Andreas Dombret: How to meet Asia's needs for infrastructure financing – could the European capital markets union be a blueprint?

Keynote remarks by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Annual Meeting of the Asian Development Bank, Frankfurt am Main, 3 May 2016.

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1. Introduction

Distinguished board members of the ADB

Dear panellists

Ladies and gentlemen

It is my pleasure to be here with you today – not least because by attending this panel, I am redeeming the promise I gave my fellow Bundesbank board member, Joachim Nagel, to stand in for him here at the Host Country Seminar. He has accepted a leading position at KfW Group – whose history as a development bank is closely interwoven with economic prosperity in Germany.

Aside from this particular crossover, the tasks of central banks and development banks have other meaningful overlaps as well. At the very least, both kinds of institution have a keen interest in funding issues. For example, as part of their financial stability mandates, central banks monitor the financial system – be it bank-based or market-based – to see if it provides sufficiently stable funding for real economic activities. And much like central banks, development banks also reflect on the appropriate balance between funding via banks and funding via the capital markets.

2. Asia in need of more infrastructure

Harnessing stable and reliable funding sources for economic development is particularly important for emerging economies like the Asian countries. Infrastructure financing plays a key role here, because infrastructure is crucial for sustainable economic growth. Given the socio-economic trends in Asia, the countries' need for more and better infrastructure is plain to see.

The numbers involved are utterly breathtaking. According to a recent ADB study, 120,000 people move to Asia's urban centres – every single day. As a consequence, the motor vehicle fleet doubles every 5 to 7 years. Traffic jams are an inevitable outcome. This leads the ADB study to estimate that road congestion costs the Asian economies between 2 and 5% of GDP every year, not to mention the damage done to the environment.

This led a Japanese research institute to project that Asia will need USD 6,500 billion in infrastructure investment until 2020. The crucial question, then, is how this immense volume can be raised.

To begin with, I will argue that infrastructure financing benefits from stable and reliable financial infrastructure. Indeed, the numerous development banks play an important role in this respect. The World Bank and the ADB, for instance, granted a total of roughly USD 25 billion for infrastructure-related projects in 2014. In addition, the Asian Infrastructure Investment Bank and the New Development Bank can contribute significantly to satisfy Asia's need for infrastructure funding. And in many Asian countries – in particular those where capital markets are less developed – governments still cover a significant fraction of infrastructure-related costs.

Still, many observers have their doubts whether Asian economies can meet all their funding needs – in particular as banks in some countries ran up huge volumes of non-performing loans and seem to be constrained when it comes to financing new projects. I see a number of similarities here to the euro area and its bank-based financial system. Real economic activity in some euro-area countries is being stifled by the non-performing loans which are still weighing on banks' balance sheets and making banks reluctant to grant new loans. This is acting as a drag on economic recovery.

3. Diversifying funding sources and risk: the goals of the European capital markets union

Allow me to illustrate why the euro area's banking system plays such a consistently important role in financing the real economy. For one thing, bank credit today makes up around 30% of borrowing by euro-area enterprises. And business loans still play a key role for domestic banks and savings banks as well. At just over 23%, loans to enterprises alone constitute a significant portion of the consolidated total assets of the entire euro-area banking system.

However, the global financial crisis has made us painfully aware that it is rarely a good idea to place all your eggs in one basket. A system in which enterprises can rely on just a single source of funding will run into difficulties if that source dries up.

Against this backdrop, the European Commission presented an action plan in September 2015 for the establishment of a European capital markets union. Its idea is not to suppress funding through banks and savings banks. The optimal funding structure is not an "either/or" question. Instead, the European capital markets union aims to complement bank-based funding with capital market products.

Ultimately, then, it's all about diversifying the sources of corporate financing. If we give the capital markets a more prominent role in funding the real economy, that will give businesses broader and better access to funding. What it will also do is create a more efficient financial system that can better support sustained economic growth.

The second objective of the European capital markets union is to deepen the integration of the capital markets in order to improve risk sharing. Experience from the USA tells us that integrated markets for capital cushion around 40% of total cyclical fluctuations between the US federal states. Together with credit markets and fiscal buffers, this cushions almost 80% of an economic shock in the US.

The situation in Europe is slightly different: here, it is primarily the credit markets which act as buffers – and not particularly effectively at that. All told, just 40% of a shock is cushioned in this way. So boosting the role of the capital markets and integrating them more effectively across national borders would indeed help to improve risk sharing in Europe.

Together, improving both funding of the real economy and risk sharing will make the European capital markets union a worthwhile project – and I believe that the experiences we gather from this initiative may also be of interest for the Asian economic area.

4. The European capital markets union – a blueprint for Asia?

Of course, I am not calling for an Asian capital markets union. The situation in the EU is quite different to that in Asia, of course. Nevertheless, cross-border transactions among Asian countries gain in importance when it comes to infrastructure projects. And I do believe that Asia's infrastructure-related funding needs will require financing from non-Asian investors as well. This leaves me in no doubt that the renminbi clearing hub here in Frankfurt will prove to be particularly beneficial going forward in attracting European funds for Asian projects. But in general, more deeply integrated global financial markets – accompanied by sound regulation to avoid negative spillover effects and financial contagion when the going gets tough – might be an answer to the challenges which Asian economies are currently facing. This is because, at the end of the day, the European capital markets union is implementing the well-known principles of good financial sector governance.

Simple though this may sound, the European capital markets union shows us that putting these principles into practice will be far from easy. The capital markets are a complex beast, and capital market funding comes in many shapes and sizes. Corporate bonds, private and listed equity capital, venture capital and peer-to-peer loans are just some of the instruments in the market. And deeper integration affects not just the financial instruments themselves but also integral components of the respective markets, like exchanges and central counterparties.

Let me stay with that last point for a moment, because the importance of effective and robust financial market infrastructures cannot be overstated. In Europe, the regulatory framework, especially for CCPs, has been significantly strengthened. The internationally accepted principles for financial market infrastructures have formed the basis for national or regional legislation – known in the EU as EMIR – the European Market Infrastructure Regulation. Currently, additional work is underway to improve the recovery planning and resolvability of CCPs. This is necessary, since the regulatory move towards central clearing goes hand in hand with the risk of CCPs becoming too big to fail.

Stress tests are another tool we can use to identify both the potential vulnerabilities of CCPs and the need for appropriate regulatory action. Last week, ESMA, the European Securities and Markets Authority, published the results of the first EU-wide central counterparties stress test exercise. The results of the test show that the system of EU CCPs can be regarded as resilient overall. Taking all these points into account, European financial market infrastructures are on the right path to foster the implementation of a capital markets union in Europe.

Besides, a raft of different measures are also needed in a wide variety of other areas. For instance, equity financing would particularly benefit from abolishing the unequal tax treatment of equity and debt capital in Europe. Reforming the corporate taxation regime is naturally a difficult task, and strong political will would be needed to push it through. But: introducing a neutral tax regime for equity and debt capital would not only reduce the temptation to be highly leveraged, but also boost efficiency levels across the board.

Last but not least, there have been a handful of initiatives aimed at rekindling the continent's markets in securitised products. These include the European Commission's efforts to establish a framework for simple, transparent and standardised (STS) securitisation. Emphasising these three qualities is crucial, given the lessons learned from the crisis. The securitised products which fanned the flames of the crisis were neither simple, transparent nor standardised. In fact, there was a proliferation of complex and opaque products that led to the problems we are all too familiar with. So in my eyes, the Commission's initiative is a sensible move that will revitalise the securitisation market and promote the flow of funding to the real economy.

5. Conclusion

Esteemed colleagues

Emerging Asia is facing significant challenges as regards financing its additional demand for infrastructure. Indeed, the numerous development banks will play an important role in this respect. However, it is likely that additional funding from Asia and elsewhere might be needed to ensure that the region's economic expansion is not unnecessarily hampered.

In Europe, we are currently pushing towards a capital markets union that aims at both diversifying funding sources for the real economy and boosting risk sharing among investors. Is it thus a blueprint for Asia? I don't think so, at least not one on one. However, I firmly believe that the lessons we learn from this project may be of interest for the Asian economies as well.

I have highlighted some components of the capital markets union which I think are particularly important. In a nutshell, the capital markets union is about fostering stable and reliable financial markets by establishing an appropriate level of transparency for financial products and comparable legal standards. That kind of environment will help attract investors to invest in the European real economy and help European corporations diversify their funding sources. The same should hold true for the Asian real economy in general, and for infrastructure projects in particular.

Indeed, there is a long way to go until we have achieved an optimal funding structure. But as Confucius once said, "a journey of a thousand miles begins with a single step".

Ladies and gentlemen, let us take these steps together to build a sustainable financial system that is fit for the 21st century.

Thank you.