SESSION SUMMARY - BERLIN SEPTEMBER 2020

Conditions for relaunching investment and growth in the EU in the post-Covid context

1. The EU faces an investment and growth weakness

An official opened by stating that long term and productive investment are essential for economic growth. However, corporate, infrastructure, energy and R&D investments are higher in large economies than in Europe, and real GDP growth and productivity gains in the euro area have failed to catch up with the US, China and Japan over the past two decades. The COVID-19 pandemic and the global lockdown have induced a sharp slump in the world's economies. The pandemic is destroying capital, including human capital; it is causing businesses to invest less, given the uncertainty, and has led to much higher private savings, which is reducing overall economic demand. Moreover, higher public debt can have a negative impact on growth in the long-term.

In May, the European Commission calculated that, in a relatively optimistic scenario, corporate Europe would lose €720 billion by the end of the year. One quarter of all European companies with more than 20 employees would exhaust their working capital and run out of cash by then, even while benefiting from wage subsidies. This will have repercussions on growth. This very hot topic lies behind much of the thinking about the German presidency.

1.1 Low productivity growth, weak demand expectations and regulatory uncertainty

A policy maker stated that investment developments in the decade since the global financial crisis have been disappointing, in pace and quantity. The reasons are essentially threefold: low productivity growth, weak demand expectations and policy uncertainty.

When thinking about levels of investment, it is better to reflect more on the barriers, rather than having a specific number in mind. The main barrier is the low allocative efficiency of corporate investment. In Europe it is not oriented towards the most productive areas or efficient markets. This is holding back rates of returns, many of which can be attributed to inefficiencies and blockages in product, labour and other markets. This inhibits the reallocation of resources from less to more productive sources and is also linked to the unfinished agenda of the banking and capital markets union (CMU).

Regulatory uncertainty is another factor which explains the EU investment weakness. There have been some changes to not only the regulatory frameworks, but the tax framework for supporting green investments, for example. The quicker a medium term investment framework can be provided, the more investments there will be in this area.

Europe has also performed particularly poorly in artificial intelligence and other innovative sectors for several reasons: Pricing intangibles is extremely challenging; these investments are also held back by the lack of developments in banking union and CMU. Often, investments in these areas are complementary to investments in other assets, such as human capital, and technological infrastructure. If conditions in any one of those areas are lacking, it can hold back more cutting edge technologies. This is where the Recovery and Resilience Facility (RRF)[1], by supporting public investment in years to come, can play a particular role. Unfortunately, in large parts of the European and domestic markets, opportunistic power is inhibiting the capacity of rival companies to grow.

A market expert stressed two points about the situation just before COVID. First, like most advanced economies, Europe had suffered from longer downfall trends in productivity and growth alongside an increase in their share of older people. This long fall in productivity is due to a maturing of the old capitalist cycle.

1.2 Overly fragmented banking and financial markets in Europe

Lack of investment in the EU is probably due to a number of weaknesses, in the view of a market expert. Among them is that important savings are largely invested abroad. Although the euro zone has a large surplus of savings over investment, European companies do not benefit from them, largely due to the failure of CMU. There is a real paradox: the euro zone's savings surpluses do not contribute to investment in Europe.

Second, banks in Europe, which are a key component of the financial markets, are in a weaker position compared to their American competitors. Banks continue to make too little profit in Europe compared to the US. The banking sector in Europe is too fragmented, not concentrated enough and oversized. EU banks still have to absorb a significant amount of non performing loans due to the economic downturn. In addition, they do not benefit, as in the US, from a securitisation system that would help the intermediation of banks, insurance and pension funds to transfer sound risks to the market. Thus, some weaknesses have accumulated in Europe compared to the US, which has fewer rigidities and has recovered its growth.

An industry participant added that complicated access to risk capital and start-up funding, plus the fragmented financial markets, unfinished banking union and high dependence on bank lending could be reasons why low interest rates and accommodative monetary policies have not kick-started investments.

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1 The Recovery and Resilience Facility (RRF) constitutes the core of Next Generation EU (NGEU). For NGEU, the European Commission has been authorised to raise up to €750 billion on the capital markets on behalf of the European Union. The funds can be used to provide loans of up to €360 billion and grants of up to €390 billion. These will be disbursed up to the end of 2026 and repaid by 31 December 2058 at the latest. The entire loan portfolio and 80% of the grants will be assigned to the RRF. The remaining part of NGEU will mainly be used to reinforce EU-wide spending programmes under the MFF.

1.3 Lasting very low interest rates have developed a preference for liquidity over productive investment

A public representative evaluates how, in the last 10 years, the European economy was in a real liquidity trap and did not do enough to solve it. Lasting very low interest rates developed a preference for liquidity over productive investment. This has to be recognised. Germany's position on the current fiscal rules was correct; unfortunately, more could not be invested, because of the Stability and Growth Pact. Individual national fiscal policies over the last year have not been evaluated without analysing the fiscal policy of the eurozone as a whole. Maybe the necessity for a common European answer would have improved the level of investment in Europe. Analysis of this situation is particularly relevant now, following the European Council summit in July, the Commission's proposal and the position of the European Parliament, all of which are working together to deliver a fiscal answer to Europe's current crisis.

An industry representative agreed on the presence of this liquidity trap for the last 10 years. The question is what banks can add. A company will not change an investment decision if the loan is a few basis points cheaper. Relaunching investments needs fiscal policy, whether through financial incentives, implementing structural reforms or defragmenting financial markets and finalising CMU. The COVID-19 crisis has shown what governments and fiscal policy are able to achieve in unprecedented times.

1.4 Demographics and low investor confidence issues

Uncertainty and low investor confidence are given by an industry representative as other reasons why companies are not investing even when they possess the financial means. Structural factors, such as ageing societies, fragmented financial markets, EU break-up risks and the lack of a common fiscal policy seem to weigh on future returns from investment. With economic prospects often higher in other parts of the world, Europe has become less attractive for both domestic and foreign investors. Demographics are related. They make potential growth in the eurozone extremely low and, in the view of market economists, explain why companies have been focusing on other geographic areas.

Adding to what was said earlier about inefficiencies, this industry participant characterised the last decade as one of austerity measures. Looking at investments in AI and other high tech areas, a combination of public and private investment can be seen in the US and China, creating incentives for the private sector. This has been much less the case in Europe, which has somehow missed the train with these sectors.

1.5 National public banks also have their share of responsibility

A public finance representative believed that European growth is lower than it has been for the last half century. There is a role for public institutions in changing this. Keynes said: 'When facts change, I change my mind.' The public institutions did not change their minds, not only about COVID, but the crisis of 2008. The financial sector's profits have to be better allocated to produce growth that is so desperately needed.

Having addressed the structural features and demographics, the conversation began to look forward towards institutional and public policy priorities. A great bulk of responsibility remains in the national sphere, in an official's view. National support for the euro area altogether amounts to roughly €3.5 trillion. European support is roughly half of that and rescue packages are €1.3 trillion, so there is a massive need to implement domestic structural reforms and ensure the sustainability of public finances after the pandemic, as prerequisites to relaunching sustainable growth. Given challenges affecting future growth - demographics, lasting very low interest rates, collapse of world trade, weak profitability of the EU banking sector, high level of public debt in many member states – all European countries should prioritise strengthening productivity and competitiveness in the future, while promoting a green and digital economy.

2. Making Europe's response to the pandemic a success

Another official reported that Europe responded quickly to the pandemic with several policy measures designed to help the most affected countries. At the beginning of April, euro area finance ministers agreed on three safety nets worth a total of €540 billion. Each of these has a different purpose: the ESM's pandemic crisis support helps countries to cover direct and indirect healthcare costs; the Commission's SURE programme is for workers; and the new guarantee fund of the EIB can be used to finance corporate investments. At the same time, monetary policy measures by the ECB have stabilised financial markets. In July, the €750 billion Next Generation EU recovery plan of the European Commission was adopted. It is now crucial to agree on the recovery package with the Parliament and begin distribution of the funds.

2.1 The fiscal deal agreed in July by the EU Council and national responses to the COVID crisis were a significant step forward

An official earlier summarised how public action has been quick and solid, both on the national and the European sides. As well as dealing with some sudden challenges, a public decision maker described how regulatory obligations were loosened so that banks could continue providing credits and member states could support the industry. National governments also came up with support plans quickly. The first phase was to stabilise, not letting companies go into insolvency or lay off large numbers of workers because of liquidity shortages. That quick action meant money was made available rapidly.

The second phase was to provide money at the national and European level to invest in the future and stabilise economic development. The official explained how the German presidency is trying to put the heads of states' agreements from July into action. Following that painfully agreed compromise, the Commission is going to the market, for the first time ever, to raise money to be spent via the EU budget.

2.2 The EU Parliament welcomed the EU agreement on the Recovery and Resilience Facility (RFF) but deplored some shortcomings in the Multiannual Financial Framework agreement

A public representative congratulated the German Government on their excellent work in reaching agreement at the European Council. Now they need to deliver the legislative proposals that will put this package in place by the beginning of next year. The RRF is currently being negotiated in the European Parliament, which wants the same responsibility to evaluate and control the Commission as the Council itself.

The Multiannual Financial Framework (MFF) agreement was very difficult and community funds will be less than expected over the next few years. The Parliament will look for the possibility to review this, which is difficult when there is less money on the table. It needs a clearer commitment about the resources required to repay the debt that the Commission will use in the next few months to eliminate any uncertainty about policies in the 2028-34 period. This requires a strong position on the development of new European own resources that does not increase the tax burden but addresses fraud and tax avoidance.

There are some further conversations to be had on the overall governance of the RRF before agreement of the Parliament with the Council, represented by the German presidency.

2.3 Making the Recovery and Resilience Facility a reality

2.3.1 Spending EU money wisely and quickly

A policy maker sees the immediate next step as converting the political agreement of July into actual legal reality. This requires not only the German presidency, but member states and the European Parliament, to get the deal over the line, so that money can start to flow. Before then, the Commission is engaging with member states on the design of their RRF plans. The scale of this challenge is huge.

RRF calls upon member states to come forward with a detailed plan covering both reforms and investments. Higher levels of public investment need to be combined with framework reforms to make sure that they are allocated to the right sectors. There will always be a risk that resources are channelled to corporates or sectors that are not the most productive and do not take account of the genuine structural changes and impacts emerging from this crisis. Emphasis has been placed on the digital and green components of member states' investment plans to help reduce investments flowing to incumbents or sectors that are poorly placed for the future of the European economy.

The RRF is designed to be bottom up, with member states taking ownership. The hope is that they take the broader European dimension into account, as they can only deliver their full benefits if they are part of a common European package.

2.3.2 Boosting EU investment and productivity for sustainable development, energy transformation and digital areas is essential from a geopolitical perspective

In the view of a market expert, this is a transitional period for the RRF, in which the economy should be stabilised. The problems will come afterwards. There are enormous challenges from the strength of Europe's competitors; in the market expert's opinion, China is already planning for 2030 or 2040, so Europe must act quickly if it wants to maintain its role in global competition. Some of this region's weaknesses have already been covered but could be summarised as a lack of investment in disruptive innovations – digital, hydrogen, artificial intelligence and health. The region lacks the infrastructure to improve productivity and must concentrate on these technological challenges alongside a strong industrial policy with such a strategic orientation. Investing in these disruptive technologies will ensure the correct pooling of resources.

The expert added that faced with the "technological war" between the United States and China, Europe must lay the foundations of its sovereignty for the next 20 years. In the field of security and defence, reinforcing technological autonomy is essential. Sovereignty must also be exercised in the field of green technologies, and Europe must become the leader in this area. Moreover, addressing technological challenges requires a European industrial policy and an EU strategy for technology funding. In this respect, a holistic industrial policy marrying finance, research, industry, competition, trade, existing local eco systems and education is vital and urgent

2.3.3 Helping economies to become more competitive

An official related how the 'own resources' decision legally allows the Commission to go to the market and raise a certain amount of money. It also regulates repayment over a longer period, whereas the RRF sets out how to spend that money. Each member state needs to file a comprehensive reform package before it can access this money to ensure that it is channelled to the right areas. Helping economies to stabilise is fine, but this is helping economies to become more competitive and to build the foundations for future growth, avoiding the same liquidity trap of the last 10 years. It will ensure a V shaped recovery.

2.3.4 Defining the appropriate governance

Turning to governance, an official described how what is first needed is for the Commission to draw up guidelines that will form the conditions by which member states can create the programmes to access European money. This should show how to implement climate and digital targets, and how to achieve the mixture of investment and reform required. The second imperative is to get the governance right, so that decisions can be taken quickly. When it comes to disbursing the money, the milestones have to be clear cut too. Another recommendation is for the member states to talk to people in the market – stakeholders, smaller companies and young firms – about what is needed from the reforms. Those discussions then need to be integrated into their plans.

2.4 Public finance plays a key role provided restrictive measures on public funding are alleviated

A public finance representative explained how national promotional banks (NPBs), as countercyclical actors, have an active role to play in financing the EU economies. Long-term investment projects need a system that uses NPBs or public finance as support. They are enablers to relaunch investment, as they trigger a high leverage effect, and they are prepared and ready to act. In this context, it is essential that they should continue to benefit from the active support of InvestEU. Hence the agreement reached in July, when InvestEU went from €38 billion to €23 billion, caused some disappointment. The public finance representative believed that this July EU agreement sent some contradictory and risky signals. Europe was not made by grants over the last 70 years. Among expected clarifications, restrictive measures on public funding should be alleviated by generalising and simplifying the possibility of mixing European subsidies and investment with public capital.

2.5 Implementing domestic structural reforms and ensuring the sustainability of public finances after the pandemic are prerequisites to relaunching sustainable growth

A policy maker noted that many speakers praised the MFF plan as exceptional, but one central obstacle remains: the past shows that money alone does not ensure recovery; what really matters is reform. The direction of the reform needed is clearly twin – green and digital. Other reforms are horizontal to the functioning of the economy, such as in public administration and governance, but reform is not easy.

Hence the recent creation at the EU Commission of two new DGs, DEFIS and REFORM, and a Secretary General with the role of coordinating these efforts. Likewise, the technical support instrument of the EU Commission was increased by about 40% in the negotiation of 17 21 July. The lifecycle of any investments must also be kept in mind; it is not only a point in time that matters. The policy maker compared this instrument to the ESM, which enters the financial markets to acquire money under privileged conditions. Technical support does the same, not on the financial markets, but on the knowledge markets. This money is then passed to the beneficiaries of over 1,000 technical support projects across the member states. Ownership is essential and projects must be constructed from the bottom up, if these countries are to realise the reforms they envisage. There is perhaps little contradiction between the ownership of member states and Union priorities. After all, the latter are decided by representatives of the people of Europe. An

official (Strauch) also praises this instrument as one of the most successful projects of the Commission.

Another official reminded participants how a number of interventions suggested that European economies had not taken full advantage of the last 10 years. Some had not fully recovered from the financial crisis and their public finances were not in the best condition before the Covid crisis. Thus, member states do not have the same budgetary resources to deal with the crisis and this increases the risk of economic fragmentation between countries. The sustainability of public finances will continue to be a concern in the years ahead. Member states need to implement the structural reforms now that will improve the business climate and increase potential growth.

The RRF cannot have a permanent role in the eyes of a market expert. It shifts the burden largely to the states to reduce their current unproductive expenses and increase their infrastructure investments. This will help the industrial policy of the European community to prepare for the big challenges of the future, such as the security of its maritime borders, defence and immigration. Member states must adapt and invest in strategic new sectors, improve the size of their start-ups and adapt competition policy to avoid more examples of predators picking up the best technology firms.

2.6 Completing the Banking Union and implementing the Capital Market Union are urgent priorities to ensure an effective funding of EU economies

An expert stated that achieving Banking Union and CMU is no longer a theoretical wish; it has to be taken seriously, with securitisation and an enforcement of institutional investor capabilities to channel savings. An industry representative recommends better cross-border capital flows between EU countries to facilitate the development of equity instruments that will help Europe to compete globally. In comparison with the US, there is a greater role for venture capital and start-up financing in Europe, which will be essential in ensuring recovery.

A public representative stated that the problem with the current orientation of the new RRF is that it may have missed the real bottlenecks in the European market, which are a lack of a real CMU and, ultimately, financial fragmentation. These cannot be solved through national structural reforms only. Ultimately, European policies are needed, but Parliament will deliver. These efforts have to be accompanied by thinking on a European level with revisions of Basel that take into account the impacts of the current crisis, particularly the development of zombie companies. This work is essential so that all the other efforts will succeed, an official stressed. A policy maker agreed and advised interested parties to consult the CMU report of the High Level Forum, which covers many of the issues discussed by the panel.

A public finance representative added that priority must also be given to the functioning of the economy by encouraging both debt and capital financing. This requires an easing of prudential measures which, in the current situation, risk leading to the financial embolism experienced in 2008. It will also be necessary to introduce incentives, such as financing the deferral of debt repayment in favour of riskier investments, either because they are long term or will contribute to the general interest by being focussed on areas such as hospitals, affordable housing or education. An official had talked about a spike in bank lending because companies had needed bridge loans during the COVID crisis, but not in all European countries. In others, bank lending had stagnated, reported the industry representative because guarantees came directly from the state or EIB instead. Regulations might be amended a little, but the way forward is more CMU and open access to venture capital. ■