Background

WHY INVESTMENT IS NOT PICKING UP IN EUROPE?


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Crisis of confidence and risk aversion are deep in Europe and investment is hamstrung. Based on Confrontations Europe's work led by economists, banks and investors; Carole Ulmer and Jean-Robert Léonhard give us the diagnostic elements.

The European Commission's President has announced a €300 billion plan for investments to bolster economic growth and jobs in Europe. Investment needs for infrastructure networks of EU are estimated at €1 trillion for the period up to 2020 and *"significant long-term investment will be needed under the Europe 2020 strategy and the 2030 climate and energy package, in infrastructure, new technologies and innovation, R&D and human capital"*. Mario Draghi himself has called on the European institutions to implement an investment recovery plan *"crucial to reduce unemployment"*.
Those objectives require economic and institutional governance conditions to be met; are they? Europe faces enormous investment needs but investment remains hamstrung. Would the lack of financial resources be the explanation? No, they are abundant.
Today, banks and investors involved in Confrontations Europe's work argue that it's not the resources that are lacking, but the projects to finance.
The European society faces risk aversion and high uncertainty. Has it to do with the supply issue? In France, the industrial sector has lost 12% of its production capacity since 2002. Investments cost- expected by the companies is very poor, lower than interest rates, which are already at a low level. In some Eurozone countries (e.g. France and Italy), companies' margins keep going down. In France, the profit margin decreased to 28.5% while European rate sets to 39%. Is it a mutation of our production system due to a Schumpeterian innovation of "creative destruction" or an attrition of the production system? It's tough to say. A comprehensive assessment of both figures of business failures and start-ups creation should be made to provide a sensible answer. Do we speak of an exhaustion of technical progress or a proliferation of bullied innovations? Some people think that this lack of productivity gains could become perennial and therefore, we might risk to face a pernicious chain such as the following: while the productivity is deteriorating, investments that could improve it are not made, therefore the productivity is deteriorating again, bolstering more and more pessimist anticipations.

A risk of deflation

Far from the wished scenario of bridging the output gap, the GNP might be pulled down, toward the level of the current stagnant GNP. Inasmuch as the difficulty to design an innovative offer often goes with the impact of the deterioration of the demand.
Indeed, after decades of debt burden, economic stakeholders (households, non-financial companies, financial stakeholders, governments) are all urged to reduce their debts. But what happens when all indebted agents wish to pay down debt and save more at the same time? The latest report of the Bank for International Settlements (BIS) gives an answer: *"Give them an additional unit of income, as fiscal policy would do, and they will save it, not spend it. Encourage them to borrow more by reducing interest rates, as monetary policy would do, and they will refuse to oblige"*. Afterwards, balance sheet recessions tend to be deeper, give way to weaker recoveries, and result in permanent output losses. But balance sheet recessions are less responsive to traditional demand management measures.
Thus, we might observe some Eurozone countries facing a risk of deflation and a risk of "liquidity trap". It is somewhat illogical when central banks have deployed a number of non-standard tools and provided the banks with unprecedented funding.
Based upon the classical theory, it would result in a twofold increase in both the activity (due to the boost of consumption and investments) and in the prices. But nothing happens. Despite low interest rates, economic agents prefer hoarding to investing or consuming.
And when a possible price decrease is announced (deflation, effective in Southern Europe), the vicious circle starts: expectations accelerate economic slowdown which in turn justifies expectations...
It's worth saying that this situation is an environment conducive to speculative bubbles.

> *"Ressources are there... What is lacking is projects to finance"*

Why investment is not picking up in Europe?

Indeed, to put its money, it's tempting to buy debt (bond bubble) in order to get dividends (stock market bubble) and housing (real estate bubble).

Role of public investments

The report "public debts in the Eurozone" issued by the Institute CDR for Research provides us with a wide, geographical and historical analysis based on the French case since 1890 and recent Scandinavian and Japanese experiences. It states that during the thirty years of Post-war economic growth as well as during the 1990's Scandinavian renovation, *"public investments played a major role"*. Today, while public expanses are cut due to the explosion of public debt, it remains important to grant some resources for public investments in France as in Germany as well as at the European level.

From contradictions to paradoxes, the current situation is truly complex. This article didn't mean to solve the problem but to list some facts on the current situation. However, solutions do exist as you will see in the coming articles.

ZONE EURO: SPECIFIC FACTORS

While investment recovery is generally hampered, the Eurozone is facing its own challenges.

Financial fragmentation

The first factor is the fragmentation of the Eurozone. The crisis in the Eurozone triggered a fragmentation of European financial markets characterized by the dramatic rise of the interest rate spreads between member states bonds.

Despite recent improvements on reducing those spreads, financial fragmentation remains high in the EU. For instance, Germany stills benefits from better financing conditions than Italy does. Today in Europe, we do not have a genuine financial integration as defined by Benoit Coeuré: (i.e. *"a situation whereby there are no frictions that discriminate between economic agents in their access to and investment of capital"*)[1]. Those frictions are undeniable, both in terms of allocation and distribution. In the euro area today it is the location of borrowers, rather than their creditworthiness per se, that matters most for access to finance, in particular for SMEs (e.g. banks' credit assessments are influenced by the health of local sovereigns; most banks are not structurally set up to provide cross-border lending). The location of lenders can also affect allocation to the extent that non-economic factors influence banks' business decisions (e.g. the connection between local banks and local interests; "national champions"). Besides, *"financial markets in the euro area do not provide much cross-border insurance"*, which can be explained by two factors: European financial firms are interdependent and, prior to the crisis, there wasn't any private insurance against banking crisis. Accordingly, we can say, strictly speaking, that European banks do not finance the European economy. This underlines that reaping the allocative benefits of a single market in capital is linked not only to having a more integrated banking system, but also having more arms' length governance of it.

The lack of a sovereign – public body, the budget issue

The second factor specific to the Eurozone explaining to the lack of the investment recovery in Europe is due to the lack of resorts for European public investments and therefore a lack of private investments. As seen in the previous article, during the thirty years of Post-war economic growth as well as during the 1990's Scandinavian renovation, "public investments played a major role"[2]. Unfortunately, the EU budget which represents only 1% of the European GNP, does not provide enough funds for growth (i.e. 9% of the EU budget allocated). Despite the EU project bond initiative for innovative infrastructure financing, the resources remain very low and insufficient to cover all the European Union's infrastructure investment needs for growth recovery (e.g. infrastructure projects in the sectors of transport, energy and information and communication technology.)

In order to meet this objective, the Caisse des dépôts recommends to *"revamp the funding framework for investments for the Future beyond the framework of the financial system via a specific European funding mechanism based on leveraging between European budgetary resources and an European financial intermediation whereby public funding and public guarantees would encourage financial private agents*[3]. *Besides, as the EU's institutions do not to collect taxes, the budget is only made of member states' contributions"*.

The current debate is exploring two leads which are worth following up: Should the EU be provided with its own resources and should the EU issue Eurobonds?

EU: first answers

Regarding those frictions, the European Commission took the lead. On one hand, the Commission replaced the EU's existing supervisory architecture with a European system of financial supervisors consisting of three European Supervisory Authorities and a European Systemic Risk Board. On the other hand, financial regulation has been a key project of Michel Barnier's DG (e.g. stronger prudential requirements, single rule book, and bail-in principle). One of the major achievements of this financial regulation is the establishment of the banking union[4].

To face the Eurozone sovereign debt crisis, the European Union brought forward emergency measures to pave the way for direct bank recapitalizations via the European Financial Stability Facility (EFSF), shortly replaced by the newly created European Stability Mechanism (ESM).

The EU has also undertaken long-term measures to better control debts and public deficits such as: the strengthening of both the Stability and Growth Pact and the European Semester.; adoption of the intergovernmental treaty on stability, coordination and governance and adoption of new supervisory tools to identify and correct macroeconomic imbalances. Nonetheless, all those measures remain below the necessary mutualization needed to both solve the public debts issue and to boost investment. The following articles list some thoughts on the possible solutions.

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1) Speech of Benoît Cœuré, member of the ECB's board.
2) www.caissedesdepots.fr/fileadmin/PDF/Rapports_et_etudes/finance/rapport_final_dettes_publiques_2013_2014.pdf
3) *Ibid*
4) See article of Marie-France Baud on p. 14, n° 106 of *Confrontations Europe La Revue*.