How to Spur Investment in Europe

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An Investment Plan for Europe

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I. The Investment Gap

II. The Investment Plan - A Critique

III. The Need for a Capital Markets Union

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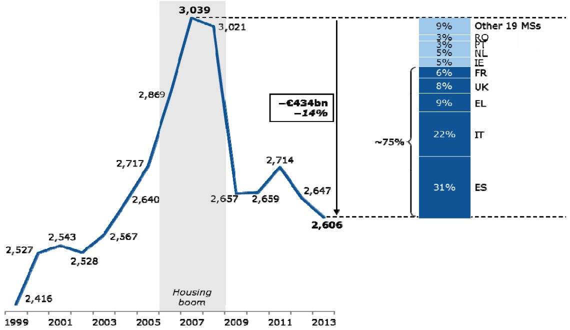
Starting point

- Sluggish growth in Europe, high unemployment, threat of deflation
- Two questions:
  1. How to get out of the current crisis?
  2. How to increase overall production potential in Europe?
- The *magic bullet*: **Investment** $\Rightarrow$ Raises demand in the short run and expands the production potential in the longer run

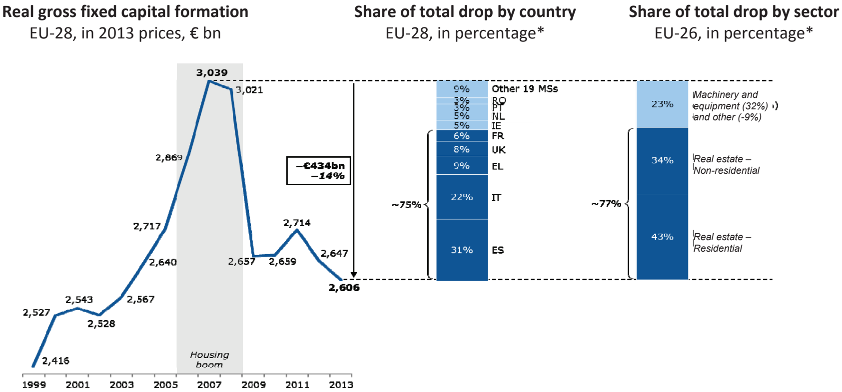
Sharp drop in investment since 2008: −434 billion EUR (EC/EIB, 2014)

Real gross fixed capital formation
EU-28, in 2013 prices, € bn

Share of total drop by country
EU-28, in percentage*

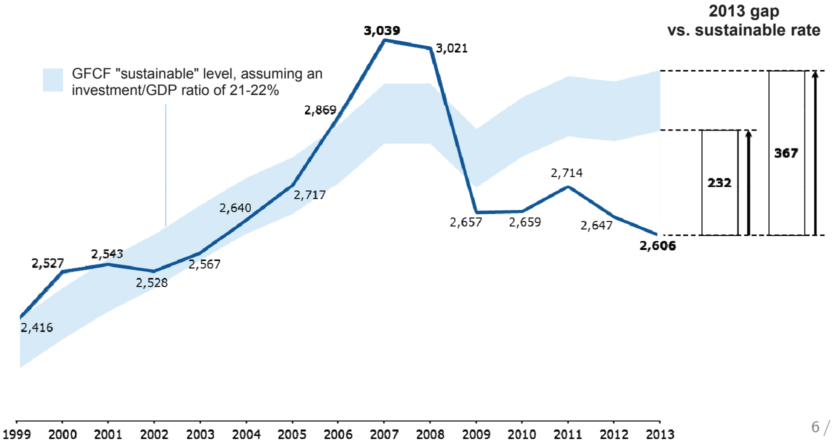


… driven largely by real estate investment (EC/EIB, 2014)

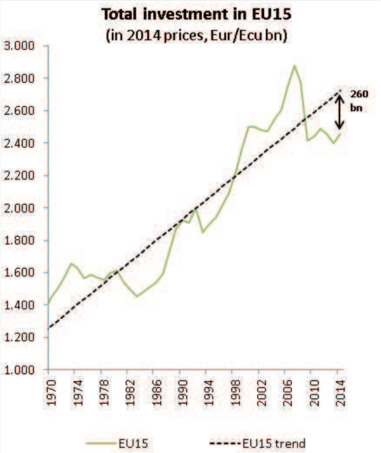


… leading to an investment gap of 232-367 billion EUR relative to the "sustainable level" (= long-term average, 21-22% of GDP) (EC/EIB, 2014)

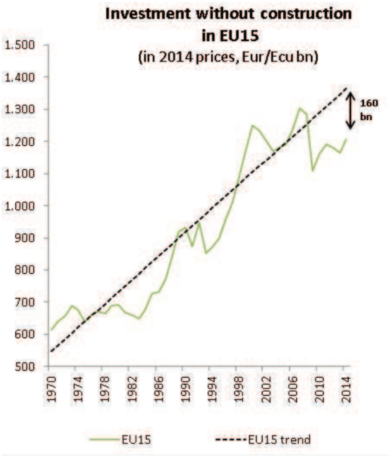
Real gross fixed capital formation – Observed trend vs. "sustainable" level
EU-28, in 2013 prices, € bn



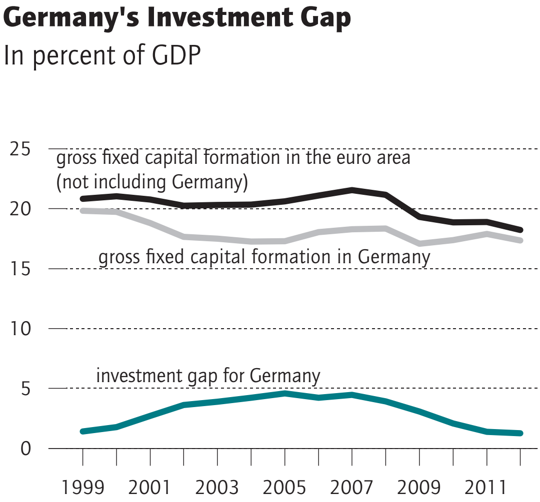
Bruegel calculates an investment gap of 260 billion EUR (plus 20 bn EUR other EU) relative to a linear trend since 1970 (1995 other EU) (Bruegel, 2014)



... shrinking to 160 billion EUR (plus 10 bn other EU) excluding construction (Bruegel, 2014)



DIW calculates a cumulated investment gap of 1 trillion EUR since 1999 for Germany alone relative to the rest of the eurozone (Bach et al., 2013)



Why the calculation of investment gaps is not useful

- Underlying assumption: *More investment is always better*
  - *Quality* of investment does not enter the analysis (Example: Real estate bubble in Spain)
  - We would have to observe *optimal* investment levels to identify investment gaps
  - Optimal investment levels vary over time and across countries (demography!)
- All studies quantifying investment gaps use *questionable benchmarks*: either the past or other countries
- Issues:
  - *Structural breaks*: Reunification in Germany, financial crisis
  - *Sectoral composition* matters and varies over time
  - *Definition of investment* is unclear and subject to change
- Conclusion: Quantifying investment gaps is not particularly useful

Problematic policy implications

- Calculation of investment gaps suggests that one simply has to *fill the gaps* in order to solve all problems
- Such a strategy treats the *symptoms* rather than the causes
- Before one designs an investment strategy one has to understand the *causes of low investment*
- Causes depend on the type of investment:
  - *Public investment*: Fiscal constraints and wrong priorities (e. g. in Germany)
  - *Private investment*: Different causes for different countries, firms etc. including a lack of demand, poor longer-term growth expectations, uncertainty about future policy, geopolitical risks, financing restrictions, existing regulations and bureaucracy, demographic factors (shrinking markets, lack of qualified personnel), taxation, energy prices
- Given the large set of causes, a single cure is unlikely to be sufficient

The Investment Plan for Europe

- 3 pillars:
  1. Mobilization of finance: **European Fund for Strategic Investments (EFSI)** plus leverage $\approx$ 315 bn EUR (optimistic!)
  2. Project selection and technical assistance
  3. Improvement of the investment environment
- Attention mostly focuses on the first pillar
- Announced time schedule does *not include a single concrete step concerning pillar 3!*

European Fund for Strategic Investments (EFSI)

- Volume of *additional funds* is small:
  - Reshuffling of funds (e. g., from Connecting Europe Facility, Horizon 2020) with substantial opportunity costs (cf. Veugelers, 2014)
  - Difficult to avoid pure windfall investments (cf. Claeys et al., 2014)
- Main effect is the *new financing structure*:
  - Various financing structures with the common feature that the *first-loss tranche* is taken over by the fund
  - Investment plan de facto creates a huge CDO where the downside risk is taken by the public and the upside risk goes to investors
  - This increases the desire to invest but is likely to *distort risk-taking incentives*

European Fund for Strategic Investments (EFSI)

- Success of funding structure crucially depends on the fund's *governance*:
  - Ensure *quality*, not just quantity of investment
  - Use *co-funding models with immediate loss participation* to obtain private signals whether investments are really profitable
  - Avoid *political and competitive distortions* of project selection
- Private involvement is especially useful if this leads to *efficiency gains* in the implementation of the project
- Mobilization of private funds should not simply be used to *circumvent fiscal constraints*, which would undermine the credibility of consolidation programs
  - "Favourable treatment" of additional member country contributions under the Stability and Growth Pact clearly points in this direction

What we need: Strengthen Pillar 3 of the Investment Plan

- If a *lack of confidence* is the main cause of the lack of investment, a program filling the "gap" will not solve the problem
- Instead we need **Pillar 3 of the Investment Plan**:
  - an economic policy agenda creating *predictability* of consolidation, taxation, and regulation
  - further development of the Single Market (e. g., European Energy Union, Digital Single Market)
  - simplification of regulation and reduction of bureaucratic burdens
  - improved access to long-term and high-risk finance
- Progress on Pillar 3 is the *most important aspect* of the Investment Plan and is most likely to provide for permanent improvements rather than a temporary push (cf. Gros, 2014)

Financing conditions in Europe

- Overall financing conditions are still tight, with some heterogeneity across countries and types of borrowers
- Two types of financing restrictions:
  1. Lack of *risk capital* (equity) for innovative firms in the start-up and expansion phase ⇒ Improve access to equity
  2. Lack of *long-term financing* due to weakness of the European banking sector ⇒ Strengthen capital markets
- These are *structural factors*, hence it is not sufficient to simply "fill the gap" by public funds
- Restrictions are reinforced by increasing *risk aversion* since the crisis and the *tightening of regulation* for banks and institutional investors (such as insurance companies)

1. Improving access to equity

- Establish *financing neutrality* in taxation
  - Remove preferential treatment of debt, which distorts the choice of capital structure towards debt financing
  - GCEE has made a proposal how to design such an improved taxation system in Germany
- Reduction of leverage to mitigate the *debt overhang problem*

2. Strengthening of capital markets

- Financial crisis has shown the *strong dependence* of most European countries on a functioning banking sector
- Only large companies could compensate for a reduction in bank lending by *tapping capital markets*
- Strengthening of capital market financing is needed to obtain a more *diversified funding structure*
  - This includes the development of *securitization markets*, which is particularly important for SME financing
- Overcome *financial fragmentation* in Europe

$\Rightarrow$ Crucial role of the **Capital Markets Union**

Conclusion

- One should try to understand and treat the *causes* of low investment instead of simply filling "investment gaps"
- More investment is not always better - *quality of investment* matters
- Investment Plan holds the danger of generating *windfall gains* for investors and *distorting risk-taking incentives*
- **Pillar 3** is crucial to raise the willingness to invest, therefore it should be the *top priority*
- **Capital Markets Union** is an important part of that Pillar and may improve the availability of *equity and long-term financing*, provide a more *diversified financing structure*, and *overcome financial fragmentation* in Europe