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2012

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Abstract

Since the establishment of the single monetary policy and introduction of the euro, it is pertinent to investigate the link between financial stability and integration.

Is there a complementarity between the two or are financial stability and integration a contradiction in terms? In other words, isn't a search for a highly integrated financial system that would strengthen stability a bit like a search for the Holy Grail?

Investment has been the cementing element of EU integration, institutions and policies – in brief, in creating more Europe. More concretely, investment in people, in knowledge and in physical assets, to ensure that Europe preserves its role and position in the world. The current crisis transcends national, even continental borders. Europe is reminded of its severity on a daily basis. Record unemployment is one of the consequences; shrinking public budgets and financial austerity another. In the run-up to the current recession investment grew by 5-6% a years. Exporters and home buyers drove this expansion, which ended in 2008. Since then, the lack of investment has been a main source of demand weakness in the European Union.

A collapse of investment activity of this magnitude has inevitable repercussions for economic expansion in the longer term. If productive capital stocks do not grow – indeed, if they are not even maintained – EU growth potential will inevitably shrink.

A revival of investment activity is therefore crucial to the long-term growth prospects of Europe. One precondition for such an investment revival is access to reasonably priced funding for long-term projects. The process of fiscal consolidation at national and European level has already placed a severe restriction on public budgets – and will continue to do so in the medium term. This pressure means that the EU has to find ways to achieve more with less. In particular, at European level, one needs to ensure that a limited EU budget is used to maximum effect.

The newly established EU project bond initiative is seen as a means to go ahead in the current circumstances. As it does not impose an additional burden on domestic budgets, sovereign debt or contingent liabilities.

The review looks into the type of investment that can be catered by the project bond initiative and the sectors selected for magnifying the growth potential.

Financial stability and integration

Since the establishment of the single monetary policy and introduction of the euro, it is pertinent to investigate the link between financial stability and integration.

Is there a complementarity between the two or are financial stability and integration a contradiction in terms? In other words, isn't a search for a highly integrated financial system that would strengthen stability a bit like a search for the Holy Grail?

Judging from developments during the first decade of the euro, we can say that stability of the financial markets does indeed contribute to their unification, which is one of the key policy objectives for the EU because it fosters economic growth.

In the opposite direction, this integrated financial sector has brought along additional risk-sharing opportunities, improved market liquidity, and led to significantly more cross-border activity by financial institutions. All this has, at least in the first years of the euro's existence, led to more stability.

In addition, the removal of the foreign exchange risk which came with the creation of the common currency has accelerated trade in goods and services inside the euro zone. The EU has indeed, witnessed the creation of new trade, not just trade diversion from outside the euro area.

However, it wasn't just the forex risk premium that has disappeared. Most other risk premia have vanished as well. This has triggered:

- external account imbalances (deficits in some countries, surpluses in others)
- and it also led to fiscal imbalances in many countries.

As a result of the absence of the risk premia as price signals, many European banks have took on their books a significant amount of sovereign debt from other Member States which, unfortunately, later got into serious financial and economic difficulties. For example, in 2011 German banks still had a net sovereign exposure to European Economic Area countries of EUR 425bn.

The unsustainable flows of funds and accumulation of external debt by governments and the private sector – the various "credit bubbles" – are phenomena with which we grapple to this day.

An adjustment process to correct these imbalances is underway, and will no doubt be long and painful. As part of this process, we have observed an increase in the "home bias" of financial institutions – reversed capital flows and financial nationalization.

The largest drop in cross-border lending since Lehmann Brothers actually came in the fourth quarter of 2011. This worldwide decline was largely driven by euro area banks trying to deleverage. And even though cross-border claims expanded slightly at the beginning of this year, they remain way below pre-crisis levels. [2] Obviously, this is not beneficial in the long term.

At face value, then, one could see tension between financial integration and financial stability. Financial integration led to unsustainable debt accumulation – most notably by some governments - and was therefore among the causes of the current sovereign debt crisis.

Paradoxically, the risk premia came back with a vengeance, making countries using the same currency paying vastly different interest rates on their debt.

But is it really the case that the concept of financial integration was the root cause of the financial instability that we currently observe?

No, of course not. Financial integration is good in its own right, as it allows capital to be allocated to the best possible use. Conversely, lack of financial integration means that capital is not allowed to flow where it is best used.

However, we've learned from the crisis that a closely integrated financial system does not result in more financial stability **if** it is not well managed and **if** the regulatory framework doesn't develop as quickly as the integration itself.

The current episode of financial instability is rooted both in market and policy failures. Investors made clearly wrong judgements by not pricing in any of the risks that have materialized. And the institutional, regulatory and supervisory frameworks that were in place to support financial and broader macroeconomic stability were inadequate.

The crisis has exposed some failures endangering the very essence of a sound financial system, for instance a lack of emphasis on risk management; the misuse of securitization and mistakes by the rating agencies when assessing securitized products; and, last but not least, moral hazard in the form of excessive reliance on the "lender of the last resort," i.e. government.

Thus, the right policy to restore financial stability is to address those root causes, and one should not fall into the trap of blaming financial integration itself for creating instability. And the core issues are being addressed at the European level:

- the EU is in the process of overhauling its framework for monitoring and addressing macroeconomic and financial imbalances;

- the set-up for regulating and supervising banks and other financial institutions is being reformed;

- the ESM will become a cornerstone of financial stability; and the monetary policy executed by the ECB is also playing a big role in remedying the situation.

The roles of the ECB and ESM are key, and they are complementary in stopping and preventing contagion: The ECB focuses on securing an effective transmission of monetary policy into the real economy by providing liquidity through the financial system. The ESM, in turn, will provide a permanent crisis management mechanism. Taken together, the ECB and the ESM offer the firepower that is needed to confront the negative impact of contagion in the short and medium-term.

Last, but not least, policy action also includes efforts to complete the establishment of a single capital market and a single market in financial services.

Europe is in the process of addressing the sources of the financial disequilibrium, and is well advanced in setting up backstops to prevent, or at least better respond to, crises in the future.

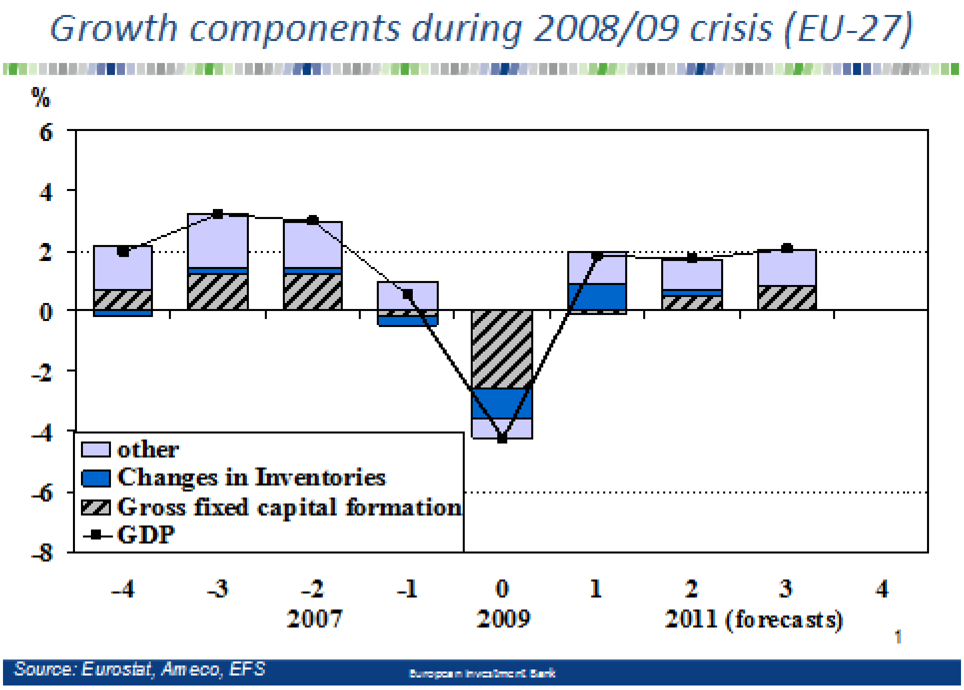
To restore financial stability Europe needs more financial and economic integration, not less. At the same time one can certainly say that integration is a means, not an ends. The key policy focus must be putting Europe on a path of sustainable growth and make it more competitive in the globalized economy.

Need for investment

Above all else Europe needs sustainable economic growth to raise living standards, secure welfare and jobs. Investment – smart investment in key infrastructure assets, in research, in people – is the key to raising productivity and long-term growth in Europe.

The importance of investment can be best illustrated by its mere definition. As commonly defined i.e. gross fixed capital formation together with changes in inventories – investment is widely acknowledged as a key driver of growth: both in the short term, influencing the length and depth of normal cyclical movements in economic activity, but also – through innovation and productivity gains – in determining the long run growth potential of an economy.

This chart illustrates the impact of contracting investment on the recent economic crisis. This chart plots the change in EU economic growth (scale on left-hand side) over time, with zero equal to the slump in 2009. The change in GDP is broken down into investment through changes in gross capital formation (dashed grey colour) and inventories (dark blue).



The chart demonstrates how the contraction in investment in 2008 and 2009 explains a large percentage of the slump in GDP. In 2010, partly due to coordinated efforts by EU governments, gross fixed capital formation recovered to only slightly negative levels.

Investment is needed, in an abstract sense, in European unity, cohesion, institutions and policies – in brief, in creating more Europe.

More concretely, it is also needed in people, in knowledge and in physical assets, to ensure that Europe preserves its role and position in the world.

The crisis transcends national, even continental borders. Europe is reminded of its severity on a daily basis. Record unemployment is one of the consequences; shrinking public budgets and financial austerity another.

The central position of Europe's economy and the impact the downturn has had on its trading partners – China, Russia, and the Americas. Investment in Europe is therefore in the interest of all of its commercial partners

At the same time, we know that investment tends to be the most volatile component of aggregate demand, and, sadly, this crisis has not been an exception.

In the run-up to the current recession investment grew by 5-6% a years. Exporters and home buyers drove this expansion, which ended in 2008. Since then, the lack of investment has been a main source of demand weakness in the European Union.

Gross fixed capital formation contracted massively early in the crisis and has remained feeble, nearly 15% lower than five years ago.

A collapse of investment activity of this magnitude has inevitable repercussions for economic expansion in the longer term. If productive capital stocks do not grow – indeed, if they are not even maintained – Europe's growth potential will inevitably shrink.

A revival of investment activity is therefore crucial to the long-term growth prospects of Europe. This is the core message of the EU 2020 strategy – to invest in smart ways, in sustainable core infrastructure; in research and innovation to increase productivity; in people. In core infrastructure networks alone, such as the TEN networks in energy and transport; energy generation and broadband, the Commission has estimated a need of 2 trillion euros until 2020.

Europe has tried this also before; the Lisbon strategy failed largely because of a lack of commitment by member states, and a failure to align national policies with EU priority objectives. This time, the EU is expected to have learnt the lesson and take advantage of a new model of economic governance.

Financing investment

One precondition for such an investment revival is access to reasonably priced funding for long-term projects.

The process of fiscal consolidation at national and European level has already placed a severe restriction on public budgets – and will continue to do so in the medium term.

Europe's main concern is long-term investment underpinning sustainable growth. Of course, there is currently a compelling case for loans with a significant short-term multiplier effect giving an immediate boost to production and employment. But long-term economic, financial and environmental soundness and viability of investment must remain a pre-requisite for EU institutional support.

The "golden rule" is: debt should be incurred for investment capable of producing economic benefits that allow its repayments.

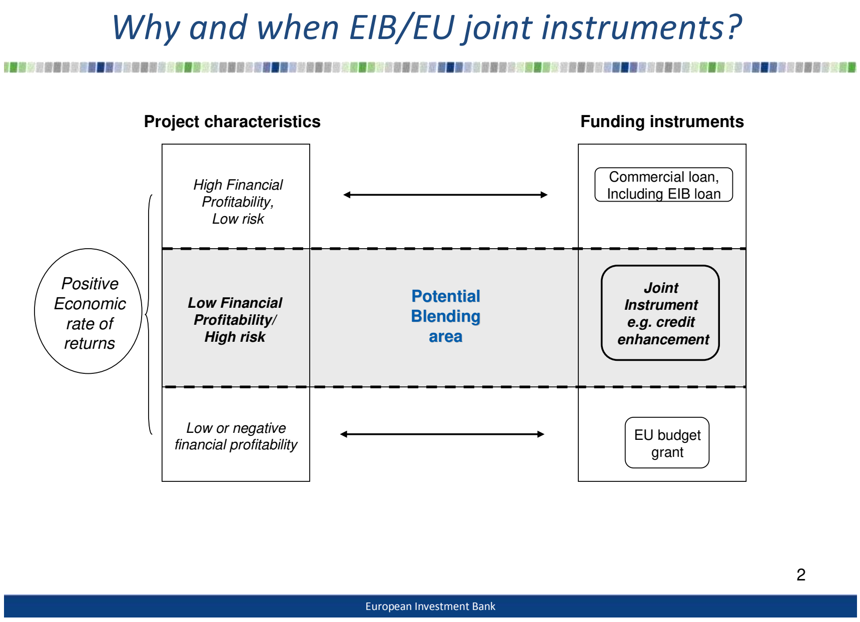
The need for a structural change to European economies is well published. But a switch to a more resource-efficient and smarter economy – which is absolutely vital for Europe if it wants to remain competitive on the global scale - will not happen overnight. This switch will not come about without large volumes of long-term investment and structural reforms that unleash the potential of that investment. The "long view" must prevail. It must balance out short-termism, which has been at the root of the current financial crisis.

There is systematic evidence that the near future**,** the drive for immediate profit maximization, plays a disproportionate role in financial decision-making to the detriment of the more distant future. This "quarterly capitalism," as it is sometimes called, has been omnipresent in households, on the financial markets, in banks, businesses, even in governments. This short-termism - and the under-investment in projects with long payoff periods that comes with it – has highlighted the importance of those lenders who have not lost their sight from the long term

This suggests that the private sector will need to do more and in the right way. Yet it is clear that, since the crisis unfolded in 2008, a substantial portion of market liquidity has dried up – in particular the participation of institutional investors such as insurance companies and pension funds. At the same time, bank balance sheets are under pressure and will continue to remain so under Basel 3. As a result project companies face greater difficulties to secure long-term financing; either from banks or from capital markets.

This pressure means that the EU has to find ways to achieve more with less. In particular, at European level, one needs to ensure that a limited EU budget is used to maximum effect. As the EU bank, we also consider the EIB to be a 'second leg' to finance EU policies, alongside the EU budget. To be successful, of course, such instruments need to unlock investment and catalyse existing and new investors, aligning all EU funding possibilities in a judicious blend, including Commission grants and European Investment Bank financing. The Project Bond Initiative is one result of those discussions.

Whereas grants are well understood policy instruments, what is the rationale for using public funds as risk capital? What determines the value to taxpayers in choosing one instrument or another? The chart below– although very simple – captures the essence of this trade-off. It matches project risk and return profiles with funding sources.



Assume for a moment that we have a set of European projects with a strong economic case: the benefits to society outweigh the costs. Yet within this set, financial returns vary.

At one extreme – at the bottom of the chart, we have projects with limited revenues streams and/or significant risks such that the financial rate of return is very low or even negative. This is the world of grants – and will remain so.

At the other extreme – at the top of the chart, we have a set of projects with robust financial returns. This is the ‘bread and butter’ of financial markets – there is little rationale for using public grants.

In between, of course, – in the middle of the chart – are a range of projects with significant revenue streams, with quantifiable and limited risk profiles – but which fail to make an investment grade rating. This is exactly the set of projects for which a tailored instrument, using risk capital provided by the public sector, can provide high value for money. In the limit, the presence of such an instrument can help bring a project to financial close that otherwise could not; or at least not without significant delay. In this sense, relative small amounts of public money can help underpin and accelerate relatively large volumes of investment – the so-called “leverage effect’’.

This has indeed been the philosophy behind the European Investment Bank’s design of the Risk Sharing Finance Facility (RSFF) in the field of research and development, as well as and the Loan Guarantee for TEN-T projects (LGTT) designed to reduce investor exposure to traffic risk in the early years of project operation. Both instruments, have been well utilised. In the case of RSFF, for example, at the end of 2010, loans worth almost EUR 6.3bn were signed, with EUR 3.5bn disbursed. For LGTT, there is pipeline of 16 operations; with signatures of guarantees for EUR 140m, supporting capital investment of around 2.1bn.

In parallel, since the 1990s, the European Investment Bank has sought to broaden the geographic and sector spreads of its PPP lending. As a result, the Bank is now Europe’s foremost funder of PPP projects, with a portfolio of 120 projects and investments of around EUR 25m.

But lending volumes come only at the end and are therefore only part of the story. For getting at the finance phase, projects have to be designed in a bankable way, being at the same time technically, economically and environmentally viable. The EU therefore has developed a series of complementary instruments as joint initiatives of the European Investment Bank and the Commission. These are designed to boost infrastructure investment: from programme development, such as the European Centre of Expertise on PPPs (EPEC) or project-level technical assistance in JASPERS, through to tailored financial support, through equity, notably through the Marguerite Fund, as well as LGTT.

The Project Bond Initiative

The Project Bond Initiative seeks very much to draw upon this collective experience. It is designed as a credit enhancement mechanism to ensure that project companies can issue senior bonds with a high enough rating to be attractive for institutional investors. It can potentially play a useful role in securing renewed interest from institutional investors in sound infrastructure assets.

The project bond initiative does not impose an additional burden on domestic budgets, sovereign debt or contingent liabilities. On the contrary – it relies on a small EU budget contribution re-directed from existing programmes coupled with an EIB guarantee or loan.

Together, these two elements will improve the quality of debt raised by project promoters, allow institutional investors to buy this debt and support considerable investment throughout Europe. The multiplier effect – that is, the ratio of the budget contribution versus investments supported – can be significant. Current estimates show that with a EUR 230m guarantee from the EU budget and an EIB contribution, up to EUR 4.3 bn of investment could be supported.

This is the rationale for using public money as risk capital in the times of crisis. A careful scaling of the EU guarantee and EIB loan element will allow for a more efficient use of EU budgetary resources. The project bond initiative is therefore another fine example of synergy between the "EU Bank" and the European Commission.

The Europe 2020 Project Bond initiative was signed on 8th November 2012 in the form of a cooperation agreement by EU commissioner Olli Rehn and EIB president Werner Hoyer.

The European Investment Bank will seek to use project bonds to deliver energy, transport and communications infrastructure, with the most likely deals to benefit in the short term being the UK OFTOs, the A11 in Belgium and the A7 in Germany.

Eligible sectors are currently being assessed and the EIB is expected to confirm projects to be supported by project bonds in the coming months.

The EIB has come up with 2 structures to deliver project bond credit enhancement:

- with a tranche of EIB mezzanine debt standing between the equity and the senior debt, ie the project bonds.
- an EIB guarantee through a contingent liquidity facility which comes on top of a full-funded structure with additional funding to cover construction shortfalls. This is a revolving guarantee that is available until the end of the project life and provides a reduced probability of default and losses given default.

The pilot phase starts now and falls within the current 2007-13 EU spending plan, utilising EUR 230m it has remaining which has to be used up to the end of 2013 at which time – if it is successful – it shall be included in the next spending plan from 2014.

The EIB estimates that its EUR 230m will stimulate up to EUR 4.4bn of investments – on a 19x multiplier.

It will target transport projects – predominantly those that fall within the TEN-T programme – and energy deals falling under TEN-E, as well as broadband projects and it is available to projects able to reach financial close by calendar end 2016.

Project bonds will not be restricted to greenfield PPP projects, but will also be available to refinance brownfield projects during construction or in the early phase of operations.

The EIB is describing this structure as Project Bond Credit Enhancement (PBCE) and it is a tool for improving project credit ratings – and therefore stimulating capital market financing.

Conclusions

The investment needs in infrastructure in Europe over the next decade are tremendous – delivering this investment is key to ensuring economic growth and competitiveness in the region, as well as meeting long-term climate goals.

Public budgets – both at national and EU level – will remain constrained over the medium term and in some cases longer; hence it is paramount to involve the private sector. Yet, due to the financial crisis, important sources of liquidity have dried up; and securing attractive long-term finance for project companies remains difficult.

The Project Bond Initiative, building on the experience to date in developing joint EU instruments, can play a useful and significant role in stimulating investment in key European infrastructure projects.

There is, of course, more to investment than just tangible capital that can be financed through the project bonds initiative. In advanced economies, growth is crucially dependent on intangible capital and has to be sustainable. Hence, Europe's growth strategy requires:

- An acceleration of investment in research, development, innovation and education;
- And a shift to a more resource-efficient economy.

Lending to RD&I must remain one of European central priorities for the future. Research and development, and the innovation associated with it, are the main drivers of productivity growth. Investment in this sector is therefore critical for Europe if it does not want to be side-lined by new players in the global game.

Since RD&I spending by businesses tends to be strongly cyclical, public support is particularly important in times of economic downturns.

Now, if safeguarding funding for innovation in a recession is especially important for developed countries at the frontier of technology, another challenge of truly global dimensions concerns energy and climate policy. This will play an essential role in achieving green growth and green innovation.

Given the finite nature of fossil fuels, an investment into "green growth" means also an investment into competitiveness and jobs.

According to estimates by the United Nations Environment Programme, some 20 million people could be employed in the renewables sector by 2030, up from 2.3 million in 2006. So you can see that this sector is becoming quite a large provider of employment worldwide, partly also thanks to a shift of jobs from high-carbon industries.

The countercyclical timing of some of the investments needed for decarbonisation has provided a welcome stimulus for countries in a downturn. Indeed, a number of national recovery programmes arising from the crisis have targeted explicitly green investment.

In times of crises as well as in "good times," there will always be investment that financial markets alone will fail to fund, even though it would boost growth potential, employment and well-being for future generations. The need for greater cooperation among financing institutions to mobilize resources that no single institution can mobilize on its own - is growing.

The current challenge is to contribute to good standards of living without depleting the Earth's resources or running up massive levels of public debt. Long-term development cannot be sacrificed for short-term benefit.

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