An Investment Agenda for Europe

By Ferdinand Fichtner, Marcel Fratzscher and Martin Gornig

Only strong economic growth will help Europe emerge from its crisis. The reforms implemented to date at national and European level have failed to impact the economy positively; this is due to excessive national, corporate, and private debts, weakness of the banking system, the lack of structural reforms, an insufficient institutional framework at European level, as well as a persisting climate of distrust in the stability of economic development. The probability of economic stagnation, characterized by high unemployment, declining incomes, decelerating potential growth, and deflation, is high and has increased significantly. The risk of economic development in Europe following Japan's example of the 1990s is very real indeed.

This *Economic Bulletin* shows that one of Europe's biggest economic weaknesses is a lack of private investment and that a European investment agenda is vital in order to generate the impetus required to push the European economy towards a sustainable recovery. European economic policy should focus not on higher public spending, but on increasing private investment as well as creating markets that function properly.

In the euro area, the economic crisis is not over—or, more precisely, the four crises, since there are four mutually reinforcing crises. The *debt crisis* can be seen in the debts that many countries, businesses, and private households continue to hold, thus hampering demand. The *bank crisis* has not been resolved, either. Businesses and households in the crisis regions are having tremendous difficulty obtaining loans at acceptable conditions, since many banks are still having to reduce risks and build up equity capital. The *economic crisis* is still very much present. In many places, for example, unemployment is still very high and economic growth remains slow. Furthermore, some countries have not yet resolved their structural problems and have taken very few steps to shape their national economies so they are competitive at the international level. Finally, the *crisis of confidence* has not yet been tackled successfully. Many businesses and households are still very doubtful as to the efficiency and future of the European economy, as well as the prospects for European integration.

Consequently, in a global comparison, investment activity in Europe is also exceedingly weak. This applies to the European Union as a whole and to the euro area in particular. Even before the financial and economic crisis in 2008/2009, in some euro area countries, for instance, in Germany, investment was lower than a level which, taking into account the different factors influencing investment activity, would have been appropriate in an international comparison.[1] In other countries such as Spain or Portugal, in contrast, investment activity was very strong.[2] Uncertainty in the global capital markets instilled by the global financial crisis has caused international financial flows to slow down and investment

1 For a more detailed discussion of lack of investment in Germany, see also Bach et al. "More Growth through Higher Investment," *DIW Economic Bulletin*, no. 8 (2013).

2 See Baldi, Fichtner, Michelsen, Rieth (2014), Weak Investment Dampens Europe's Growth, in this issue of *Economic Bulletin*.

to collapse, even in southern European countries.[3] As a result, investment activity throughout the euro area has been sluggish since the crisis began. The following article in this issue of *Economic Bulletin* identifies gaps in investment for OECD countries, and shows how, in almost every country in the euro area, these gaps have grown immensely since 2008. Furthermore, direct investment within the euro area has also taken a clear tumble.

The calculations on investment intensity (the ratio of investment to capital stock) in the second article in this Economic Bulletin show that, as early as 1999–2007, the modernity and growth of capital stock in Europe were lagging far behind other OECD countries in virtually every sector.[4] This applies in particular to education and healthcare; however, the manufacturing industry, which should be instrumental in Europe's recovery,[5] was also affected by this lack of investment. The energy sector, where considerable investment is needed to help reduce carbon dioxide emissions and safeguard energy supply, also displays comparatively low investment intensity.

In recent years, key reforms of economic policy have been initiated at national and European level and, in some cases, have been implemented successfully.[6] The European Banking Union, which will include a common supervisory board for the 128 major banks and a resolution mechanism for failing financial institutions, is to be introduced by early 2015. With the help of various measures such as the Fiscal Compact[7] and the European Semester,[8] greater coordination in the areas of economic and, in particular, financial policy has been achieved in the euro area. Many national governments have begun implementing structural reforms to their labor markets, social systems, institutional frameworks, and financial systems.

These measures are not enough, however, to get the economies in Europe back on track for sustainable growth. In fact, structural reforms of this nature — as important as they are — are not much use if companies are unable to obtain the loans needed to make investments and create jobs. Despite the hugely expansionary monetary policy of the European Central Bank, banks will not issue enough new loans if the economic climate is weak and too many bad loans exist, if businesses do not have a sustainable business model, or if there is a lack of competition. And as long as debt levels continue to be high, tax revenue is low and crisis-related welfare spending remains high in what is a weak or dwindling economy, governments will be forced to further cut spending.

In a situation like this, there is insufficient economic momentum to push the euro area out of these four mutually reinforcing crises. What can now be done on the government front to generate impetus and get Europe back on track for sustainable economic growth?

The first option — one that is widely discussed — is to give *governments more political leeway* to enable them to use fiscal stimuli to get the economy going again. France and Italy's questioning of the deficit limit defined in the Stability and Growth Pact met with a particularly mixed response. Anti-cyclical fiscal policy is undoubtedly desirable, especially given the extent of the crisis still affecting many national economies.

However, three factors speak against an approach of this kind. First, public debt and current deficits are so high in many countries that sustainable growth cannot be guaranteed. In a situation such as this, the crisis might flare up again, resulting in new distortions on the financial markets.

Second, relaxing the budget rules in the Stability Pact would send out a fatal signal to companies and financial markets. New regulations and other important reforms will be very difficult to implement. The credibility of European regulations and institutions could suffer terribly if the criteria were to be relaxed.

A third critical aspect is that the proposal by France and Italy could easily turn out to be deceptive packaging: governments are unlikely to use any additional leeway granted to them solely for public investment, but rather for discretionary consumer spending. In other words, fiscal impetus in the area of public investment is desirable and useful, but a pledge such as this is difficult to monitor and many governments would use it for other purposes.

What is missing in European fiscal policy at present is binding obligations on the part of the member states, for example, as to how they plan to make their national finances sustainable in the medium and long term once again. One possible solution here would be a step-by-step approach that would give the affected countries the chance to defer fiscal consolidation commitments for two to three years, provided they

3 On this, see also Kolev and Atanas, "Factors influencing investment during the financial crisis and deep economic recession: the European experience since 2008," in *Investment and Investment Finance in Europe* (EIB: 2013).

4 See M. Gornig, A. Schiersch "Weak Investment in the EU: A Long-Term Cross-Sectoral Phenomenon" in this issue.

5 European Commission, IP 13/09/862.

6 On this, see Fichtner, Fratzscher, Podstawski, and Ulbricht, "Den Euroraum zukunftsfähig machen," Wochenbericht des DIW Berlin, no. 24 (2014).

7 The EU Fiscal Compact, agreed in December 2011, envisages automatic sanctions for any euro area member state violating the fiscal rules in the Maastricht Treaty.

8 The purpose of the European Semester, agreed in December 2011, is to review the fiscal and economic policy plans of the member states before they are adopted by the national governments.

pledge to introduce more resolute structural reforms in the short term and draw up a definite plan as to how debts are to be brought under the 60 percent mark in the long term.

A second, more important area of reform is the *European Banking System*. In the crisis countries, bank lending, particularly to small and medium-sized enterprises, is still experiencing setbacks. In such situations, structural reforms and fiscal measures are not enough. Monetary policy measures taken by the European Central Bank are not expected to have much effect, either because banks do not wish to or are unable to pass the loans on to the real economy.

Many banks in Europe continue to be in a process of deleveraging, thus reducing risks and increasing equity capital. Great hopes are being placed in the Asset Quality Review of European banks, the results of which will be published at the end of the year. The Asset Quality Review may be the last chance that Europe has of resolving its banking problem and avoiding finding itself in the same position as Japan, which has been suffering under its zombie banks for several years now. There are, however, considerable concerns about the impact of this third review, since it is perceived to be insufficient and lacking in credibility.

The central argument in this *DIW Economic Bulletin* is that the reforms of the banking system and fiscal policy will not suffice: *impetus from the private sector is needed* in order to push companies to invest again and create jobs.

Such impetus for private investment takes on a very important role. As a whole, the euro area now has annual net savings — as measured by the current account balance — of more than 250 billion euro or 2.5 percent relative to GDP. Private net savings of companies and households are even higher, since public debt is increasing. In addition, even in crisis countries, companies and households have managed to accumulate considerable assets over the past few years. The financial resources needed for a clear increase in private investment do exist; what matters is mobilizing them and getting them to companies that will utilize them productively.

What form might an investment agenda of this kind take? Our findings show that a strategy based on three components is needed and should focus on overcoming both structural and crisis-related causes for the lack of investment in Europe.

To create a better structural framework for investment in Europe, the first thing that counts is efficient competition policy which generates more investment and growth as a result of increased competition.[9] High levels of competition promote innovation as companies attempt to use new developments to relieve the pressure of competition or catch up with their competitors.[10] Accordingly, particularly significant investment gaps have been identified in highly regulated sectors such as education and healthcare, where the investment and growth potential of appropriate deregulation could and indeed ought to be capitalized on.[11]

Another step would be to consider a more investment-friendly tax policy which, for example, would allow for broad-based improvements in investment depreciation opportunities by increasing the assessment basis or declining depreciation rates. Currently, depreciation rates and methods are very heterogeneous across the EU. These differences could be used to identify investment-friendly depreciation methods and rates in the future.[12]

A third element in a European investment agenda could be to establish a new temporary EU investment fund. There already exist the European Investment Fund (EIF), which is the venture capital financing arm of the European Investment Bank (EIB) and invests primarily in funds and financial institutions focusing on small and medium-sized enterprises; to date, however, the financing volumes of the EIF have been moderate.

An EU investment fund could be similar in structure to the EIF, but the EU investment fund would be a more direct route to investment for SMEs. With the help of guarantees from the EU member states, the fund would be able to refinance itself and, accordingly, offer capital at relatively attractive conditions. Especially for SMEs in crisis countries, such guarantees would mean reduced loan interest rates. The result could be better loan offers as well as increased demand for loans.

The aim is not to use state control to give certain economic sectors in individual countries particularly favorable access to funding, thereby creating growth by means

9 OECD, *A Policy Framework for Investment: Competition Policy* (2005), http://www.oecd.org/daf/inv/investmentfordevelopment/35488898.pdf and P. Buccirossi, L. Ciari, T. Duso, G. Spagnolo, and C. Vitale, "Competition policy and productivity growth: An empirical assessment," *Review of Economics and Statistics* 95, no. 4 (2013): 1324–1336.

10 D. Acemoglu, P. Aghion, and F. Zilibotti, "Distance to frontier, selection, and economic growth," *Journal of the European Economic Association* 4, no. 1 (2006): 37–74.
P. Aghion, R. Blundell, R. Griffith, P. Howitt, and S. Prantl, The effects of entry on incumbent innovation and productivity," *The Review of Economics and Statistics* 91, no. 1 (2009): 20–32.

11 A. Alesina, S. Ardagna, G. Nicoletti, F. Schiantarelli, "Regulation and investment," *Journal of the European Economic Association* 3, no. 4 (2005): 791–825.

12 European Commission, *Assets and Tax Depreciation*, DG Tax and Customs Union, CCCTB/WP\004\doc\en (Brussels: 2004).

of a government intervention that would not have been generated by private investment activities. Instead, the objective here should be to provide state guarantees to counter uncertainties about the future of the economy and economic policy that is currently prevalent in parts of the euro area; similar to monetary policy on the financial markets, this essentially means temporarily alleviating microeconomic risks through government intervention.

For this reason, the fund must not be subject to regional or strict sectoral regulations. What matters is that private investment is pushed, regardless of the EU member state; this will be crucial for ensuring that private capital is shifted in the direction of economic sectors that create opportunities for sustainable growth in the European Union, and, more importantly, the euro area. As to the actual contents of private investment, certain limits and restrictions could be used, as has been seen to work with the European Regional Development Fund (ERDF), for instance.[13]

In addition, given EU objectives for industrialization levels as well as in relation to the modernization of energy supply, the fund could focus on investments in the energy sector and industry. A further important focal point might be backing for joint ventures, especially those between countries in the EU. This would increase capital flows between the countries in the euro area, countering the lack of foreign direct investment within the euro area identified in this issue of *Economic Bulletin*.

Similar to the new TLTRO program[14] of the European Central Bank, the aim should be for these loans to go to companies operating in non-financial sectors. One advantage of an EU investment fund of this kind — and an important difference to the European Central Bank's TLTRO loans—is that the TLTRO loans might mean more money for the banks, but they do not reduce their lending risks. By way of contrast, the guarantees given in an EU investment fund would lower these risks for financial institutions, thus improving lending and consequently investment activity.

The reforms being pushed in Europe at present focus on government actors. This approach fails to provide growth impetus in Europe. What is needed to tackle the crisis is more involvement by the private sector — including, and especially, outside the financial markets. A European investment agenda aimed at boosting private investment ought to be an essential strategic component of economic policy in order to help Europe emerge from the crisis and provide new impetus for sustainable economic growth in the future.

13 European Union (2013): Regulation on the European Regional Development Fund and on specific provisions concerning the Investment for growth and jobs goal. Official Journal of the EU, No 1301/2013.-

14 Through the "Targeted Longer-Term Refinancing Operations" (TLTRO), banks will be able to borrow up to 400 billion euro to refinance credits they currently lend to businesses and households. In contrast to previous LTROs, banks cannot refinance credits to governments.

Ferdinand Fichtner is Head of the Forecasting and Economic Policy Department of DIW Berlin | ffichtner@diw.de

Marcel Fratzscher is President of DIW Berlin (German Institute for Economic Research), Professor of Macroeconomics and Finance at Humboldt-University Berlin | president@diw.de

Martin Gornig is Deputy Head of the Department Firms and Markets of DIW Berlin | mgornig@diw.de

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DIW Berlin — Deutsches Institut
für Wirtschaftsforschung e. V.
Mohrenstraße 58, 10117 Berlin
T +49 30 897 89 –0
F +49 30 897 89 –200

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