RELAUNCHING PRODUCTIVE INVESTMENT IN THE EU

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Supporting the economic recovery in the light of high uncertainty

Less than two years after the pandemic hit Europe, EU real GDP is back to pre-crisis levels. The immediate rebound in investment has also been encouraging. Real investment got back to its pre-pandemic level in less than two years. To put that into perspective, it took more than a decade for investment in the EU to reach its pre-crisis level after the 2008 financial crisis.

This crisis has been tough, but the economic policy response has been quite remarkable. Working together, the EU and its Member States have achieved a rapid emergency policy response, which has been well-coordinated, targeted and commensurate to the enormous task of preventing the initial shock from multiplying into a full-blown systemic crisis.

According to the EIB Investment Survey, an annual survey among 12,000 firms in the EU, more than half of firms in Europe benefited from some kind of policy support since 2020. Most companies confirm that this support was crucial to weather the shock and adapt to a new reality.

I am convinced that it is, in no small part, due to these bold efforts that Europe is in such a strong position today.

However, we have to remain cautious in our outlook. The Bank's annual Investment Report highlights a series of fault lines to pay attention to as we start the new year. One such fault-line is the pandemic itself, which is still not over. About 4 in 5 firms say that they are holding back on investment activities due to 'high uncertainty'.

High energy prices - and how policy makers will respond to them - constitute a second fault line. A major risk in this regard is that some will be tempted to blame the climate transition for the high energy prices, but this would be a terrible mistake! The green transition should be seen as part of the solution to the problem of high energy prices.

Of course, we need to pay close attention to the burden on vulnerable consumers, but we must avoid interventions that reduce incentives for green investment including by increasing uncertainty about climate policy going forward!

The risks of an asymmetric recovery is a third fault line that we need to be aware of as we start to scale down our crisis support measures. We still do not know what economic scars this pandemic will have left behind once it is over and how resilient will firms be once the exceptional policy support measures are fully removed.

What we can say is that severe impacts on firm revenue have been quite concentrated in terms of sectors, and uneven in terms of geography, but there still is significant uncertainty as to how much asymmetries will emerge once the economy recovers, and whether this may pose systemic risks in some locations.

Public investment has played an important stabilising role over the past two years. It also plays an irreducible role in creating the enabling conditions to catalyse action by the private sector. Our research shows, for example, that where digital infrastructure was better, firms have been more likely to digitalise as a response to the pandemic.

Going forward, it is, therefore, important that we keep the positive momentum going. The Recovery and Resilience Facility promises to be essential in that regard. The initial, impressive commitment, however, now needs to be followed up by effective implementation. Building up a pipeline of high-quality projects, as well as European coordination, will be key for this.

At the EIB, we stand ready to support Member States in this endeavour.

But no matter how impressive public investment is in the EU, we will not be able to close the enormous investment gaps, if we do not manage to bring private sector on board. Think about the green transition: the Bank's engineers estimate that about 50% of the emission reductions needed by 2050 depend on technologies that are at the prototype or demonstration stage, i.e., not yet available in the market.

It is critical that - irrespective of whatever need for transition solutions - we keep on pushing more high-impact, private sector investment in this area. This is not just a matter of good climate policy, but also key for our strive towards more energy independence, as well as for the EU's competitiveness more generally.

A similar argument can be made for the digital transition, which depends squarely on strong firm-level investment in innovation, technology adoption and workforce skills.

The crisis has shown us an effective way of mobilising more private sector investment: the same risk sharing instruments that have been used to safeguard investment under extreme uncertainty at the outset of the crisis, can be used to unlock risky investment activities also in areas of strategic importance such as innovation, new climate technologies as well as their large scale deployment. And they can do so at very low fiscal costs.

Europe has weathered the crisis well. It is now time to make it ready for the future. To do this, accelerating public and private investment in the light of high uncertainty will be key.

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NextGenerationEU has an ideal partner in the EBRD

The future must be green and it will be digital. As economies recover from the Covid crisis, the NextGenerationEU Programme can seize the historic opportunity we now have to promote sustainable growth and prosperity in the EU. The challenge is to move from planning to implementation. For that, the EU needs high quality projects that deliver impact, as well as reliable partners.

In Central and Eastern Europe (CEE), the EBRD – with its strategic focus on the green and digital transitions and promoting equality of opportunities – is an ideal partner. The RRF green target in particular aligns perfectly with the EBRD's own objective of ensuring that, by 2025, over half its annual investment is in climate and environmental finance, a goal already achieved in 2021.

NextGenerationEU is a unique investment and reform programme, one which not only heals the scars of the current crisis but also encourages continuing economic transition and convergence. The programme will leverage much needed private sector financing and funding to achieve lasting sustainable impact beyond the temporary response to the pandemic's economic impact. Overall, early signs are promising, with 22 EU-approved national recovery plans, triggering over €52 billion of pre-financing disbursed by the EU to 17 member states.

The EBRD is very active in the EU member states in the CEE region and especially in those countries where productivity is lowest and which are among the largest recipients of EU recovery funds as a percentage of their Gross national income (GNI), notably Greece, Croatia, Bulgaria and Romania. Last year the Bank invested € 2.9 billion in its 12 countries of operations in the EU, almost 100% of it in the private sector.

Nevertheless, the implementation challenges NextGenerationEU faces remain huge, particularly in CEE.

First, the region's capital markets, anticipated to play a major mobilisation role under the programme, are still fragmented and illiquid. They need further streamlining to channel the additional private sector funding required to finance necessary infrastructure projects. A robust green recovery and improved access to finance for underserved sectors will be less effective without better technical and digital solutions and further significant capital market reform.

The RRF green target in particular aligns perfectly with the EBRD's own objective.

Given its experience, the EBRD is well placed to support capital market development and efficiency. For example, the Bank is assisting countries in CEE in strengthening capital markets infrastructure, diversifying the local investor base, crowding in private sector investors, and promoting the expanded issuance of securities in domestic markets and in local currency.

In the Baltic countries, the EBRD supported the consolidation of the local stock exchanges and the creation of a Pan Baltic Capital market. In Poland, the EBRD supported the design of a Capital Market Strategy and worked with the Warsaw Stock Exchange to develop new ESG Guidelines for companies that want to list on it.

The second main challenge NextGenerationEU faces is the reality that the transition to low-carbon economies will be particularly acutely felt by CEE countries which are highly reliant on coal and fossil fuels. Energy intensity in the CEE region is almost twice as high as the EU average. The main priority and challenge for these countries - as well as for the EBRD - will be supporting a transition that is not only ambitious but also Just. Policy as well as financing will be critical to achieve this. For example, in CEE – where close to 80% of EBRD's investments support the green transition - the Bank supports the shift of one of Poland's largest energy firms from coal to renewable energy sources, thereby helping transform a coal-reliant region and providing new employment opportunities.

The third challenge is the lack of suitable candidate projects. To be successful, NextGenerationEU must also be an opportunity to tackle key priorities such as institution building to develop project preparation, absorption capacity of the public administration and the need to adapt regulatory ecosystems to create an enabling business environment. It is equally important that EU resources are channelled towards the most innovative and riskier technologies that require concessional funding and avoid distorting markets.

The EBRD is well equipped to support this effort thanks to the scaling up of its digitalisation work and the leveraging of the digital transition as an enabler of economic transformation. This includes: building the foundations for digital transformation through investment in infrastructure and developing the right legal, regulatory and institutional frameworks; adapting enterprises and governments to the demands of the digital era; and fostering innovation.

NextGenerationEU represents a once in a lifetime chance to deliver a Europe transformed, one ready to address the challenges of the future. In the EBRD, the EU has an ideal partner to look to for support and expertise in doing just that.

HARALD WAIGLEIN

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NGEU and private investment: how to ensure crowding in

Total investment in advanced economies is typically around 20% of GDP. Public investment accounts for a relatively small share (between 2% and 4% of GDP), while the bulk of capital is formed by the private sector. In a crisis, an increase in public investment can (partially) compensate private demand shortfalls and generate income and employment. This can prevent the emergence of hysteresis, i.e. persistent demand weaknesses that undermine the productive capacity of an economy.

Against the background of an unprecedented recession, the investment needs related to the EU's Green Deal agenda, and over-indebtedness of a number of EU Member States, EU leaders agreed on an 800bn Recovery Instrument. NGEU was the response to a symmetric shock with heterogeneous impacts on Member States, new political priorities and unresolved legacies from the past crisis. The Recovery and Resilience Facility (RRF), which is at the heart of NGEU, is rooted in cohesion policy and defines as its primary objectives to avoid an increase in divergences following the COVID-19 crisis and to stimulate the green and digital transition.

Spending money is a relatively sure path of fuelling short-term growth. According to Commission estimates, EU GDP in 2026 will be some 1.2% and employment 1% higher than without NGEU. Yet a temporary increase in public investment does not automatically cure structurally low private investment, nor does it generate the long-term growth needed to repay the debt incurred. The permanent impact on potential output depends on the type of spending and accompanying structural measures.

Reforms targeted at the frictions that hold back investment are key. According to the EIB 2022 investment survey, the most important long-term barrier is the availability of skilled staff. This is followed by uncertainty, business and labour regulation and energy costs. By contrast, the availability of finance, access to digital infrastructure and adequate transport infrastructure are major obstacles for less than 20% of firms. With regard to green investment, firms require first of all clarity on the decarbonisation path at the national and EU level.

The effectiveness of NGEU is a function of the quality of reforms.

What does this mean for the NGEU impact on investment? Beyond the short-term impact, the potentially largest effect may come from investment in education and training. In addition, the reform angle of Member States' Recovery and Resilience Plans is promising: reducing obstacles to doing business and reforms of labour markets and social protection systems. NGEU should also help reduce energy price volatility (via investments in renewables), but not necessarily the cost of energy (as this would conflict with the green objectives).

About 60% of the RRF funds are directed towards green and digital investment, consistent with the main aims of the Facility. Investments in renewable energy, energy efficiency, electric charging stations or high-speed internet to remote areas will stimulate GDP via their impact on demand, but the medium- to long-term effects remain to be seen. The results from the EIB investment survey suggest that expectations towards the more permanent growth impact from the green and digital transition may be too optimistic. Moreover, the fact that only very few Member States committed to structurally change incentives for the green transition, e.g. via the introduction of CO_2 taxation, suggests that there remains room to attract private investors into green activities.

Beyond an ambitious implementation of Member States' Plans, additional steps may be needed to crowd in private investment, notably with a view to addressing skills gaps and inefficiencies in labour and product markets and the public sector. Mobilising private capital through further developing equity and venture capital markets and increasing the efficiency of insolvency systems is also important. And finally, clarity on the path towards CO_2 reduction and appropriate tax incentives are key to capitalise on the stimulus from NGEU.

To conclude, the 800bn envelope from NGEU will not automatically relaunch productive investment in durable manner. NGEU can only be a game changer if it changes the conditions for private investment. Thus, the effectiveness of NGEU is a function of the quality of reforms. Catalysing private investment with a view to raising GDP permanently is a joint duty of all EU Member States. It is a key determinant of the EU's repayment capacity in the next decades, and as such, it should be prioritised over the speed of pay-outs from the Facility.

PHILIPPE HEIM

Chairman of the Executive Board - La Banque Postale

Banks play a key role in achieving the green transition

As climate change is a tangible reality, organising the transition is an economic and social priority for all of us. As the stakes are high, financing needs have to be up to this unprecedented challenge.

The EU Commission estimates financing requirements for green and digital transitions at €650 Bn per year until 2030, the former requiring €520 Bn alone. The Commission's Recovery and Resilience Facility, the largest component of Next Generation EU (NGEU), is intended to be supported by private sector investment by an appropriate mix of market and bank financing.

Indeed, certain large or mid-sized companies will find resources on the market (green bonds and private placements in particular), and the Capital Market Union's completion will be instrumental to shift the trillions to this end.

The finalisation of the taxonomy, the upcoming EU Green Bond Standard, the building of a "European EDGAR" – a centralized access point to financial and non-financial information – as well as a possible alleviation of listing rules will undeniably enhance the shift towards green projects.

However, the main bulk of financing, that of SMEs and households, will come from banks. Their ability to provide funding will depend on the available liquidity, the profitability of green investments and their capital treatment, as well as on a globally conducive regulatory environment for such investments.

As illustrated by the latest ECB stress tests, European banks have robust balance sheets and have accumulated savings. Combined, these two elements should ensure credit supply. There are also significant income opportunities in green investments: according to a report by Oliver Wyman (2021), the financing of the energy transition could provide up to 25 or even €50 Bn revenues to banks over the next 5 years. As regards the opportunity of a "green" incentive or a "brown" penalising factor, the forthcoming assessment to be performed by the EBA will be a decisive milestone. This work will also be contingent on the standardisation and reliability of non-financial data, which will allow exposures to be differentiate. Part of the solution lies in the future reporting rules for corporates (the so-called CSRD) that will hopefully soon be adopted.

At la Banque Postale, the energy transition is at the heart of our strategic plan.

On the demand side, companies have been asked to better formalise their long-term transition strategy to convert macroeconomic estimates into precise financing needs. It might be useful to focus, at European level, on the interactions between the EU taxonomy framework and sectoral transition plans for activities that are not considered as "green". To support this effort, in October 2021, La Banque Postale committed to an ambitious decarbonation trajectory, which was validated by the Science Based Target Initiative (SBTI).

In many Member States, ecological and digital transitions are also addressed through specific policies and resources. The French recovery plan provides a substantial amount for ecological transition (30%). Its first assessment report illustrates that households' incentives have reached their targets in transportation and dwelling improvement. However, due to more demanding long-term investment cycles, some industrial companies find it difficult to give priority to environmental projects. This is precisely where banks have a paramount role to play.

At la Banque Postale, supporting the energy transition is at the heart of our strategic plan, an objective that we also incorporated directly into our articles of incorporation. We aim to transform our banking model into an impact-driven one, notably by developing the necessary tools (such as an Impact Weighting Factor) to ensure that each of our financial and investments decisions meet environmental, social and territorial criteria. We provide all our clients with a diversified range of products and offers, for enhancing home's energy efficiency, the purchase of a greener vehicle or to provide our local and corporate clients with respectively green loans and green bonds.

Moreover, financing is not the only driver of business transformation. A study carried out by BPI France in 2021 identifies four drivers to help SMEs manage their own transition: developing a strategic vision, leveraging innovation and R&D to improve competitiveness, mobilising employees' skills and commitment for achieving change, and using the corresponding financing resources.

All in all, there is clear need to help corporates realising their transition projects. But such transformation should also be viewed from a holistic standpoint, incorporating the social impact of what should be a "just" transition. A globally more conducive and supportive ecosystem for economic players is therefore needed, and banks are instrumental to this end, not only through their funding role.

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A decisive European policy response to the crisis: investing for the future

The decisive European policy response to the COVID-19 pandemic has led to a strong rebound in growth, an unusually fast labor market recovery and a sharp uptick in investment. A key pillar of the policy response, and an important demonstration of European solidarity, has been the 750 billion Euro Next Generation EU (NGEU) package. The NGEU offers a unique opportunity to push ahead with structural reforms and fill investment gaps, especially those that will support the green and digital transitions. On average, countries are planning to devote nearly 40 percent of the spending in their Recovery and Resilience Plans (RRP)—the largest part of the NGEU package—to climate change-related investments. IMF staff estimates that, over the next decade, national RRPs are expected to expand EU's GDP by 1.4 percent and reduce greenhouse gas emissions by 2.1 percent compared to 2019 levels.

As is common during recessions, investment fell during the initial phase of the pandemic, further reducing the investment rate in the euro area that had never fully recovered from the global financial crisis. In fact, net public investment was negative in several European countries, including Italy and Spain during 2013-17, which implies an erosion of the public capital stock. Deep cuts to public investment tend to deprive the private sector of much-needed common infrastructure and adversely affect growth. The NGEU boost to investment thus comes at a crucial moment.

But more is needed to meet the huge investment needs, especially those related to the green and digital transitions. Estimates point to public investment needs for the climate transition of 0.5-1 percent of EU GDP per year until 2030, of which national RRPs cover about 0.2 percent of GDP annually for 2021-26.

Public policy is key to boost public investment and set the right incentives for private investment —through policies and regulations. Given the magnitude of the investment needs, it is clear that private sector investment will need to be significant. Public investment should focus on projects with high social returns and that provide key infrastructure needed to increase private sector investment.

Public policy is key to boost public investment and set the right incentives for private investment.

Correctly pricing carbon is a necessary step to provide the private sector with the right incentives. As the IMF is arguing, carbon pricing provides across-the-board incentives to reduce energy use and shift to cleaner fuels, and it is an essential price signal for redirecting new investment to clean technologies. Guaranteeing that private investors have access to transparent and clearly defined information on the sustainability of different investment products, is also important to appropriately channel capital. In that context, improving and harmonizing climate-related disclosures and taxonomies would be a useful step. And given the importance of bank financing for the European economy, including climate within broader bank risk assessments—as is increasingly the case—is key. These are only a few concrete steps, and, clearly, a broad holistic approach is needed. Labor and product market policies which facilitate the transition of workers and capital to a new climate-friendly and more digitalized economy, including training to reskill and upskill workers, are just as important.

Coming back to the role of public investment, the creation of an EU Climate Investment Fund (CIF) could help countries meet their common climate goals. The EU CIF could help finance some of the additional spending needed as the benefits of reducing carbon emissions are felt across national borders. Such an EU fund should be well placed to identify and coordinate projects requiring cross-border investments to achieve the fastest carbon reduction at the lowest cost, while internalizing the effects of and interactions with other emissions reduction policy instruments, such as the emissions trading scheme. In addition, an EU CIF would eliminate the incentives to free ride on emissions reducing investments of other members. Given the need to frontload climate investments, the EU CIF could have a borrowing capacity. Borrowing would not be to provide for cross-country transfers, but based on the need to arrest the flow of greenhouse gas emissions into the atmosphere as quickly as possible.

The climate challenge we face is historic. There is little time, and the transition will impact all aspects of the economy. It will be essential to maintain a societal consensus as policies move ahead, including to provide the necessary support to impacted segments of society.

Climate change is a global challenge that will need global solutions. In this regard, the EU will have to continue playing a crucial leadership role.

This article has been co-written by Asghar Shahmoradi & Frederik Giancarlo Toscani, International Monetary Fund