PRIORITIES FOR FOSTERING INVESTMENT IN THE EU

Over the last few decades, real gross domestic product (GDP) growth and productivity gains in the European Union have failed to catch up with the US, China, and Japan. If Europe wants to recover the ground it has lost due to COVID 19, it is important to change course and encourage higher levels of productive investment. While the end goal is clear, it is less clear how best to achieve this. The panel examined this question by analysing the root cause of structurally low investment and discussed possible solutions. Speakers expressed views on key monetary and fiscal priorities and assessed the main structural reforms and regulatory priorities for overcoming the current impediments and fostering investment in a post Covid context.

1. The level of productive investment in Europe has been more affected by the Covid crisis and is recovering more slowly than other regions of the world

The decline in activity due to the Covid crisis has been much greater in Europe than in the US and investment has recovered more slowly than in other regions of the world. A policy maker described how there was a collapse in fixed investments in Europe over the last year. This drop of around 10% was almost entirely in private investment. This is understandable, given the liquidity constraints, the restrictions on working capital and the measures introduced to contain the pandemic.

1.1 Productive investment has fallen most in the EU countries that need investment the most

An industry representative noted that productive investments suffered a smaller decline following the Covid crisis compared to the Global Financial Crisis. This resilience is a result of the prompt fiscal support provided by member states and the EU, but it is also the result of continuous action by the European Central Bank (ECB) on quantitative easing (QE) and negative interest rates since 2014. This is encouraging, but it will not be sufficient to close the investment gap between the European economies and the US or Asia. Productive investment has fallen most in the EU countries where uncertainty about the virus was at its highest and where social distancing measures severely hindered the economy. This was exacerbated by factors such as uneven fiscal space, uneven reliance on tourism and uneven access to finance. Productive investment has fallen the most in the countries that most need investment such as Greece, the south of Italy and the east of Poland. In other words, Covid has increased the economic divide between EU countries and contributed to the western eastern divide.

1.2 Europe will be slower to recover than the United States

A Central Bank official explained that since 2014 15 private investment in Europe has broadly followed the dynamics in the US. However, there has been a falling back in terms of public investment in Europe. Relative to the US, Europe's economy is oriented towards areas such as construction rather than intellectual property. Due to its support policies, the US will close its output gap by the end of 2021 or early 2022. Europe, however, will not close its output gap in the current or next year. To some extent, this is an issue of ambition. While the Recovery and Resilience Facility (RRF) is a step in the right direction, the process has stalled due to problems concerning the establishment of effective packages of projects. Ultimately, this is a problem of the architecture of the EU. With common monetary policy, there is a need for a much larger common fiscal facility and a larger and more operational common investment facility. A genuine European Banking Union and deep, well functioning capital markets are not luxuries; Europe needs these achievements in order to go forward.

1.3 GDP in Europe is projected to recover by mid to end 2022

A policy maker outlined the prospects for recovery in the immediate term. Based on the Commission's most recent forecast, GDP in Euro area is planned to recover its pre-COVID real GDP level by the first quarter of 2022, though this projection is predicated on a recovery in private investment. Whether or not this materialises will depend on the successful rollout of vaccinations, and therefore the lifting of restrictions, and the gradual adjustment or tapering of support measures to avoid cliff edge effects.

2. Diverse structural impediments to investment

There are diverse structural impediments which are hindering sustainable investment across member states, including high levels of public and corporate debt, the absence of a single market for services, the predominant role of bank finance and an inappropriate business environment.

2.1 The business friendly environment is a key structural determinant of investment

A Central Bank official highlighted the importance of having a business friendly environment. There is work to be done on the business environment in Europe both in terms of differences between countries and in comparison with the US or Asia. This should have been done 10 or 20 years ago. Without addressing this, Europe's macroeconomic management tools will not foster more investment in the future.

2.2 Structural impediments to investment in Europe

2.2.1 Business demography

An official explained the role of business demography. Europe's production output is heavily skewed towards small and medium sized enterprises (SMEs) compared to many other advanced regions. This is a structural impediment, because SMEs are less productive than large corporates. Many studies show that larger companies tend to be more nimble in their response to similar increases in demand.

2.2.2 The absence of a single market for services

A public decision maker described how Europe has not managed to successfully create a single market for services despite a very good intention to do so. The lack of a single market for services constrains the growth of some enterprises because they do not benefit from the advantages of a single market to supply. In areas like professional services, there are barriers created by a lack of national implementation of the directive on this subject. A Central Bank official agreed that there has been positive progress on the single market for goods, but there are unresolved problems in services, including digital services. A public representative noted that in the US some sectors such as aeronautics have been brought together with a rigid approach from the federal government in Washington.

2.2.3 The high level of corporate debt

A policy maker described how SMEs' prominence, production and contribution to growth is a structural impediment. SMEs are typically characterised by higher corporate debt and higher leverage, which constrain investments.

2.2.4 Banks are too dominant and capital markets are underdeveloped and fragmented in Europe

An official noted Europe's heavy reliance on bank finance. The reliance on banks is a structural impediment to growth and investment, because banks do not invest very dynamically, i.e. they are not very good at investing in intangibles. Typically, banks lend against collateral. Europe has much lower investment in intangibles than the US. Considering the example of start ups, Europe is very rich with innovative ideas and new initiatives, but at some stage of growth these start ups lack finance and resort to a more global capital market, especially the US, which limits corporate expansion. A Central Bank official agreed that banks are too dominant as a funding source. They only value certain types of risk and certain business models. Underdeveloped capital markets, especially in smaller jurisdictions, offer fewer sources of financing for investment, less diverse risk taking and a limited set of business strategies.

An IFI representative considered the issue of fragmentation to be very important. The complex patchwork of different markets is a key obstacle to developing better equity markets, notably in CEE countries. Encouraging smaller stock exchanges to consolidate will improve efficiency and performance. There is a clear correlation between a market's size and depth and the level of initial public offering (IPO) activity and liquidity, which illustrates why the European Bank for Reconstruction and Development (EBRD) has been involved in attempting to create a pan Baltic capital market.

2.3 The negative consequences of high public debt on investment in Europe

An official suggested that high public debt explains some of the fragmentation in Europe. The countries in Europe with high public debt have a high risk premium in their capital markets. High debt countries' banks have higher funding costs, and this translates into higher implicit or actual borrowing costs for the corporate sector, particularly SMEs. Large corporates in Europe have generally been able to access other sources of finance. In the current crisis, the part of the European corporate sector that accesses the capital markets rather than the banks has performed well compared with the US. Corporate yields in both the investment grade and high yield sector have not suffered substantially. In this low rate environment, corporate sector yields are on par with the US. The bank funding cost for SMEs is the source of the problem. High public debt also explains the disparity and fragmentation in bank funding costs.

2.4 Slow progress on corporate balance sheet restructuring after the global financial crisis

A policy maker noted that one additional structural factor in Europe is the relatively slow pace of corporate balance sheet restructuring in Europe following the global financial crisis, which was due to issues on the financial market side and issues related to insolvency. Unusually, public investment held up well during the Covid crisis. Last year, public investment showed slight growth of about 3% of GDP.

2.5 There are both cyclical and structural factors at play

A Central Bank official suggested that there are both cyclical and structural factors causing the lack of investment in Europe. On one hand, both foreign and domestic demand play a role as cyclical factors, particularly during the pandemic, along with uncertainty. On the other hand, there are factors which are partly cyclical and partly structural, such as the financial conditions. There was a huge monetary expansion during both the Covid crisis and the Global Financial Crisis, but this has not created more productive investments. This is partly due to structural financial problems caused by cyclical factors in the structure of the banking system, such as the tightening of financial conditions in banks and the tightening of lending standards. Much of the monetary policy space has been used up; there is now a need to use a large amount of fiscal policy space without creating a substantial number of investments. The high levels of public and private debt make the usual macroeconomic management tools less effective at boosting investment.

3. Regulatory and tax barriers

It is unfortunately likely that the revision of Solvency II will further disincentivise insurers from making equity investments, because the set of capital charges will reduce the overall solvency ratios in the insurance sector. In any case, the accounting environment and the Basel framework also discourage financial players from financing long term investment.

3.1 Solvency II: a major impediment to equity investment for insurers

An industry representative described how the insurance sector is disincentivised from investing in equity. The risk free rate dropped by 50 basis points in both 2019 and 2020. Insurers normally invest in equity when fixed income is low, but the fact that the solvency ratio drops when the risk free rate drops means that there is no space for institutions to take risk. The French insurance sector has €2 trillion which cannot be invested in equities, because of this drop in the solvency ratio. Through the design of Solvency II's solvency ratio, the EU is actively preventing European insurance companies

from providing equity financing. An official agreed with this, noting that the IMF has highlighted this as a constraining factor on investment for some time.

3.2 On taxation, there has always been a preference for debt

An industry representative suggested that there has always been a preferential tax treatment for debt, which is based on the deductibility of loan interest. If there is no tax to pay on loan interest, it incentivises companies to take on debt. An IFI representative agreed that regulatory and taxation barriers hinder the equity market and disincentivise its development. With very low interest rates, debt financing is an easy option, especially for collateral rich companies. The problems with Solvency II and taxation, however, are not the sole reasons for comparably low equity financing in the EU.

3.3 Accounting standards also hinder investment

An industry representative outlined how accounting standards hinder investment. The use of fair value in IFRS 9 and IFRS 11 incentivises institutions not to invest in equity; rather, there is incentive to invest in debt. Second, there are issues with Solvency II and the Basel framework. The European prudential standards privilege debt versus equity. When there are difficulties in the market, debt might ensure an institution's survival, but equity will not.

4. The way forward: a recipe for relaunching productive investment across member states

Unfortunately, monetary policy cannot solve structural problems. Ensuring adequate remuneration for savings and risk is a prerequisite for relaunching productive investment. Increasing investment will also require structural reforms across member states, including improvements to the labour market, education and training, increasing the efficiency of public administration and judicial systems, and a reduction of excessive expenditure to the benefit of public investment. It is also critical to create the right regulatory incentives. Long term investment should not be discouraged, particularly by the review of Solvency II. The Next Generation EU (NGEU) package could be a game changer for resolving these investment challenges, provided that the funding is spent wisely and that credible structural reforms are implemented effectively.

4.1 Normalizing monetary policy

4.1.1 Monetary policy can help but cannot solve structural issues

A Central Bank official stated that monetary policy has 'brought the horse to water but cannot make it drink', describing how monetary policy has provided ample support for investments. There are many new instruments to support lending and investment, but the weak investment in Europe is fundamentally a structural problem. The low and negative rates are the consequence of the double dip recession 10 years ago and insufficient fiscal and structural policy responses. This has led to a situation where monetary policy has been given too much to do. Ultimately, the debate around investment is about structural issues. For example, R star has been sliding down over the last 20 or 25 years from 2% to 0%; some estimates show that it is now negative. This slide must be arrested. Rates will not be at such low levels forever. The change will be cautious rather than abrupt, but countries cannot rely to an excessive degree on monetary policy. It is time to address the structural issues in a much more resolute way than in the past. Fiscal policy and monetary policy are complementary and should function together. An official (Mahmood Pradhan) agreed with these remarks, stressing that this perspective aligns with the IMF's view that monetary policy is not a problem here.

4.1.2 Escaping the monetary deadlock: the need for adequate remuneration for savings and risks

An expert emphasised how interesting it is to hear the panellists' explanations for the insufficiency of investment in Europe. The debate has focused on three key areas which could be used to draw comparisons between Europe and the US. First, in Europe there is more debt; in the United States there is more equity. Second, in Europe banks are responsible for the financing of the economy; in the United States, it is the financial markets. Third, Europe has many structural problems; the United States is a very flexible economy.

An expert considered that there will be no investment if savings are not sufficiently remunerated. Negative interest rates in Europe are one explanation of the poor investment behaviour; thus, if the remuneration on complex productive projects is zero or negative, economic agents have a natural propensity to move towards more liquid ways of holding their money, which is a behaviour that was well described by Keynes. This is one explanation of the very fast increase in the share of household savings in the most liquid forms, i.e. banknotes and bank accounts. The expert suggested that there is a very simple way to view this. If monetary policy means that the cost of capital is zero or negative – i.e. it carries a tax – there will be no long term investment. People will wait for better days and put their money in highly liquid forms, which is what is happening currently.

The expert described how there has never been a period in history with healthy investment accompanied by zero or negative rates; it has simply never existed. If economic agents want to invest in a long term project that carries risk, it is normal for them to expect positive remuneration. It is very unusual for monetary policy to be depressing interest rates in the way it has. The natural interest rate in Europe is low, given the demography and the importance of savings, but it is further reduced by monetary policy, which is reducing interest rates to zero or less than zero. This is a mistake because it means there will never be any investment. It is absolutely clear that people are motivated by remuneration. When people believe that interest rates will remain at zero or negative for the next 10 years, what Keynes called the 'animal spirits' of investors will be depressed. Discouraged by the prospects for growth, entrepreneurs move towards share buybacks and speculative opportunities. This is the main negative effect of the non remuneration of capital. It is somewhat tautological, but 'anyone in the street' would agree with it.

The expert stated that what is needed is a change of gears and to abandon the sacrosanct idea that zero interest rates will foster investment. This sentence

makes grammatical sense, but it does not make sense, because people expect remuneration. In the United States, the situation is much better. When bonds are not renumerated, as is the case in the US, there is a shift of savings towards equity and stocks. Europe lacks this fungibility of savings. People hold bonds without remuneration. They do not shift towards equity naturally, because they are risk averse. This must be factored in with changes to monetary policy. Ultimately, it is monetary policy that depresses the ‘animal spirits’ of Europe to a degree that is incomparable with the United States.

Lastly the expert stressed that it is necessary to have a more realistic view on price developments. Indeed, having a positive cost performance index (CPI) that is slightly less than 2% is not a sign of instability. If yields move higher, central bankers should not entirely repress that tendency by providing member states with the unconditional “benefit” of a zero rate guarantee.

4.2 A larger common fiscal capacity would yield a more effective policy mix

A Central Bank official suggested that frontloaded investment geared fiscal support is needed not only at a national level but also at EU level, indicating that there is a need for a larger common fiscal capacity. It would also be more beneficial to have a more effective policy mix along with monetary policy, including structural reforms and bolder fiscal policy. Countries with excessive debts will need to reduce their debt levels; current expenditures should be substituted significantly by public investment. The lack of investment in Europe has structural causes. If these structural problems are fixed, it will be possible to move forward sustainably.

4.3 Implementing structural reforms in all parts of the EU

4.3.1 Improving the labour market, education and training and increasing the efficiency of public administration and judicial systems

An official highlighted the importance of structural reforms to the labour market and education and training. First, the high share of temporary workers in quite a number of countries discourages firms from investing in human capital. Second, in terms of education and training, a high proportion of the labour force in some countries in Europe is unskilled, which constrains dynamism and growth. In the public sector, the key priorities are the efficiency of public administration and the judicial system. It is encouraging that some countries’ efforts on digitalisation within the Recovery and Resilience facility (RRF) and the Next Generation EU (NGEU) package will focus on digitalising the public sector to make the delivery of public services and the administration of the public sector more efficient.

4.3.2 Supporting viable SMEs

An IFI representative outlined several positive trends, including the development of the venture capital market and state equity. The important question, however, concerns what action to take on SMEs. It is important to ensure that small businesses are not ignored in the recovery. It is crucial for SMEs to have access to equity capital markets through products like redeemable equity, convertible loans and alternative financing channels. The EBRD believes that measures such as the Baltic states’ commercial paper framework, for example, can enable the sustainable financing of European economies in the future. The idea of building back better and sustainable recovery is very important here.

4.3.3 The issue of urgent structural reforms: the example of Croatia

A Central Bank official explained the situation in Croatia, noting however that many of these structural issues also apply to other European countries. For years, the Croatian National Bank’s survey of businesses suggested that the main problems in Croatia were overregulation, ever changing regulation and slow administration. Before the pandemic, the lack of a qualified labour force became the number one issue. This problem is not seen as urgent during the pandemic, but when the pandemic is over the lack of a qualified labour force will again be a significant problem. Next Generation EU funding could speed up the work of administration through digitalisation and support education and training, which would help with the lack of a qualified labour force. The two public sector areas where structural reforms have been needed are the judiciary and healthcare. A faster and more predictable judiciary would reduce risk and make banks more willing to finance projects. The healthcare sector has a very inefficient structure. The world is experiencing a pandemic, but the sector has needed reform for many years.

4.4 Setting the right incentives for private investments

A reduction in capital requirements would allow European insurers to provide capital for the economy. However, it is likely that the revision of Solvency II will further disincentivise insurers from making equity investments. Remunerating savings is a prerequisite for escaping the monetary deadlock and encouraging entrepreneurs to relaunch productive investment.

4.4.1 Disregarding EIOPA’s advice regarding Solvency II

An industry representative stressed that the key priority would be for the European Commission to disregard EIOPA’s advice on Solvency II. EIOPA has advised that the interest rate shock in the formula should be increased because the risk free rate has dropped by 100 basis points, which would magnify the constraining effect on financial institutions. EIOPA wants insurers to hold even more capita given the interest rate risk, which means even less capital for equities. There is a belief in some governments that this can be compensated for by adjustments to the risk weight of equities, but this is not true. As the risk weight for government bonds is zero, which is impossible for equities to achieve, financial institutions will put their money into risky bonds. If the Commission and Parliament follow EIOPA’s advice, they could ‘kiss goodbye’ to the equity financing on insurers’ balance sheets.

4.4.2 Lengthening the duration of banks’ corporate loan portfolios

An industry representative explained that prudential regulations do not prevent banks from holding equity; banks are simply not a good place to house equity. Regulatory progress is being made on banks’ loan portfolios, however. The last revision of the Capital Requirements Regulation (CRR) increased the capital discount for SME financing and introduced a new

discount for infrastructure financing. This infrastructure supporting factor has been fast tracked in the Spring 2020 'Quick Fix'. In terms of priority areas for progress, there should be further effort to lengthen the duration of banks' corporate loan portfolios. This means there will be a need to improve the synthetic risk transfer from banks' portfolios, although this is more to do with the revamp of securitisation than the regulation of capital.

4.5 NGEU: an ambitious answer to EU investment needs

4.5.1 NGEU is a bold and unprecedented step for addressing investments and structural reform needs

A policy maker explained that the Commission is now in the closing stages of negotiations with member states on the designs of their recovery and resilience plans. In many, but not all, cases, the Commission hopes to be able to complete and approve these processes by the end of June. The funding will hopefully start flowing around then or shortly after the summer break. The funding will support demand and investments directly through spending. The grants part of the funding is deficit neutral and it will contribute to the productive capacity of European economies by ensuring that money is channelled to the right investments. The RRF is not only about investment, however; it is also about reforms. In terms of potential impact, the Commission's models suggest that every additional percentage point of GDP on public investment could translate into near term GDP growth of 0.7%. However, this impact could reach 1.5% GDP growth over the longer term. This is extremely significant for countries like Croatia, where the grant transfer is 10% or 11% of GDP, or Italy, where it is 4%. It is important to ensure that the investments are high quality and the reforms are ambitious. The regulation requires targeting spending on the digital (20%) and green (37%) transitions, but some member states have shown a slight tendency to favour older or more traditional types of investment. It is essential to ensure that this funding helps create transformational change in the public and private sectors.

The policy maker agreed with the remarks made by previous speakers on the areas for structural reform but stressed that it is also important to be realistic. RRF will not solve all of Europe's underlying structural problems, but it is an opportunity to make a decisive step forward. The Commission will focus on reforms that will create the essential framework conditions for investment and growth, which means focusing on the unnecessary impediments to doing business and investment and the modernisation of public administration and the judicial system. Digitalisation can catalyse this process. These reforms are extremely important. RRF is not merely about investing more money on digital projects. Unless those investments lead to interconnected systems across government, there is a risk that countries will spend large amounts of money but not realise the potential benefits. It is vital to find reforms which can support the sustainability of public finances. Pensions is also an important topic, but it is a very difficult issue.

The policy maker suggested that the critical issue for public investment will be the quick implementation and rollout of NGEU. This will ensure that public investment can be supported and even increase in the years to come, in sharp contrast to the curtailment of public investment after the global financial crisis caused by the need for fiscal consolidation. An official (Mahmood Pradhan) praised the fact that much of the RRP is deficit neutral, which is positive for the move towards public investment and increased growth prospects. For example, it is encouraging to see that Italy's National Recovery and Resilience Plan (NRRP) will enable Italy to reach an investment to GDP ratio of 3.5%, which is 1% higher than it has been for the last 10 or 20 years. An industry representative (Sylvain Broyer) considered that continued fiscal support, fiscal solidarity and financial integration are critical to foster investment in Europe. The EU economy is in dire need of Next Generation EU, capital markets union and the banking union.

4.5.2 Public finance is part of the solution

An industry representative described how not all businesses suffered from the crisis in the same way. Some businesses have experienced a 'double blade' effect, in which they experienced the Covid crisis and then a second structural crisis. This demonstrates the double need here: there is a need to overcome the current crisis and a second need to adapt to the new world. For many years, it was considered that public financing is less efficient than the private sector, but these times are over. During the crisis, market participants in every country came to the public finances and said, 'We need you'. Public finance creates positive externalities by attracting and spending money on social infrastructure and public infrastructure. Second, the leverage effect of public finance is much more important than for other types of investment. In order to redevelop public investment, there should be tailor made prudential rules for public finance. There must be a clear definition of the assets that should have a specific accounting treatment. This is where national banks and financial institutions can play a dedicated role. This has been seen during the crisis of last 18 months, in the Juncker plan in the past and in InvestEU in the future.