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Mediterranean Infrastructure Challenges: The Potential of Public-Private Partnerships

Keynote Speech

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IMPROVING THE FINANCIAL ATTRACTIVENESS FOR PPP'S IN THE MENA COUNTRIES

Preliminary draft

1. The need for long-term investment to foster economic development and social cohesion, with a focus on MENA countries

In the next decades there will be a growing demand for long-term investment, both in advanced and emerging countries, led by the evolution of the world economy.
By 2050, world population will grow from 7 to 9 billion, while total GDP will rise from 72 trillion USD in 2010 to about 380 trillion USD in 2050[1]. According to forecasts, the fastest growing regions will be Africa (7%) and developing Asia (5,4%).
As a result, in the period 2010-2050 North America and Western Europe will reduce their share in world GDP from 41% to only 18%, while Africa will register a three-fold increase, shifting from 4% to 12%.

In the XXI Century most of the people in the world will aim to have – and does have the right to have, on grounds of justice - the same living conditions and sustainable growth of the advanced world. It is economically convenient and politically binding to share the size of this exceptional global growth phase. This process will need good world and regional governance and strong cooperation.

[1] Citi Global Capital Markets (2011), *Global Growth Generators: Moving beyond 'Emerging 'Markets' and 'BRIC*, Global Economics View, February.,

Investing in long-term fixed capital contributes to long-run economic growth by increasing the productivity of the economy. Core infrastructures including ports, airports, railways, highways, water and sewage system, as well as health and education building, improve business and consumers' environment by modernizing the interconnection framework and lowering the transport costs. They also support the green economy and thereby induce sustainable growth. By creating new jobs, they sustain employment and global stability, strengthening in this way the social cohesion.

Within this general framework, countries in Middle East and North Africa – the so-called MENA countries[2] – are expected to show a sustained process of development and modernization over the next future. However, the recent increase in commodity prices and, in particular, in oil and food prices, will pose significant challenges for these countries, although with an asymmetric impact on oil exporters and importers countries.

Particularly, in the case of oil importers, the economic outlook is mixed and strongly affected also by the raise in agricultural commodity prices, which contributed to create recent social unrest. In 2011 GDP growth is expected to be on average 2.3% (compared to 4.7% in 2010), also reflecting disruptions to economic activity due to protests and a decline in tourism, with differences in specific countries.

As for public finances, while the crisis impacted negatively on government budget in the most advanced countries, its consequences for MENA countries have been more heterogeneous. Oil exporters have shown widening balance surpluses due to oil revenues, while importer countries have experienced remarkable deficits increasing in 2011 to the range of 5%-7% of GDP. Nevertheless, the stock of debt in MENA countries, on average, is relatively low when compared to more advanced economies, since they have a debt to GDP ratio often below 60% (with considerable differences, such as Lebanon, with a ratio larger than 130%).

Current account balances are also reflecting these dynamics: on the one hand oil exporters present huge surpluses; on the other hand importer countries have relatively large and increasing deficits. Tensions on exchange rates and interest rate dynamics could be foreseen if these imbalances will persist in the coming years.
Moreover, the regional outlook could also be influenced by the risks related to the sovereign financial difficulties of Southern European countries, which are the main trading partners of the Maghreb region.

From a structural perspective, economic growth should go hand in hand with a sustained process of job creation, in order to offset the rapidly growing labor force and to ensure a socially inclusive pattern of development. In fact, a main

[2] Middle East and North Africa (MENA) countries: Algeria, Bahrain, Djibouti, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Oman, Mauritania, Morocco, Qatar, Saudi Arabia, Sudan, Syria, Tunisia, the United Arab Emirates, and Yemen.

source of uncertainty is still linked to the capacity of the area to go through a rapid evolution towards more stable political and social conditions.

2. Need to mobilize private investors for financing infrastructures

Therefore, in the next decades, we expect a huge increase of demand for capital investment that will go from today's almost 11 to 24 trillion of US dollars $ by 2030. In mature economies there will be a pressing need to maintain and improve infrastructural assets, to finance research and development projects, to support environmental programs, and to prepare for the consequences of an ageing population. In middle-income emerging countries and in developing countries the catching-up process in income per capita will require vast investment in education, innovation and in infrastructures like transportation, telecommunications, energy, water supply and urban development.

But in mature economies, the need of a very challenging fiscal consolidation imply that, today, government spending cannot provide the desired level of investment. Consequently, high-public debt countries will not be able to finance such investment mainly with their own budget resources, as high-growth and low-public-debt countries (such as China, Korea, Russia, Brazil, Australia) can do (and decided to do). So, the mature economies need to attract an increasing amount of private capital to replace declining public capital, to increase their share of long term investments to exit the crisis, to reinforce their growth rates and competitiveness on global markets and to ensure public debt sustainability (successful fiscal long-term consolidation requires both stricter fiscal policy and more economic growth).

But the low-debt developing countries too need to attract private capital, considering the huge amount of the investment required and the limited size of their public budgets. So, in the coming years, the competition for capital will be intense, the need for both equity and debt for financing infrastructure will rise dramatically, leaving open the question whether we will have to face in the future an infrastructure "Equity (and Debt?) Crunch".

In order to finance strategic infrastructural projects in the Mediterranean Area, it is therefore very important to increase the capability to attract long-term private and public capital from international markets, including from emerging economies with high level of private and public resources.

In any case, in the MENA countries as well as in Europe, there will be an increasing need to mix public and private resources, in terms of finance, human capital and expertise, by bringing together distinct advantages from the private and the public sector in strategic fields like infrastructure.

Public Private Partnerships (PPPs) can provide effective ways to deliver infrastructure projects, to provide public services and to innovate more widely in the context of recovery efforts (as has been also stressed by the European

Commission)[3]. Moreover, PPPs can offer extra leverage to key projects to deliver shared policy objectives, such as combating climate change; promoting alternative energy sources as well as energy and resource efficiency; supporting sustainable transport; ensuring affordable health care; and delivering major research. Finally, PPPs offer capacity to leverage private funds and pool them with public resources.

In this respect, Long-Term Institutional Investors, in close collaboration with financial institution and private companies could play a key role for the future of the economic and social development of the Mediterranean countries. The strong collaboration of private and public-private bodies in realizing PPP projects is crucial in order to overcome the negative consequences of financial crisis, to reduce credit and public budget constraints, and to increase the benefits, in terms of efficiency, of long-term strategic projects.

3. The conditions needed for private investment

Private investments in Project Financing Initiatives (PFI) and PPP activities usually require:

a. Political stability. A good and stable political framework is the first requirement. An unambiguous political commitment to PPP process is also needed to allow operators to act without unwarranted interference or obstruction.
b. Certainty of legal framework. A clear, stable and consistent legal framework is essential to give the right incentives to the operators.
c. A favorable framework for private investment. A robust institutional framework ensuring transparent models and standards, low (or reasonable) regulatory and bureaucratic costs, easy concessions' procedures and absence of delays, an efficient and technically skilled public administration and government services, fair and timely procurement and management process may dramatically improve the attractiveness of private investment.
d. Favorable rules for PPP and PF. A broad set of supportive rules, which include regulatory and accounting standards, are necessary to improve the efficiency of PFI and PPPs instruments. Institutional roles and responsibilities should also be clear. In this respect, the PPP specific law recently introduced in Egypt and the similar legislative initiatives being in progress in Jordan and Lebanon could represent good examples.
e. Favorable taxation system A friendly taxation system not discriminating long-term investment should be considered. This could involve also tax incentives in order to stimulate equity as well as debt financing.
f. Independent and effective judicial system and regulatory Authorities. A reliable judicial system is fundamental to guarantee effective, transparent and impartial mechanisms for disputes resolution. For

[3] Communications from the European Commission. *Mobilising private and public investment for recovery and long term structural change: developing Public Private Partnerships* [COM(2009)615].

instance, looking at the World Bank Doing Business Indicators, the efficiency of MENA countries in enforcing contracts is generally worse than the global average (683 vs 605 days)[4]. Therefore, international arbitration rules for PPP agreements can play an important role in ensuring a further guarantee for foreign investors.

g. A balanced risk allocation between public and private sector is also needed in order to ensure a correct risk management of PPP projects. Some macroeconomic risk factors, such as exchange and interest rate risks, particularly present in MENA countries, should be allocated to the public sector. On the other hand, not every risk not controlled directly by the private sector can be exclusively managed by public sector. In this respect, a well developed insurance sector supporting private partners is a key requirement to favour PPP market and projects.

4. The need of new rules and new instruments supporting PPPs

To support PPP investments there is a need to move towards two directions:

1. To introduce new financial instruments for financing infrastructure. The role of European Investment Bank (EIB) and other public development banks for financing long-term investments and designing new financing instruments will be useful for PPPs initiatives in key policy areas.
2. To create a new international regulatory framework more favorable or (at least) less penalizing for long-term savings and investment in social infrastructures, environment, renewable energy, innovation and R&D.

5. Financial instruments supporting PPP initiatives

In order to satisfy the growing demand for infrastructures in the Mediterranean Area, new long-term financial instruments should be introduced to attract public and private resources from investors with a long-term perspective.

The recent European experience in developing new institutional long-term financial instruments, like international equity funds - Marguerite and Inframed – and the project bonds initiative represent an important breakthrough. In addition, more general credit enhancing mechanisms are able to lower the risk and decrease the cost of long-term initiatives in strategic sectors such infrastructure, energy and technology.

Marguerite and Inframed may be a prototype of new families of international equity long-term funds for infrastructures. If the experience will be successful, more instruments for collaboration would be promoted, for instance, in sectors related to carbon saving and renewable energy.
Furthermore, InfraMed, a joint initiative of CDC (France), CDP (Italy), EIB, Hermes (Egypt) and CDG (Morocco), must be a laboratory for building a new model of development and fostering cooperation and peace among the three

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[4] Doing Business in the Arab World, 2011: *Making a Difference for Entrepreneurs*, IBRD/World Bank

sides of the Mediterranean Sea. The target of the Fund is to finance mainly greenfield projects in the fields of sustainable urban development, transportation and energy infrastructures, by adopting a socially-responsible investment policy and respecting minimum requirements on environmental protection, social impact, transparency, and procurement.

Potential alternatives do also exist to raise funds for infrastructure. Project bonds and guarantee schemes for energy or transport programmes could be particularly important in cases when leverage is severely diminished. New asset classes can be created to attract investors seeking to match their liabilities with long-term, fixed-income assets, including European households and foreign sovereign wealth funds.

It is worth mentioning the "Europe 2020 Project Bond Initiative" recently launched to provide EU support to project companies issuing bonds to finance large-scale infrastructure projects. The Initiative, with the endorsement of the European Commission and the EIB, aims at collecting additional private sector financing of individual infrastructure projects by improving the rating of the senior debt of project companies, thereby ensuring that this can be placed as bonds with institutional investors.

We should consider the opportunity of a similar Mediterranean Project Bond Initiative in order to finance PPP in the Mediterranean Area. A network of institutional long-term investors could provide, for instance, debt service guarantees to cover project bonds. Their solid reputation and technical expertise in "assembling" PPP projects could attract investors helping fund raising processes.

Following the Milhaud Report, we should consider also the possibility of strengthening and enhancing the role of FEMIP, in the framework of the EIB, making it the core of a co-development bank of the Mediterranean Area, jointly held by Northern and Southern countries. The new bank could also involve the contributions of some other long-term institutions, such as EBRD, WB, CDC, CDP, CDG, Spain's ICO, and, if possible, the German KfW, and Gulf SWF, but also of States and other institutions from Mediterranean and Gulf Countries.

6. Implications of the international financial architecture (i.e. Basel III)

The rationale of a new regulatory framework more favorable to long-term investment is very strong. In few words: there is a general need to enlarge the worldwide share of financing for long-term capital investment at the expense of the short termism and speculation, to favour the match of long term saving and long term capital investment. The issue of long term investment is really crucial for the future of world economy. It may play a positive role for the financial markets' stability. It is pivotal for a sustainable long term planning of economic and social systems, to tackle the major challenges facing our societies: sustainable growth, job creation, climate change, scarce natural

resources, environmental protection, poverty, immigration, and education. A long term policy framework must be based on strategic public and private/public investments in infrastructure, energy, environment, TLC (NGN), R&D and human capital, which have strong positive externalities for the economy as a whole, and for human well-being and social cohesion.

Therefore, policy makers and international regulators around the world should work not only to assure financial stability, prevent global crisis and "level the playing field" to allow for fair global competition on the markets of global savings, but they should also work on creating a prudential and accounting framework that encourages managers of financial institutions to focus more on long-term rather than on short-term results, especially on investments with significant positive externalities for growth.

Nevertheless, the overall regulatory setting has often been providing unfavourable incentives to such LTIs and to long-term oriented investors. The Basel rules and capital requirements have promoted short termism and discouraged long term banking and financial initiatives. Accounting rules conceived for investment banks and trading activities and appropriate for their business model, have often penalised LTI and proved to be inappropriate for the long-term investors (such as pension funds, insurance companies, SWFs, and development public banks) and for their quite different business model5. Such large long-term institutional investors are potential wide recipients of financial instruments for initiatives in project financing. With assets estimated at 50/60 trillion dollars, they may represent huge players in financing growth stimulating investments6.Today on average they invest around 2%-5%of their resources in infrastructure, as an asset class. Potentially their balance sheets could have room for over 6.5 trillion of dollars in long-term assets (and over 12 trillion when including the investment funds), which larger part could be invested in equity or debt for infrastructure.

But the IAS mark-to-market philosophy is particularly damaging for them, attributing instant market values to assets the value of which is by essence based on several years7; and the Solvency II Directive in Europe discourages insurance companies and pension funds from holding infrastructural assets, not allowing for a proper matching of long term liabilities and assets on their balance sheets.

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[5] De Larosiére, J., (2011), "*Don't punish the banks that performed best*", in *Financial Times,* 4th March 2011.

[6] See OECD Discussion Note, *Promoting Longer-Term Investment by Institutional Investors: Selected Issues and Policies*, 2011. See also Eurofi, *For an EU Action Plan to Remove the Disincentives to Long-Term Investment*, 2010 and Conseil d'Analyse Économique, *Investissements et investisseurs de long terme*, 2010.

[7] See De Larosiére, J. (2010), "*Long term investment: what appropriate regulatory framework?"*, The Long-term Investment in the Age of Globalisation, Rome, 17th June, in http://www.astrid-online.it/Dossier--d1/DISCIPLINA/The-Long-T/index.htm.

After the big 2008 crisis, a strong action was needed to assure financial stability without hinder the capacity of banks (and, even more, of other investors) to serve the economy, especially in the financing of SMEs and long-term infrastructure investment, which are sectors crucial to future growth and to competitiveness. But, after the Pittsburgh G-20 call for a strong, balanced and sustainable growth, the focus of global community has shifted mostly on financial and fiscal stability. The correlation between financial and fiscal stability and growth is of course evident: the Greek, Irish and Portuguese crisis are excellent examples of it. But this correlation is - in fact - a bidirectional one. Durable and sustainable growth requires financial stability and a long-term fiscal consolidation; but financial stability and fiscal consolidation both require a durable and sustainable growth.

Nevertheless, among the Basel III principles and the new IAS, many rules potentially imply a negative impact on long-term investments, not only for the banking system. Stricto jure the rules of Basel III apply to banks, and not to long-term investors like insurances, pension funds, SWFs and development banks. However, on one hand Basel rules inspire Solvency rules and the regulations of other LT players; on the other hand, de facto and by default, the same rules (or very similar ones) are frequently applied by the markets (for instance, rating Agencies) to these investors, dramatically reducing their firepower in financing LTI. There is good reason to fill the void with an additional or integrative protocol to Basel III or another international document establishing which of the Basel-like rules are relevant for the different categories of LT investors and which are instead the special rules and exceptions designed for the specific mission and business model of these institutions. There is, moreover, an even better reason to define criteria to spot the real quality of LTIs in order to link a more favourable prudential regulation to specific strengths (i.e. strategic nature of the investment, implicit government support, strength of collateral guarantees,.....).

Within this context, accounting rules should be also partially revised to increase long-term investors' potential and to better represent their long-term nature. As for this, the Long-term Investors Club is providing the IASB with comments for new accounting rules going in this direction.

7. Conclusions

To conclude: it is crucial to establish some basic conditions to foster long-term PPP's initiatives.

The development of both national financial and insurance markets is crucial to favour PPP agreements and at the same time to create general condition to attract private capital. A balanced risk allocation mechanism must be implemented with the aim to allocate to each partner, the public and the private one, only that part of risk which is able to manage.

Moreover, the adoption of favourable political, institutional and legal framework, the improvement of regulatory framework supportive to PPP investments, and the introduction of new financial instruments, like international equity funds, project bonds, and guarantee schemes, will give a great contribution to the economic and social development of countries belonging to the Mediterranean Area.

NOTE: **Treatment of PPP in National Accounts in EU.**

According to the Eurostat's decision regarding PPP treatment and National Accounts statistics (Decision Dec. 2003 and rev. ESA Manual), assets involved in a PPP should be classified as non-government (off balance) if both of the following conditions are met: (1) the private partner takes the construction risk (CR) and at least one or either performance (AR) or demand risk (DR). Risk evaluation is under the responsibility of the National Statistical Offices.