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Boosting long-term investments to promote growth, jobs and social cohesion: the reforms needed and the role of Development and Promotional Banks

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1. Some years ago, when the last systemic financial crisis reached its peak (zenith), the G20 identified the achievement of a strong, balanced and sustainable growth as a key global strategic objective together with the need to prevent the financial crisis and assure the financial stability.

Since then, much has been done to improve the financial regulatory framework and to define and implement policies and instruments aimed at sustaining growth and jobs'creation. However, although some key results were accomplished, the final goal is far from being achieved.

The last World Economic Outlook released in April by the International Monetary Fund highlights that global growth will remain subdued in 2016 at a mere 3.2%. The title of the Outlook, "***Too slow for too long***" leaves no room for interpretation.

Growth in advanced economies, shaped by unfavorable demographic trends, low productivity growth and legacies from the global financial crisis, is projected to remain modest, in line with 2015 outcomes. Growth in emerging markets and developing economies remains geographically uneven and generally weaker than over the past two decades, although still accounting for the lion's share of projected world growth in 2016.

International trade in 2015 has grown less than GDP. Usually it grows at a much faster rate thus functioning as the locomotive of growth. No surprise that the cruising speed of global economy is at the weakest point since 2009 and that forecasts for the next few years are gloomy.

In fact, at a global level uncertainty has increased, renewed episodes of global asset market volatility and financial turbulence have materialized and risks of weaker growth scenarios are becoming more tangible.

There are two main instruments to support growth and they have now to be used together. The first is to support the domestic demand and consumption worldwide. Both are today not sufficiently strong: that seems to be due, first of all, to the persistence of wide areas of poverty and of strong inequalities across the world and within major countries. In many advanced economies, the weakness of domestic demand and consumption seems also due to the growing impoverishment of the middle class. Poverty alleviation (and social infrastructures financing) seems to be a crucial way to support growth, on the demand side, and also to defend the social cohesion and the democratic values threatened by populisms.

The second main instrument to support growth and jobs is to speed up recovery by giving a real boost to investment at the global level. This is why long term investment is a top priority in the agenda of policy makers.

Investment is indeed one of the great challenge of our century. In general, more investment has a positive effect on current demand and productivity growth in the future, which is key for competitiveness. Stronger investment is crucial also to face the transition to a low-carbon economy.

Investment, and in particular long-term investment needed to promote sustainable growth and to finance the energy transition are still largely insufficient. In many countries, fiscal consolidation and deleveraging, needed in order to bring public debt down to manageable levels, has led to scarce public investments (particularly in Europe, where the short-termist rules of the Growth and Stability Pacyt do not distinguish between investment and current expenditures). The huge mass of private financial resources is today almost totally directed towards financial investments, mostly short-term and often speculative. The estimated gap in economic infrastructure over the next 15 years is estimated to be $15-20 trillion.

In fact, much progress has been made on the regulatory ground and in the development of adequate rules, tools and instruments to prevent and tackle systemic financial crises and to assure financial stability. On the contrary, the necessary efforts have not been put in place in defining the rules, the policies, the tools and the incentives to sustain and boost growth and jobs, both on the demand and supply side.

This is true, in particular, if we consider the real dimension of the objective of a strong, balanced and sustainable growth: a growth which cannot be measured only in term of GDP, but must be declined and built in term of wellbeing, quality of jobs and management and conservation of the scarce natural resources of the planet. Which is, moreover, the only type of growth able to deal with the major challenges that the world is facing: poverty/inequalities, environment/energetic transition, ageing of population/sustainability of welfare systems, immigration/migrants integration and so on.

2. The above mentioned scarcity is even more evident for investments aimed at financing material and immaterial infrastructures, at promoting innovation, technology, research and education, and at financing SMEs and start-ups (venture capital).

There is an increasing and incumbent need for policies, rules and instruments suitable to boost such investments.

However, public policies are mostly still national (or regional); instruments can be developed by national Governments, but also by multilateral, international or national institutions; and rules are largely, although not exclusively, defined at a global or regional level.

Coordination tools among national public policies are thus necessary and political institutions (governments, UN, G20) are in charge of setting them up.

Obviously, an important role must be played by regulatory authorities and private finance actors; however that role is not always consistent with the political directions established or suggested by the political institutions.

Looking at rules and instruments, given the important role that the above-mentioned political institutions are required to play, the institutions within the D20 and the LTIC can and must provide a key contribution (in terms of proposals, advice and execution).

3. Allow me now to submit to you some reflections for our debate and our final D20 Statement:

a. Liquidity and financial resources are now abundant worldwide, savings are copious in many areas, central banks' expansionary monetary policies have contributed to raise liquidity. But these resources are predominantly directed towards short-term investments, still in large part speculative in nature, with a very poor impact on growth and job and important pro-cyclical effects. It remains

difficult to direct a satisfactory share of these great resources towards the financing of medium to long-term investments that bring along key positive externalities for a strong, balanced and sustainable growth, such as the investments in infrastructures, R&D, technologies, human capital, innovation, start-ups and SMEs.

b. In the draft of our D20 Statement and in the proposals contained therein, we highlight the negative effects caused by the persistence of marked and relevant inequalities and of wide poverty areas. These factors translate into a global weakness on the demand side, which consequently, turns into a subdued economic recovery.

c. Together, we should emphasize the opportunity for new policies, rules and tools for the adoption and implementation of advanced welfare systems and we should advocate the importance of the role that institutions to which we belong, together with national governments and other international organizations, can play in promoting social infrastructure and investment with a social impact.

d. In the D20 Statement, we particularly stress the positive impact of investments in innovation, technologies, human capital and infrastructure. Most of these investments provide economic returns only in the medium to long-term, involve a high level of risk, or produce positive systemic externalities without necessarily providing economic returns to investors: that is the reason why they may require instruments of public risk mitigation.

e. If we want to increase investment in infrastructure, we need to enhance the technical quality of pipelines and to create the right financial instruments to make a full-fledged "asset class" of its own. Now, the lack of a clear definition of an asset class of infrastructure investments practically translates into an incongruous accounting regulation and higher financial transaction and capital costs for long-term investors. Thus, to increase long-term investors' asset allocations, infrastructure needs to be transformed from the realm of an 'alternative' investment category into a real 'asset class', subject to *ad-hoc* regulations and with its own capital absorption ratios, supposedly lower than the actual ones. The

regulation should recognize that debt for infrastructure has lower default rates and higher recovery rates than corporate bonds, which means lower probability of capital loss. The goal should be to create a new class of activities in the accounts of institutional investors, which could be placed in between sovereign and corporate bonds. Thus, the affirmation of an asset class for infrastructure would directly translate into lower transaction costs for players in the market.

f. Long-term institutional investors have globally over 100 trillion of asset under management. Today only 1% is invested in infrastructure. Central banks have soaked most of high rating sovereign bonds. According the OECD recent estimates, there is today over 5 trillion dollar gap in search for investment with long-term and stable risk-profile. Infrastructure and securitization of SMEs loans, if properly structured, have all these features. So we need to favor this transition: long-term institutional investors will become major investors of financial products backed by real economy assets.

g. Public authorities should facilitate the development of financial innovations, such as risk-mitigation and credit enhancement schemes, that enable private finance participation in infrastructure. The Juncker Plan in the EU represents a best practice in this respect.

h. Moreover, we should consider that investors and sponsors take their decisions to finance infrastructures and long-term investments on the basis of their perceived level of riskiness of the underlying project. Such risk heavily depends on the level of uncertainty of the projects, including regulatory uncertainty. As we claim in the draft of the D20 Statement, projects would therefore highly benefit from an appropriate guarantee scheme backed by governments that would ring-fence projects with a well-recognized impact to growth and employment from the regulatory changes (such as change in tariffs or concession conditions) which could undermine the economic viability of these projects Such product or vehicle could involve public international financial institutions to ensure that needed criteria are met and economic impact is expected.

i. A much more active presence of the public sector can indeed significantly foster liquidity in the field of infrastructure sector, not only by actively participating in the project capital but also acting as anchor investors to attract

private participation in infrastructure investment (through the use of appropriate financing and PPP models). By means of public contribution, or public guarantees schemes, private participation can substantially be leveraged. The effect could be extremely desirable: increasing institutional investors' infrastructure allocations could provide an extra $5-8 trillion for investment in economic infrastructure (excluding real estate, oil & gas and mining) between now and 2030[1].

ii. As far as climate change is concerned, we acknowledge with enthusiasm the great strategic commitment showed by all actors in the Paris Agreement of COP 21. Enormous amounts of investment, especially long-term investment, are required to finance the energetic transition. After the Agreement, policy makers are accelerating the low carbon economy transition, with different approaches. De-carbonization is taking place in the financial sector.

l. There is a very strong climate policy risk for investors. There is large consensus that markets' short-termism has not yet priced the forthcoming taxation on polluting companies, or the costs and risks of the decommissioning of nuclear plants. Regulation, fiscal policies and pricing mechanisms (i.e. carbon pricing) are relevant risks. It is hence of key importance that investors act timely by divesting polluting companies, decarbonize their portfolio and proactively invest in the low carbon economy transition.

m. Our institutions can play a leading role in all the above-mentioned aspects, not only as direct actors, but also as catalyzers and anchor investors for other private or public stakeholders, by acting in complementarity with respect to the banking system and to the others long-term investors (insurances, pension funds, sovereign funds, institutional investors).

n. Moreover, long-term Development and Promotional Banks and other long-term non-banking financial institutions should contribute to assist countries with their own expertise and knowledge to facilitate development planning, consulting, education and training in poverty-stricken areas, and assisting the local governments in drawing up a well-defined roadmap, setting out development targets, pand progressively enhancing own local capabilities whenever needed.

[1] B 20 II TF (Turkey 2015).

D20 Institutions are also well placed to assist public and private investment project promotors in terms of technical assistance and financial advisory, again one of the pillars of the Investment Plan for Europe.

4. To conclude, a few reflections on the regulatory framework.

Our institutions are not of course entitled to intervene directly in political or regulatory decision-making processes. However, since we respect this regulatory framework within our public or development mandate rather than only with a limited profit objective, we can certainly invocate a proper and well-shaped treatment for our institutions in light of our business models.

On the other side, it is equally of our interest that the regulatory framework for commercial banks, insurances, pension funds and other institutional investors does not result to have undue penalizing effects for long-term investment. Of course, we are not in the position to do everything by our own. We can be catalyzer, but only if, together with us, other players are ready to take the role of long-term investors. To that end, a friendlier and fair regulation is necessary.

We surely acknowledge that the prudential regulation, set up in the aftermath of the financial crisis, made the financial global system much more resilient and stable. However, we must keep in mind that the relation between growth and stability is not one-way: growth surely needs financial stability, but stagnation and recession seriously undermine stability. Authorities and regulators have sometimes failed to recognize the reciprocity between growth and stability and have often underestimated the negative impact that a low growth can have for financial stability, by giving priority to the achievement of financial stability at the expense of growth and jobs and by neglecting rules capable to harmonize the two aspects. On this basis, we believe that it is now becoming a priority to strike for a better balance between the stability of the financial system and its capacity to finance long-term investments.

It is the time to accelerate the analysis of the impact of financial regulation on the financing of infrastructure, R&D, innovation, SMEs and, in general, long term investments. In the case that we discover that such an impact is significantly negative, I think that political and regulatory authorities should be ready to re-calibrate and fine tune the regulatory framework so that it can achieve oth the two non-conflicting goals: financial stability <u>and</u> long-term investment.

Some robust empirical evidence has already been produced to show, for instance, that loans to project financing have better recovery rates and lower default rates than corporate bond. But, still corporate bond with same ratings and duration have much lower capital absorption.

To be clear. I am not asking for a preferential treatment. I am asking for a proper measurement of the risks underlying these asset classes.

We should avoid "hazard". But we should take into consideration the "business model" of long-term investors; and we should also take into consideration the role played by public credit enhancement mechanism on the risk profile of the investment.

Finally. Of course political Authorities must delegate the definition of the regulatory framework to technical regulators: but too often they do it, without bothering too much to check and monitor whether their strategic policy directions are indeed followed and respected by the technical regulators. Their strategic directions require to combine the objective of financial stability with the objective of a long-time global growth. The regulations, often, do not.

We believe that it is now time for the political authorities to take on this issue their responsibilities. They have the legitimacy and the power to ask international regulators to seek better fine-tuned solutions to harmonize the need for financial stability with the need for a strong boost to long-term investment. Better regulation can do a lot: in order to avoid that the goal of a strong, balanced and sustainable growth will remain just a noble but unattainable aspiration.