WORKING PAPER

FINANCING LONG-TERM STRATEGIC INVESTMENT IN EUROPE: WHICH OPTIONS?

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The latest analyses of the economic situation in European countries – the OECD's Outlook 2011, and those illustrated in the recent OECD Forum, Better Policies for Better Lives – highlight three things: first, that we have a recovery, but it is too slow and too feeble to offer a solution to the problem of unemployment. Second, that it is not possible to expect a return to past glories, in terms of growth rates, because the distribution of production and of wealth among countries in the whole world has undergone irreversible changes. Third, that only radical changes to economies, taking into due account the major issues of environmental and social sustainability, can give new impetus to European economies.

Given this situation, it is particularly important to reflect upon public investments, since the structural changes that these new situations require cannot come about without new infrastructures. New, because they would be to create new modes of communication and of transport; new, because they would be to generate power from renewable sources; new, as they would be to strike a new geopolitical balance in terms of production and trade, with special reference to the trading of raw materials and foodstuffs; and last but not least, new because they would be needed to support ambitious projects in the areas of education and research, as per the Europe 2020 strategy.

Long-term strategic investments. Investments for which there is a direct responsibility, or at least a direct involvement, based on EU Treaties.

The very title of this session is a statement, namely that there is no intention of re-proposing Keynesian solutions, for which public investments have a role to play as factors in supporting aggregate demand. So we are not interested in even discussing whether such a solution has been applied, or is applicable today. The title of the workshop refers to the finances of the Union. It should be realised that EU policies are not aimed at managing short-term macroeconomic trends, nor at redistributing wealth. It is however set forth in the Treaties that a task of the EU is to encourage economic development, using budgetary resources for this purpose. At this moment in time, this means working so that European growth in the medium-long term can return to a structural growth rate, bearing in mind the changes that have occurred.

The European Union is strongly committed to taking a long-term view, and is imposing this vision on member States. It is a time frame in which it is possible to measure the effects (outcomes) of policies pursued, of projects that have been rolled out. It is a time frame in which one can correctly measure the sustainability of public debt, also being able to see the outcomes of choices made in the sphere of public spending on the behaviour and results of the private sector of the economy.

2.

Investments, especially investments in initiatives that take time to be completed, are the type of public spending that is now made most difficult by the States budgetary policies. These policies focus on reducing deficits and public debts, and do not admit exceptions even for investments that are recognised as being able to raise the growth rate of GDP, which is an integral part of the objectives being pursued. The drop in public spending in investments throughout the Union in recent years shows how difficult it is to persuade citizens to accept a higher tax burden in order to effect expenditure, the benefits of which may only be seen after a number of years. Governments engaged in painful public spending cuts and in high taxation policies will always prefer to take actions that are of immediate benefit to today's citizens rather than tomorrow's.

In a brief aside to the line of reasoning I am about to describe, I have to say that failure to consider at all the positive effects of public investments on the productivity of the economic system ends up entrusting the need to maintain the level of the denominator in the objective fraction – the GDP growth rate – to so-called structural reforms. These are of course indispensable and strategic, but their effects cannot easily be quantified in advance, due to the lack of adequate statistics usable in macroeconomic modelling, unlike effects associated with an increase in capital, both public and private, that have long been the subject of study in all countries. This also means that deficit-reducing policies have taken into account only financial sustainability, and not other forms of sustainability.

I believe the Union can intervene here, drawing inspiration from the principle of subsidiarity. This element could be an important part of the long-term financial strategy, but requires two policies regarding the EU Budget. On the expenditure side, it requires the restructuring of sectoral programmes, so that a greater level of expenditure is allotted for investments, with a lower level of income support. I believe this can be done for both the CAP and structural funds, with positive results even in the specific sector (as argumented in Astrid, Il Finanzimento dell'Europa,2010).

The second policy relates to the revenue side. I know this is a minefield, where scepticism has a stranglehold. But perhaps things would be different if it were clear why there are plans to tax financial transactions, or air fares, or other. I wonder, if there were a direct, explicit relationship with actions designed to raise growth rates in Europe, whether we might not be better able to find the right technical solutions to make of these levies a genuinely European tax.

It may be useful to discuss this question in relation to the very recent proposal of the Commission (as sketched in some newspapers)

It seems that the idea is to tax financial services, in order to reduce the financial instability and in the same time to find “own” resources to substitute partially the State transfers. One can wonder if it would be better not being tied to the existing distribution of burdens and benefits, but aiming to ease the necessary changes in UE Financial perspectives.

3.

One consequence – and not necessarily negative – of the difficulty of financing, using public resources, investments in strategic infrastructures will be that of further shifting the boundary between PA and the semi-public sector of the economy, that in which the State has a strong presence, either as a regulator or a part-owner, but in which private ownership is prevalent.

In studies that have highlighted the positive effects of public investments on productivity and development, led by Aschauer, public investments include categories that are outside the PA, managed and owned by private entities. Roads and motorways, railways, telecommunications, ports, to name just some sectors, have been privatised everywhere, often leading to mixed public-private companies. The process is spreading, and the State entrusts to private entities the construction and running of important infrastructures, of public use, which PAs then rent and use. Hospitals, care homes, student residences, real estate used by the PA, equipment used in research centres, are all examples of this solution. Public authorities have the important job of planning and programming actions, calculating cost-effectiveness, also in terms of taxation, when considering the alternative of the PA undertaking the investment itself or paying rent.

Regulating Project Financing initiatives is very important in this sense. There may be forms of public participation in shareholding set-ups. Or the State may help with financing, or guarantee future resources upon the occurrence of specific circumstances, such as requirements unforeseen when the project was being drawn up. Or it may give a guarantee for rent payments, or to the fixing of rates, which may also be in the form of a supplement to the funding operation.

It is not my intention to deal with such complex matters here. But I would like to use them as a starting point for the discussion of two proposals that I believe to be important for the purposes of our debate. The first is the possibility of the European Union issuing its own securities to finance investments. The second is the EU giving guarantees in favour of bonds ceated to finance specific projects.

4.

In his State of the Union Speech, last September, President Barroso announced the Europe 2020 Project Bond Initiative. In February 2011 the Commission initiated stakeholder consultations. Olli

Rehn, Commissioner for Economic and Monetary Affairs, returned to this proposal in April, at the EC/EIB Conference, giving a more thorough description and putting forward a preliminary list of questions that need to be answered in order to construct the project in a technically sound and complete manner.

The Commission has proposed, as far as I can make out, two possible EU actions, different but not necessarily alternative. First, the granting of an EU guarantee on securities issued by private entities that intend to embark on major infrastructure projects. This instrument has already been tried out with the Loan Guarantee for Ten Transport (LGTT) and the Risk Sharing Finance Facility (RSFF). This is a guarantee to partly take over with the payment of senior bonds issued by the private undertaking that develops the project (Project Bonds) if the company is no longer able to honour its commitments. The second instrument is a commitment to provide a credit line, a ‘conditional’ line, if the funding structure organised around the project proves to be inadequate in the future, both near and distant, with reference to the complexity of the project, or if expected returns are not realised. There would thus be a need for additional resources, and the EU would provide a long-term funding guarantee, i.e. the guarantee could be used in the distant future; this would also amount to an indirect guarantee for the subscribers of Project Bonds.

It would be interesting to discuss whether, in light of previous experiences of major Project Financing operations, there is a specific “market failure”, in that the market has not managed to put in place (at least not adequately) valid insurance or reinsurance mechanisms to counter the danger of the proposed financial package proving to be inadequate, after a while, due to changes in external circumstances, which could not be anticipated when stipulating relative contracts. This would warrant public intervention of the part of the EU.

5.

I believe the Commission is right to promote consultations, as the problem is a complex one. Many responses have been interesting.

The possibility of an EU guarantee is presented with reference to two different sets of problems currently affecting the funding of major infrastructure projects. The first set refers to the question of project assessment, in terms of costs and revenues. In this post-crisis period, but also because of the problems posed by the strategy to overcome the crisis, it has become more difficult to forecast, and the usual references used in forecast modelling, such as yield curves observed at a given moment, are no longer as reliable. (The European Central Bank for example is uncertain about using the benchmark rate as an instrument of its policy.)

The second set of problems is also a consequence of the 2007-08 financial crisis. The banking system is now much less able to act as broker between short-term fund raising and long-term financing, since the crisis actually originated from the inappropriate use of instruments designed to ensure a high volume of maturity transformation, outside the constraints imposed by legislation, especially for some types of broker. With the bankruptcy of some intermediaries, who were unable to refinance commitments undertaken, banks are now even more tempted to operate in the short term, defending their liquidity position, while financial institutions operating solely in the long term have had great difficulty in obtaining access to banks and to the liquidity market.

In such a situation, it is also difficult to develop long-term direct funding operations in the market, and this is for two reasons. First, possible long-term investors – pension funds, investment funds, insurance companies – know that investment risk has objectively risen, but are not sure of the price to be attributed to this risk, in terms of the greater yields requested. Furthermore, they are less confident than in the past about the ability of intermediaries, and of their banks, to help them with this evaluation, and sometimes they view with suspicion their suggestions, remembering the conflicts of interest between banks and clients. Some categories of securities that were used a lot prior to the crisis, such as asset-backed securities, even in the most standard forms, have seen a drop in their ability to attract long-term savings.

In the responses to the consultation, an EU guarantee is seen as a valid aid to overcoming these difficulties, since in a way it helps to reinforce the reputation of the issuer, and the credibility of the broker's offer. Although it is limited in quantitative terms, the guarantee may in any case raise the prospects of a market of specialised securities: Project Bonds. A market in which specialist issuers, naturally including the EIB, and operators specialising in the appraisal and brokering of securities, have the qualities and operational abilities to overcome the main objection that is raised, namely that these securities might not be liquid enough, their market not efficient enough, and consequently difficult to satisfy portfolios that tend to the long term, but whose operational criteria provide for the possibility of continuous changes, also through specialist operators.

According to some evaluations, if we calculate investments up to 2020 in the areas of major transport infrastructures and power generation, of between 1,500 and 2,000 billion euro, and a funding structure with securities accounting for 20% of this sum, then the EU guarantee could be between 1 and 5 billion a year in the first years, and between 10 and 20 billion euro in the second period.

I do not know how these figures – or others that can be read – have been arrived at, whether looking at requirements or referring to projects already examined by financial backers, or in some other way.

What might be of interest to discuss here is whether some sort of global forecast needs to be formally acquired in the decision-making process regarding the guarantee on each initiative, or whether it may be possible to follow the method of fixing a “ceiling”, in absolute values, for guarantees and commitments undertaken, the procedures for setting such a ceiling, and whether an annual time frame, or the entire period of long-term EU planning, can be referred to.

It is not only a problem of quantities.

The main goal of the EU’s new role of guarantor must be that of reducing the information gap. It must be supposed that in granting the guarantee the competent bodies – Commission and Council – have studied the proposed project in sufficient detail, possibly resorting to advisors, or even to its own consultancy structure. This is no small problem. The very reasons we indicated when referring to rising risks, which have made the use of long-term funding much more difficult, require a new, in-depth examination of the validity of methods used to assess future prospects of the project. It is important to ensure here that all methods take into due account the probabilistic nature of the problem, in other words the fact that the forecast made must be the best possible one at this point in time.

6.

I am still of the opinion however that the use of the EU Budget to support strategic, long-term investments cannot be limited to these guarantees, but there must be the aim of directly supplying the resources that are needed, which member States are unable to mobilise. If it is not possible to increase one’s resources, then the EU should issue its own debt, and use it for the economic development of the whole area.

There is talk of a public debt of European institutions, not always used precisely, with reference to differing hypotheses and objectives.

There has been talks of this in the past, but not recently, aimed to expand the resources of the Community budget. Now there is talk of Eurobonds chiefly in relation to the various proposals put forward by researchers and research centres to “pool” the public debts of countries in the Euro area, to form a single public debt, with a view to avoiding crises. Another possibility is that of EU securities being issued to obtain resources that can be used in financial “packages” specially prepared to rescue the finances of individual countries in the Euro area.

I will not dwell on the second hypothesis, which I feel is important, but not quite ready for implementation, as M. Draghi said in his hearing before the European Parliament. As regards the third hypothesis, I believe it may be related to the theory I intend to set out, that in existing provisions there is room for the issue of EU debt.

This debt must be directly referable to the Union itself, or to its direct emanations (such as Euratom in the past). A debt that must not have behind it a scheme of guarantees distributed among States participating in a specific agreement, but rather that must refer to the European Union as a whole, whose 27 members are called upon to take joint responsibility.

We all know that the Treaty establishes, as a constitutional norm, that the Budget of the European Union is in balance. The initial reasoning for this was the fact that the Budget was basically a budget for the financing of Community organisations and administrations, a task that could not justify the assumption of debt. The historical evolution of the Union has been one of totally innovative contents, but uncertainties derive from its very uniqueness. It should come as no surprise that the question of the budget – i.e. the question of what we want to do by allocating resources to the EU for spending – appears to be equally uncertain, the result of an historical process rather than a precise institutional design.

The Union has gradually gained the ability to pursue spending policies aimed at producing "public goods" in areas that member States cannot deal with adequately on their own. But this ability has come up against a big impediment, that of the unavailability of resources, especially as State budgets are no longer able to supply resources, and the inability to find real, additional European resources.

A few years ago, prior to the reform of the Treaties, in a study commissioned by the IAI, I argued that the EU's structural and development policies could be pursued effectively if it were possible to resort to debt, eliminating relative constraints. I gave the example of the United States. I also argued that EU debt could play an important role as regards the international status of the Euro, which could become an increasingly valid alternative to the dollar.

At a time of low confidence in the sovereign debt market in many member States, EU debt might be welcomed by many investors, especially institutional investors. Standardised securities should be offered, with few variants, being for relatively small amounts, at least in an initial phase. Investors would not have to conduct in-depth credit assessments or justify the use made of funds. The confidence that Community institutions enjoy, and the transparency of procedures used, might be good enough.

I realise of course that we cannot now propose a revision of the Treaties for which ready agreement would be forthcoming. There is however another solution, to which many of the arguments presented here are leading.

7.

European accounting and statistics standards precisely define which items form part of the calculation of budget deficits. These items do not include operations that relate to the capital and financial position of the entity, which is made up of financial liabilities and assets, the variations of which are recorded on both sides. The acquisition of equity interests, granting of loans, and in general any purchase of assets may be financed with debt issues, according to these principles. Loan transactions related to project finance schemes may also form part of this category. These are "below-the-line" operations. In the past this system was used (it is indeed possible to purchase European Community securities in stock markets) to grant loans to States having balance of payments difficulties.

But apart from what can be done on the juridical front, I believe we should reflect on the possible choices ahead of us.

On the question of loans, it is quite logical to believe that at a time when States are engaged in policies to reduce – and defend – their debt, an EU loan to a member State may be viewed as a sign of weakness by the markets.

Another thing would be to act through loans granted as part of schemes to solve possible debt crises: this would place under the right light the institutional significance of the Union's participation, representing we might say all of its members, unlike the other hypotheses put forward.

With regard to loans to the private sector, for investments in the vast field of public services and utilities, of which we have already highlighted the private-public interests involved, we should in principle be in favour, as such intervention would certainly be consistent with the ends of European policies. An objection may however be raised, and it is that of the presence of the EIB, which is very active in this field too, and is basically already performing a task that may be considered as being entrusted to it within Europe's institutional set-up.

It may perhaps be worth discussing whether the EIB has sufficient resources to perform this task; whether the dimension of its capital is adequate. Whether it is necessary to raise this capital (possibly considering the possibility, that we are about to discuss, that debt be issued by the EU for the purchase of equity interests). One may ask whether the EIB has selection procedures that are too much tied up with the "bankability" of the investment to be funded, and too little engaged in turning into concrete actions the development policy choices made by the EU. Thus whether we should be acting in some way to strengthen, in terms of decision-making procedures, the role of the EIB as an EU Agency more than as a Bank. And finally, whether there can be an advantage, in terms of the cost of credit, in fund raising being performed by the EU, rather than by the EIB, which is of course an issuer with a high rating.

8.

A third possibility, which I believe could be discussed, is that resources collected by issuing EU securities should be allocated to participate in venture capital initiatives. The case of most immediate interest is that of Special Purpose Companies. But it would be possible to steer the decision towards not a single case, but a range of cases, related by their being in a network, which may enhance their value, and that could be well connected to single sectoral policies given high priority by the European Union. The dearth of resources for funding public investments, and concerns from observers that the situation can only get worse in the future, highlights the inadequacy of programming processes. Often this results in the funding of a number of separate projects, not adequately filtered by comparisons based on cost/benefit analyses. Participating in the capital of companies that propose initiatives to be funded means immediately forging a strong link with policies decided by States and the European Union, working in unison.

This question is undoubtedly related to the strategy, still not fully implemented, of separating the network – i.e. infrastructures supporting many public service activities – from the management of the entity that enjoys a dominant position. One may ask whether in this context a strategic role might be played by careful public intervention in companies' shareholding set-ups. We can discuss whether the European Union might be – or not be – one of the public entities to be involved in policies for the creation of infrastructures through this mode of action.

Interesting examples that come to mind are the water industry, in Italy in particular. Here investments in the water supply and treatment network must be undertaken by owners that are chiefly within the PA, i.e. entities with little chance of undertaking such investments. Intervention on the part of the European Union would constitute a clear-cut choice in favour of environmental protection. Another example could be that of infrastructures serving major ports, the growth of which is now indispensable thanks to changes to world trade flows, but that in some cases at least, are an objective bottleneck for the development of European economies.

9.

We could at least ask, after having discussed the issue here, for the question to be studied by the Commission, to gauge its feasibility, place boundaries, carry out simulations. Such a study should also look at the question of how to guarantee the payment of interests on issued debt. In theory, being financial transactions and not transfers, the asset itself, i.e. the transaction funded in this way, should generate a flow of resources that can be used to cover the cost of the debt. But this coverage may be incomplete, or delayed in time, or prove to be less than expected. In such cases, resources taken from the EU budget may be necessary, at least temporally. It may be useful to create a reserve Fund.

It may also be borne in mind that the link between State budget transfers and GDP could mean that policies that can very much have a bearing on growth may automatically generate resources to be used in such cases.