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QUO VADIS PUBLIC FINANCE
Challenges and opportunities for public asset managers and issuers at a time of world-wide monetary transition

Financing Europe

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I would like to approach this topic from a different perspective. Let's look at the medium to long term financing problems of Europe.

To me "Financing Europe" means providing funds to households and companies to enhance potential economic growth.

Much attention has been devoted to the sustainability of public debt, but the global crisis has demonstrated that excessive private liabilities can be even more destabilising than large government debt alone.

Even the ECB, in its August 2013 report on "Corporate finance and economic activity in the Euro area" highlighted that corporate debt in Europe rose much faster during the years leading to the crisis than in previous crisis episodes, with large differences among European countries and economic sectors.

In fact, private debt has been often used as a substitute for risk capital to finance investments so that enterprises and even households have been encouraged to seek loans, instead of saving and accumulating capital, thereby increasing leverage in the economy.

Let me give you some figures. Overleveraging was apparent before the crisis: from 2000 to 2007, in the Eurozone the ratio of total liabilities to GDP rose by about 170 percentage points to 590%, 40% more than its initial level; the same ratio increased by 50% for financial corporations, 25% for households and 13% for non-financial corporations. By contrast, the public debt to GDP ratio over the same period declined by 6%.

From 2007 to 2012, leverage continued to increase by 30pp to 622% for the Eurozone economy mainly led by financial corporations and general governments with a shift of liabilities from the private sector to the governments.

An over-leveraged economy is notoriously more vulnerable to shocks and market volatility. Servicing large debt makes corporate balance sheets less flexible and exposes enterprises to higher insolvency risk. In turn, bad and non-performing loans worsen the balance sheets of banks and other financial institutions, resulting in the spreading to the entire economy of even local and sectorial adverse shocks.

It was apparent that the economy, and particularly the financial sector, was strongly under-capitalised before the crises or, equivalently, over-indebted.

However, deleveraging is painful, long lasting and costly, especially at the end of a deep recession, when a credit crunch becomes a clear danger. Deleveraging inevitably implies less investment and consumption in the short run and some degree of resource under-utilisation that can damage also medium and long-term growth. In fact, the current loss of output cannot be offset at a later stage by simply postponing the use of unexploited resources. Therefore, deleveraging risks causing some permanent damage to the supply side of the economy.

As deleveraging involves the private and the public sector at the same time, the drawbacks of reducing debt are amplified. Nevertheless, consolidating the financial position of economic agents in both the private and public sectors is crucial to ensure sustainable and stable growth in the future.

Based II and III regulations have tried to rebalance the risks taken by banks. However, in the near term, the effects of these regulations have been and will continue to be restrictive at a macroeconomic level, as long as alternative (and more efficient) channels to finance investment and economic activity do not develop fast enough.

For instance, a recent research paper by the OECD estimated a negative impact of the Basel regulations of up to 0.15pp on OECD GDP in the medium term, and a larger negative impact of 0.23pp for the Eurozone, mainly due to a predicted 50bp increase in interest rates by 2019. Furthermore, achieving the minimal capital requirements prescribed by Basel III can have macroeconomic pro-cyclical effects, notwithstanding the flexibility of the newly introduced counter-cyclical capital buffer.

On the other hand, it is well known that the main driver of economic growth is innovation, when it is effectively embodied in investments in new machinery and new firm formation. However, investing in innovation is costly and risky too. Risk capital should be the preferred source for funding innovation, rather than bonds and loans.

The economy is thus apparently trapped between the need for making financial institutions safer and less vulnerable (by introducing regulations for banks) and the need for allowing more investment in innovation.

The latest report by the European Investment Bank on “Investment and Investment Finance in Europe” provides some suggestions on how to move away from this trap. First of all, some form of risk sharing among lenders and investors is necessary to foster investment in Europe. Secondly, structural reforms that encourage a shift of resources to more productive activities should be accelerated in those countries suffering from persistently low investment returns. Finally, policy makers should facilitate bank lending and alternative financing sources, as appropriate.

However, available evidence suggests there is no ongoing rebalancing of liabilities away from debt financing into risk capital.

In addition, developing alternative financing sources is crucial to spur the European and the world economy, as bank credit is going to be channelled to safer and 'traditional' uses by regulation. Since innovative projects are too uncertain to be funded on their own merits by the market, through the traditional channels of equities, bonds and loans, only securitising many innovative projects in specialised vehicles can provide the necessary funding resources. Thus, the role of venture capitalists, credit funds and other specialised operators is essential to sustain innovation and make both companies and credit institutions less vulnerable.

In its 2013 "Global Shadow Banking Monitoring Report" the Financial Stability Board focuses on the advantages of further developing institutions outside of the traditional banking channels that provide credit to firms. Nevertheless the report also warns against the systemic risks that arise when specialised operators perform bank-like functions, particularly with close connections with the traditional banking system and strong links between each other. Therefore, appropriate monitoring and regulatory frameworks for the shadow banking system are required. At the moment, only a few jurisdictions have bank-like prudential regulations, and international standards are still lacking, allowing operators to potentially bypass national rules. A patchwork of national standards also raises compliance costs and creates regulatory uncertainty, further discouraging the growth of this important sector. Also, shadow banking entities are outside the scope of the Basel regulatory framework.

Although the scope of shadow banking is still limited in Europe (apart from a few countries), stricter monitoring is recommended together with harmonisation of national rules. At the moment, the relevant discipline in Europe derives mainly from consumer protection legislation, therefore is not fully suitable to address the risks of providing credit to businesses. In addition, the public disclosure of information by the traditional financial institutions could enhance the understanding of relationships between banks and shadow banking entities.

To conclude, there is a need to shift the burden of financing the economy from debt capital to risk capital to support innovation and stronger potential growth in the future in a way that limits systemic risks. This, in my view, is the challenge for Europe, and indeed the world, going forwards.