IMPROVING CAPITAL ALLOCATION ACROSS THE EU

The Chair stated that the issues for discussion are well-summarised by the Eurofi background note, which documents the EU productivity weaknesses and its financing gap and examines the role of a risk-taking culture and whether Europe lacks one. The first issue for discussion was to explain the investment and productivity gap between the EU, the US and Asia. The second was to consider the role of policy, and priorities for policymakers, in improving the investment climate, while addressing growth areas and the digital economy, where the perception is that Europe needs to catch up.

1. The investment gap between the EU, the US and Asia

The panellists considered the current situation in the EU compared to its competitors and the underlying causes of existing conditions.

1.1. The facts

Corporate investment and productivity gains are higher in the US and Asia than in the advanced countries of the EU. The EU is falling behind the US and China in economically and geopolitically essential technologies. Europe is home to only 16 unicorns[1], versus 91 in the US and 44 in Asia. The 15 largest digital firms are American or Chinese. In this context, European success will necessarily entail a shared strategy.

A private decision-maker advised that the EU is home to 7% of the world's leading technology companies. In 2016, European private investments in artificial intelligence (AI) amounted to approximately €3.2 billion, compared to almost €10 billion in Asia and €18 billion in the US. In 2018, China attracted almost half of the 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.

A public decision-maker disagreed that there is a European investment gap. Corporate investment in Europe is as expected, considering demographic trends and the share of less capital intensive sectors such as the service sectors and digitalisation as a proportion of gross domestic product (GDP). This reduces the equilibrium rate of corporate investment to GDP, so is a specific problem. One pressing issue is the breakdown of cross border capital flows at a local level in certain countries.

A private decision-maker noted that the world is different from that of 11 September 2001, yet challenges remain. New technologies face the challenge of an interconnected global economy, with a web of contracts, production and consumption chains. Comparisons between regions, cultures and markets are difficult and often simplistic but in the context of innovation, the cultural, linguistic and commercial realities include the different legal and regulatory frameworks of China, the US and Europe. Geography is no longer necessarily destiny. Investment in innovation should transcend traditional cultural or structural differences, which inhibit foreign direct investment (FDI) and local investment in Europe.

A market expert stated that the lagging situation of investments in Europe compared to other regions is a problem for the future of an economically independent Europe, as it concerns new and intensely technological activities. These are key to the future competitiveness and social equilibrium of the region.

Financial philosophy recognises the lack of accumulated investment, as demonstrated by the Juncker Plan's success. It needs a coordinated approach to help organisations such as the European Investment Bank Group (EIBG) use a guarantee to leverage or tap the market, and this has helped create €430 billion of new investment in close to 1 million interested firms in three years. This was achieved via local platforms and the EIBG, which is vital for creating a better regulation environment for firms. Innovation often emerges from the existing regional ecosystems of European countries. This early success preceded the vital InvestEU project, to be introduced in a future budget.

The last 70 years have had an automatic-pilot concept of Europe, where words speak for themselves. There is no government but governance. The direction of travel is towards improving strategic sectors but it lacks a shared view of the long-term destination. This is a key priority for the new Parliament and EU institutions.

1.2. Underlying causes

1.2.1. Markets are more flexible and the role of the state in economic life is less important in the US

A private decision-maker stated that firms operating in the EU face a higher tax and compliance burden than in the US, Japan, Australia or Canada. This reduces their competitiveness in global markets. A focus on education and training is needed, as is an attractive, sensible policy, regulatory and legal framework, including appropriate tax incentives and competition policies to enable Europe to develop and maintain a prominent global position in the industries of today and tomorrow.

1.2.2. The absence of a European industrial strategy

A private decision-maker noted that the EU currently does not have an agency like the US Defense Advanced Research Projects Agency (DARPA). The European Investment Fund (EIF) has made a good start in providing finance for small and medium-sized enterprises (SMEs) through: private banks and funds; the European Fund for Strategic Investments (EFSI); InvestEU, focusing on sustainable infrastructure research, innovation and digitalisation, SMEs and social investment and skills; VentureEU, which aims to boost private VC investment and innovation in Europe; and the European Innovation Council (EIC) a pilot project under the Horizon 2020 EU Research and Innovation Programme planned for 2021. These are not close to the DARPA initiative. The UK had a similar Defence Evaluation and Research Agency, which was privatised in a heavily criticised deal. It now has the Defence Science and Technology Laboratory, which has some similarities with DARPA but is much smaller.

A market expert agreed that vital progress has been made in the strategic defence industry due to the dual innovation process. Europe is starting to understand the importance of facilitating innovation from military to civil industry and changing its original defence approach.

A private decision-maker considered European investment in AI initiatives fragmented and inadequate for promoting ideas to maturity and commercialisation. Europe acts as an incubator for the US and China, which must be addressed urgently. The development of machine-learning, AI and robotics is unstoppable. There is the question of who will write the music and who will conduct the orchestra. It is obvious that it is easier to start and operate a business in the US than in the EU since in the US, capital is more readily available, markets are more flexible, risk-taking is encouraged, and failure is not as newsworthy as in the EU or Asia.

1.2.3. The financing gaps in European risk capital markets

A public decision-maker stated that financing problems in European capital markets drive early-stage and growth-stage companies to non-European – US and Chinese – investors to meet financing needs. Skype, Minecraft and Beddit are all cases of great ideas born in Europe but bought up by the likes of Apple and Microsoft when the time came to move to the next stage in their development.

These financing gaps have three causes: a lack of funding; regulatory fragmentation across the EU, which hampers cross-border investments; and the risk-averse nature of the European investor. There is no quick fix for improving innovation financing, but there is much to be done, and the public sector can play a pivotal role.

A private decision-maker noted that Brexit will likely affect EU innovation financing. Around one third of the EU's AI activities take place in London. In 2019, the UK's investment in AI was almost equal to the rest of the EU combined. The EU must define and strengthen its relationship with the City of London.

1.2.4. Specific issues experienced by Japanese companies

An industry representative stated that Japanese companies often struggle to find employees, particularly good managers. One reason might be lack of familiarity with the Japanese company ethos. Japanese corporates are deeply concerned within expectations of long term loyalty to the company. They invest in intensive staff training on this point, so there is a cultural mismatch there. There is also an information gap. At investment seminars, Japanese investors demand accurate and detailed local information, as most have never visited Central and Eastern Europe (CEE). However increasing cultural understanding and information exchange should overcome distance and further enhance investment.

A private decision-maker considered that, despite geopolitical turbulence, Brexit and economic inequality, there is a consensus towards cooperation at the institutional level. Christine Lagarde's speech before the Parliament urged rich eurozone governments with low deficits to bolster their crisis-fighting capacities by spending money to address populism and the inequality gap. Central banks should not be the only game in town.

2. Policy priorities for improving capital allocation across the EU

There exists a range of priority policy areas able to address the current funding shortfalls in the EU market.

2.1. Defining and implementing an EU investment strategy

A market expert agreed that any discussion of future sectors must include unicorns, digital and AI. It must also include a sustainable transition to a greener economy. The President-Elect of the next Commission showed an organigram with two feet: digital and a new Green Deal. The expectation after the euro and Lamfalussy process was for smooth-sailing and a cross-market to follow. Then came the crisis. The situation now shows more cross-border regulation, resulting in fewer cross border operations.

Confidence is a problem but, as it contains elements of sovereignty in banking or financial markets, it has been difficult to move on harmonisation for cross-border products or institutions. Both were tried and the same kinds of obstacles arose in each. Symbols of this was the discussion on the Capital Requirements Directive (CRD), the Banking Union and Capital Markets Union (CMU) – including the Pan-European Pension Product (PEPP) – and the European supervisory authorities (ESAs) review.

The challenge for the next Commission in the banking area is to remove the divide between the home/host debate and proportionality. A recommendation from Mario Draghi is about dealing with the architecture of the financial and banking sector within the EU. This will be difficult.

Furthermore, the new Commission should implement a horizontal, consistent strategy to favour investment with a comprehensive understanding of the future challenges. It must: make full use of InvestEU to build bridges with the use of structural funds; ensure a strong implementation of Horizon Europe for which the EU Parliament has requested a budget of EUR 120 billion over the 2021/2027 period from the next multi-annual financial framework; a review of the Stability Pact to include a capacity to drive investment and define the eurozone's proper fiscal stance, and for member states to use the currency's stability to support long-term investments; to utilise lessons from national promotional banks (NPBs) in re-launching the CMU, to ensure that long-term investment thresholds in green transition and digital education are met and to avoid speculation; to have a fresh look at the taxation biases favouring debts towards equity; to correct existing imbalances, especially between the north and south of the eurozone; and to consider a carbon tax as unavoidable in creating incentives for market investment. It requires a courageous answer to counterbalance potential unfair social impacts.

The Chair asked if a forceful implementation of the EU services directive could make Europe into one bloc. A market expert advised that it should not be the cornerstone of a single market. A public decision-maker agreed that there is support, but it will not be key to transforming the views of Europe or unlocking the issues under debate.

2.2. Restoring capital flows within the EU

Europe competes against the US and China, which benefit from large, relatively homogeneous markets. Data shows that financial integration 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.

The Chair asked if the eurozone's decline in cross border capital flows – particularly since the sovereign-debt stresses, despite work done in its public and private-sector balance sheets – is a different problem and whether a slowdown will follow until balance-sheet problems are addressed. A public decision-maker stated that it is disappointing. Much has been done to overturn the financial crisis' stresses, but clearly the work has to be completed. A debate is scheduled for the Economic and Financial Affairs Council (ECOFIN), with a discussion on rebooting the CMU, which anticipates giving input to the new Commission.

The issues relating to innovative parts of the economy such as research and development (R&D), the digital economy and unicorns are separate from capital flows. The CMU and the Banking Union relate to the mundane corporate investment that keeps the economy running while creating unicorns is a different discussion. There is work to be done on the Banking Union and the CMU. The obstacles are known but overcoming them is not easy. Roadmaps are being drawn up, so hopefully one of them will lead to the right destination.

An industry leader welcomed the EU's ambition to accomplish the CMU and unlock the full potential of the single market. The EU is 28 markets with 500 million people, versus the US's single market with 320 million people. The EU market is fragmented culturally, politically, linguistically and, crucially, regulatorily, so it cannot be as agile and decisive as a single national government. The EU may benefit from removing barriers to attract greater investment from third country investors, and reducing regulatory fragmentation. The creation of a single EU securities exchange as part of the CMU will increase harmonisation and be aligned with the US approach.

A market expert stated that spreading investment between the north and the south of the EU cannot be ignored. InvestEU tries to address these challenges. It is a legacy from the Juncker Commission and will need to be followed up by the next Commission. InvestEU begins to answer the need to bridge public and private money to leverage investment. It ensures that there is a good network with the EIBG and NPBs.

Eurofi's background paper for this session notes the proposal from Jacques de Larosière and others for a European savings and investment fund. The PEPP is not going to be this. It was an idea, but the delivery is not there. This product will not be a real cross-border solution for long term and innovative investment.

2.3. Boosting European capital risk markets

2.3.1. A quantum leap for private equity and venture capital is urgently needed

A public decision maker noted that there are many potential actions, some of which are partly in hand. Market feedback is crucial, so hundreds of funds have been consulted, with replies from over 300. The answers are telling. The first question was whether the public sector should be there and what it should be doing. The answer was positive beyond expectations. It is catalytic and has an important signalling effect. Public money should not be squandered but, in areas of market failures, it is vital that the public sector should be present.

Institutional investors should be reached out to. However, the sentiment on achieving this is pessimistic. Funds and ticket sizes are too small. Investors in Europe, Japan, Vietnam and South Korea have been contacted as part of a policy steer, which is something that should happen systematically in the context of trade arrangements and missions. The problem is not about the EIF making a difference but one of putting Europe on the map. Large funds such as Softbank or Mubadala may be well-informed on European VC opportunities but other institutional investors look to the US and China with more interest. The starting point is making the case for the valuable business proposition and investment and the performance paradigm in Europe.

A Japanese pension fund with 1 trillion of assets under management will not want an exposure to one region, or even one country. They want an exposure to Europe. They want diversification, with different vintage years and stages. The regulatory framework is important. Private money will not invest in unfamiliar structures. European fund structures do not exist. There is one for each country and the result is that they turn to Jersey or US structures. Much time is spent on taxation and there are reputational issues in this. Ensuring that there is no tax evasion or avoidance is vital but having 27 different regimes makes things difficult.

Investors do not only look only at good returns. That is a precondition, but they also look at solid monitoring, environmental, social and governance (ESG) issues, and non-financial returns. Talking to sovereign-wealth funds is about cooperation as well as money, as with NPBs, and ensuring knowledge transfer. These discussions occur with Asian and Middle Eastern investors and are key issues.

The strategy must overcome fragmentation. It has begun in early-stage venture capital (VC), where prime-market failures exist, but this is not enough. Continued focus here to the exclusion of later stages means missing the growth finance question, which means becoming an incubator for other industrialised nations.

A holistic view of companies' needs is vital and must start earlier. There is a good research and innovation base but a problem with commercialisation. The European Innovation Council is a useful bridge between research and the pre-seed/seed ecosystem. It is time-intensive and involves data review and information clustering. The later stage where companies scale up is critical, as is a corporate or industrial perspective that identifes disruptive technologies for the whole funding chain, including climate change. Clean tech is equally vital. Companies must include funding for tomorrow, with attention focussed on industrial sectors which may have the industry of the future. Good policy papers exist, but pooled money is critical. A shared vision of the destination is crucial, as is pooling resources to achieve critical mass, with the right support. This means pooling together EU, national and regional funds as well as attracting private resources. It is not about throwing public money around but creating layered structures with risk-return profiles for private money of significant size.

2.3.2. Fostering and encouraging cooperation where the EU is lagging behind

The Chair asked for the Commission's thinking on these issues, and how to increase capital flow between countries, as well as for comment on the need for a European investment fund, be that a Norwegian-type sovereign-wealth fund or a savings fund larger than existing initiatives.

A policymaker considered it a funding problem. Much has been said about VC. The VC markets are concentrated and functioning well in France, Germany, the UK and Luxembourg, but a large part of Europe consists of flyover states. More states need ecosystems that facilitate matchmaking between investors and entrepreneurs. VC is about trust, so when bringing a project to investors they will invest in the people as much as in the project itself. They need to meet each other and to build trust.

Scaling up is a key issue that has been discussed by the Commission and the EIF many times. The instruments focus on seed and early stages, so when companies become profitable, they cross the Atlantic. Europe takes the risk and other regions take the profit, which is not the best division of labour. Europe cannot afford to be the incubator for other industrial countries. Efforts have been made to build instruments on a test case in the current multiannual financial framework (MFF) to support scaling up, but more needs to be done.

Mentalities are also an issue. Previously, countries prohibited the CEO of a bankrupt company from holding a chequebook for 10 years. Financing in Europe depends on banks, not an optimal VC financing mechanism, as banks are exposed to the downside and not the upside in making a loan. The VC model of financing 100 companies, having 90 fall and profiting from 10 is not suitable for banks, so more initial public offerings (IPOs) are needed. The current MFF can build instruments to support marketing financing via IPOs.

Europe is active and the EIF is doing an excellent job. The next MFF will have InvestEU with a €650 billion target, VentureEU with €400 million and the EIC financing disruptive technologies. Other actions are also needed. Regulatory fitness checks are key to ensure that obstacles to innovation are not created inadvertently. The bulk must come from the private sector, beyond public investment.

It is vital to foster and encourage cooperation where the EU lags. This has been tried for important projects of common European interest. 40% of the value of electric cars comes from the battery and 85% of battery production is in Asia, so Europe must catch up urgently. The EU has created a European Battery Alliance, to develop cooperation in this field. That is an example of the kind of cluster approach that is required.

3. Towards an EU Sovereign Wealth Fund?

The EIF thinks it is big because it is the main fund of funds for VC with a policy mission in Europe. Asia has funds that are 100 times bigger. The lack of a sovereign-wealth fund is a problem, to address tomorrow's pensions and support Europe's future industrial competitiveness. Norway has one; Europe does not.

A policymaker advised that a European sovereign-wealth fund and other ideas have been floated. The possibilities for financing within the context of the next MFF are limited. Money cannot suddenly be found that has not yet been identified, so progress in this direction will need to be made primarily by associating member states on a voluntary basis. The Chair understood that any EU-wide sovereign-wealth fund will be outside the MFF and will be an EU member state's initiative. The Chair asked for views on investment and following the comment that Norway is doing well, asked why Europe cannot do the same.

A market expert agreed that it sounds good. The question is how to do it. It is out of the question that it can be done in the MFF. MFF and programmes such as Horizon 2020 are key to the topics under discussion. It would be good to follow Parliament's proposal, which is quite ambitious for Horizon 2020. A challenge for this discussion is that the last Commission started a discussion on a sovereign fund. It cannot be done in the MFF, so must be done among the member states. The problem is how to get them to agree to it.

A public decision-maker responded that if there is a European corporate investment gap, the US's is larger, as shown by comparing the numbers and demographics. The US should have a higher rate of corporate investment than Europe, but does not. The UK has a dismal rate of corporate investment, so functioning capital markets are not an automatic solution to unlocking it. The Norwegian fund is not a tool of industrial policy and does not invest in Norway but abroad, so it is not a perfect example.

The need for a European fund focussed on late-stage VC has been identified, but this is a difficult area to work in. It may not be possible to build the structures to enable the running of such a fund on a purely commercial basis without national industrial-policy interests intruding. This would be an immense challenge and a difficult one to handle. The EIF is doing a great job but this would be far more difficult. A market expert considers it to be excellent, given that households are risk adverse. An ageing population likes bonds, not shares, and so a transformation system between bonds and shares is needed. This is the main utility of a sovereign-wealth fund.

4. Attracting global investment in Europe is fundamental

A private decision maker noted that we are a Japanese bank operating in Europe since the 1950s, and is active in supporting Japanese companies to enter the European market. Japanese financial institutions played a key role in providing liquidity for the EU economy.

Reviewing Japanese stock FDI, the European share is 27% versus 30% in the US and 28% in Asia, so there is not much difference between them. This is surprising, as Europe is distant from Japan, while Asia and the US are thought of as neighbours across the water. The US and China are huge single markets whereas Europe's borders and local regulations are fragmented, although it is trying to unite.

If the investments made over the last three years are calculated on a flow basis, the aggregate figure for Europe is 37% versus 24% for the US and 21% for Asia. Europe has become a larger destination for Japanese investment as Japan tends to acquire high-value-added companies, such as pharmaceuticals or electronic and technology companies. CEE is a candidate for manufacturing companies that continue to invest in their facilities, although logistics and infrastructure weakness is a potential barrier.

The EU is an important global partner for Japan, and it is expected that the EU will be able to attract more investment, by utilizing the EU-Japan EPA. Financial institutions would play an important role in promoting investment in the EU.

5. An EU industrial policy is required

A market expert considered it vital to be conscious of the speed of technology. It is not about creating a basis for investment. The problem of the basic manufacturing sector has been dealt with through the EIF, local platforms and maybe a sovereign-wealth fund. This is the first stage of an industrial policy.

The second problem is a lack of means and tools. Europe does not have the necessary technology to finance the giant technology platforms, given their vast financing needs. A long-term strategic view is needed and is a critical political matter. The Commission and member states have the competencies, but do not have a shared view. As noted by another panellist, corporates do not have a long-term model, so there is no trust among corporate investors or managers on the destination. This is a key task for the new Commission.

A policymaker noted that a holistic industrial policy is vital, which means marrying finance, research, industry, competition, trade and education. The necessary labour force skills must be developed through upskilling and reskilling. The efficient functioning of the internal market is key to allowing companies to grow. It is not mission accomplished when only one third of European businesses trade in another member state and only one in 10 companies have made a purchase or a sale in another member state. There is potential that needs to be tapped further. Geo blocking is an issue in many sectors.

Competitors do not always play a fair game: China is hands-on on all fronts; Japan has a strong industrial policy; and the Trump Administration uses trade policy to push its industrial-policy agenda. Existing rules must be reviewed to see if they are fit for purpose. A delicate balance will allow companies to reach a critical size. Competition is key to fostering innovation, so dropping competition rules would be stupid.

Conducting an industrial policy is easier said than done. The public sector is not good at picking winners or making the right support decisions. France was once ahead of all other countries in spreading digitalisation to a large public, with a terminal called Minitel, which offered online services. The intention was good; the technology was wrong. Authorities' efforts should support the development of the sector rather than a given company, and decisions should be sound and integrate market views. This has been built into instruments in the Juncker Plan and in InvestEU. Support decisions are not taken by the Commission or by the public sector, but by an independent investment committee composed of market experts who do not pretend to have superior knowledge. The primary focus is to encourage innovation. There are also interesting national initiatives, such as the Joint European Disruptive Initiative (JEDI) launched by France and Germany. Clearly more JEDIs are needed to win that war.

6. Rethinking competition policy and how it can support an EU industrial policy

This policy was first targeted to oppose monopoly but in a more complex world trade environment the debate has emerged on how EU competition policy should favour EU stakeholders vis-à-vis global competitors.

A market expert advised that competition policy is one of the Commission's strongest tools for influencing the EU market. It is a cornerstone of this strategy. Competition policy in a changing world means that Europe cannot remain naïve and not move. Member states have ambitions and sometimes use the European level to defend national interests. There was a huge reaction when the Commission opposed the Alstom and Siemens merger. There are good arguments for the decision, although the Chinese are entering the German market. A common understanding of modern competition policy is crucial.

A less orthodox idea is that the EU is good at contributing to a global debate and has the capacity to be creative, as with the Copyright Directive, which is unique at the global level and was invented by Europe. It is not fixed and was not easy, but it matches the real world. It could be an advantage for the EU to evaluate competition at a global level and create tools that allow for it. Another field is the High-Level Expert Group (HLEG) and green finance. There is a need for that and, if invented, it will influence world competition.

The Chair asked for a last word on competition policy. It is about what a level playing field looks like in the current world. A public decision-maker agreed that competition policy is one of the great successes of the EU and care should be taken when fiddling with it. Finland is starting a political debate around building high-speed rail lines. The idea that perhaps Alstom and Siemens will participate in those projects as separate bidders brings relief compared to the alternative. It is difficult to create winners without picking winners. It will be difficult to create a completely level playing field in this sensitive, murky, high-risk area where most projects fail, and a few are great successes. This is not something that naturally fits into the EU policy framework, so it will be curious to see how it can be made to work.

A public decision maker advised that it is vital to be clear about the aims for tomorrow, with Europe leading or having a meaningful place. That does not mean that colleagues at the Commission or the EIF will pick individual companies but should go through a field-proven indirect, intermediated scheme with the private sector. It will be highly selective, so a fund could have two high-fliers, four that struggle through and the rest that fail, as is the case in the private sector. This is the type of system that is being considered.

[1] Private companies with a value of at least $1 billion.