European Institutions and the Crisis: Investing to Grow and Compete[1]

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The crisis of Europe: financial stability, fiscal consolidation and growth. The role of investment

How can we reconcile growth and austerity in constructing an exit strategy for the crisis? Two models are very briefly compared.

From the very outset, the United States has decided to intervene on two fronts: cleaning up the balance sheets of financial institutions and recapitalising banks, insurance companies and the automobile industry (through TARP[2]) and enacting an extraordinary economic stimulus plan containing instruments designed to stimulate investment in infrastructure,[3] thereby pushing the US public debt over the "symbolic" threshold of 100% of GDP.[4]

The European Union, where national intervention in support of banks amounted to EUR 1,600 billion (including guarantees),[5] imposed rigorous plans to restore public finances and reduce sovereign debt, including introducing rules and constraints in the national constitutions of the Member States, effectively making it impossible for them to undertake Keynesian-style stimulus

[1] This is a chapter from the ASTRID research report: *"Le istituzioni europee alla prova della crisi",* edited by G. Amato and R. Gualtieri, forthcoming, Passigli Editori, Florence 2013.

[2] The US government, with the Troubled Asset Relief Program (TARP), purchased assets from financial institutions hit by the crisis. TARP originally called for USD 700 billion, which was cut to USD 475 billion by the Dodd–Frank Wall Street Reform and Consumer Protection Act. The Congressional Budget Office (CBO) estimated that USD 431 billion in TARP resources were disbursed, with a good portion of this amount already repaid to the government (of the USD 245 billion allocated for banks, USD 169 billion has been repaid).

[3] The American Recovery and Reinvestment Act (2009), commonly referred to as the Stimulus or Recovery Act, envisaged USD 787 billion in stimulus spending, which then rose to USD 831 billion, of which USD 552 billion for infrastructure, education, health, energy, unemployment benefits and other social welfare spending, and USD 288 billion in tax incentives. The priority given infrastructure investment was also intended to help the US overcome its relative competitive handicap compared with countries with more advanced infrastructure.

[4] Using Eurostat criteria, the entire US public sector debt would exceed 130% of GDP according to the most reliable estimates.

[5] Between 2008 and 2011, the EU Member States approved EUR 4.5 trillion (36.7% of the EU's GDP) in aid to banks. See *High Level Expert Group on Reforming the Structure of the EU Banking Sector*, Chaired by E. Liikanen, *Final Report*, October 2, 2012, box 2.2, p. 21.

programmes. It also required the banking industry to accelerate application of the most stringent prudential rules under Basel III[6] and plans to introduce analogous rules for insurance and pension funds,[7] with a consequent tightening in financing investment. As to growth, it has maintained the ambitious goals of the Lisbon Agenda (EUR 2,000 billion in investments in transportation, energy and TLC), but (having setting aside, at least for the moment, the idea of financing them by issuing Eurobonds) plans call for achieving these mainly through private investment and, for infrastructure projects, through project financing initiatives. In brief, while in the US attention has been focused primarily on boosting growth and jobs, in Europe, the policy focus has been directed at financial stability, sovereign debt crises and rebalancing the public finances.

It is too soon yet to measure the long-term effectiveness of the two different economic policy approaches. It is clear, however, that the US cannot avoid tackling the problem of its rising national debt.[8] And it is also clear that Europe will not be able to achieve its goals of financial stability and fiscal consolidation without taking steps to boost growth and to reduce the macroeconomic and productivity imbalances between Northern and Southern Europe. At present, the financial crisis and the measures taken to foster stability and fiscal consolidation have helped generate recession (particularly in the peripheral countries), deindustrialisation (France and Spain) and widening inequality (between the North and the South), thereby constraining economic growth – as has been recently noted[9] – to a greater extent than experts and market operators had expected.[10]

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[6] This refers not just to the rules prescribed by the EBA, but also to the proposed CRD IV Directive (which rejected calls to retain a measure of flexibility in transposing the Basel II restrictions, similar to that proposed in the US). The US has recently announced that it is postponing the application the Basel III rules.

[7] Solvency II and IORP, both still under discussion.

[8] Ben Bernanke was the first to use the term "fiscal cliff", asserting that "on January 1, 2013, there's going to be a massive fiscal cliff of large spending cuts and tax increases", if Congress is unable to reach an agreement on eliminating or reshaping the Bush tax cuts and the spending cuts provided for in the Budget Control Act of 2011.

[9] IMF, World Economic Outlook, *Coping with High Debt and Sluggish Growth*, October, 2012. And previously, L. Christiano, M. Eichenbaum, and S. Rebelo, *When Is the Government Spending Multiplier Large?*, in the *Journal of Political Economy*, Vol. 119, 2011, pp. 78–121; G. B. Eggertsson, and P. Krugman, *Debt, Deleveraging, and the Liquidity Trap*, in the *Quarterly Journal of Economics,* 2012, pp. 1469–1513. And recently, O. Blanchard and D. Leigh, *Growth Forecast Errors and Fiscal Multipliers,* IMF Working Paper, January 2013.

[10] According to IMF estimates in *Coping with High Debt and Sluggish Growth*, op cit., the multipliers for these effects are currently estimated to be between 0.9 and 1.7, compared with the 0.5 used in past estimates. According to Christiano, Eichenbaum and Rebelo in *When Is the Government Spending Multiplier Large?,* op cit., the multiplier could reach 3 when nominal interests rates are close to zero. A. Auerbach and Y. Gorodnichenko, in *Measuring the Output Responses to Fiscal Policy*, in the *American Economic Journal – Economic Policy*, Vol. 4, 2012 , pp. 1–27, assert that the multipliers associated with public spending should be around 2.5 during periods of recession. According to Blanchard and Leigh, *Growth Forecast Errors and Fiscal Multipliers*, ibid., p. 6, "multipliers were substantially above 1 in the early

It is well known in economic theory that investment is essential for sparking growth and enhancing competitiveness, as well as eliminating imbalances. The literature on this topic is vast and concurs in its conclusions: investment in infrastructure has a positive (and significant) effect on potential GDP growth. This also holds for corporate investment in innovation, R & D, technology and human capital. Any debate essentially regards the measurement and size of this effect.[11] But in addition to the Keynesian multiplier effect on growth, investment is also one of the key factors for the productivity of the entire domestic and European economy.

Given the stringent constraints of the Fiscal Compact, it is obvious that while in Europe these investments were once financed directly or indirectly from the public budgets, increasing recourse is now being made to private capital and financing. But the European banking system is in critical condition and has dramatically slowed down medium and long term lending. If governments and European banks do not finance enterprises and infrastructure, the economy cannot grow. If the economy does not grow, the public finances will not improve, and if the public finances do not improve, Europe will not be able to lift itself out of crisis and risks slipping into a dangerous, vicious circle. While it is true that financial stability and fiscal discipline are the *sine qua non* for enduring and sustainable growth, it is also true that recession and stagnation undermine financial stability in the long run and make fiscal consolidation efforts unsustainable over time.

Only recently has Europe taken steps on a number of fronts where it should have taken action earlier, such as harmonising prudential supervision criteria and actions and speeding up the cleaning up of bank balance sheets (EBA rules, banking union and the Liikanen Report). But the new banking and financial regulations, while useful for preventing new crises and ensuring financial stability, threaten at the same time to discourage investment in the real economy and infrastructure and, more generally, to generate pro-cyclical effects.

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years of the crisis; the lower coefficients in recent years may reflect in part learning by forecasters and in part smaller actual multipliers than in the early years of the crisis". It is also obvious that, when restrictive fiscal policies are implemented by different countries at the same time, the recessive effects are accentuated as a result of the contraction in the foreign component of the aggregate demand of the other countries.

[11] The Bank of Italy recently published a survey of the literature on the issue, finding that the research generated estimates of an average elasticity of 0.105, which, although lower than that found in the pioneering studies of Aschauer and Munnel, confirms the robustness of the positive link between infrastructure and GDP. See also V. Di Giacinto, G. Meucci and P. Montanaro, *L'impatto macroeconomico delle infrastrutture: una rassegna della letteratura e un'analisi empirica per l'Italia,* in Bank of Italy, *Le infrastrutture in Italia: dotazione, programmazione, realizzazione,* pp. 21-56.

Europe therefore finds itself in the typical Keynesian situation of the so-called “liquidity trap”. It is continuing to focus on supply-side policies (which many countries, Italy included, should have been undertaken decades ago) when the problem is now one of demand. The ECB is aware of this, but it also knows that monetary policy is not enough, especially when interest rates are close to zero and the external constraints of the euro are very strong. The upcoming European Councils must tackle the issue of effective policies for supporting growth and investment. It will also be impossible to avoid certain basic questions that today appear provocative: does it make economic sense to increase national debts by more than EUR 500 billion[12] to finance the ESM and to combat financial speculation aimed primarily against the peripheral states because, above all, they are not growing (and one reason they are not growing is restrictive fiscal policies)? Would it not be better to use these resources to stimulate the economy or to lower the tax burden? Would it not be more logical to give the ECB the powers of the Fed or the Bank of England, allowing it to print money (or threaten to do so) when speculation rears its head too high?

The financing of investment and the European banking industry crisis[13]

In Europe, the banks have always played a central role in the medium/long-term financing of the economy. In the US, by contrast, the capital market finances most projects. This is mainly due to the structural differences between the two systems. European Banking Federation (EBF) data show that, in 2010, the total assets reported in the balance sheets of US banks amounted to EUR 8,600 billion (80% of GDP), while those of European banks totalled EUR 42,900 billion (350% del GDP). In the US, during the 2008-2009 period, thanks to the Obama Recovery Plan, public works in the amount of USD 200 billion were financed through the placement of project bonds (so-called Build America Bonds - BABs) on the market.[14] In Europe, as we shall see, the crisis has reduced bank

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[12] Divided between: callable capital, new issues to cover rescue programmes already in place, and subscription of the uncalled capital of the ESM. In Italy alone, the additional issues for the portion of EFSF debt amounts to EUR 45.9 billion for the 2010-2014 period, with an increase in the debt/GDP ratio of 3.1% (DEF (2012) - update).

[13] See F. Bassanini, *Innovative financial instruments to fostering long-term investment in infrastructure – Project bonds and beyond,* in *Astrid Rassegna* (www.astrid.eu), issue no. 16/2012; F. Bassanini, *Improving the financing of projects to favour growth in the context of deleveraging and fiscal discipline,* in *Astrid Rassegna* (www.astrid.eu), issue no. 17/2012; F. Bassanini, *The role of long-term investors to support growth, 8 October, 2012, Luxembourg,* http://www.astrid-online.it/Dossier--d1/DISCIPLINA/Studi--ric/Bassanini_LTIC-Luxembourg-Conference-FB-keynote_DEF.pdf

[14] BABs are issued by public entities (municipalities or public authorities). Their success was also due to the associated tax incentives and by the fact that there exists a wide, deep and liquid municipal bond market on which they are traded. Generally, a public entity finances various PF initiatives that are bundled into single bonds, thereby balancing the cash flow risk of the various initiatives. BABs are not included in the public debt, something that would not be permitted in Europe under Eurostat rules. For this reason, European project bonds will be issued directly by the project companies and not directly by the Government or by Government’s entities.

financing of investment by SMEs and in infrastructure, and the market has struggled to take over this shortfall.

But why are the major European banks no longer financing the real economy? The recent Liikanen Report[15] found excessive risk in European banks – mainly in trading activities, especially for more complex products, and in real estate lending – and an excessive reliance on short-term funding sources. The risk was not covered by sufficient capital. Furthermore, the systematic risk was rooted in overly close ties between the various players in the financial market. The portion of revenues from net interest income, which traditionally reflects banks' role in intermediating between deposits and lending, began to fall compared with other sources of revenue. Currently, the largest ten European banks have an average loans to customers/total assets ratio of less than 30%.[16]

In short, the major European banks grew enormously prior to the crisis and continued to expand even afterwards. But the traditional banking activity of channelling savings into productive investments has become almost "residual" compared with other business, of which trading is now far and away the largest. With this growth in profitable short-term risky assets, leverage has risen to abnormal levels. To increase their capital without turning to the market, the largest European banks have sought to: (a) expand short-term, speculative revenues so as to boost capital with substantial profits, (b) deleverage[17] their positions through asset disposals, and (c) accelerate repayment of loans without granting new credit (thereby engendering a credit crunch). With the cost of money so low, this decision is certainly "attractive", especially for Northern European banks, but devastates medium/long-term lending, i.e. financing for investment. In this regard, four aspects are considered: (1) the negative effects on long-term investment (LTI) of the capital and liquidity requirements under Basel III; (2) the liquidity requirement of the European financial system, (3) the need

[15] The measurement of risk based on internal models allowed under Basel II made it possible to achieve a very high ROE, but the increase in leverage has sharply reduced the ability of banks to absorb adverse shocks and losses. In the meantime, while deposit growth has tracked GDP growth, banks began to finance their rapidly expanding assets (greatly outpacing GDP growth), through the interbank markets (unsecured) and repo markets (secured).

[16] The Liikanen Report contains two charts on the largest and fifth largest European banks, respectively. In 1993, their total assets were divided equally between loans and other financial assets. In subsequent years, the weight of other assets grew significantly. In 2011, in the case of Deutsche Bank, out of total assets of around EUR 2,200 billion, other assets accounted for EUR 1,800 billion, while loans made up EUR 400 billion; in the case of Barclays, out of total assets of EUR 1,900 billion, other assets accounted for EUR 1,400 billion, while loans amounted to EUR 500 billion. And all this with a total capital/total assets ratio of 2.3% for Deutsche Bank and 4% for Barclays. Finally, in both cases, funding from deposits was below 30%.

[17] The BIS recently estimated that one-third of the deleveraging process will involve the sale or write-off of low-quality securitised assets and other risky loans. The IMF – in its latest *Global Financial Stability Report* (October 2012) – estimated the degree of deleveraging stress of the European banks under three different scenarios, obtaining a figure that ranges from a minimum of USD 2,800 billion to a maximum of USD 4,500 billion.

to "clean up" the balance sheets of certain banks, and finally (4) the regulatory differences between national systems, which are already discounted by the market, but are not taken into consideration by international and European regulators.[18]

The European Banking Authority (EBA) recently published its report on bank recapitalisation, estimating a need for EUR 200 billion in capital increases (which many experts believe should be raised to EUR 350/400 billion). To this we could add the costs of harmonising supervision criteria which may be imposed by the Banking Union.[19]

Both the capital and liquidity ratios provided for under Basel III (and by the EU's CRD IV Directive) penalise bank financing of LTI, first and foremost by requiring banks to maintain higher margins on their funding. Accordingly, European banks are gradually reducing their risk-weighted assets (which represent the denominator of their capital ratios), rather than increasing equity (the numerator). Some financial analysts[20] have estimated that the short-term liquidity shortfall faced by European banks would therefore reach EUR 1,300 billion, while the medium/long-term liquidity shortfall would be EUR 2,300 billion.[21]

Funding conditions for banks also deteriorated considerably in 2011. The two extraordinary three-year refinancing operations (LTROs) undertaken by the ECB helped to alleviate the liquidity crisis, but they obviously could not have an impact on medium/long-term lending.[22] Moreover, the many major European

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[18] The differences between the various national regulatory systems are important and relate to measuring risk, the cost of funding and asset quality. A banking union should drastically reduce these disparities, creating a single supervisory mechanism based on: (1) use of a single rulebook for defining impaired/substandard assets and for classifying the weights to be assigned to assets for the purposes of calculating capital ratios, (2) harmonised schemes for protecting depositors and (3) a single bank rescue system. This would increase funding costs for large French and German commercial banks, which are more highly leveraged. The effect for the single market should be positive, rebalancing the higher funding costs of banks in the peripheral countries, which face higher country risk and a larger sovereign debt cost. See European Commission (2012), *Banking union: Commission proposals for a single supervisory mechanism*, http://ec.europa.eu/internal_market/finances/committees/index_en.htm#maincontentSec1.

[19] The impact of banking union on harmonisation of the definition of "non-performing loans" (NPLs) could require EUR 80 billion in extra capital, especially in those countries that are less strict in this area, such as Germany, the UK and the Netherlands. The different rules on measuring the risk associated with bank assets, which Basel III left to national regulators, could also have an impact, which still needs to be estimated. For further discussion of this issue, see Mediobanca Securities, *Harmonising EU banks' asset quality*, October 2012 and *Banking union clouds*, October 2012.

[20] McKinsey, *Basel III and European banking: Its impact, how banks might respond, and the challenges of implementation*, McKinsey Working Papers on Risk, Issue no. 26, Nov. 2010.

[21] It should also be noted that the new ratios would force banks to hold an excessively high level of liquidity (in relation to the risks) in financing the early stages of projects (construction phase). This could create a strong disincentive for banks to take part in project financing initiatives.

[22] The BIS estimated that one-third of the EUR 1 trillion aggregate of the two LTROs was re-deposited with the ECB to cover bonds maturing over the next few years, one third was used for

banks must clean up their balance sheets. The BIS estimates that one third of the deleveraging process will involve the sale or writeoff of low-quality securitised assets and other risky loans.

In particular, this applies to project financing for infrastructure initiatives (which, as we pointed out, becomes essential when fiscal crises force governments to reduce investment). Prior to the crisis, the European banking system financed over 90% of the debt component of these projects (and more than two-thirds worldwide). Institutional investors (mainly pension funds and insurance companies) covered around 40% of medium and long-term bank lending for infrastructure, acquiring bank bonds and securitised loans for these projects in their portfolios. Monoline insurance companies guaranteed risk related to any (temporary) instability in the cash flows generated by the works being financed. With the arrival of the crisis, this model stop working. Monoline insurance companies have all but disappeared; the new regulations act as a disincentive for life insurance and pension funds to invest in infrastructure assets. The European banks, which are already having to cope with the crisis and the new more stringent ratios, face (in the peripheral countries) higher funding costs, and have lost confidence in each other, thus making it difficult to syndicate loans, especially medium and long-term exposures.[23] Together with the decline in public subsidies and the increase in lending costs, this has blocked many infrastructure investments.

There has been a similar adverse impact on financing for corporate investment, which is crucial for competitiveness and growth (such as investments in R&D, innovation, technology and human capital). The capital requirements under the new regulatory framework hit bank lending to SMEs especially hard. The most recent ECB data show that, over the last year, around 20% of SMEs have seen the terms of their access to credit deteriorate, while only 4% of large companies have been hit by the credit crunch. Only major companies continue to be able to access the capital markets directly by issuing corporate bonds.

The European banking crisis has therefore had serious repercussions on banks' ability to finance LTI. Are we witnessing a structural change in the European economic and financial system? And particularly a change in the European model of financing investment, with institutional investors partially replacing banks or with companies directly accessing the capital markets? It is difficult to say. But in any case, a structural change of this magnitude, which

carry trade (including purchases of government securities) and just under one third was used to make loans for the real economy and infrastructure.

[23] According to the latest BIS figures, in the final quarter of 2011, lending for project financing fell by around 39% for the weakest European banks and around 18% for the rest. BIS (2012), *European bank funding and deleveraging, BIS Quarterly Review,* March.

would push Europe closer to the Anglo-Saxon model, has a long way to go. There are too many cultural, regulatory and structural differences between the economic and financial systems on both sides of the Atlantic. More likely, the European system will evolve into a hybrid model, in which the banking sector will continue to play an important, but not exclusive role in financing the real economy.

While waiting for a return of stability in the European banking system, the role of long-term institutional investors will become increasingly important. As regards so-called public development and/or investment banks (EIB, KfW, CDC, CDP, etc.), the change is already on the way. As we shall see, new financial instruments have been designed; additional resources have been mobilised to support the economy during the crisis, most importantly by financing infrastructure and SMEs, either directly or through the banking system; and new European and domestic long-term equity funds have been launched to invest in infrastructure projects and strengthen company capitalisation. Cooperation between these institutions could lead to new initiatives and new instruments. But it is obvious that by themselves they cannot meet the funding needs for the huge volume of investment envisaged in the Europe 2020 agenda and, in any case, that needed to boost growth and make Europe more competitive in the global economy. Other long-term institutional investors, such as insurance companies and pension funds, can do even less if pro-cyclical regulations that penalise LTI in the real economy and infrastructures prevail. Thus, the challenge of developing national, and European, public policies that foster growth and investment must be at the top of the European Agenda.

The initial response of European institutions

After the approval of the Fiscal Compact and ECB measures to combat speculation in the secondary markets for government securities issued by the peripheral countries of the euro area, the discussion of European policies to boost growth has taken centre stage. The European Council of 28-29 June 2012 established the pillars of a Compact for Growth and Jobs, acknowledging, perhaps for the first time, the need to harmonise fiscal rules with support for growth and investment. Alongside the renewed commitment to achieve the goals set out in the Europe 2020 agenda to complete the Single Market for goods, services and energy, to create the Digital Single Market and to reduce bureaucratic and regulatory burdens, a commitment emerged to direct the European budget and the new Multiannual Financial Framework towards promoting growth, employment, innovation, research, competitiveness and convergence.

But very few concrete measures have been defined thus far. The recapitalization of the EIB (in the amount of EUR 10 billion) could, in large part, be absorbed in strengthening its own capital ratios. While the reallocation of the

structural funds should not be downplayed, in practice it has run up against significant limits and restrictions. The greatest change involves the Connecting Europe Facility (CEF),[24] proposed by the Commission within the context of the new Multiannual Financial Framework for 2014-2020.[25] The new integrated European instrument would provide EUR 50 billion for investment in the Trans-European Networks for energy (TEN-E),[26] transport (TEN-T)[27] and ICT (above all digital networks).[28] The related regulation proposed by the European Commission[29] is scheduled to come into force on 1 January 2014, following the co-decision legislative procedure. The regulation identifies the priority corridors, the types of infrastructure that can be financed using EU resources and the forms of financial assistance available, with a special emphasis on innovative financial instruments designed to attract private investors. Significant resources will be allocated for risk mitigation instruments that create a multiplier effect for financial resources received directly from the EU (which could be as high as up to 1:20).

The Project Bond Initiative is part of this framework. It is designed to attract additional private capital using mechanisms to enhance the senior debt rating of companies that issue bonds to finance TEN-T, TEN-E and NGN infrastructures through project financing. The Commission will share the risk along with the EIB (or other financial partners) through guarantees or subordinated debt (up to 20% of the total debt component).[30]

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[24] See European Commission Communication COM(2011)665/3, to be read in conjunction with Communication COM(2011) 676 of 19 October 2011 *A growth package for integrated European infrastructures*.
[25] See European Commission Communication COM(2011)500 of 29 June 2011, *A budget for Europe 2020* and Communication COM(2011) 398 of 29 June 2011 *Proposal for a Council Regulation laying down the multiannual financial framework for the years 2014-2020*.
[26] The European Commission estimates that, by 2020, a total of EUR 1,000 billion will be needed for investment in energy transport infrastructure. Under the CEF, around EUR 9.1 billion has been budgeted for investments in the Trans-European Networks for energy.
[27] The European Commission estimates that, by 2020, a total of EUR 500 billion will be needed for investment in the TEN-T networks. The CEF will have a budget of EUR 31.7 billion specifically for TEN-T projects, of which EUR 21.7 billion will come from the Member States and EUR 10 billion from the Cohesion Fund.
[28] The European Commission estimates that, by 2020, EUR 270 billion will be needed for investment in next generation-networks (NGNs), of which EUR 9.2 billion to be financed by the CEF.

[29] See European Commission Communication COM(2011)665/3, to be read in conjunction with Communication COM(2011) 676 of 19 October 2011 *A growth package for integrated European infrastructures*.
[30] The pilot phase was launched in November 2012. The EU has budgeted around EUR 230 billion for about 10 projects. If we consider a multiplier of around 15-20, it could mobilise investments of up to EUR 4.6 billion. The goal is to create a large, deep and liquid market for European project bonds. See Bassanini F., Del Bufalo G. and Reviglio E., *Financing Infrastructures in Europe: Project Bonds, Solvency II and the "Connecting Europe Facility"*, in *Astrid Rassegna*, issue no. 16/2011; Bassanini F and Reviglio E., *Financial Stability, Fiscal*

This instrument is not a panacea, but could serve as a valid alternative for those institutional investors, including international investors, who want to expand their interests in infrastructure assets. A major role could be played by pension funds and life insurance companies. Infrastructure assets generate stable, long-term cash flows and ensure a balanced distribution of investments compared with a business model based mainly on long-term liabilities.

As regards the focusing of the Multiannual Financial Framework and the EU budget on promoting investment, much remains to be done. Any targeted increase in resources for this purpose runs into widespread resistance from the Member States, which are already seeking to comply with the rules of the Fiscal Compact. The use of new European taxes, such as the Tobin Tax[31] and the Carbon Tax, to finance these investments, while an intriguing possibility, has already met with push-back from countries that would rather use the funds to reduce national contributions to the European budget. Some hope remains, in part fostered by the proposal of European Council President Van Rompuy to use these resources to fund a euro-area "fiscal capacity", or at least to create a fund to finance common projects (the latter being less ambitious, but politically and institutionally more feasible).

Elements of a European policy to promote investment

Measures for promoting and supporting the investment needed to achieve the Europe 2020 agenda and the objectives of the Compact for Growth and Jobs obviously cannot be limited to those examined here. We believe that a European policy for promoting investment of strategic importance for the EU's growth and competitiveness must also act on other fronts, and comprise at least five main types of action: 1) the establishment of a regulatory framework that does not penalise LTI as heavily and that is more attractive to private investors; 2) the development of new sources of public funds for LTI; 3) the creation of innovative financial instruments for LTI and non-regulatory risk mitigation instruments; 4) the introduction of tax incentives and, finally, 5) extraordinary intervention by the ECB to counter the liquidity crunch affecting LTI (VLTROs).

1) *The recalibration of the regulatory framework (Basel III-CRD IV, Solvency II, IORP, IFSR).* Today, the regulatory framework is skewed in favour of short-term lending, including speculative loans, while penalising LTI, thereby

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Consolidation and Long-Term Investments after the Crisis, in the *OECD Journal of Financial Trends*, 1/2011.

31 On 9 October 2012, eleven governments (including Germany, France and Italy) announced that they plan to introduce a financial transactions tax through the enhanced cooperation mechanism. The Commission proposed a rate of 0.1% on stock and bond trades and 0.01% on derivatives contracts. According to EU estimates, the new tax could generate EUR 10 billion per year in additional revenues. Italy has discussed the possibility of early implementation (however, this acceleration could have the undesired effect of causing financial transactions to move outside of the country).

discouraging those investors (particularly pension funds and insurance companies) that, in view of their usual business model, could hold long-term assets. This does not mean diminishing the effectiveness of measures meant to prevent new crises and preserve financial stability, but to fine tune them in order to reduce their recessive effects, adapting the rules to the specific business models of financial institutions other than commercial banks. This could be a win-win strategy if one recalls that, while it is true that financial stability and balanced public finances are necessary conditions for growth, it is also true that financial stability and fiscal consolidation are not sustainable over time in conditions of recession or economic stagnation.

The development of a new regulatory framework more favourable to LTI was advocated in the reports by Jacques de Larosière and Mario Monti,[32] as well as in various European Commission communications (such as those on *A Single Market Act,*[33] *A Comprehensive European international Investment Policy,*[34] and *The EU Budget Review*[35]). But the broad consensus on the need for changes to the existing regulatory framework has not yet been translated into effective action. On the contrary, international and European regulators still seem to be prisoners of a short-term, pro-cyclical, and excessively mark-to market mind set.

But fine tuning prudential and accounting regulations alone is not enough to create a regulatory framework more favourable to LTI. At the European and national levels, much still remains to be done to obtain investment friendly regulation and to reduce risks and regulatory costs. Political and legislative stability, fast and streamlined administrative procedures, low regulatory and bureaucratic burdens, a swift and reliable judicial system, and an efficient and technically capable public administration are recognised as key factors in investment decisions, which today consider the entire globe. In several European countries, the low quality of regulation and high regulatory risks are still, despite some recent progress, among the greatest barriers to LTI. In the European administrative space, which finally acquired a legal basis with the Treaty of Lisbon,[36] we can now consider a European policy of better regulation, aimed at

[32] *The High-Level Group of Financial Supervision in the EU*, Chaired by Jacques de Larosiére, Brussels, 2009 ; and *A New Strategy for the Single Market. At the Service of European Economy and Society*, Report to the President of the European Commission by Mario Monti, May 2010

[33] European Commission Communication - COM 608 (2010), *Towards a Single Market Act,* 27 October 2010.

[34] European Commission Communication - COM 343 (2010), *Towards a comprehensive European international investment policy*, 7 July 2010.

[35] European Commission Communication – COM 700 (2010), *The EU Budget Review*, 19 October 2010.

[36] See Astrid, *Lo spazio amministrativo europeo*, edited by M.P. Chiti and A. Natalini, Bologna, Il Mulino, 2012.

the convergence of European and national regulations towards investment friendly models.

2) *New financial instruments*. On the equity side, we could leverage, replicate and build upon the successes achieved with long-term funds, both European (such as the Marguerite, InfraMed, and Energy Efficiency Funds[37]) and national (such the French and Italian strategic funds F2i and FII). They could be used as “prototypes” for broad “families” of long-term funds for investment in infrastructure, technology, R&D, SMEs, start-ups, local utilities, energy, urban development, health care (using both equity and mezzanine instruments, as in the case of the European Energy Efficiency Fund - EEEF), compensating for the general shortage of risk capital engendered by the crisis.

On the debt side, recent initiatives[38] should be expanded. But beyond that, one or more European debt funds could be set up jointly with the public development banks (EIB, KfW, CDC, CDP, etc.) in order to mobilise resources to finance infrastructure, medium-term investment by enterprises and exports to non-EU countries.

These same institutions could create common guarantee instruments designed to mitigate risks associated with the long-term nature of LTI, perhaps with the partial involvement of European and national resources, especially with regard to regulatory risks. In order to reduce the latter, consideration should also be given to drafting a specific European directive prohibiting retroactive *reformatio in peius* of rules that would significantly affect the profitability of investments, or that impose forms of (at least partial) compensation.

Moreover, the scope of application of European guarantees for project bonds (at present this only covers bonds issued in association with TEN-T, TEN-E and NGN) could be extended to a wider range of investments, such as health care, R&D, public utilities, urban development and energy efficiency.

3. *Public resources*. As crucial as it is today, recourse to private capital and financing it not, in and of itself, sufficient. There are investments – such as theoretical research or railway infrastructure – that, despite efforts to develop

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[37] The European Commission participates directly in the Marguerite Fund and EEEF with its own funding. For a description of the Marguerite Fund (*2020 European Fund for Infrastructure and Climate Change*) go to www.margueritefund.eu., for the InfraMed Fund visit *www.inframed.com* and for the EEFF see www.eeef.eu.; see also Bassanini F and Reviglio E., *Financial Stability, Fiscal Consolidation and Long-Term Investments after the Crisis,* op cit.

[38] Such as the High-Growth and Innovative SME Facility (GIF), the SME Guarantee Facility (SMEG), the Risk-Sharing Finance Facility (RSFF) and other more traditional financing projects in the area of Research, Development and Innovation (RDI). In February 2011, the EU launched a public debate on drawing up new guidelines and financial instruments for future European investments in research and innovation for the next Multiannual Financial Framework: *Green Paper – From Challenges to Opportunities: Towards a Common Strategic Framework for EU Research and Innovation funding*. COM(2011)48.

innovative solutions[39] to make project financing a possible option, are unable to generate sufficient returns on investment so as to make public subsidies, or at least partial subsidies through PPPs, unnecessary.

The way ahead is obviously to conduct strict, rigorous spending reviews that enable national Governments to shift resources from non-essential current expenditures to public investments. At present, many Europeans countries (including Italy) find this route impracticable, given the need to allocate any savings achieved on current spending to paying down the public debt and reducing the tax burden. However, partial earmarking of these resources for qualified public investments could be justified, considering the positive externalities that these investments could generate for government deficits and debt, acting on both the numerator (higher tax revenues) and the denominator (GDP growth). In this light, it has been proposed that the Fiscal Compact be restructured at the European level to allow recourse to the so-called "golden rule" (i.e. deduct investment from the calculation of public debt during recessionary phases of the economic cycle with clear counter-cyclical effects). The golden rule has, up until now, encountered fierce resistance in the EU due to fears that it would, *de facto*, be extended to many areas of current spending.[40] Mario Monti has therefore proposed limiting its scope to those investments envisaged by the Digital Agenda for Europe. Along the same lines, we suggest that application of the golden rule be limited to national co-financing of infrastructure projects financed by the EU (CEF, Structural Funds) or the EIB.

There is also the debate over the use of sovereign debt instruments issued by the EU to finance strategic European investments; i.e. the so-called "Eurobonds for Growth". First proposed by Jacque Delors in the early 1990s, until now the idea has met with insurmountable political resistance, exacerbated by recent attempts to use them to mutualise the Member States' sovereign debts after the outbreak of the crisis. But Eurobonds for Growth, especially if used to finance (or guarantee) investments with safe returns, even if deferred, would not, in reality, create any moral hazard, i.e. the risk of saddling the "virtuous" countries with the

[39] An example is the recent introduction into Italian law of availability payments, making it possible for private investors to finance, build and operate infrastructure intended for public use (schools, hospitals, prisons) in exchange for long-term leases of the structure, which the private investor must ensure will be properly built, maintained and operated.

[40] Recently, on 14 May 2012, the Economic and Monetary Affairs Committee of the European Parliament rejected an amendment proposed by Roberto Gualtieri to deduct two-fifths of investments key for European growth from the deficit calculation. Nevertheless, the amendment garnered more support than expected.

debts of the "wicked" countries, but would be an extraordinary instrument for promoting the growth and competitiveness of the entire European Union.[41]

The issue is still open. It may be possible to find a solution after the German elections in the autumn of 2013, if, in the meantime, major strides are made in building the fiscal, economic and political union set out in President Van Rompuy's issue paper,[42] which will be discussed by the European Council at upcoming meetings.

4. *Tax incentives*. These were crucial to the success of the US stimulus plan and the related BABs.[43] If used to encourage project financing and PPPs, then there seems to be a strong argument for them: on the one hand, they enable investments that otherwise would require the use of public resources; on the other, these investments contribute to growth and, therefore, fiscal consolidation (in both the numerator and the denominator).

This is indisputable, at least in cases in which the incentive is strictly intended to rebalance financial plans that have been impacted by the elimination of expected public subsidies or the increase in the cost of bank loans. And it is limited to a portion of the higher tax revenues generated by this investment, net of any substitution effects, as recently provided for in the Italian legislation on financing infrastructures through tax relief.

On the funding side, tax incentives could be introduced to promote long-term saving and its allocation to LTI.

5. *Very Long-Term Refinancing Operation (VLTRO) by the ECB*. To combat the credit crunch at medium and long term, the ECB should consider an extraordinary refinancing operation along the lines of the two recent LTROs, but with three significant differences: a longer term (6-9 years), a lower amount (EUR 150-200 billion would be sufficient) and clear earmarking of the funds for financing LTI (infrastructure and productive investments).[44]

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[41] See A. Favero and A. Missale (*EU Public Debt Management and Eurobonds in Euro Area Governance – Ideas from Crisis Management Reform*, DG Internal Policies, Brussels, 2010) and the extensive bibliography found on the Astrid website. See also F. Bassanini and E. Reviglio, *Union bond per finanziare una crescita sostenibile*, Il Sole 24 Ore, 16 February 2010, and A. Quadrio Curzio, *On the Different Types of Eurobonds,* in *Economia Politica*, vol. XXVIII, issue no. 3, 2011.

[42] EU, *Strengthening Economic Governance in the EU. Report of the Task Force to the European Council*, Brussels, 21 October 2010.

[43] See notes 3 and 14 above.

[44] See F. Bassanini, *Financing long term investment in Europe: the case of project financing,* 2012 OECD Forum *Policies for a new infrastructure investment model,* Paris, 23 May 2012, now in *Astrid Rassegna,* issue no. 11/2012

Under certain conditions, the investment projects themselves could be accepted as collateral, if receiving co-financing from the EIB (and which have therefore been technically and financially validated) and if backed by government guarantees (or by a system of guarantees developed jointly by the European development banks and the EIB).

A condition for accessing the VLTRO would be depositing to the ECB the medium/long-term financing agreements to which funds are allocated.

Conclusions.

In conclusion, investment plays a fundamental role in sustaining growth, fostering competitiveness and ensuring the conditions necessary for financial stability and the consolidation of the public finances. In the current economic environment, resources for funding LTI can no longer come primarily from government budgets (which are squeezed by fiscal imbalances) or from banks (which are restructuring and under pressure from Basel III). We need to create the conditions for promoting the entry of private capital. More specifically, institutional investors can play an increasingly important role. However, substantial changes in public and regulatory policies and new financial instruments are needed, both at the European and national levels, to encourage, or at least not penalise, LTI.

The Commission is preparing a Green Paper to identify rules, conditions and instruments that could foster the flow of private capital into LTI. Internationally, the Russian president of the G20 is going to propose that the issue of LTI financing be given priority status on the agenda for 2013. This could mark a turning point. At the first G20 summit (Washington D.C., 2008), during the discussion on the guidelines for reforming the financial system, the issue of LTI was not even considered. It is true that the conclusions of the G20 summit in Pittsburgh made the objective of growth (strong, balanced and sustainable) a central priority. But in reality, this did not alter the bank-oriented, short-termist, pro-cyclical approach that dominates the international regulatory culture. Rules and measures aimed solely at ensuring financial stability have helped transform the crisis into a double-dip recession, thereby thwarting, at least in a good portion of Europe, efforts to restore financial health and achieve fiscal consolidation. The persistence of the crisis obliges all of us to acknowledge that, in a modern market economy, financial stability, growth and social cohesion are inextricably intertwined, and that investment is a key factor not just for growth and competitiveness, but also for the stability of financial institutions and for rebalancing the public finances. It would have been better to understand this earlier. But, as always, better late than never.