Financing Long Term Investment after the Crisis

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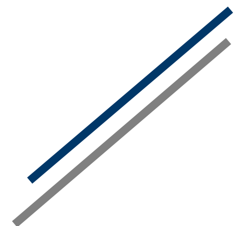


Global capitalism and short-termism

- The short-termism that characterized recent global capitalism had negative effects on the economy and the global financial system
- The so-called "shareholders' capitalism" created strong incentives to maximize short-term, rather than long-term, value
- Indeed, the managers of the firms are "winners" if they maximize the value of the shares, which is directly related to generous bonuses and stock options
- The excess of liquidity originated in the 1970s with the "petrodollar", coupled with deregulation of financial markets and institutions, exacerbated arbitrage and short-term speculation

Global capitalism and short-termism

- In the past, the Western financial system was based on the strict institutional partition between “banking” and “securities”
- Over the last decades, socio-economic evolution and technological innovation favored the legal breaking up of market segmentation and the creation of financial conglomerates and giant financial institutions
- Deregulation brought typical “banking risks” into “objectified capital markets”
- The abolition of the Glass-Steagall Act led to a tremendous increase in the securitization process carried out by financial institutions, many of which was previously concentrated in banking activities

Global capitalism and short-termism

- Financial innovations, along with massive liquidity and low interest rates, created a huge credit expansion. 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 (i.e. “credit default swaps” – CDSs), “off-balance sheet” operations, and “subprime” mortgage loans produced a leverage effect on existing risks, instead of spreading them out
- The aforementioned factors facilitated the creation of a financial bubble, which explosion hit the real sector of the economies, rapidly propagating itself throughout the world

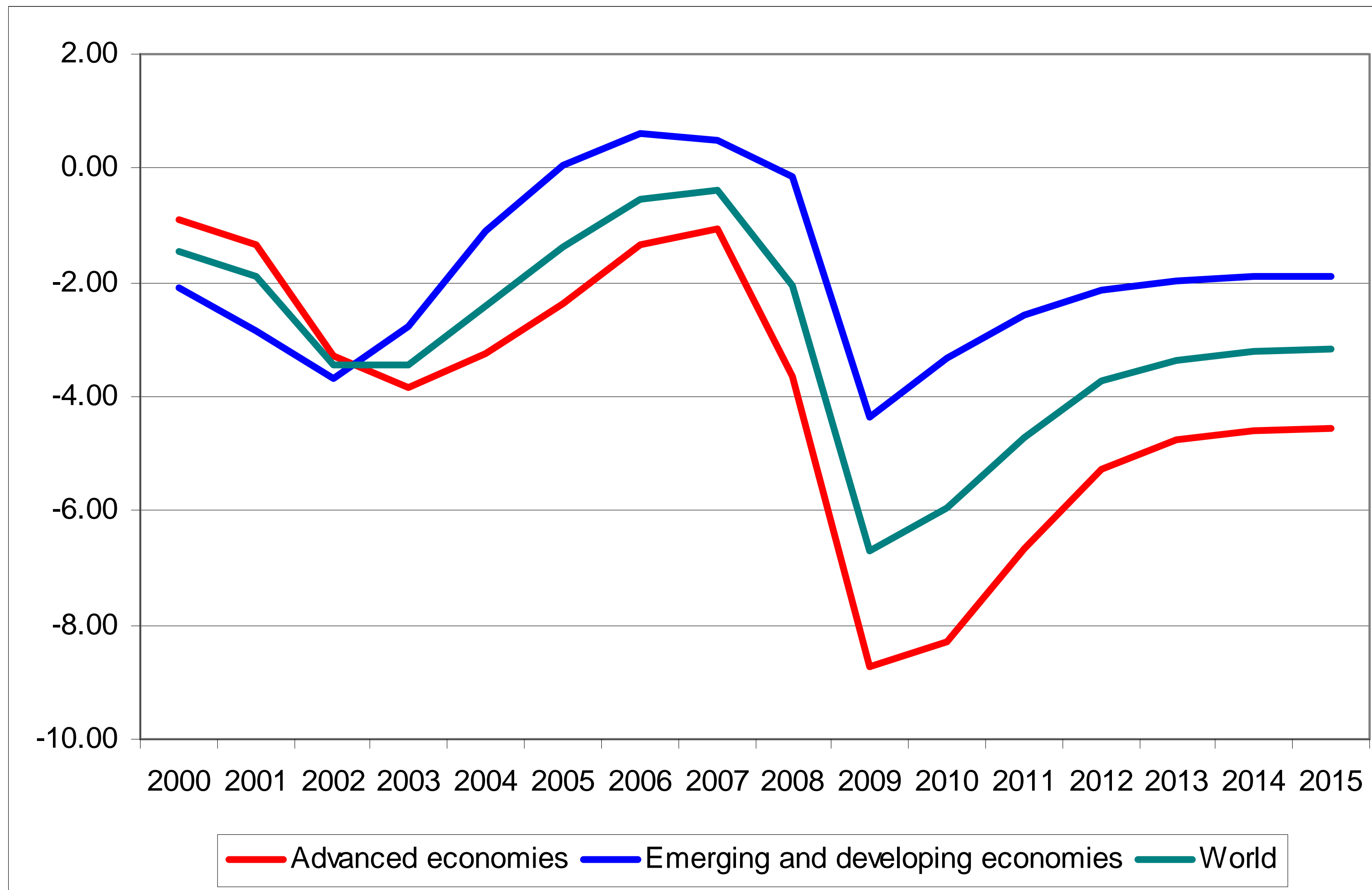
Financial System Regulation

- In the last two years, we have been witnessing the most serious crisis of market economies since 1929
- In order to sustain economic recovery, trust in financial institution should be restored. To this aim, financial markets needs to be regulated and, therefore, stabilized
- 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, and strengthen supervision authorities

The crisis and the public finance

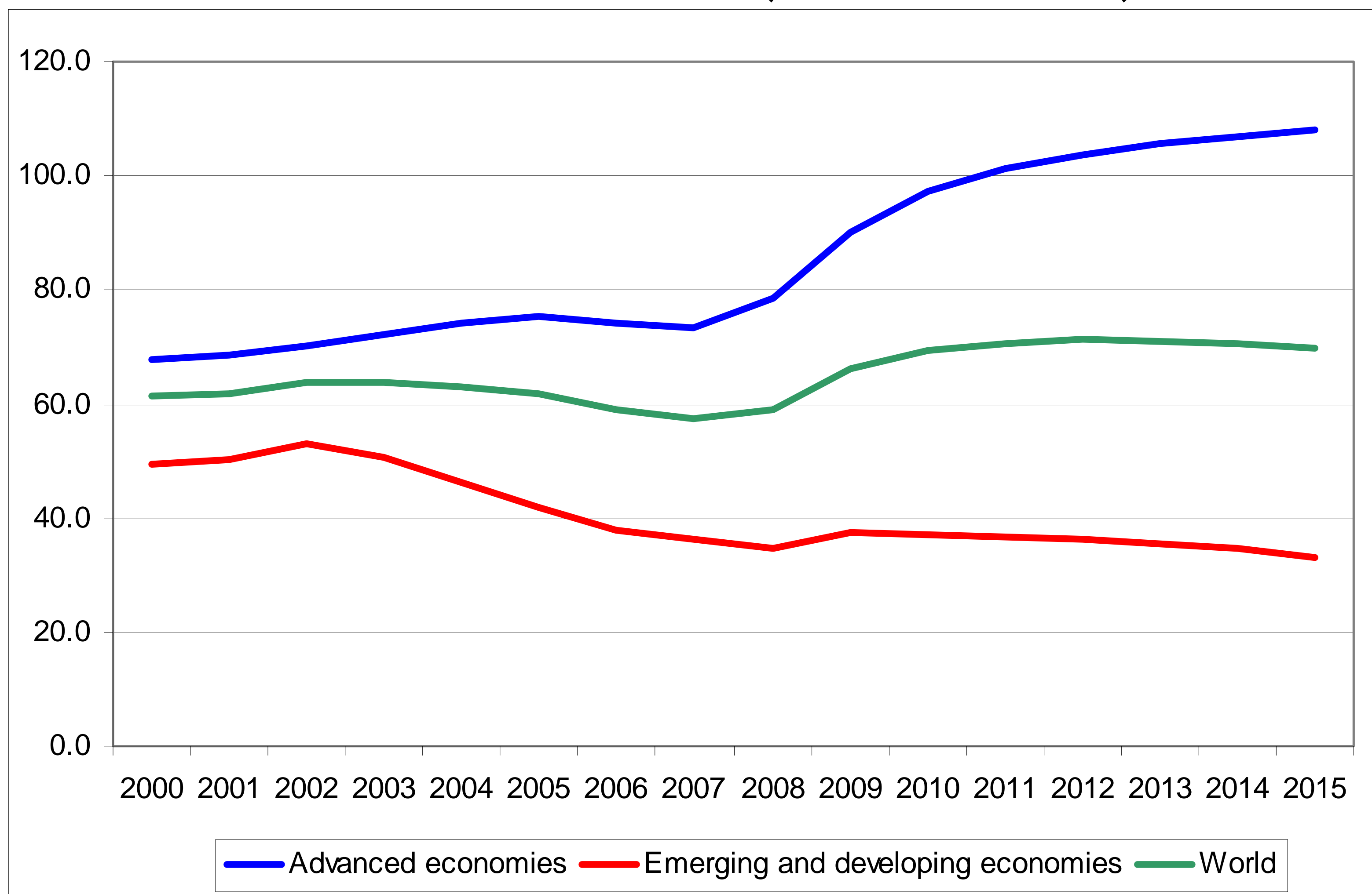
- After the 2008 crisis, public finance of advanced economies is under stress
- The level of public debt/GDP ratio of G-7 countries soared to post-war levels
- For the "advanced economies" within the G-20, this ratio peaked to 102% in 2009 and is expected to reach 122% in 2014
- According to IMF, 10 to 15 years of fiscal adjustment are needed to return to pre-crisis levels of public debt

Fiscal balance (% of GDP)



Data source IMF, 2010.

Public debt (% of GDP)

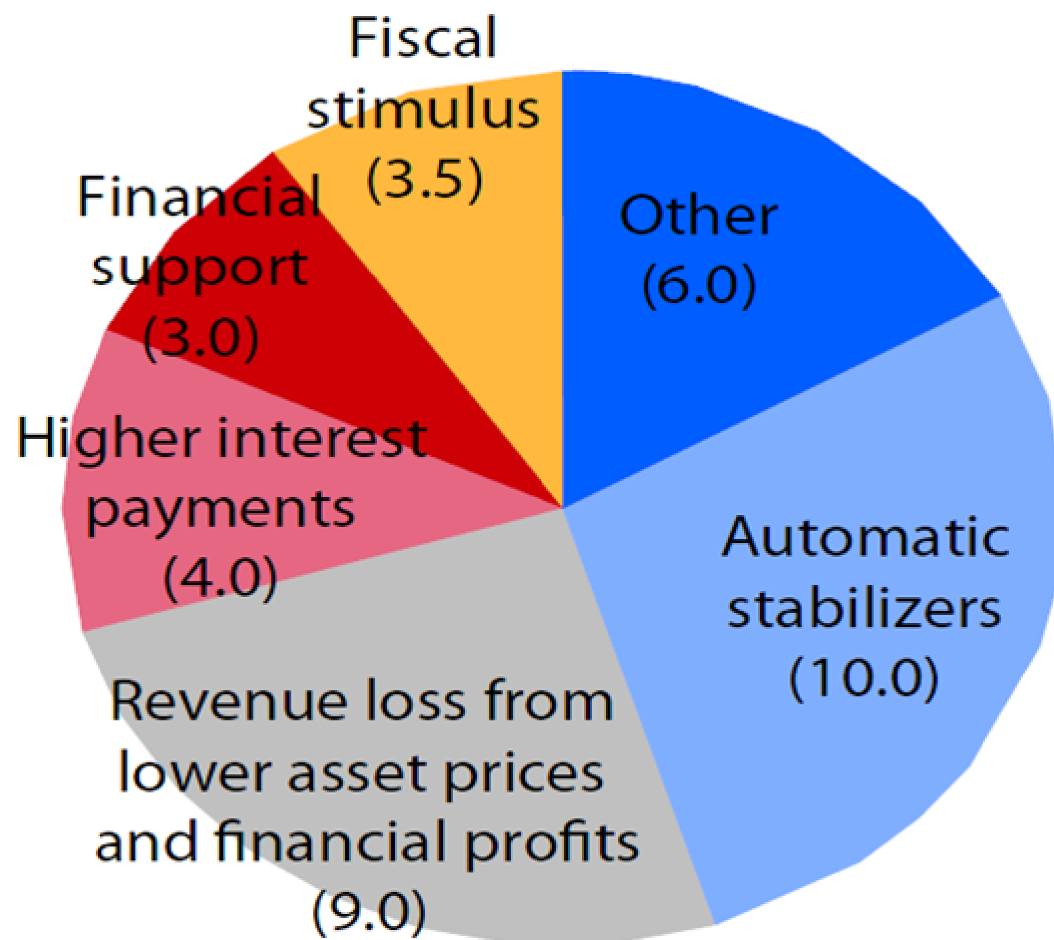


Data source IMF, 2010.

The crisis and the public finance

- Public budgets are drained by government interventions to save financial institutions and other sectors hit by the crisis
- Revenue losses, automatic stabilizers, and higher interest payments constitute the main part of government debt increase
- Most advanced economies need to lower their deficits and their debt substantially

Decomposition of Government Debt Increase (2007-2014)



The crisis and the public finance

- 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 addition, the economy should supports a growing population of ageing citizens
- The problem is therefore “structural” not just cyclical
- Restoring sustainable debt over the medium term will be indeed a very challenging task

Global imbalances

- The world economy is experiencing changes in both saving and investment behavior, which are having implications for the configuration of current account (CA) imbalances
- After the Asian Crisis (1997), CA surpluses were favored by weak currencies in developing Asian countries and Newly Industrialized Countries and by strong economic growth in China
- Moreover the increase in commodity prices after the crisis recessionary period helped to generate surplus in oil-exporter countries

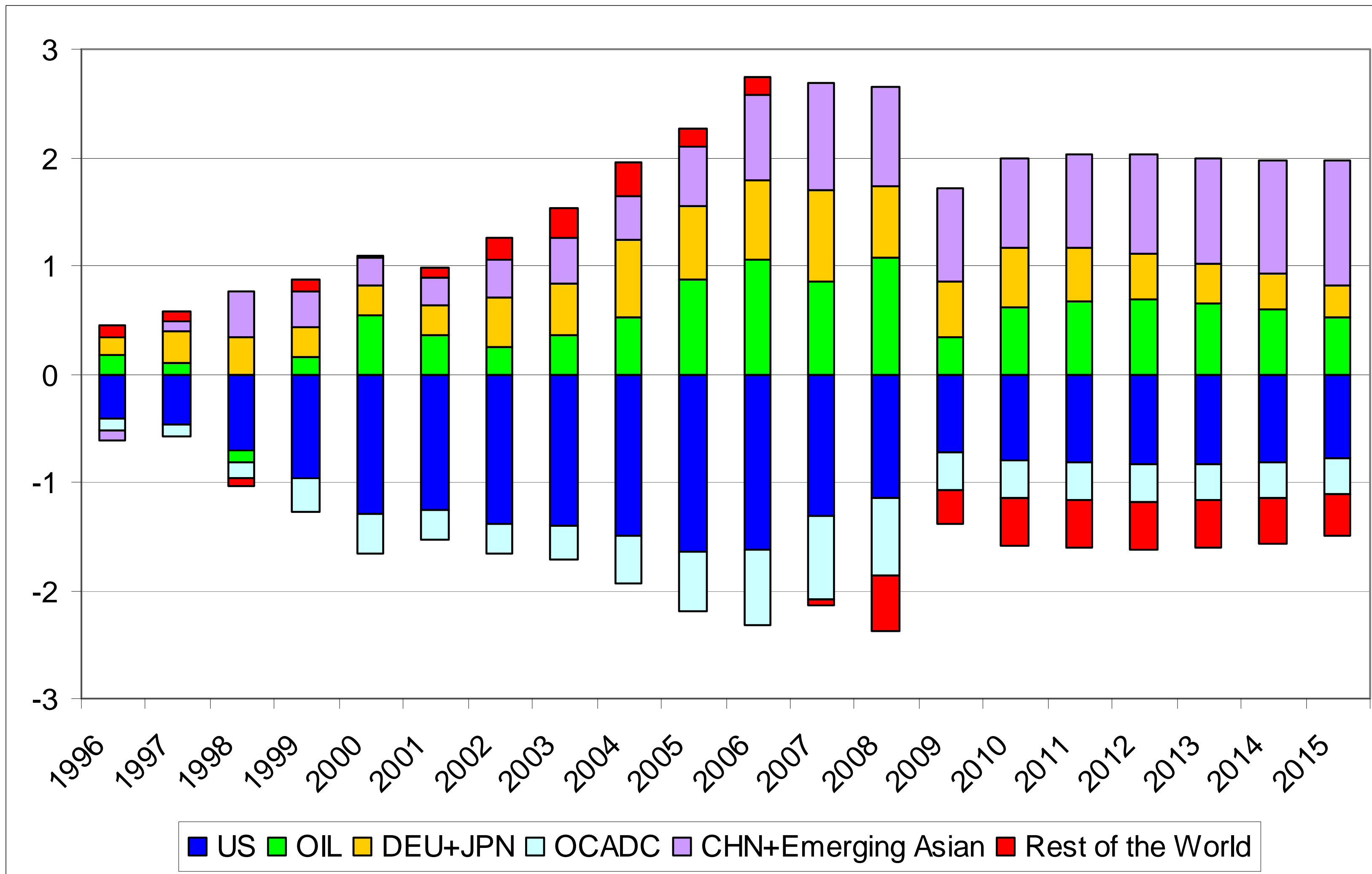
Global imbalances

- After 2000, surplus in Asian Countries and oil-exporters proved to be persistent: Gross domestic savings at pre-crisis levels with declining investments
- CA surpluses were supported by exchange rate policies: rates at competitive levels with respect to pre-crisis period, in order to benefit form export-led strategies and to accumulate international reserves as buffers against future financial crisis
- In the first years of 2000s, equity prices played an equilibrating role in international financial markets

Global imbalances

- In particular, the expectations of future productivity growth in US attracted capital from emerging market savers, which flowed in US causing an increase in stock prices and a appreciation of US-$
- Moreover, under a generally accommodating monetary policy in advanced countries (especially in US), low interest rates, and a strong emerging countries growth (China), the overall deficit rose for advanced countries after 2004, with Eastern Europe deficit adding to total world demand for excess savings

Global Imbalances (% of world GDP)



Data source IMF, 2010.

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After the financial crisis

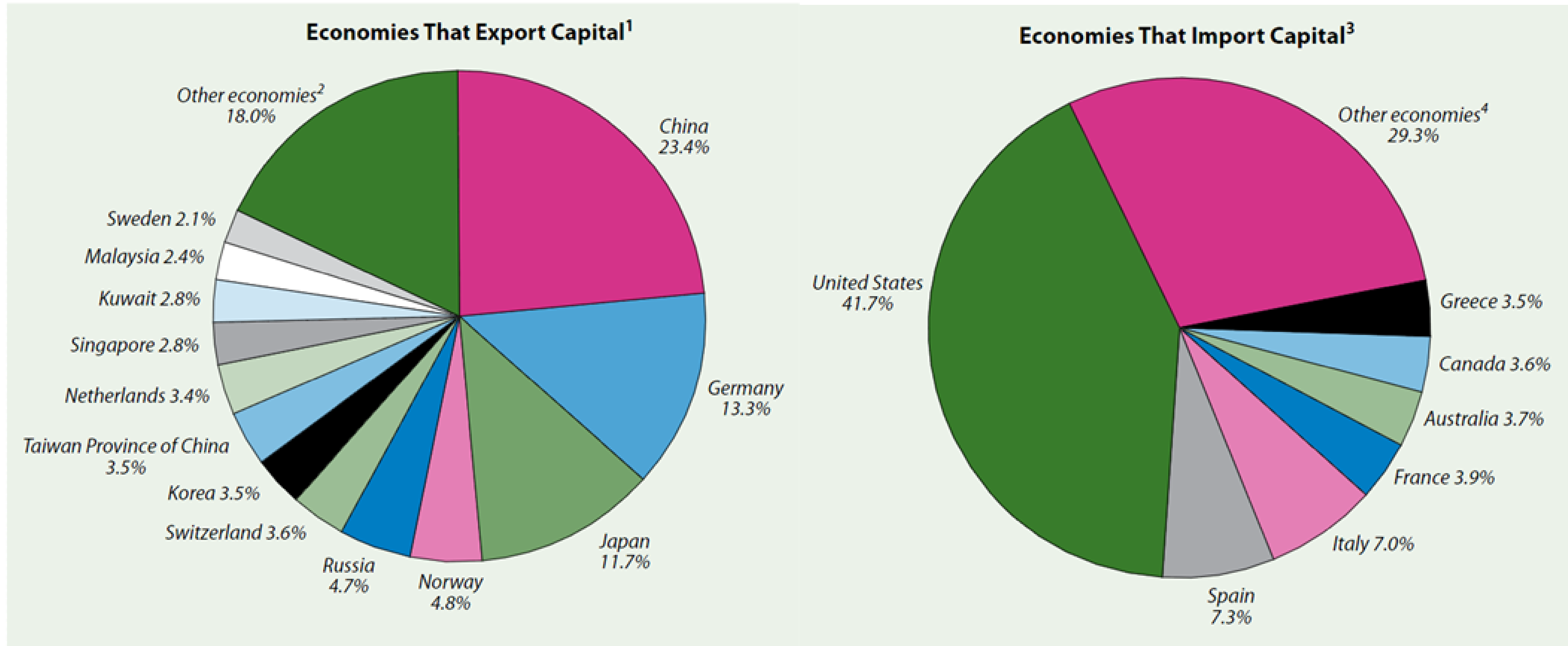
- Global imbalances nearly halved during 2009-10 as a result of the crisis, with a marked decline in the United States' deficit and in the surplus of the oil-exporting countries
- Fiscal consolidation tends to follow current account reversals on the basis of previous experience and will be much needed in some countries as a result of a massive build-up of government debt related to the global crisis
- The current high debt and/or budget deficits of most advanced countries can lead to a reduction over the next years of the supply of government bonds of these countries

After the financial crisis

- Thus, this process could favor a rebalancing of capital flows from surplus to deficit countries towards corporate bonds, equity and/or foreign direct investment

- Of course, this shift in the international capital allocation can take place only if the return-risk profile of new and different instruments of public or public-private securities will fit the preferences of long-term investors and international savers

Major net exporters and importers of capital (2009)



Source: IMF, World Economic Outlook database as of March 10, 2010.
[1]As measured by economies' current account surplus (assuming errors and omissions are part of the capital and financial accounts).
[2]Other economies include all economies with shares of total surplus less than 2.1 percent.
[3]As measured by economies' current account deficit (assuming errors and omissions are part of the capital and financial accounts).
[4]Other economies include all economies with shares of total deficit less than 3.5 percent.

The demand for infrastructure

- International capital flows can match the long-term exit-strategy policy mainly based on strong investments in infrastructure (see for instance the Obama's infrastructure plan and the EU "2020" strategy)
- Thus, we expect that the global demand for infrastructure will grow rapidly in the next year
- For instance, the overall cost of the Trans-European Transport Network (TEN-T) still to be financed has been assessed at around 500 millions euro by 2020
- The overall cost investments in Energy and Climate Change is estimated in over 2,500 billion by 2020. It includes energy infrastructure, energy generation, renewable energies, and environment systems and infrastructures

The need for long-term investment

- Investing in infrastructures requires a long-term perspective, due to the time horizon of projects realization
- As far as they are productivity-enhancing, large scale infrastructural investments contribute to lung-run economic growth
- At the same time, they express their potential returns only after several years
- These kind of investment are mainly related to the improvement of the business and consumer environment, by modernising the interconnection framework, by lowering the transport costs, and by supporting the green economy, among other things

The need for long-term investment

- Long-term investment may also induce sustainable growth, employment and global stability
- It generates stable cash flows over longer periods and financially sustainable long-term risk-adjusted rates of return
- In developed financial markets, long-term investment is usually countercyclical and thereby mitigates volatility, stabilizes the economy, and sustains growth
- In presence of credit constraints, however, long-term investment can face a higher liquidity risk and weakens, sometimes, the solidity of the industrial and banking sectors

The role of long-term investors

- Long-term investors are characterized by a low reliance on short-term market liquidity, due to stable resources, often made of regulated or guaranteed deposits, long-term savings products or long-term borrowing
- They usually have a robust capital base, which relies mainly on reserve accumulation and enables them to absorb short-term fluctuations in financial markets (drawing on reserves in bad years and feeding them in good years)
- Long-term investors comprise major financial institutions financing economic development, sovereign wealth funds, pension funds, public retirement funds, insurance funds, etc.

The role of long-term investors

- Main characteristics of long-term investors are:
  - ✓ the ability to retain assets longer than other market players, even in crisis periods, playing in this way a counter-cyclical role on financial markets
  - ✓ investments in - often illiquid - capital or debt instruments that yield a profitable return in the long-run, such as those issued by companies operating in sectors like general interest utilities, infrastructures, innovation projects, renewable energies and the like
  - ✓ liabilities that differ in quality from those of other financial investors
  - ✓ investments that are typically carried out with performance and risk targets calculated on a long-term basis

The role of long-term investors

- Long-term investors may play a key role in sustaining and attracting capitals for strategic investments, looking at a new economic model oriented to "commons" rather than "consumer goods"
- Long-term investors do not generally seek speculative IRR or strong capital gains, due to the clear social responsibility that they usually have in their mission
- They are willing and capable to keep in their books long-term assets and liabilities
- They are able to spread risks between generations

The size of long-term investors

- According to recent estimates by the French Council of Economic Analysis (2010), the weight of the potential long-term investors is equal to about 60% of world GDP and more than 40% of the stock markets

Size of long-term investors (end of 2009)*

Pension Funds	29.5
Insurance Companies	20.0
Sovereign Wealth Funds and Public Savings Banks	3.8
Total	53.3

*Trillion dollars. Source: Conseil d'Analyse Économique, Investissements et investisseurs de long terme, 2010

The size of long-term investors

- On April 2009, the Long-Term Investors Club (LTIC) was established by
  - ✓ Caisse des Dépôts (CDC)
  - ✓ Cassa Depositi e Prestiti (CDP)
  - ✓ European Investment Bank (EIB)
  - ✓ KfW Bankengruppe
- On June 2009, new members joined the Club:
  - ✓ China Development Bank (CDB)
  - ✓ Caisse de Dépôt et de Gestion (CDG) – Morocco
  - ✓ Mubadala Development Company – United Arab Emirates
  - ✓ Omers – Canada
  - ✓ Vneshekonombank (VEB) – Russia

The size of long-term investors

- The Club aims at bringing together major worldwide institutions with the common identity as long-term investors
- At the end of 2009, the assets managed by the LTIC members were equal to 1.3 billions euro
- In the near future, these figures could easily reach the value of 3 billions euro, by taking into account the assets of those institutes that are requiring to join the Club

New long-term financial instruments

- After the financial crisis, new and feasible ways to channel major capital flows from the global market to long-term infrastructural initiatives should be sought
- These initiatives should have strong 'positive externalities' for the environment, the energy sector, the transport sector, R&D, human capital, TLC, and the economic system as a whole, while using the least amount of public resources possible
- Public and private sectors must work together to build new forms of complementarities
- New rules and incentives for PPPs and PFIs and new financial instruments should be introduced

New long-term financial instruments

- New architectures for equity funds, project bonds, debt instruments and, more generally, credit-enhancing initiatives must be considered
- A new regulatory framework - more friendly with long-term investment or, at least, not discriminatory against it - is needed
- This should involve accounting standards, prudential principles, and corporate governance, as well as ‘ad hoc’ systems of fiscal incentives

New long-term financial instruments

- Regarding the European new financial instruments, the first examples are the *2020 European Fund for Energy, Climate Change and Infrastructure* ('Marguerite'), set up in 2009, and the *Inframed Fund,*
- 'Marguerite' is a pan-European equity fund for investment in energy, climate change and infrastructure, which core founders are EIB, KfW, CDC,CDP, ICO, PKO and the EU Commission
- The expected total fund size is EUR 1.5 billion. It is estimated that over the next few years, the Fund will mobilize investments in the range of 30-50 billions euro.

New long-term financial instruments

- 'Marguerite' will invest in 'greenfield' projects in energy and infrastructure sectors, such as TEN-T, TEN-E and particularly interconnectors, gas storage and LNGs, renewable energies, distribution and hybrid transport systems, etc.
- These sectors/projects will have solid IRR and satisfactory Economic Rates of Return (ERR)
- The Fund will be an investment vehicle for long-term institutional investors from both the public and private sectors. It will mainly invest in equity stakes, but it will also have associated debt facilities
- The 'Marguerite' Fund is one of the first examples of 'reinforced cooperation' in the European financial sector

New long-term financial instruments

- 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,CDP, EIB, Hermes (Egypt) and CDG (Morocco)
- Other common financial instruments should be considered, such as Project Bonds, Eurobonds and Guarantee Schemes
- If successful, these financial instruments will be an interesting long-term investment opportunity for institutional investors such as pension funds, insurance companies, SWFs, as well as households
- In addition, they could become the prototype for a family of funds (i.e. ‘Marguerite’ 2, 3, and 4; ‘Inframed’ 2, 3, and 4, etc.)

New accounting standards

- As for the accounting standards, the 'mark to market' principle does not permit distinctions between short-term and long-term investment values in the balance sheets
- Therefore, some reforms are needed to:
  - ✓ introduce accounting criteria that reflect long-term investors specific business model
  - ✓ distinguish between different temporal durations/matching liabilities and investments
  - ✓ take into account the value of future cash flow over the long-term

New fiscal incentives

- In many European Countries' tax systems, the long-term investments are disadvantaged when compared to the financial short-term investments. These discriminatory disincentives should be abolished
- 'Ad hoc' incentives for long-term initiatives of general interest might be introduced, as those granted to the US Project Bonds or awarded to the renewable energy projects
- On the one side, financial institutions can be eligible for incentives if they decide to hold part or all of their assets as long-time investments. On the other side, investments can be considered as long-term projects if they have certain specific characteristics

Conclusions

- To conclude, financing long-term investment will
  - ✓ strengthen economic growth
  - ✓ give a contribution to restore fiscal stability
  - ✓ create value for next generation

Thank you!