New Instruments for Financing European Strategic Infrastructures

A contribution to the European Exit Strategy[1]

by

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European public finance is under unprecedented stress. Recent IMF estimates, predict public debt to GDP ratio in the Euro region nearing 100% by 2014. Germany, France and the UK are likely to reach 90%.

Public budgets are debilitated by recession and drained by government interventions buttressing dysfunctional financial institutions and other sectors weakened by a waning economy. The situation will not improve with time. The cost of a Welfare State – in a society which supports a growing population of aging citizens, will put a heavy burden on Europe's fiscal framework. Cuts in public spending may be possible, but they are

[1] This note is an abstract of the paper presented at the Goteborg Eurofi Financial Conference 2009 (Bassanini and Reviglio, *New European Institutional Long Term Financial Instruments for a Sustainable and Balanced Growth*, now in "Astrid Rassegna", http://www.astrid-online.it/rassegna/06-10-2009/Bassanini_Reviglio_Goteborg_-riimpag.pdf).

An Italian abridged version of this note has been published in *Il Sole 24 Ore*, Oct. 7th 2009 (see http://www.astrid-online.it/Riforma-de/Rassegna-/Bassanini_reviglio_Sole24Ore_prox_pubbl.pdf).

politically difficult. Strong inflation can reduce public debt, but the ECB would do well to avoid it.

A demand side boost to the economy, similar to that which the United States and Chinese governments are enacting, could be a partial solution. Europe should raise capital to accelerate the financing of major investments that promote its material well-being – benefiting the environment, creating alternative energy sourcing, and building infrastructure.

Strategic investments in Europe are dearly needed. The Commission has determined that the EU, in order to achieve the 20/20/20 and the TENs strategic objectives, must invest an estimated 3 trillion Euro (2,500 billion in energy and 500 million in transport– in addition to funding Research and Development, Telecommunications, Next Generation Networking, and biotechnologies.

Action to foster growth in the European economy should carry a strong political EU message.

New instruments to finance investments in European energy programs and infrastructures may help to overcome the present economic and financial crisis and to give the European contribution to the “strong, sustainable and balanced global growth” planned by the G20 Pittsburgh Summit.

To achieve these goals Europe needs a new long term vision. The paradigm of political economy is changing. The short-term approach of financial capitalism is partly responsible for the present crisis. We need to revive the long term view of European Continental capitalism.

The economic and financial crisis and the risk of ungoverned globalization are troubling the European community; creating widespread fear of precarious social peace and economic wealth, at present and for future generations. Therefore, most imminently needed is an initiative for growth, a European “sovereign” response to the fear of a changing world order.

The European Union may then return to centre stage, with a strong political message in supporting investments with long term horizons. How may we manage it in the present state of public finance?

Introduce new financial instruments which will not represent a burden on national public finances and future generations and amass European institutional long term investors to support large public initiatives.

Two proposals have been discussed in the EU in the last few years. The first is the issuance of Eurobonds. The second, based on an idea, launched by Italian Finance Minister Giulio Tremonti at the Nice Ecofin in 2008 and reintroduced at the Goteborg Ecofin in 2009: to activate the "great collectors" of private savings (such as the EIB, the German KFW, the French CDC, the Italian CDP, the Spanish ICO and the Polish PKO) on common long term instruments for financing European strategic investments (with an acceptable IRR) by attracting public and private financial resources from countries which have a capital surplus.

In the first case, Eurobonds would be issued by a sovereign political entity within the EU institutional framework and the funds collected would presumably be used to finance specific investments plans, according to common needs, decided by a coordinated and democratic decision making process.

In the second case, typically "market conform" instruments are issued by EU Long Term Financial Institutions which act directly on single projects. (EU Equity Funds, EU Single Project Bonds, Debt and Guarantee Schemes)

In both cases, however, the goal is to transfer the European and global institutional and households' savings to long term investments by making better use of the EU leverage potential.

The Euro, a strong currency, has delivered important results under the fiscal policy framework designed by the Stability and Growth Pact. It is time to cash in the credibility dividend and to spend it on growth enhancing initiatives.

"Marguerite European Network" sponsors one in a group of financial instruments more likely favoured by global investors: The major European development banks (EIB, KFW, CDC, and CDP) have recently created the Club of Long Term Investors, presently launching an institutional equity fund for energy, climate change and infrastructure (named "Marguerite", a prototype of a "family" of large European funds for growth). They are also prepared to coordinate action on other common financial instruments such as debt and guarantee schemes.

“EU Single Project Bonds” may also be issued to finance debt: Individual project bonds provide a sound and immediately useable new form of financing PFI Projects. Severe constraints on debt and equity (and leverage), accentuated by the collapse of the monoline insurers and subsequent closure of the wrapped bond market in late 2007, left bank debt alone as a viable source of (debt) funding to PFI projects.

“EU Single Project Bonds” may also be promoted by institutional long term investors or by similar groups. “Reputation premium” derived from EU endorsement together with long term institutions’ “high standing” could lessen the cost of financing and increase credit ratings, creating an asset class attractive to large institutional investors (by matching their own liabilities – long term, fixed income) and, more generally, medium size European (retail) households’ savings. The portfolio’s reputation could be further enhanced by a Network provided monoline guarantee and a subordinated loan or guarantee senior debt. Single tranche size would depend on the risk profile of the project furthering the goal of raising the credit profile of higher ranking senior debt financing to A/AA/AAA, and provide a range relatively more attractive than existing alternatives within the sector.

The proposed EU Single Project Bond structure has several advantages: (1) As a non-funded instrument it has limited impact on Network's own funding program; (2) No crowding out effect, as opportunities both to bond investors and the providers of the other portion of senior debt; (3) Follows a well-established model of wrapped bonds, which is a familiar structure to the relevant investor base; (4) Project benefits from Network's extensive monitoring and control of projects; (5) Such bonds would attract investors because of the credit quality and the backing of a community institution; (6) During times of persisting uncertainty regarding financial markets such bonds would be an interesting long term and safe investment opportunity for investment or pension funds; (7) Valuable involvement of the Network in the preparation phase of the bond issuing (i.e. expertise, due diligence).

Such bonds may represent the European version of the “Save America Project Bond” proposed by Obama’s stimulus Plan.

As we anticipated in the opening remarks, the EU could choose to issue the Eurobond.

Proposals by Jacques Delors initially and more recently by Giulio Tremonti met with sharp political resistance. Though as national public debts grow and converge, Eurobonds may no longer be perceived as an asymmetrical burden supported by a limited group of virtuous countries.

A limited issue dedicated to financing the strategic investments under the Lisbon Agenda (mostly with IRRs which may safely pay the cost of capital) would allow the projects, totally or partially, to pay for themselves: lifting a burden on European public finance and on future generations.

In 2014, the public debt to GDP ratio of the G-20, according to IMF estimates, will exceed 100%. The ratio is not expected to grow in a uniform manner: higher growth in advanced countries is projected over the 100% threshold, while emerging countries' will arrive at about 40%. At which point, it is predicted that the flow of savings' investments will shift from countries with low public debts to those with high public debts. Consider also the emerging economies' growth at a threefold pace in comparison with growth in advanced economies.

When the new and growing masses of middle income savers from China, India, Russia and Brazil, begin increasing their shopping of Western bonds, the competition between the dollar and the Euro will probably get tougher. China and Japan, which together hold almost 50% of US public debt, may then decide to diversify. At that point, a reallocation of global savings and central banks reserves on more strong currencies may be a reasonable scenario. If the EU plays it right, within the G-20, USA, China, and Europe, could form a "G-3".

Time is ripe to consolidate European sovereign debt - to strengthen the political union of Europe, to spur growth and stabilization in global financial markets and to force the European Union to speak with a single voice.