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The New Crisis of Finance

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This report is part of the Observer Research Foundation's "Financing Green Transitions" series which aims to find potential linkages between private capital, in all its forms, and climate action projects. The series will primarily examine domestic and international barriers to private capital entry for mitigation oriented climate projects, while also examining potential avenues for private capital flow entry towards adaptation and resilience projects.

ABSTRACT The failure of global finance to create a bridge between savings that earn low returns in the global north and the projects that would create much-needed infrastructure in the global south has caused a crisis that needs the attention of global regulators. Among the multiple causes of this crisis is the stringent regulatory response to the 2008 financial crisis, including new lending norms for banks; the tardy response of institutional investors to their new responsibilities; and the inability of developing-country sovereigns to open a constructive conversation with global capital. The consequence of this crisis of finance are severe for domestic politics, the global order, and the targets set by the Paris Agreement on Climate Change.

INTRODUCTION: 2008 AND AFTER

The great financial crisis in 2008 was a product of, among others, global imbalances. Production of goods was getting increasingly concentrated in certain parts of the world, such as the People's Republic of China, which then ran large current account surpluses. These in turn helped finance credit booms in consumption-focused economies that ran up asset prices and eventually caused the crash of 2008.

Since then, stricter institutional controls on lending have been introduced in much of the world. Leverage, or the amount of debt considered permissible for traditional financial institutions, has come down, and the

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risk profile of many lenders is more carefully monitored. It is generally hoped that this new post-crisis institutional paradigm will lead to greater stability and efficiency.

This brief argues, however, that in doing so the seed of another, if slower-moving, crisis has been sown. Another type of global imbalance has been allowed to build up; has, in fact, been encouraged by financial regulation. This imbalance is in the use and control of capital, and it has problematic consequences for both international financial stability and efficiency.

THE IMBALANCE OF SAVINGS AND RETURNS

What is the nature of this imbalance, and what implications does it have on the international financial system?

The first fact is this: Over the next 15 years, an estimated $89 trillion will be needed for infrastructure investment in developing countries; in addition, over $4 trillion is needed to finance low-carbon transitions in the developing world if the targets set under the Paris Agreement on climate change are to be met.[1] The World Bank has estimated that the $1 trillion currently invested annually in infrastructure will have to be tripled over the next decade if the United Nations' Sustainable Development Goals are to be met.[2]

In real terms, this means that across the global South, infrastructure projects, especially those that build in resilience to the stresses brought by climate change, require financing. Many of these are remunerative if the right financial structures can be found. Yet the primary responsibility for financing these projects has fallen on the shoulders of the impoverished and underpowered states of the developing world. This creates fiscal stresses in countries which have poor tax bases, at precisely the time when their development trajectory requires them to invest in human capital. Partnerships with local private capital can help, but even that will not be enough—and an excess of local capital has created governance issues, given the close networks in many countries between domestic capital and politicians.

The second fact is this: between $70 and $100 trillion[3] of the world's savings, much of it from the aging populations of the developed world, is managed by institutional investors. Pension funds in 22 major markets alone count for just over half of that, at $36.4 trillion in 2016.[4] This is the money that will have to finance the reverse demographic transition that the developing world is undertaking, as the generations who benefited from the post-war productivity boom transition into being renters of capital and productivity stagnates in the developed world.

Yet this money is not earning the returns it needs in order to finance this transition. Although developed-world central banks have finally moved towards tightening monetary policy, albeit slowly and deliberately, about $9 trillion worth of government bonds still earns negative interest rate.[5] An even larger proportion of this $70 trillion is invested in debt that earns returns that are close to zero, even as their assets under management continue to rise. This low-risk, low-rate equilibrium is in the process of creating a serious financing shortfall. In three decades, the pensions systems in six advanced

economies alone will face a $224-trillion deficit.[6]

Put these two facts together, and you have the beginnings of a serious structural imbalance. The investible funds are piling up in one geography, the projects providing returns are accumulating in another geography, and there appears to be no bridge between them. In order to provide reasonable returns for developed-world investors, financial structures need to search out projects in the developing world that meet a different risk-return profile than the current preferences being shown by international finance. In order to ensure that investible projects in the developed world receive the resources that they need, international finance needs to build a bridge between the pools of capital in the developed world and the possibilities inherent in developing-world infrastructure.

Building that bridge is the central task of global finance, but it is failing to do it. If indeed we live in a world in which financialisation and globalisation are ruling ideologies—in spite of whatever concerns about them, politically, are being expressed at this time—then it is important to ask why, precisely, global finance is being neither particularly global nor doing the tasks associated with finance.

DELINEATING THE FAILURE OF FINANCE

The purpose of finance is to identify, manage, and reduce risk. It is to match investors with projects that meet their risk-return profile—and, further, to create notional products and mechanisms that produce an appropriate risk-return profile out of baskets of real-world projects with different such profiles. It is from providing this service—of information gathering, increasing transparency, and engineering appropriate risk-return profiles—that finance is supposed to earn its income.

How has this failure of function come to pass? What are the components of this failure?

In recipient geographies:

Within the developing world, the reasons are easy to identify, if not to solve. The problem is that political risk is still a large "black box" that few governments or private companies have made the effort to disentangle in order to attract foreign investors. Any investment in, say, climate-resilient infrastructure in the developing world has to surmount three barriers. First, to overcome the bias against investing in long-tenor infrastructure, subject to one kind of perceived political risk; second, to overcome the bias against investing in the developing world, subject to another kind of perceived political risk; and third, to overcome the bias against investing in climate-change related projects, which are subject to technology-related risk. The last is not something that finance or states in recipient countries can do that much about. But the first two can and should be.

Consider the most drastic possible risk for an investor in such a project, the possibility of expropriation. This can take many forms: the drastic depreciation of a project to which the investor has committed funds, *force majeure* on the part of the state, or a nominally legal expropriation conducted by domestic capital in collaboration, overt or covert, with state power.

The duty of domestic regulators is to conduct a conversation with global capital that ensures that the perception of such risks declines. For example, to reduce the possibility that the domestic legal system appears stacked against global capital, and has a bias towards domestic capital or local state authorities, international arbitration of commercial disputes should be a major priority. But countries such as India have in fact reduced the scope of international arbitration in recent years. For example, India unilaterally abrogated a series of bilateral investment treaties and made a new draft treaty public that makes it drastically more difficult to appeal to international arbitration, insisting that domestic dispute resolution mechanisms would have to be exhausted first.[7] Nor has the Indian state effectively renounced the retrospective application of tax law, something that caused widespread fear among global investors.[8]

Overall risk may be difficult to reduce in developing-sector infrastructure. But it is necessary at least to make the risk more transparent and heterogenous so that global finance can do its job of sorting such projects and matching them to suitable pools of long-term capital. The task is to open a discussion with global capital that keeps in mind the shared tasks of easing the operation of international finance.

In source geographies:

In the developed world, finance is not following through on its assigned task of examining and decomposing risks. The constraints on the operation of finance are less well understood than in the developing world, and have even more fraught political implications.

First, there is the general question of a sociological bias within international finance, based as it is in the developed world, and staffed by those with little ground-level experience of emerging markets. This phenomenon is generally under-studied, and may be a crucial barrier to building a bridge between patient capital and emerging-market infrastructure even if other obstacles are removed.

Second, there is the vast expansion of central bank balance sheets in the developed world. This was undertaken in order to support economic recovery following the downturn caused by the 2008 financial crisis. However, it has created, in some sense, "lazy" finance. Theoretical models have established the crowding out of private long-term lending by central bank actions.[9] Structurally, for the purposes of analysing cross-border investment, a behavioural distortion is introduced: when a central bank is busy buying up bonds, credit traders merely have to examine generally accessible data on the instruments the bank is targeting and then pass them on to clients. The presence of central banks as the anchors for these markets means there is less incentive for finance to go out and create the sort of instruments that moderate and intermediate risk from emerging markets and climate-resilient infrastructure. The project finance market suffers from a chronic liquidity shortage as a consequence, since so much effort in financial institutions is spent on analysing, chasing or second-guessing central bank strategy.

Third, there is the question of the contraction of formal lending following the regulatory changes introduced to counter the build-up of risk that caused the last financial

crisis, in 2008. A common refrain at that point was that banking needed to be made "boring" again. In other words, controls were placed on risk and on leverage by both domestic regulators and by international accounting standards. It is often argued that these constraints, including the Basel-3 norms, have dried up the financing of projects in the developing world. An important further destination for academic work is to delineate the scope of this contraction. It has been shown that the market for larger loans—above 100 million GBP—with tenures of over seven years has shrunk drastically, while the market for fifteen year-plus tenures has vanished. This development is often blamed on Basel-3's introduction of constraints on liquidity, in particular the net stable funding ratio or NSFR.[10] The NSFR mandate is meant to fix the "asset mismatch" problem, in which a banks liabilities might be of shorter tenor than its assets, such as loans for project financing. NSFR, in essence, required banks to match long-term lending with equivalently long-term backing on their balance sheets. The effects of this regulation are three: increasing the cost of capital to infrastructure projects, perhaps by a percentage point or more; reducing the supply of capital, for example by limiting lending to those projects that can find institutional or sovereign sponsors; and by forcing more frequent refinancing.

Thus the cumulative effect of this requirement was to reduce banks' long-term lending overall and to create pressure on institutional investors to move into project finance, which themselves have failed to develop the competence or—currently—the risk appetite to serve as sufficient replacements. In some cases, the "shadow banking" system has risen to compensate for the absence of bank or institutional lending to global infrastructure projects.[11] The opaque and risky nature of this sector lends itself to bubbles and errors that may have systemic repercussions, and its rise as a source of project finance needs to be more thoroughly investigated.

CONCLUSION: IS THIS A FINANCIAL CRISIS?

The usual definition of a financial crisis is a moment when a bubble bursts, or when markets freeze up because of sustained mispricing or misallocation. The eerie quiet of the current moment may not appear to be a crisis of this nature—but it could be argued that it is, however, a crisis for global finance.

The sustained inability of finance to provide yields for savers in developing markets has helped stoke inter-generational and other social tensions in the West. Welfare states discover their cumulative savings are insufficient to both invest in their economic futures and support their aging populations, causing friction between these groups for scarce resources to transform into dysfunctional politics.

Meanwhile, in the global south, the failure of finance to do its job has caused a crisis of funding that threatens to not just defund important physical and human capital build-ups, but also to threaten the two-degree target for global warming set by the Paris Agreement on climate change. Without new, climate change-sensitive infrastructure, the battle for carbon mitigation and adaptation—which will

be determined by the actions of the developing world and of countries like India—will be easily lost.

Like any other financial crisis, there are geopolitical implications as well, with the inability to build a bridge between Western savers and southern projects causing developing countries to seek other forms of funding from non-market systems like the People's Republic of China, with dangerous consequences for the existing world order. The effort to avoid a financial crisis like 2008 has counter-productively caused another, different crisis of finance—but international regulators and world leaders are, like the generals of history, still fighting the last war. ORF

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