Note for the discussion of the Juncker Investment Plan at Bruegel on 12 January 2015.

This note outlines my views on the Juncker Investment Plan, as presented as of early January.

European Commission President Juncker's plan to boost European investment consists of three parts: (1) The creation of a "European Fund for Strategic Investment (EFSI), which is hoped to transform EUR 21bn of reallocated money from the Commission and the EIB into about EUR 315bn in investments over the next three years; (2) an agreement on a pipeline of new (or stranded) projects, which are hoped to get off the ground with the help of a new "investment advisory hub"; and (3) still unspecified improvements to the general conditions for private investment.

Juncker and his Commission deserve considerable credit for making a significant expansion in public and private investment (and the partnership between them) a cornerstone of his presidency. The Plan, although still missing several details, includes many of the components needed to address the severe investment shortfall – but not all. And timing seems to be an issue: The EIB, through which the entire first component of the plan will flow, curiously has announced that they do not envisage any expansion (actually a small decline) in activities during the first of the plan's three years.

1. The issues:

Following the financial crisis, Europe suffers from a significant investment deficit. While reasonable people can disagree on the exact magnitude of Europe's investment shortfall, the numbers are broadly as follows:

Since 2011, when significant fiscal cuts kicked in, net public investment has dropped to about 0.4% of GDP from an average of 0.7% during the previous 15 years. As a result, present pent-up demand for public investment is now likely to be at least EUR 190bn. The number is probably higher because Germany's net investment ratio was already comparatively low during the pre-crisis years.

The private sector tapered their investment activities earlier in the crisis than the public sector did. Since 2008, private net investment has been only 2.4% of GDP, less than half the level (5.4% of GDP) during the previous 15 years. At face value, this suggests pent-up demand for private investment of up to EUR 2.6 trillion. However, some of the pre-crisis private investments, e.g. housing in Spain and Ireland, turned out to be a waste, so the EUR 2.6 trillion most likely overstates the gap. Yet, even if half of all private investment during the previous 15 years were unproductive (a highly unlikely suggestion), the European private sector would still be facing pent-up demand of some EUR 1.0-1.5 trillion.

It has long been appreciated that growth will suffer in Europe over the medium term unless these shortfalls are being addressed, but considerable confusion about how to address the shortfall, as well as the role of public investment, has so far clouded much of the discussion.

Two key arguments have typically been stated against an expansion in public investment: (i) the public sector tends to waste the money; and (ii) there is no fiscal room.

I dispute both:

Most fundamentally, if indeed the public sector is incapable of investing sensibly, then we have a very different and even more serious problem, which needs to be urgently addressed via a strengthening (i.e. an expansion) – not a weakening via cut-backs – of the public sector. The prospect of still less (or none at all?) public investment cannot be the solution. Indeed, what is the evidence (beyond the inevitable occasional anecdotals, which are not that different from what the private sector experiences) that European government structures, after decades of building and supporting world-class societies, now have become incapable of investing public money, and less efficient than e.g. the US or China? Of course, there are issues to be addressed when public investments are boosted, but safeguards can (and should) be put in place, as outlined by e.g. Sylvie Goulard and Mario Monti in "Fiscal Discipline and Public Investment"; 3 October 2014.

And is there really no fiscal room for public investment? I acknowledge the excessive debt levels in most countries, but he very definition of an investment is an outlay with an expected positive financial return, for the public sector through the less-transparent path of additional growth. In the WEO in October 2014, the IMF devoted considerable research to the issue of public investment and its effects, concluding that "public investment shocks have statistically significant and long-lasting effects on output … An unanticipated 1 percentage point of GDP increase in investment spending increases the level of output by about 0.4 percent in the same year and by 1.5 percent four years after
the shock." Following five years of severe under-investment, and at a time of record low funding costs and near-record unemployment levels, to claim that there is no room for additional public investment is not credible, and only serves to fuel support for more politicians with more extreme ideas.

Meanwhile, with a huge private sector investment gap and record liquidity, reflected in record low interest rates, criticism has been directed at the banking system for not making credit available for the assumed demand from corporates.

There may be some truth to this accusation, but banks – like other private businesses – have simply reacted to changes in legislation and regulations. Following the crisis, banks were put under significant pressure to delever their balance sheets. Substantial capital was raised, but following a crisis, which caused underperforming return on equity for the sector and a future clouded by further tightening and restructurings demands, there are natural limits to this route. Work to improve the quality of the asset side is a natural consequence. As a result, assets have been sold and loan standards have been toughened among many banks, e.g. by requiring more equity from the borrower, and by longer processes of scrutiny.

At the same time, banks have had to allocate considerable additional resources to dealing with recent years' tsunami of demands for stress tests and asset quality reviews by supervisors, significantly increasing the cost of financial intermediation. In an interview with the FT on November 16, Christian Clausen, CEO of Nordea and president of the European Banking Federation, said that ever-increasing capital demands meant that banks needed to charge a margin of 6-7 percentage points to SMEs. Looking ahead, one must not underestimate the anxiety among European banking executives at the prospect of 16% TLAC – who has time to talk to clients about loans and investments, when you are facing at best a massive further demand for more equity and/or a significant restructuring of the ownership structures – and, at worst, an existentialistic crisis?

But while some supply side issues are present, there is an even clearer demand issue fully in line with historical experience. In Europe, credit to the corporate sector lags GDP by 2-3 quarters – it never leads!. Hence, to now hope that private investment will lead the economy out of recession is not realistic. It remains an illusion to expect fundamentally healthy businesses to demand loans for investment projects so long as they don't see a pick up in demand for their own products.

2. So, what's needed?

Europe needs a plan to boost public investment by EUR 150-200bn during the next few years. Both because of the magnitude, but also because of the local knowledge and expertise required, this needs to be generated at both the EU level as well as national levels. This is a point made by others, including by Goulard and Monti, in their piece from October, quoted above.

Europe also needs a significant boost to private investment, which requires (i) credible prospects of increased in general demand, i.e. for businesses' products; (ii) an easing of regulations and other impediments to investment, so that the private sector (in both the EU and elsewhere) chooses the EU for the location of such investments, and (iii) financing at affordable real rates (i.e. continued low funding rates for the financial system and a limit to the cost of intermediation.)

3. How does the Juncker Plan square up to these needs?

The Juncker Plan addresses a big part of this basket of needs, but not all.

Not surprisingly, the overwhelming part of the public attention to the Juncker Plan has been devoted to the first component: The promise to generate EUR 315bn in new investment out of a reallocation of EUR 21bn inside the

Commission and the EIB! (It feels a bit like me declaring, ahead of a golf game, that I'll now shave 10 strokes off my handicap by putting my tees at an angle and hitting the ball harder and with greater precision.)

On present information, these are my specific concerns relating to this first component:

I have four questions with respect to "additionality" and the assumed gearing: (1) Where does the initial EUR 21 bn come from, and – not being "new money" – what will be the negative effects of the reallocation to EFSI? (2) What type of money will be committed to the EFSI? Cash or guarantees? (3) How will the first-stage leverage (the 3 times to EUR 63bn) be achieved? And how confident can we be that the second-stage leverage (the 5 times to EUR 315bn) will materialise?

Specifically, on the source of the EUR 21bn, EUR 16bn is supposed to come from the Commission, of which EUR 8bn will be allocated from other investment and research plans. I have been unable to identify the source of the other EUR 8bn from the Commission. I have not seen any estimates of the negative effect of these cut, but it is (hopefully) not money the Commission used to just waste? Also, it seems that the EIB's EUR 5bn will be allocated from other uses, raising the same question of what the additionality really is.

These concerns aside, EFSI's EUR 21bn will be inside the EIB balance sheet, but will it be paid-in cash, or just guarantees? This will have an important impact on the EIB's ability to gear it the assumed three times to generate the stated EUR 63bn during the next three years.

And what will its legal structure be? Graph 2 in the Commission's communication to the European Parliament, the Council, the ECB and others on "An Investment Plan for Europe" on 26.11.2014 suggests hopes for "possible other public and private contributions", but if the EFSI is not an independent legal entity, I suspect that such additional contributions will be difficult to come by. Also, as far as I understand, the Commission's EUR 16bn first-loss guarantee in debt and equity investments is available only to the EIB. This seems problematic; other investors should be pari passu with the EIB, otherwise it will surely hold back the private sector's involvement.

In all, instead of creating the EFSI, I wonder why the already existing European Investment Fund, with statutes completely in line with this objective and a broad public-private ownership, was not utilised for this instead?

Either way, whatever will be committed to the EFSI will need to get geared the first three times (to EUR 63bn) via expanded EIB issuance to then be put to work – along with another 5-times gearing from the private sector – to create the estimated investments. In this light, it was surprising to see the EIB's press release on 23 December, in which they announced a decline [sic] in its funding plans for 2015 to EUR 60bn from EUR 61.4bn in 2014, and, explicitly, "these projections include funding needs associated with the European Fund for

Strategic Investments."
(http://www.londonstockexchange.com/exchange/news/market-news/market-news-detail/12194788.html) Does this mean that the EIB expects no expansion at all from the Juncker Plan in all of 2015?

If the EUR 23bn is indeed converted into EUR 63bn, I have less concern about the 5-times gearing to EUR 315bn; it is broadly in line with the experience from the national promotional banks. However, projects have to be identified and the incentives for the private sector to participate have to be in place. This leads to the second and third component of the Plan.

The second and the third component of the Juncker Plan (the pipeline of new, or stranded, projects, and improvements to the general conditions for investment) will be of great importance. However, few details have been provided, so I'll fold that discussion into the next section on the missing parts – i.e. suggestions for further considerations:

4. Next steps:

As noted, the boost to public investment needs to be both at EU and at national levels. A first step would be to engage the national promotional banks to a larger degree. Apart from having better local knowledge than the EIB, the combined balance sheet of just the four largest development banks (ie KfW, Cassa, CDC and ICO) amounts to some EUR 1.2 trillion, which is more than twice the size of the EIB.

A natural route would be to create a Eurosystem of national promotional banks, as suggested by Natacha Valla, Thomas Brand and Sebastian Daisy ("A New Architecture for Public Investment in Europe"; July 2014.)

To strengthen the second leg of the Plan, the Hub needs to be urgently developed and communication with the financial community on modalities, projects and opportunities for participation should be put on "fast-forward" if the Plan is to deliver results already in 2015.

To strengthen the third leg of the Juncker Plan, the Commission should draw up a list of "best practices" for tax and regulatory regimes for private investments. (One good place to start would be the World Bank's "Ease of doing Business") with concrete suggestions for each EU country how to improve their national investment environments.

National governments should be encouraged to boost their public investment budgets, as well as educational spending, through – or in addition to – the coordinated expansion of the NPBs' activities. The Commission should urgently announce a temporary (limited) waiver of the SGP's budget limits for pre-approved additional investment and educational spending for member countries implementing structural changes as outlined above.

Meanwhile, work should be done to change the present SGP budget limits (so flexibly interpreted that it has begun to erode the Commission's credibility) into a firmer set of rules for public consumption and public investment (including education).

The key argument against changing the rules is one of credibility. However, fiddling and applying flexibly (and opaquely) a set of rules with no clear analytical justification is surely more damaging to credibility than changing such rules into something that is analytically based, and growth enhancing.

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Erik F. Nielsen
Global Chief Economist
UniCredit