Improving capital allocation across the EU

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Improving capital allocation and promoting investment across the EU

Long-term, flexible and efficient investment is essential for the economic growth of the EU, the well-being of its people and facilitating upward convergence. Lessons from the crisis have shown that not all investments (e.g non-tradable investment in peripheral Europe, excessive residential investment) lead to lasting growth. An appropriate allocation of capital is essential to ensure that investment support productivity and growth through attracting exports, FDI and technology for Europe's future.

An appropriate regional allocation helps to transform savings into investment and growth across the entire EU, avoiding financial fragmentation. Data on cross-border capital flows shows, however, that despite recent improvements, financial integration in the EU remains below pre-crisis levels. Retail credit markets are fragmented, cross-border private risk sharing is subdued and a persistent home bias remains in portfolio allocations. Instruments at the European level, such as the Macroeconomic Imbalances Procedure, help to identify emerging weaknesses in the economy which e.g widening current account deficits may suggest. However, without appropriate private risk sharing, country-specific shocks will continue to cause persistent dispersion in economic outcomes across countries of the EU. Accelerating the integration of European capital markets and the completion of banking union are important policy priorities in this respect.

> *"Transform savings into investment and growth across the entire EU."*
>
> \- BENJAMIN ANGEL

An appropriate sectoral allocation ensures that private sector funds are attracted to (also riskier) sectors which can deliver returns and that idle capital is unlocked. This entails removing obstacles to investments and venture capital. The Investment Plan for Europe focuses on identifying and removing obstacles to investment, providing visibility and technical assistance to investment projects, and making smarter use of financial resources, including through supporting the development of venture capital funds of an appropriate size. All this aims to allow follow-on investments, to

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>>> consolidate market practices, support pan European activities, develop regional markets and reduce administrative barriers. Deeper equity markets would bring economies closer to the technological frontier, supporting growth and encouraging 'greener' innovations.

Most capital is, and will continue to be, allocated through the private sector. But where the private sector is not willing or able to take partly or fully the risk of undertaking a specific category of investment, the public sector has a role to play, at both national and EU levels. For example, the new InvestEU Programme will allow implementing partners (including national promotional institutions) to finance projects that would not be financed without a budgetary guarantee, working in tandem with private sector financial intermediaries targeting specific EU policy priorities.

It's also important to keep the long-term perspective in mind. The next decade may well see a revolution in manufacturing service provision, through shared platforms built on control over data flows. Countries are increasingly engaging in active competition to secure leadership in many of these sectors. But none of the world's 15 largest digital firms are currently European. A strategic focus on growing future innovation leaders is important here, as is attracting and retaining skilled labour in Europe. A possible investment arm of a European industrial strategy should keep in mind the objective of developing innovation in key industries of the future, fixing financial market inefficiencies and fostering technological adoption and diffusion. It could, for example, focus on strategic long-term investments, tailor-made to support European champions of the future.

Roger Havenith

Deputy Chief Executive,
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Boosting European risk capital markets: an EIF perspective

The financing gaps in European risk capital markets are driving both early-stage and growth-stage companies to turn to non-European - for example US and Chinese - investors to meet their financing needs. Skype, Minecraft and Beddit are cases in point: all great ideas born in Europe, and all of them bought up by the likes of Apple and Microsoft when the time came to move to the next stage in their development.

These gaps in the financing market have three main causes. First, a lack of funding. Second, regulatory fragmentation across the EU, which hampers cross-border investments. Third, the risk-averse nature of the European investor. There is no quick-fix to improve innovation financing and give bright European minds the opportunities they deserve right here in Europe, but there is a lot that can be done and the public sector has a pivotal role to play.

Sustainably improving innovation financing across the EU comes down to strengthening the financial ecosystems that drive European economic growth. EU public sector support has proven key to fostering these ecosystems. In 2017, the average European fund size grew to a record EUR 98m, and in 2018, the number of 1350 ventures financed constitutes a new record high – both in part thanks to EU support. As we move into the new EU budgetary period, continuing to step up public support for innovative European ventures should remain at the heart of Europe's strategy to improve our competitiveness in the global arena. >>>

>>> In order to compete with large, uniform economies like the US (where average fund size is significantly larger, exceeding EUR 170m), or economies where the state plays a strong role, the EU must focus its efforts and boost its firepower. We need to design market-oriented financial instruments that target gaps in terms of sectors, geographies and SME segments that stand to benefit most, so that we can ensure long-run growth benefiting future generations. But we also need to offer continuity in our offer of support, throughout a company's lifetime, focussing as much on early-stage innovative ventures as on companies in the growth and expansion stages.

> *"We can no longer afford to be the incubator for other industrialised countries."*
>
> \- ROGER HAVENITH

We need to offer the kind of support that will allow the next global industrial champions to not only be born in Europe, but grow and flourish in Europe, without having to relocate to access the finance they need. Today, of the world's 15 largest digital firms, not one is European. We can no longer afford to be the incubator for other industrialised countries. We must support disruptive and critical technologies that are key in maintaining Europe's leading role in innovation and global competition.

At the EU-level, we have already been making considerable progress in this direction. The EIF alone has been committing around EUR 3.5bn annually to equity investments over the past few years, making financing available and building up know-how in the venture capital ecosystems. And we have diversified our offer of financing solutions to include securitisation, loan funds, social impact funds and business angels. But we need shift gears and significantly increase volumes. One way to do that is by facilitating the pooling of resources from European, national, regional, and private sources. Needless to say, simplifying the regulatory regime and reducing the administrative burden will help crowd-in more private capital. Ultimately, however, this will entail a political decision to channel more resources in this direction.

With some of the best universities and research institutions in the world, the potential to nurture the next great idea is there. But to turn that idea into a viable business proposition, Europe has to do more. The public sector, and in particular the EU, need to reinforce financial instruments so that they are able to offer effective, field-proven, market-based solutions that can attract private capital and boost the European innovation ecosystem. ●

Pervenche Berès

Former MEP

A challenge for the next Commission: implement a EU sustainable long-term investment strategy

Invest in the future for the EU economy means in priority, besides technology or innovation in digital, ecological transition, education and ageing.

The European innovation scoreboard 2019 is quite positive since it figures out that the EU's average innovation performance has increased by 8,8 % between 2011 and 2018, one point above the US. This might be true but what ever the level of comparison may be, the EU is facing a long-lasting structural issue regarding the level of incentive for public and private investment. This has already been acknowledged by the outgoing Commission when the Investment Plan, the so-called Junker plan, was launched followed by the capital market union. Nevertheless, the bottle is still to be filled in and all the lessons to draw from the recognition of a specific lack of investment in the EU have still not been draw.

In addition, the interest rate environment should stimulate the decision process at a time where the ECB has clearly made public it's intention; this >>>

>>> should not be a loose opportunity like the one we had with the "jackpot".

A debate among economist, led by Olivier Blanchard from the Peterson Institute, invites public authorities by take the lead. The Junker plan has renewed the role of the public sector as leverage for private investment in a depressed environment. The debate is obviously still up to date.

"The EU is facing a long-lasting structural issue regarding the level of incentive for public and private investment."

\- PERVENCHE BERÈS

Having all this in mind, the new Commission should implement a horizontal consistent strategy to favor investment with a comprehensive understanding of the future challenges:

- make full use of InvestEU, the follower of the Junker plan that allows to build bridges with the use of structural funds;
- insure a strong implementation of Horizon Europe for which the European Parliament has request from the next multi-annual financial framework a budget of 120 billions euros over the 2021/2027 period;
- review the Stability Pact to include a capacity to drive investment and define for the euro zone the proper aggregate fiscal stance. Euro area member states should much better use the privileged of stability given by common currency to support long-term investments;
- when re-launching the capital market union, draw all the lessons from the success of national promotional banks in insuring a certain threshold of investment and make sure not to build incentive for speculation but for long term investment towards ecological transition and education with a digital priority;
- have fresh look at the taxation biases favoring debts towards equity;
- rethink the competition policy and the way it should support an EU industrial policy. Up to now this policy was first targeted to oppose monopoly but in a more complex world trade environment the debate has finally emerge on how should the EU competition policy favor EU stakeholder vis-à-vis their global competitors. In this spirit, it will be very interesting to follow the next step after the adoption of the copy right directive with which the EU could be taking the lead to boost it's cultural and creative industry;
- make sure that this new strategy allows to correct existing imbalance inside the EU and especially within the euro area between the North and South;
- and finally, the question of a carbon tax is unavoidable if you want to have the right incentive for market investment. It requires that a courageous answer will be given to counter balance the unfair social impact of it. ●

Edite Ligere

Barrister, Advisor, Galileo Global Advisors

The future is promising, even if artificial

The European Union (EU) is in transition. Fragmentation instead of an ever closer union looms. Productivity is slowing, inequality rising and climate change continues to require urgent concerted effort. The race to avoid similarities with the extinction of the Venetian Republic described by William Wordsworth: "… And what if she had seen these glories fade; Those titles vanish, and that strength decay; Yet shall some tribute of regret be paid when her long life hath reached its final day; Men are we, and must grieve when even the shade of that which once was great, is passed away" is on.

"A clearer focus on responsible investment in AI and a sufficiently flexible regulatory framework are needed to improve sustainable capital allocation across the EU."

\- EDITE LIGERE

While there are many dimensions to capital flows in the EU, the development of machine learning and artificial intelligence (AI) are revolutionising many, if not all, sectors of the EU's and global economies. These developments have great potential to enhance productivity yet the economic impact remains hard to define. Greater clarity about the regulatory framework for AI within the EU is likely to contribute to attracting investment from outside the EU. The Recommendation on Principles for the Responsible Stewardship of Trustworthy AI published by the Council of the Organization for Economic Cooperation and Development which includes all EU Member States in May 2019 and adopted by the Group of Twenty in June 2019 is a convenient starting point for providing a degree of consensus which is likely to encourage investment in digitalisation from outside the EU.

Approximately one third of the EU's AI activities currently take place in London. In 2019, the United Kingdom's investment in AI start-ups was almost equal to that of the rest of the EU's Member States combined. While investment in AI involves several risks, including commercial and technological risks, strategic deployment of public and private investment in the context of skills training, infrastructure investment, research and development and digital eco-system innovation is needed to explore AI opportunities and encourage confidence in AI development in the EU.

At present, the EU is home to 7% of the world's leading technology >>>

>>> companies. In 2016, European private investments in AI amounted to approximately EUR 3.2 billion, compared to almost EUR 10 billion in Asia and EUR 18 billion in the US. In 2018, China attracted almost half of global investment in AI start-ups. There is considerable divergence of investment in AI across the EU with Northern European countries eclipsing Southern and Eastern European countries.

Attracting global investment in AI is fundamental to ensuring the EU's continued success, particularly in the context of the challenges and opportunities posed by Brexit. Doing so in a less fragmented way seems to be the only way forward. A clear focus on responsible investment in AI in the EU and a sufficiently flexible regulatory framework are needed to improve the mobility of capital within the euro area, attract investment from outside the EU, embrace the many opportunities presented by AI for economic growth and encourage sustainable capital allocation across the EU. ●

Hiroshi Nagamine

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Attracting investment into the EU through regulatory harmonisation

Japanese financial institutions have historically played an important role in providing liquidity to the EU economy. However, for a sustainable contribution, we should progress beyond conventional boundaries of solely providing financial services and provide complementary non-financial services to add value to our clients, compete effectively with nascent players in the market and attract non-EU investors. A core part of this strategy is digitalisation, which creates more choice, more competition, more transparency and ultimately more efficiency for clients. Building a market where non-EU financial institutions may seamlessly provide funds and services to non-EU investors willing to contribute to digitalisation initiatives in the EU is fundamental.

We welcome the EU's ambition to accomplish the Capital Markets Union and to unlock the full potential of the single market. The EU is effectively 28 markets with 500 million people, as opposed to the US: a single market with 320 million people. The EU market is fragmented for cultural, political, linguistic and, crucially, regulatory reasons. Therefore, it cannot be as agile and decisive as a single national government. The EU may benefit from breaking down these barriers in order to attract greater investment, including from third country investors, reducing regulatory fragmentation. The creation of a single EU securities exchange as part of the Capital Markets Union would also increase harmonisation and align with the US approach.

For global financial institutions to operate in the EU, they generally have two options: establishing a subsidiary or operating out of a third country branch. The former may allow the institution to operate in the EU on a passport whereas the latter requires compliance with the applicable national regulatory regimes. Regulatory fragmentation concerns relate not only to discrepancies between the laws of member states but also worldwide. Contrast, for example, Japan's precise implementation of the Basel reforms within the requisite timeframe with the approach of other jurisdictions. Although marginally differing regulatory regimes may be necessary to respect sovereignty, onerous requirements such as those relating to capital or liquidity may trigger third country banks to consider the extent of their presence and business model in Europe. The reduction of market fragmentation was highlighted as a key priority at the June G20 summit in Japan. We hope there will be a move towards greater globally harmonised financial regulation through increased home state recognition of regulatory and supervisory frameworks.

We conclude with the elephant in the room. The EU financial markets will inevitably be harmed by Brexit. The UK is a top performer and contributor to the European financial industry. We would welcome the EU maintaining close cooperation and dialogue with the UK post Brexit, to preserve, as far as possible, a consistent regulatory and supervisory framework so as to encourage investment into the region as a whole. ●

Jean-Jacques Bonnaud

EUROFI

Europe needs a strong industrial policy

The lagging situation of investments in Europe compared to the levels in other regions in the world is a major concern for the future of an economic independence of Europe, in as much as it concerns new and intensely technological activities that are keys to future competitiveness, and not only to the social equilibrium of the region.

It is true that in certain sectors such as defense, security, space and energy, some important and ancient common initiatives have been taken by the European institutions and countries to challenge the rising costs of research and industrialization. No country relies only on the pure virtue of the market to facilitate the transformation of startups into large and multinational firms. The American experience itself, alongside a wide financial market, dedicated funds and numerous individuals lightly taxed has largely taken the opportunities of spillovers from dual innovations generated by huge military financial programs under the leadership of public institutions like the >>>

>>> D.A.R.P.A. We should learn from this experience to wrap our initiatives and any new ones into a common strategic analysis of our future position in the world to come.

But an industrial policy is of course not only the matter of public interventions in costly strategic new sectors, as has just demonstrated the new European program on batteries for the motorcar industry and as expressed in the common German - French manifesto of February 2019 it should include two other components: The first would be of course the success of the Banking and Capital Markets market Unions; rapid outcomes in those fields are clearly necessary to overcome the existing fragmentation of the financial system, provoking a lack of trust among the European savers. The problem is not a question of volumes of savings but of channellisation. A second component would be to use common means to help promote where they do not exist sound and effective clusters, or ecosystems, which have proved their effectiveness in the emergence of startups in some European countries -UK, Netherlands, France Germany-as well as in US in California or other places. The trust lies not only in big policies but also in visible and local successes.

However the main political problem raised by the emergence of a more common industrial policy lies in the lack of trust of some parts of public opinion in the capacity of the union to reach sizable results, and the lack of belief and conscience of the very rapid challenges facing our continent in a fast changing balance of influence and powers. This is a very crucial point for the future role of Europe as a partner respected and able to demand reciprocity in a world dominated not only by the US-with a regrettable misuse of their extraterritorial pressures- and the new emerging challengers.

Here is probably the main priority of the new European legislature. ●