Strengthening private capital markets: less of the same is more

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The financial market landscape has changed dramatically since the global financial crisis nine years ago. A key feature of today is the dominance of central banks in financial markets, especially in Europe. However, central bank activism has crowded out long-term investors (insurance companies, pension funds and sovereign wealth funds).

Not only do long-term investors hold assets worth about USD 70 trillion – more than 90 per cent of global GDP – but they also have the ability to invest with a longer-term investment horizon given the long-dated nature of their liabilities. Putting the USD 70 trillion funds to best use is crucial for financial resilience and key to kick-start the real economy. More can be done on this front, as outlined in this article and shown in the research done by Swiss Re and others on this front.

Given the importance of stable financial markets for long-term investors and economic growth, Swiss Re last year partnered on a research collaboration with the London School of Economics and Political Science; the research focuses on both the optimal design of monetary policy tools and their effect on the success of structural reforms.

I believe that economic risk-taking is out of sync with financial risk-taking. Investment flows are going to different places than they are supposed to go. Research shows that the misallocation of capital is hampering employment and growth, giving rise to the risk of creating a zombie economy. More recently, the ECB highlighted the increased capital misallocation between 2002 and 2012 in several eurozone countries. I believe that current monetary policies are not conducive to reversing this trend. With the global economic growth still being moderate, the role of long-term investments should be strengthened and with it private capital markets. To improve growth prospects and financial market resilience, let me outline a number of initiatives.

First, the policy mix needs to change. The costs of ultra-accommodative monetary policies outweigh the benefits. We estimate that EU and US insurers have foregone around USD 700 billion together in net yield income since the financial crisis in 2008. Central bank ownership of government bonds: the Federal Reserve owns 20 per cent of the outstanding US public debt market; the European Central Bank 25 per cent; the Bank of England: 30 per cent; and

the Bank of Japan: 40 per cent. Swiss Re estimates that central banks now own about 30 per cent of the markets they are active in. Too much central bank dominance undermines the positive role that private capital markets can play. In contrast to monetary policy, structural reform implementation has slowed notably over the past years, especially in developed markets. Instead of doing the same, there is an urgent need to reduce the over-reliance on central banks and implement a structural reform agenda, including a consistent, clear and reliable regulatory framework.

Secondly, we need a tradable infrastructure asset class. Over the next 15 years, there will be an annual infrastructure financing gap of USD 1 trillion. Still, the economic benefits of more infrastructure investing are significant. An IMF study shows that during periods of low growth – such as today – each additional dollar spent in public investment increases economic output by almost three dollars.

However, closing the infrastructure gap is far beyond the capacity of individual governments alone. This is a great opportunity for the public and the private sector to combine resources. Expanding Public Private Partnership models would bring many benefits: i) improving the efficiency of project planning and operations, ii) reducing pressure on government budgets, iii) diversifying the funding sources of the real economy and iv) providing long-term investors with an attractive asset class in a low yield environment.

To attract more institutional investor funds into infrastructure debt and increase the bankability of infrastructure projects, standardisation is essential. The European Financial Services Roundtable is the most advanced template for documentation and disclosure, and can continue to serve as a starting point for a good market practice.

Furthermore, strengthening investor rights is particularly important for investments with a long-term nature, which are prone to policy changes across political cycles. Possible ways forward could be a standardised dispute resolution mechanism, international arbitration, and the establishment of bilateral investment treaties. Finally, having more equity-like financing, such as GDP-linked sovereign bonds, would fit very well today's low growth and high debt environment. GDP-linked sovereign bonds would offer optionality for pay-outs and act as a countercyclical stabiliser. Governments would benefit from more fiscal flexibility, making the implementation of longer-term and growth friendly policies easier. Positive public policy actions would feed through GDP-linked sovereign bonds and could therefore incentivise good government behaviour.

I believe that once we throw the right ingredients into the mix and follow these recipes for growth we will end up with stronger economies that are marked by financial resilience.

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Notes:

- *This blog post discusses the topics of a research programme on monetary policy and long-term investment as part of an LSE-Swiss Re partnership.*
- *The post gives the views of its author, not the position of LSE Business Review, the London School of Economics and Political Science.*
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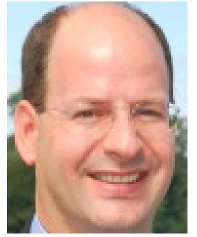

Jérôme Haegeli is responsible for formulating the overall investment outlook for Swiss Re Group Asset Management as well as the asset class views for the global investment portfolio. Furthermore, he is co-chairing the IIF's Council of Asset and Investment Management (CAIM) Working Group, whose mandate is to analyse and address issues and challenges for long-term investment arising from both market dynamics and regulatory reforms. At the IIF, he is also a member of the Principles Consultative Group (PCG) besides following the Market Monitoring Group. Prior to joining Swiss Re in 2008, he was Head of Emerging Market Bond Research at Bank Julius Baer, Advisor at the Executive Board of the International Monetary Fund (IMF) in Washington DC from 2004-07 and Senior Economist at the Swiss National Bank (SNB) and UBS Warburg. At the IMF's decision-making body, the Executive Board, he represented the interests of Switzerland and the SNB. Prior to starting his career at UBS Warburg, he was a Visiting Fellow at Harvard University for his Ph.D. dissertation on the Asian currency crisis. Jérôme holds a Ph.D. in Economics from the University of Basel and a Master of Science in Economics from the London School of Economics. He and was a Fellow at Harvard University.

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