Long Term Investments and New Financial Instruments for Economic Growth: An Efficient Response to the Systemic Crisis

by Paolo Raimondi

Two year after the collapse of Lehman Brothers which signalled the explosion of the global financial crisis, we witnessed the biggest banking bail out in human history and giant stimulus packages in all the advanced countries, and yet we did not succeed in rescuing the economy. There are many reasons and causes to explain how the global financial crisis came to be. I would like to single out one: short-termism. A normal and productive economy, as all living processes, requires a defined time for changing and development. A child should not work like an adult. The child has to grow first, playing, studying, learning competences, till a certain mature age, and then contribute with his skills to his family and to society. When we see children at work in mines, factories or in the fields, we experience one of the worst violations of divine and natural laws.

The same holds true if we want to build a bridge, a road or to prepare land for agricultural production. Everything requires its time, from the original idea till its final realization. Fundamental changes in the economy are possible only through scientific discoveries (R&D), new technological modernisations, new infrastructure, etc. All this requires large projects whose realization and maturity require time: medium term periods (3 - 8 years) and long-term (10 - 25 years and longer).

Short time can function only for sales of goods, already produced, or for certain financial operations which are detached from the production processes, in particular for speculation.

The short-termism that characterized recently global capitalism has had a very negative effect on the economy and on the financial global system and it is partly responsible for the present crisis. Its origin maybe traced back to a few well known factors.

The corporate governance model of the so-called "shareholders' capitalism"is one such factor. Such a model places the maximization of the value of shares at the centre of the stage, even before the industrial or social value of the enterprise. The firm becomes then an abstract concept, and not a "community" or an "organism". The managers of the enterprise are "winners" if they maximize the value of the shares, which is directly related to generous bonuses and stock options. This mechanism has created strong incentives to maximize short term rather than long term value.

Short-termism is related to the great unregulated liquidity and the low cost of money which has characterized the global financial markets in the past. More recently, coupled with deregulation of financial markets and institutions, it has exacerbated arbitrage and short term speculation.

Before market deregulation, the Western financial system was based on the strict distinction between "banking" and "securities". Banks managed credit and interest bearing instruments, securities' firms dealt mostly with market risk. Then, with the creation of derivatives markets, it multiplied individual banking risks, creating a disastrous situation.

Finance dominated the entire economic process, not only in term of power and control but in term of methods of thinking, of planning and decision making. Progressively, the quarterly based profit targets and shareholder interests became the dominant rule. Managers in banks, insurances but also in all the major corporations encouraged their employees to comply to this rule of the "golden calf".

It was a perversion of the economic laws, but even more dangerously, it was a moral and cultural perversion of the entire society. Here and now and as much as possible, greed was the motto of this new perverted ethic.

It should not be a surprise then, if the speculative Over the Counter (OTC) derivatives traded outside of the regular markets and not reported in the company books, reached the level of 700 trillion dollars, or if the sub prime mortgages market boomed. But, in such a situation, the real economy dies.

There will be no functioning exit strategy from the crisis if this trend is not reversed and if we do not discover again the principles of a sane, productive economy.

Let me now shortly report some of the negative economic effects of this policy.

The crisis is having a severe impact on public finance in nearly all the mature economies. First of all it produced a raising public debt and, as a consequence, it is becoming increasingly difficult to obtain credit from governments and international institutions, like the European Union for example, for investments in major infrastructure projects: a key part of any crisis exit strategy.

According to recent reports by the International Monetary Fund, the debt/GDP ratios of the "advanced economies" within the G-20 came to 101,8 % of GDP in 2009 and could reach 121,7 % in 2014. The public debt of the industrial countries are expected to expand the most, while those of the emerging countries should remain stable at around 30 % of GDP. The former include Japan (from 218 % in 2009 to 245 % in 2014), Italy (from 115,3 to 128,5), the United States (from 84,8 % to 108 %). Germany (from 78,7 % to 89,3 %), France (78 % to 96,3 %) and the United Kingdom (from 68,7 % to 98,3 %). For other smaller Western countries like Greece, Portugal, Spain, Ireland and few others, this growing ratio could create a very volatile situation. For the G-20 emerging countries the trend is very different: China (from 20,2 % to 20 %), India (from 84,7 % to 78,6 %), Russia (unchanged at 7,2 %) and Brazil (from 68,5 % to 58,8 %).

Taking a long-term view, the debt/GDP ratios of countries with mature economies in 2050 could even exceed 250 %.

This means that in the coming decades there will not only be profound structural transformations in the flow of savings and goods as part of market globalisation, but also there will be a revision of the theory and practice of global monetary economics.

The instruments of fiscal stimulus, deficit curbing and some structural reforms are proving to be insufficient to deal with the new challenges. We are facing a real historical paradigm shift. The old world, rich and powerful, is aging and falling further into debt. The new world, still weak and poor, is young, far less indebted, and is expanding rapidly and therefore has greater potential for economic growth and to accumulate savings. We have to find answers to a number of questions. Where will the flow of savings go? Securities of which country will they buy? Which are the future reserve currencies? Will these reserves aid the development of the internal economy or will return to the international markets?

At the moment, about 80 % of financial savings are held by Western countries, but the financial assets of the emerging countries are expanding at a very rapid rate. Enormous structural changes are to be expected over the long term..

The Western governments are flirting with two very dangerous and potentially devastating solutions. One says that to reduce the debt/GDP ratio we should generate "controlled inflation". A number of abstract mathematical schemes have been developed to support such an idea. It is estimated that with 6 % inflation over the next five years the average debt/GDP ratio of the advanced economies could fall by 8 - 9 %. The reality is that inflation is a beast which is very difficult to control and history should have taught us that inflation can become the source of greater social instability, of ideological nightmares and military adventures.

The second route is cutting the debt curtailing spending, increasing taxes and privatization programs. In the present stagnating economy, it could provoke prolonged deflation and even a full recession. To cut government debt to pre-crisis levels, the average budget adjustment of the G-20 advanced economies, in the period 2011-2020, would have to be in the order of 8 % of GDP. In the case of the EU-27, the largest economic area in the world, 150 - 200 billion Euros in spending cuts per year for 10 years would be necessary.

The third option instead would be to boost the average rate of GDP growth. Growth is the strongest ally in the fight against debt. For example, with debt equal to 100 % of GDP, an annual 1 % year increase in real growth (assuming constant public spending and a tax burden of 40 %) could reduce the debt/GDP ratio by 28 % over 10 years.

One feasible way to stimulate growth is to channel major flows of long-term capital in investments in infrastructure development, new technologies and new efficient energy soltions.

The realization of such program requires a few fundamental changes.

The G-20 countries must agree to create in a coordinated and peaceful way a global **multi polar economic, monetary and trade system**. The American single power domination came to end and a monetary Dollar/Euro world condominium is not workable after the global crisis for the structural weaknesses indicated above. The new international global order will require a monetary agreement based on a basket of currencies, with the participation of the so called emerging economies. It is also the main guideline of the BRIC countries' economic strategy.

A global financial reform cannot be arranged by the USA alone or only through an USA-EU agreement. They are old schemes which try to deny that the economic and financial world balance of power has changed dramatically. Global governance must be modified, taking into

consideration these changes and the future challenges. A balanced G-20 Group needs new leadership and power distribution, considering old economic and political alliances less and emerging economies and population distributions more.

It will take a long-term vision to tackle major challenges facings our society: modernization, scarce natural resources, environmental protection, poverty, migration, health and education. Exit strategies for the economic and financial crisis must be developed on this basis. Strategic investments in infrastructure, energy, telecommunications and human resources play a key role in improving the quality of life and social cohesion, necessary positive prospects for the economy as a whole. Policies aimed at long-term global objectives present an opportunity. Transition to a low carbon economy and laying the groundwork for rapid urbanization, are examples requiring major investments in technological innovation, energy, water infrastructure, telecommunication and transport. Such industries are capable of generating attractive returns, stimulating "virtuous chains" of investments and fuelling economic growth and job creation.

For example, the OECD forecasts world capital expenditure in the energy sector between now and 2030 at 26 trillion Dollars. Only for Europe, the World Bank estimates that 100 billion Euros per year should be invested in new infrastructure and for the replacement of the existing ones (mainly in energy generation, telecommunications and transport).

Governments and states will have a big responsibility in funding long term investments. But it will be difficult to fund investments of this size solely from public resources, particularly in the Western countries significantly affected by the increase in debt. More capital must come from private investors and from public sources in countries that are running financial surpluses. The issue of the forms and instruments required to channel such capital into long-term investments in infrastructure is a key element of recovering from the recession and developing a model for sustainable and balanced world economic growth.

The crisis has modified investors' risk profiles. In the future we will see greater demand for long-term, low risk investment products from large pension funds, insurance companies, sovereign wealth funds and households and small investors.

New regulatory and prudential frameworks are necessary to support such long-term investors. It must include specific incentives, appropriate accounting rules, effective corporate governance systems and new rules on financial markets.

Certain financial institutions are increasingly risk-adverse. Now there is a higher requirement of far more equity capital than in the past. A response is to make viable new forms of Public-Private Funding for long-term large projects.

For about two years the EU has initiated a program to establish major equity funds, financed by public financial institutions, for channelling private capital, households' savings and public funds also from non-European countries in search of diversification opportunities. European long-term institutional investors, Caisse des depots et Consignations (CDC) of France, Cassa Depositi e Prestiti (CDP) of Italy and Kreditanstalt für Wiederaufbau (KfW) of Germany, started developing the project, with the support of the EU Commission and the European Investments Bank.

They set up the "**Marguerite Fund** for Transport, Energy and Climate Change". The Fund will to all effects be "market oriented", but distinguished from traditional private equity funds by seeking non-speculative returns, by investing with long-term horizons and by gathering

significant institutional endorsement, first of the EU Commission. It also explored the option of deploying other financial instruments that could help increase its resources. Three such tools are the Project-Bonds, the Guarantee Systems and the Euro-Bonds.

European **Single Project Bonds,** issued directly by project sponsors such as the Marguerite Fund, would create a fast and attractive instrument. The Fund would indicate a well-prepared project and through the sale of bonds to private investors could raise funds directly, without effecting public accounts of the EU or of the member states.

The Marguerite Fund could also provide **Debt Service Guarantees** to cover other private project bonds. They are acceptable alternatives to loans provided to cover profiles at risk.

Due to a solid reputation and technical expertise in "assembling" Public-Private-Partnership projects, any Marguerite Fund recommended instrument, with high rating and low cost, is certain to attract investors. In the event a project's full funding were not cover by bonds, banks may then invest.

Eurobonds, unlike the single project bonds, are in fact European sovereign debt instruments. Even if they have so far met with strong resistance, if used only for financing strategic plans (not for current account expenses), Eurobonds would repay themselves.

The following is a very interesting proposal circulating in the European capitals. Each EU member state should transfer a quota of its national debt into Eurobonds, in proportion to its GDP. To finance this, each state would commit the funds required to service the part of the transferred debt on an annual basis, measured on the costs of its national debt service and not on the lower cost of servicing Eurobonds. Besides creating a very large and liquid Eurobonds market, which could attract global investors and central bank reserves, extra funds for common projects could come from the spread differentials between the national sovereign bonds and the Eurobonds' yields. Additionally, the creation of a common European sovereign debt will be of great political significance, as important as the Euro, for building a more effective and durable united European economic system.

It is clear that the long-term infrastructure projects will only be successful if a significant portion of the necessary funding is provided by such a Fund, by public debt or by a combination of similar innovative instruments. Public and private enterprises and institutions alone, without public support, would be highly unlikely to sustain the substantial costs of these large, strategically important projects.

Recently the CDC, the CDP, the KfW and the IDB created a **Long Term Investment Club** open to similar institutions and development banks from all the major countries in the world and also to other major global institutional and private investors. Presently the Club regroups members that together represent 3,000 billion Dollars of assets. The funds collected should go to finance major long term infrastructure projects in all the continents. The broader plan is also to convince more financial entities and the public opinion at large of the necessity to return to promote a modern growing economy of producers of real wealth.

I must add that many such ideas are not new, but they are taken from the experiences of the New Deal program of President F.D. Roosevelt. The New Deal was a large long-term program to promote a true industrial, technological and social revolution. It promoted a strategic infrastructure for a global modernization of the economy. It based itself on two fundamental innovative institutions: the National Recovery Administration to guide

investments in infrastructure and in large public works, and the Reconstruction Finance Corporation to create new credit lines to promote well-selected projects.

We are still in the middle of a crisis which was provoked by the violent, large and on-going market manipulations, and aided by a true collapse of professional ethics and by the loss of a sense of responsibility in all public and private affairs. We could say that society will only return to reason when we are able to apply and to realize our true fundamental human values in the fields of economics.

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Remarks: Opinions expressed in this contribution are those of the author.

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