



Europe's Quest for Growth

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Where the EU investment agenda comes from and how to boost it

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Introduction

Raising the banner of investment has been the most important development of 2014 for European policy. Clearly, Europe needs a better economic performance, and without more investment it will not come. Since, however, boosting investment through direct action is a new activity of the European Commission, there is no recipe for success. It is, however, important to see how this new approach developed, what are the conditions of its good functioning, and how it can contribute to stronger growth and job-creation – today and tomorrow.

Politics of investment policy

2014 was an election year in Europe, when the economy was seen as emerging from the long crisis. At the same time, the risk of deflation was constantly present (and largely underestimated) the EU economy remained dangerously imbalanced, and the general question was how to make the recovery sustainable and avoid a third Eurozone recession.

The political debate around the European Parliament elections became somewhat polarized. The centre-right insisted on sticking to the fiscal rules and subsidiarity, while the centre-left was looking for ways and means to more stimulus and job-creation. The push for an investment agenda was not without precursors. One year earlier the German trade unions were campaigning with the draft Marshall Plan, albeit without any immediate impact on either EU or German government policy.

While the EU countries (and also the euro area) have been emerging from a recession in this period, they were supposed to emerge without a specific and consistent EU recovery strategy. The European Union has had a framework for growth, but it has been a cocktail of three loosely connected plans, rather than one integrated program.

First, a long-term strategy for smart, sustainable and inclusive growth (Europe 2020) was adopted in 2010. An annual cycle of economic governance (European Semester) was built around Europe 2020, which also functioned as orientation for the budget negotiations. The latter, unfortunately, ended with cutting, instead of increasing the EU budget for investment (thanks to the intransigence of four net contributing countries).

Since 2012, the EU also had a long-term vision for the reconstruction of the monetary union (the 4 Presidents' report and Commission Blueprint), which, together with ECB interventions, contributed to short-term market confidence, but in terms of EMU reconstruction only resulted in the creation of a modest version of the Banking Union. Also in 2012, shortly after the French presidential elections, the EU adopted a Growth

and Jobs pact, promoting capital increase for the EIB as well as innovative financial instruments like project bonds.

The assumption of this policy framework was that the rapid establishment of the Banking Union would make it possible to restore the flow of funds to the real economy, while the European Semester would help delivering crucial reforms for competitiveness. Thus, competitiveness would improve, enterprises would start investing again, and eventually growth and job-creation would return.

In 2014, it had to be recognized that while the Banking Union is a vital reform, it either does not happen with the necessary speed, or it does not lead to the right form of financing the economic recovery. There is a need to go beyond the minimalist Banking Union but, at least at this stage, there is no political momentum to put the Fiscal Union on the agenda. The investment plan is in between. It is an effort to overcome the depression through more intensive political coordination of investment activities, and a kind of credit rationing resources for this purpose, in the absence of a demand side stimulus.

In July 2014, investment was declared a priority by newly elected Commission President Jean-Claude Juncker. He identified one of the Vice-Presidents as the investment chief of the EU, and presented his investment plan to the European Parliament as early as November 2014.

According to the Juncker Plan, the EU provides €16 billion from its own budget, supplemented by an additional €5 billion from the European Investment Bank (EIB). With this seed capital, the European Fund for Strategic Investment (EFSI) hopes to attract almost €300 billion in private sector investment. Member States are also encouraged to contribute, and indeed in early 2015 there are initial signs that this will happen. Potential upgrading of the program has been often mentioned, depending on future developments and needs.

Causes of low investment

János Kornai once diagnosed the socialist economy with “investment hunger”. Adopting the metaphor, we can characterize the recent years of the European economy with “investment anorexia”. Why exactly this symptom has developed cannot be fully explored here. Most certainly, ill-designed fiscal consolidation programs have aggravated rather than cured this problem.

Neoliberal policies often endeavour to eliminate the (alleged) “crowding out” effect of public spending. However, a pro-cyclical fiscal strategy rather prohibits states from functioning in a “crowding-in” role. Secondly, the internal devaluation strategies at the time of the Eurozone crisis compounded the problem of falling external demand

with shrinking internal demand, which altogether discouraged, rather than encouraged investment.

Savings are supposed to be channelled and transformed into investment. In the EU, however, the Banking Union came too late and remained too weak to revive this capacity, especially as concerns cross-border flows. And the newly created excessive imbalances procedure turned out to be too timid to push surplus countries, and especially Germany, towards necessary and adequate levels of investment activity at home.

When speaking about the need for investment, most examples point towards infrastructure, while in most countries this is not exactly the missing link. Daniel Gros rightly points out, that the excessive focus on infrastructure investment can often be well intentioned, but misguided. In his view, Europe should look at consumption, rather than investment, except for infrastructure investment in surplus countries, where the needs are undeniable.

But investment in deficit countries is also lacking, and a remedy should be found. However, the remedy has to be identified in the right form and dose. A key question in stagnating deficit countries is that small and medium sized companies find it hard to borrow, develop their business and markets.

The lack of access to finance remains the greatest impediment to growth and job creation in Southern Europe especially. Big multinational companies are less affected by unavailability of funding, since they can typically raise capital through the stock exchange or issue their own bonds. However, SMEs face much larger difficulties and constraints.

Although SMEs are keen to invest, capital markets remain reluctant to invest in more equity. This situation is to a certain extent mitigated by the availability of venture capital for start-ups. However, venture capital does not provide for the needs of existing medium-sized enterprises willing and able to expand (the so-called mid-caps). Many of these mid-caps lack access to equity investment that does not imply takeover of the company. In other words, there is a lack of investors interested in taking minority stake in medium-sized companies. Limited equity capital consequently limits the ability of these companies to borrow and grow.

The above examples show that separating cyclical from structural causes of low investment is not entirely obvious, though this question is relevant if we want to find the right policy answers. The answer would influence the role of the institutions in either addressing the causes of low investment, or filling the investment gap through direct intervention. With the Juncker Plan, the EU opened the door to the second direction, and potentially with longer-term institutional consequences.

Towards an Investment Union?

Shifting the focus of European economic policy to investment became necessary for both cyclical and structural reasons. First, EMU reform has not been deep or fast enough, which means that the resources and confidence are still insufficient for a more dynamic recovery and hiring in the private sector. The EMU's weakness to deal with cyclical and asymmetry has not been addressed.

Secondly, not enough happened to revamp Europe's broken business model. Financial sector regulation has made good progress in the last five years, but the Banking Union still has to be completed, and more could be done in the area of industrial policy, especially by connecting it with territorial cohesion and investment in human capital.

However, discussions about the Juncker Plan have pointed to a variety of further options and opportunities, as well as issues that would need to be tackled in the context of the same effort. In principle, combining new elements with the existing plan could be developed under the umbrella of an "Investment Union".

In their report to the German and French ministers of economy, Jean-Pisani Ferry and Henrik Enderlein offered a broader concept of investment coordination, in a way which is more tailored to country specific situations and policy agendas. They call for a clearer regulatory environment, and also highlight the need for more public investment, notably in Germany.

Constraints for some Member States are more objective and for others more subjective. The EU therefore would need an agreed methodology to channel investment to countries that have performed below potential. The EU also should insist that new Member States, which used cohesion policy instruments predominantly for infrastructure development in the first decade of their membership, allocate more to human capital investment from their Structural and Investment Funds in the second decade.

It is indeed crucial to specify what forms of investment are needed in which parts of the EU, which is far from being a uniform economic space. The Eurozone imbalances also need to be taken into account. In the 'North' and in particular in countries with current account surpluses, there is need and space for massive infrastructure investment. On the other hand, in the 'South', or in countries experiencing stagnation and fiscal challenges at the same time, the key question is how to boost investment in productive companies. The capacity of enterprises with a growth potential to access the equity market is a key question.

Similarly to Enderlein and Pisani-Ferry, it took very little time for the authors of the Independent Annual Growth Survey to critically evaluate the Juncker Plan and call for a more robust and comprehensive approach. The group of progressive economists

saw a chance to connect the investment agenda with an ambitious industrial policy, and in particular to contribute this way to the green transition.

A more advanced investment plan, or a concept of an Investment Union should highlight the importance of corporate governance for growth, and introduce suggestions for reform initiatives in this area. It also needs to have a meaningful social investment chapter. More space and support could be provided for the social economy, with the potential to activate actors of inclusive growth – e.g. social entrepreneurs and cooperatives (who by definition combine objectives of economic gain and social cohesion).

Looking at the social dimension of the investment agenda, the January 2015 ILO report estimated potentially 2.1 million jobs resulting from the Investment Plan. However, for the Plan to make a significant dent in unemployment, the design of the programme is crucial:

“Taking into account the magnitude and diversity of the labour market challenges, placing greater emphasis on complementary labour market policies and ensuring that small enterprises have access to credit will lead to better outcomes.”

In addition, the ILO raises the possibility of a medium-term employment strategy in connection with the Investment Plan, aiming at quality job creation and avoiding a “race to the bottom” in terms of wages and working conditions. Translated to EU language: the ILO recommends creating an explicit link between the Investment Plan and the “inclusive growth” pillar of the Europe 2020 strategy.

Concerns about the expected impact of the Juncker Plan on research budgets also point towards the same need, in this case towards a reconciliation of the investment campaign with “smart growth”. This would certainly help avoiding a perception that the investment agenda is about subsidising conventional EIB lending at the expense of agreed budget priorities and long-term EU policy goals.

Question of agency

The fact that the European Commission has been the centre of action at the genesis of the investment agenda is an advantage for moving towards such a more comprehensive approach. However, a shift towards a more comprehensive and longer-term agenda would also require a look at the institutional aspects. While it is easy to recognize that more investment is needed in Europe, it is not so easy to define who should do what and where exactly. The EU institutions in Brussels have limited experience or capacity to answer these questions and perform a management function in this area.

For an investment program to work, there is also a need for adequate agencies that implement it. Projects have to be developed by actual people in an organization, and a pipeline has to be managed, for which the Commission is not a natural actor, especially if we envisage a wider and longer-term mission.

In fact, some of these functions already exist in multilateral banks, like the EIB and the EBRD. These institutions have a capacity to contribute significantly to the success of the investment agenda (or become pillars of the Investment Union). Since the very start, the lead role of the EIB group has been highlighted, but wider opportunities should also be explored, especially if the Investment Plan would be deepened.

The crucial role of the EIB to promote investment and growth has long been recognized. The Barroso II Commission worked with the EIB on project bonds for infrastructure development, and proposed a capital increase as part of the 2012 Compact for Growth and Jobs.

If it can shift gear, the EIB group can be a pivotal agent of this strategy. However, there is a reason for caution as concerns expectations about the EIB potential. The leveraging capacity of the EIB has often been overestimated and this should be avoided to prevent further disappointment and to facilitate search for actual solutions. Secondly, just like for any other agency, it takes time for the organization of the EIB to absorb growth, especially when this is coupled with a change of organizational culture as well.

On the other hand, more should be expected from the actual investment arm of the EIB group, the European Investment Fund, which has the capacity to interact more directly with businesses. The mandate of the EIF would need to be broadened and its operational capacity significantly strengthened so that it could invest directly in companies, in case EIF is designated with the function of investing directly in SMEs.

Though the older EU member states are not among its countries of operation, the EBRD should also be considered as a potential agent for boosting and coordinating investment in Europe.

The business volume of EBRD has significantly increased during the crisis, despite earlier expectations of progressive graduation of countries of operation and phasing out the institution altogether. However, the potential of the EBRD should be recognized also from the point of view of the investment agenda, since the EBRD has been performing outside the EU what is now needed inside the EU, and especially on the Eurozone periphery.

Turkey and some other countries (in North Africa and Middle East) became countries of operation, and the bank activities also entered some of the 'old member states', earlier not considered in the context of a transition mandate. A major strategic

question for the EBRD is whether the expansion of operations can continue in older EU member states.

It also should be noted that sanctions against Russia made EBRD a victim of escalation. These developments can cause a long-term damage to EU-Russia economic relations and weaken the foundations on which a new, more cooperative relationship could be built. A smarter strategy is warranted in order to return to cooperation instead of conflict, even if the earlier business model cannot be fully restored either.

Institutional development accompanying the Juncker Plan can go even beyond the EIB and the EBRD. As Manfred Schepers argues, it is worth considering the establishment of a new vehicle (beyond or alongside EFSI), once the focus on equity support for enterprises is strengthened. If we want to assist the growth of enterprises, it is key to identify or create a public equity agency at the European level, which would take minority equity stakes in medium-sized enterprises. Such a public European investor could help attract other investors on the market and improve companies' access to both equity and debt.

Concluding remarks

Highlighting the need for investment at the EU level is a step in the right direction at the current phase, given the political and legal constraints of EU policy. However, making this a meaningful EU policy requires clarity in terms of the sectorial as well as geographical directions and agencies of investment. Consistency has to be ensured between the Investment Plan and other areas of economic governance (fiscal, monetary, industrial, employment, innovation, regional etc.).

A robust investment policy needs more detailed vision as well as greater confidence about the availability of resources it aims to mobilise. Its promoters also have to be aware that even if the EU level effort for coordinated investment is successful, it cannot be a substitute either for EMU reform, or for the Europe 2020 strategy. In reality, its connection with those two has to be better defined. These connections may also be crucial from the point of view of economic and political impact.

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