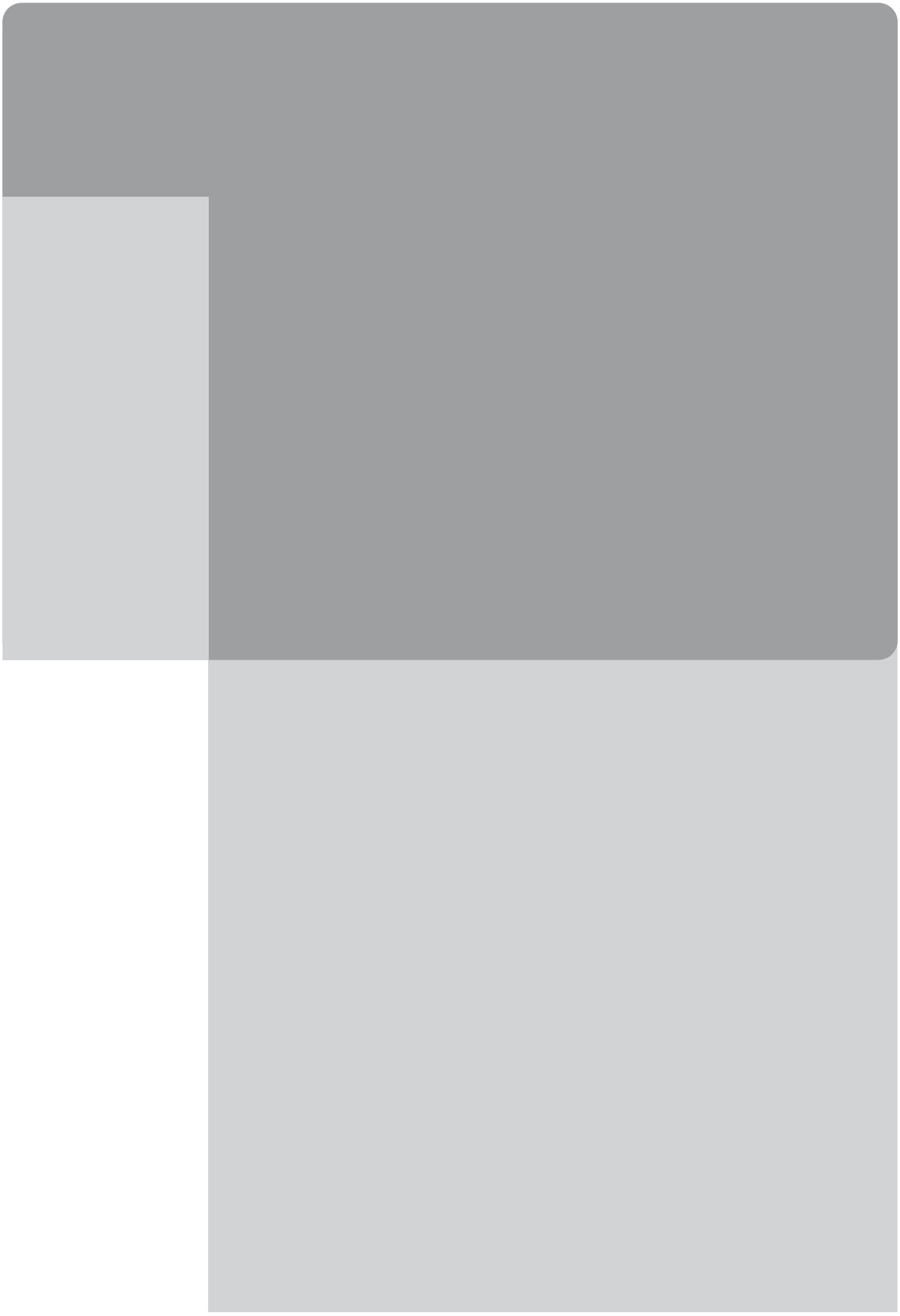


PRIVATE LONG-TERM INVESTMENT IN UNCERTAIN TIMES

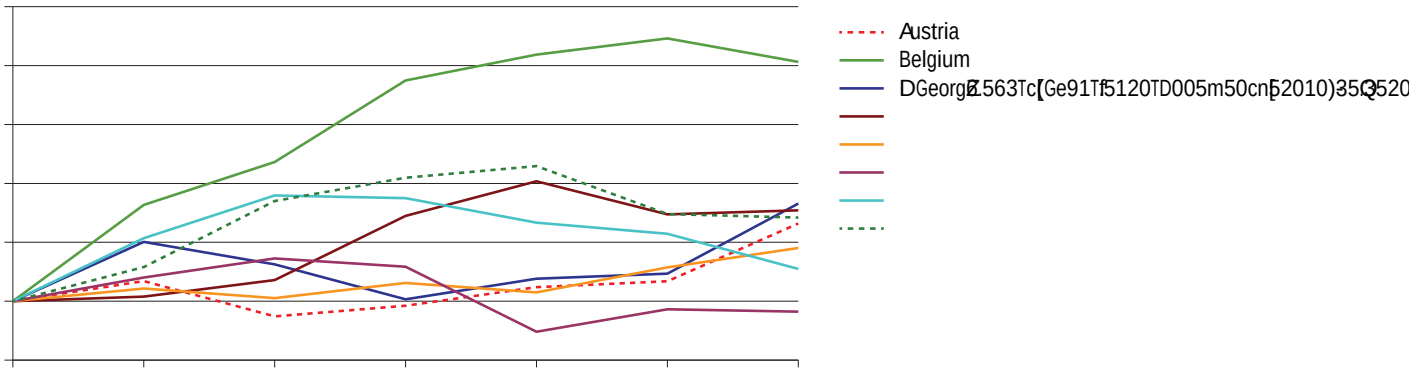
GEORG ZACHMANN, DECEMBER 2012

IN TIMES OF MOUNTING SOVEREIGN DEBT AND ECONOMIC CRISIS,

the need for austerity and anti-cyclical social spending (eg unemployment insurance) reduces governments' room for manoeuvre when it comes to public investment. As a consequence, government investment spending is expected to decline in much of Europe beyond 2010 (see Figure 1). But, the current economic and financial crisis has also reduced the attractiveness of private investment. Private sector investment fell significantly during the crisis and is only expected to recover to 2008 levels after 2014 (see Figure 2).

In this paper we focus on one important component of investment: infrastructure investment. Modern economies are built on the basis of massive investments in capital intensive infrastructure. Appropriate transport, telecommunication, water and energy networks, power plants, airports and high-speed trains are preconditions for individual well-being and economic growth in modern societies. These assets share four important characteristics: (1) they feature a high capital-specificity, ie they cannot be easily used elsewhere; (2) they have long economic lifetimes (up to 60 years for some power plants); (3) many of the corresponding investments are supposed to be provided by private companies; and (4) due to their importance for the economic development of countries and for the externalities they generate, governments often intervene in their provision.

The immediate effect of the crisis on private infrastructure investment is not straightforward to identify in the data. There is no clear trend in investment in electricity, gas and water supply; sewerage, waste management and remediation activities (see Figure 3). At the same time, investment in non-residential construction and civil engineering declined steeply after 2008, and is not expected to recover to pre-crisis level before



states, others are only present in the countries most affected by the crisis.

LOWER BENEFITS

After 2008, the expectations for future economic growth in many European countries were reduced dramatically. As the consumption of telecommunication, transport and energy services depends on economic development, future demand for corresponding infrastructure might be less than anticipated. Thus, some of the reduced investment in corresponding infrastructure is certainly due to sensibly adjusted demand predictions.

Furthermore, public support for new private infrastructure – for example new clean energy (see Figure 5) – was affected by actual and expected cuts in support levels resulting from the difficult budgetary situation.

Consequently, it is difficult to establish to what degree reduced lending to the real-economy in vulnerable countries (see Figure 6 on the next page) is due to the financial sector reducing the supply of lending, or to the real economy demanding less capital.

HIGHER COST

The economic crisis is also a crisis of the financial sector. One lesson financial regulators have drawn from the fragility of the system that was exposed by the crisis was that more prudent lending strategies should be required. For example, the Basel III reform of banking regulation rules that is set to be transposed into EU regulation and the

Solvency II Directive (2009/138/EC), which will take effect after 2013, will increase the liquidity and solvency requirements for financial institutions. In anticipation, this will also force the financial institutions to back up their long-term lending with more capital.

While regulators responded to the fragility of the financial sector by tightening the prudential framework, the market also reacted by punishing overly risky strategies. This was a probably necessary adjustment because many market participants perceived risks to be underpriced before the crisis.

Some banks that were engaged in risky lending activities faced difficulties in refinancing and had to scale down their exposures (see e.g. Severin). In the uncertain times, markets valued quickly-sellable assets higher than long-term illiquid investments. This 'premium on liquidity' makes some long-term investments more expensive for financial institutions compared to other assets. Furthermore, the 'monoline' credit insurance system virtually collapsed. Monoliners are companies whose sole line of business is to insure (typically municipal and infrastructure) bonds. They thus essentially put a price on the risk of default of the underlying asset. The corresponding rates requested before the crisis are now considered to have been overly advantageous, and the corresponding underpricing of risk is seen as one of the reasons for the financial sector's difficulties.

Changes in risk-perception on the part of both regulators and markets translate into higher costs of capital for financial institutions lending in these markets. The higher financing cost is passed-through to investors and might make some projects unprofitable that would have been deemed (barely) profitable in 2007. At the same time, the basic interest rates are at historically low levels. As discussed in the next section, this big advantage in capital cost is in many countries barely compensated for by increasing risk premia.

HIGHER RISK

While a (sensible) upward adjustment in risk perception on the part of markets and regulators increases the costs of long-term investment finance, the risks themselves have also increased. In the following, we identify three important (and partly interlinked) sources of risk for long-term investment, which have become more influential because of the crisis.

First, there in the fof BT 6 0 0 nst9ntsk foj T* 0 d

public goods. Second, public banks might help to fill a temporary financing gap for infrastructure projects. However, a cautious approach is needed in case public banks do 'too much of a good thing'. Overly well-functioning intermediation by public banks, potentially even with (implicitly) subsidised interest rates, might make the new segment of long-term infrastructure finance unattractive for private financial companies, essentially slowing down the transformation.

(2) The fair price of risk?

Mispricing of risk has been a major cause of the financial crisis. All discussions about reducing private investment risk by shifting some risks from the private sector to the public sector imply that the privately-optimal level of risk-taking is lower than the socially-optimal level. Considering the previously noted time-inconsistency problem this might well be true. The question remains: what is the fair price of risk? Industry and policymakers often indicate the right level to be the one at which the projects they have in mind still happen. This would imply that sectors that do not invest for whatever reason need to obtain subsidised interest rates. Such an approach is certainly distorting.

The big challenge is how to ensure that the partly dysfunctional financial sector in times of massive government intervention (eg artificially reducing the risk-spreads of certain government bonds) is again provided with reliable signals to optimally conduct risk-return arbitrage between different assets and asset classes.

(3) Self-fulfilling prophecies?

To reduce the risk in different sectors, certain strategies can be proposed. On the EU level, the discussion about project-bonds – essentially government guaranteed infrastructure financing vehicles – has gained some traction, even though the pilot-phase volumes are comparatively small (up to €230 million).[4] At larger scale, a corresponding instrument could reduce the cost of borrowing for infrastructure projects by shifting some of the risks from investors to the public. In the electricity sector the introduction of capacity mechanisms in order to remunerate power plants not only for the energy they generate but also their reliability are considered. This would reduce both the price and risk for investors. Such mechanisms are designed to provide additional incentives for new investment.

There is a risk that at some point the discussion about public initiative becomes self-fulfilling. If all market actors are awaiting the implementation of more attractive financing instruments in the near future, they will delay projects. For the long-term infrastructure projects discussed in this paper, waiting for years is an option. Consequently, the withholding of investment (anticipatory or even strategic) might force policymakers to implement second best policies.

(4) Economic framework for investment

Furthermore, certain industries argue that competition rules and sector regulation in Europe should recognise that the revenue situation in an industry is important for attracting capital for investment from increasingly global financial markets. Thus revenue growth is seen as vital to make certain future projects viable and to improve the ability of companies to self-finance. According to this argument, the low financing cost before the crisis concealed the investment-unfriendly regulatory framework in some industries. But with rising financing cost, there is a risk that investment will decline. Infrastructure providers in particular outlined the investment-corrosive effects of the legal limits to risk-mitigating devices such as vertical integration and long-term contracts, as well as the asymmetric (and thus highly unattractive from an investor's standpoint) nature of cost-orientated price regulation (which also tends to undermine the scope for price segmentation). The trade-off between static economic efficiency and investment/dynamic efficiency gains is complex, but, according to industry, the status quo places excessive emphasis on the former at the expense of the latter.

A particular concern in infrastructure industries is that national regulators and policymakers do not consider the positive spillovers of cross-border and innovative infrastructure. If corresponding projects are only remunerated for their direct national benefits they might not break even and

4. http://ec.europa.eu/economy_finance/financial_operations/investment/europe_2020/index_en.htm (accessed 11 December 2012).