interests, instead of the short-term shareholders' values.

\* \* \*

**F**rom a fiscal policy point of view, in many European Countries the strategic long term investments are disadvantaged compared to financial short term investments. It seems to me that, above all, these discriminatory tax disincentives should be abolished.

Considering the important positive externalities of the strategic long term investments, we may moreover think to introduce “ad hoc” incentives for financial products and firms that invest in the long-term initiatives of general interest, on the lines of the fiscal incentives granted to the US Project Bonds by the American Administration Stimulus Plan and of the incentives awarded to the renewable energy projects by many European tax systems. Following the same logic, however, higher tax rates are frequently provided for the selling back of real estate assets bought few years before (usually 3-5 years), presuming a speculative transaction.

The fiscal incentives could go directly in favour of the long term investors, trying to make more convenient to hold long-term rather than short-term investments.



Tax expenditures for long-term investments should not be considered in the Maastricht criteria.

More generally speaking, in the rethinking of the European Growth and Stability Pact, some kind of new “Golden Rule” should be applied to the duration of investments. Long term strategic investment with over 25/30-years time span, and/or the related guarantee schemes, should be considered not under primary spending, but as a fixed investment having a special accounting treatment within the European statistical framework.

\* \* \*

As many OECD Reports have shown, private and foreign investment in PPP and PFIs require also a good and stable regulatory framework, with sustainable regulatory and bureaucratic costs, efficient civil service and government services and a reliable judicial system. In many European Countries (including Italy), better regulation is the first requirement for attracting private and private/public foreign strategic investment.

Independent authorities are needed both for enacting proper rules and regulations not subject to the politicians’ fickle interest and will, and for assuring an impartial enforcement of these rules.

A good example could be offered by Italy, where relevant investments are required in some utilities sectors such as water supply, waste disposal and incinerators, but are discouraged by the lack of an independent regulatory authority, assuring proper rules and rates.

\* \* \*

As for the European new financial instruments, usable for attracting private capital and public/private foreign capital in long term European strategic investments, a first example is the “2020 European Fund for Energy, Climate Change and Infrastructure (Marguerite)”, a pan-European equity fund for investment in energy, climate change and infrastructure, set up recently by six public banks, following a suggestion of the Italian Finance Minister Giulio Tremonti.

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

The Marguerite Fund is in fact a good example of “reinforced cooperation” in the European financial sector, although not a cooperation among EU member States, but among some long term investors totally or partially owned by the EU member States.

Other common financial instruments to make more attractive European project finance initiatives should be considered, such as Project Bonds and Guarantee Schemes.

The “reputation premium”, which may come from the EU endorsement and from the “high standing” of the long term institutions involved, as project sponsors, may decrease the cost of financing of these large PFI initiatives. Increasing the credit ratings of the financing instruments could create an asset class which may attract large institutional investors from different regions of the world.

\* \* \*

**M**any 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.

Action to foster growth in the European economy is in the Agenda of the European Council, in the framework of the “Europe 2020” strategy, which sets out a long term vision of Europe's social market economy for the 21st century.

To deliver rapid and lasting results, stronger economic governance will be required. I believe that the new governance planned by the European Union should include also a strong support of long term investments.

Europe can succeed if it acts collectively, as a Union.

In the future EU long term investments will create value for next generations, give a contribution to restore fiscal stability, strengthen growth and increase public and common goods.