Building Growth in Europe
Innovative Financing for Infrastructure
Executive Summary

Europe needs economic growth. The global financial crisis has exacerbated structural weaknesses on the supply side, has made the constraints imposed by the single currency even more stringent for euro area countries, and has led to a chronic lack of demand. To unlock the potential for long-term growth and job creation, this report suggests that there needs to be more and better investment in infrastructure.

The infrastructure shortfall in Europe is huge, from power generation and distribution to transport networks. It has been estimated that countries need around €2 trillion more investment between 2013 and 2020 than currently planned. And this shortfall is due to grow over time – to a total of almost €15 trillion up to 2030 – in the face of population ageing, environmental changes and the need to replace existing infrastructure. The stock of infrastructure also needs to be revamped. In most of the major countries the proportion of output spent on infrastructure has been on a declining trend since the mid-1960s. The financial crisis further contributed to this decline. In the EU, overall investment dropped sharply after the start of the financial crisis, from 21.3% of GDP in 2007 to 17.3% in 2013.

Low interest rates currently make liquidity abundant and borrowing relatively cheap. There is now a unique opportunity to harness cheap funding and use it for long-term projects. At the same time institutional investors, such as pension funds, with total assets of approximately $75 trillion, are particularly interested in long-term investment with the potential to generate reliable multi-year revenues that would help them match their liabilities for pension payments.

An innovative approach to infrastructure projects, in terms both of policies and of financial instruments, has the potential to create a virtuous circle of stronger economic growth and job creation, improvements in productivity and enhanced financial stability. By updating existing infrastructure and investing in new, innovative projects, and by matching the duration of investment with its demographics, Europe has the opportunity to revive its economy and ward off the risk of ‘secular stagnation’.

Large infrastructure projects in Europe generate positive spillovers on job creation and productivity growth that transcend national borders. They are de facto pan-European because they employ materials, technology, machineries and people from different countries. Europe also needs more of these projects that cut across borders, such as better-integrated energy networks.

Of course, large infrastructure projects have often in the past been characterized by waste, inefficiency and in some cases corruption. Europe is littered with too many examples of ill-conceived, badly implemented and over-spent infrastructure projects. Indeed one of the forces that contributed to the sovereign debt crisis was the misallocation of resources, notably in the south, towards excessive infrastructure investments, made possible by cheap financing. But bad past experience should not prevent Europe from finding new and better ways to finance and manage infrastructure investment in the future. Lessons need to be taken on board, and safeguards put in place to ensure that resources are directed towards projects with good returns.

Above all, the public sector should go back to taking a leading role on large infrastructure projects. Only the public sector can bear the ultimate risk involved in these projects. Innovative but complex projects such as the Channel Tunnel need an ‘owner of last resort’ that is prepared to recapitalize the project, if necessary, rather than letting it fail. Private investors do not have the time horizon or the financial capacity to step in, and their objectives are often not aligned with the public ones.

In addition, as described below, the EU and its member governments should pick up a part of the tab and help launch projects financed by jointly issued ‘eurobonds’. The return on well-selected and well-managed infrastructure projects is certainly higher than the current low return on risk-free financial instruments in an environment of abundant liquidity and under-utilized resources. If economic actors, both public and private, can be encouraged to take advantage of current conditions – where finance is relatively cheap and real resources relatively plentiful – to increase investment in infrastructure, this can create a virtuous circle and kick-start growth.

Policy recommendations to boost infrastructure investment within available financial resources

1. Develop a pan-European infrastructure strategy to encourage ‘good’ infrastructure investment, address constraints and remove bottlenecks.

- Identify short-term and long-term priorities in a forward-looking approach. Countries should define priority projects, which focus on areas with a sustained impact on economic growth and the potential to enhance productivity.

- Improve the regulatory framework and provide better financial ‘instruments’ – assets, sources and vehicles – to encourage greater investment and make better use of the existing financial resources.

- Encourage the right choice of projects. In order to avoid inefficiencies and waste of financial resources, and to create a comprehensive pipeline at the EU
level, a better mechanism for project selection needs to be designed on the model of the UK’s National Infrastructure Plan.

• Projects submitted by member states to the European Commission should be selected through a bottom-up approach and on the basis of criteria such as transnational dimension, size, sectors with high technological intensity and: priority should be given to sectors with high technological intensity, and economic return.

2. Create a European Infrastructure Agency to be responsible for the coordination and implementation of the pan-European infrastructure strategy. This agency should work in collaboration with the G20, the World Bank and the regional development banks as well as with the European Commission, the EIB and the EU member states to exchange information and best practice, set up a pan-European database of projects and assist investors to seek projects relevant to them and to compare them across different countries.

3. Foster effective collaboration between the public and the private sector. If Europe has the ambition to lead again on innovation and competitiveness, then a good ‘mix’ between public and private participation needs to be devised. For example:

• the public sector should play a key role at a project’s initial stage: it should set priorities, provide a transparent procurement procedure, offer initial financial support, provide guarantees and smooth risks;
• public-private partnerships (PPPs) should be encouraged. A European PPP Expertise Centre should be created as a joint initiative by the European Investment Bank (EIB) and the European Commission to share experience and expertise, analysis and best practice relating to all aspects of PPPs. Procurement procedures should do better at specifying the costs and risks of projects in order to avoid delays and extra costs. There should also be more transparency on the returns made by equity investors;
• additional upfront guarantees from the public sector should provide support throughout their life-cycle for large projects with higher risks but high public benefits. When a project runs into difficulties, the public sector should step in and take ownership of the asset.

4. Promote a well-functioning market and implement policies that aim to match supply and demand of capital. These include:

• reviewing the rating criteria for investors, which currently favour financial assets with short-term maturities. For instance, speculative-grade short duration loans (rated ‘BB+’ and below) currently require less capital allocated by insurers than a four-year ‘BBB+’ or eight-year ‘A+’ project investment;
• facilitating access to long-term investment funds. The European Commission roadmap of March 2014 suggests new ways to unlock long-term financing to meet the needs of the European economy;
• fostering coordinated action by national governments. The political groups in the recently elected European Parliament should make this issue a priority on their agendas, communicating this also to MEPs’ national capitals.

5. Improve the allocation of Structural and Cohesion Funds in order to tackle inefficiencies, leverage up the resources available and create incentives to choose the right projects by:

• providing EU funds only to projects included in the European pipeline in order to improve resource allocation;
• ensuring support, advice and due diligence so as to reduce inefficiencies;
• reducing the proportion of co-financing by making more European resources available. The European Commission could use Structural and Cohesion Funds to fund a small portion of the total costs, with the bulk of the financing covered by loans from the EIB and national development banks. These institutions could pool their available resources by issuing euro-denominated securities for investment in infrastructure projects;
• reducing political interference at the regional/local level in the definition and management of infrastructure policies through a due diligence process undertaken by the EIB, so as to assure investors about the strength and stability of the country-specific regulatory frameworks.

6. Promote the use of project bonds to fill financing gaps in the riskier stages of infrastructure projects undertaken by the private sector and included in the European pipeline. Resources available for the EU 2020 Project Bond Initiative, carried out by the EIB and currently in its pilot phase, should be increased. The Project Bond Initiative should be strengthened through:

• broadening the pipeline of suitable projects and focusing on bridging the gap between debt and equity
capital to help projects develop through their riskier stages. Resources could be pooled with national development banks, such as Cassa Depositi e Prestiti, Caisse des Dépôts et Consignations, Kreditanstalt für Wiederaufbau, Instituto de Credito Oficial, PKO Bank Polski;

- issuing European-backed bonds (or ‘eurobonds’) with long maturities for infrastructure projects. Since issuing Eurobonds fully backed by all EU member states is still a sensitive political issue, bonds could be jointly issued by national development banks together with the EIB. These hybrid bonds would be transnational and jointly guaranteed by participating national governments, making them more attractive to investors.

7. ‘Bundle’ smaller projects that cannot reach a dimensional threshold, such as social infrastructure projects, in an ‘aggregator’ – a pooling vehicle which can help obtain finance. The EU aggregator could be modelled on the UK experience, where the Priority School Building Programme is now financing renovation works of 215 schools with a funding requirement of £700 million.

8. Promote higher infrastructure investment in countries with wider fiscal space. Germany, for instance, requires investment to upgrade and modernize its infrastructure and has the necessary fiscal capacity to undertake more ambitious investment programmes.
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