Conditions for relaunching growth in the EU

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Addressing post-Covid invesment needs

Euro area investment never fully recovered from the collapse during the European financial and sovereign debt crisis. Even today, Europe has not caught up with the upward investment trend which existed prior to the 2008-12 crisis. While it is true that the euro area investment to GDP ratio increased by four percentage points between 2014 and 2019 and reached levels recorded prior to the previous crisis, this did not compensate for the damage done by the significant decline in investment and loss of capital which the euro area suffered during the previous crisis.

At the same time, the euro area exported savings abroad by running most recently a current account surplus for a number of years. By comparison, the investment gap compared to trends prior to the global financial crisis is much smaller for the US, less than half. As a result, Europe was not on track to meet its R&D investment targets and failed to generate new market leaders in technologically strategic sectors. Relative to the United States, particularly the service sector lags behind in its digitalisation.

There are different drivers of this investment gap in the public and private sector. First, public investment displays a downward trend from 2009 to 2018. This means the recovery of the investment rate during the period 2014 to 2019 had to be driven by private investment. Second, private investment did not accelerate in the post-crisis environment because the corporate sector needed to deleverage, in some countries coping with an overhang in residential investment.

Investment was generated once the liabilities decreased sufficiently. Second, investment is highly sensitive to uncertainty in the medium-term outlook. Effectively, growth prospects were rather subdued and uncertain in aftermath of the crisis and it took some time until expectations had fully consolidated on a growth scenario. Third, Europe has a much smaller market for risk capital. While Europe's stock market capitalisation is half its gross domestic product, US stock market capitalisation is nearly double the country's GDP. Enlarging Europe's capital market could provide necessary growth financing.

The pandemic crisis further increases investment needs, while the indebtedness of firms and governments has already started to increase. The pandemic causes a liquidity squeeze for companies and households. The European Commission estimates that the loss of equity in the European corporate sector may amount between EUR 720 billion and EUR 1.2 trillion depending on the length and severity of the crisis. These investment needs differ substantively across countries, depending on the degree to which the crisis affected each country.

Similar to the past crisis experience, it can be expected that households and companies will again engage in precautionary savings as the uncertainty regarding economic prospects persists. As a result of this situation, investment may remain suppressed, despite the substantial stimulus provided by both fiscal and monetary authorities. The fiscal measures taken now will also leave less space for manoeuvre to promote capital accumulation through budgetary spending later on. Differences in fiscal space across countries reinforce economic divergence.

Europe needs to engage in a strategy of structural reform and targeted fiscal support at the national and European level. During the recovery phase, public investment should support R&D and human capital, digitalisation and the greening of our economies. Policies addressing climate change imply substantive investment needs to cover transition risks and contain carbon levels. Targeted public support to companies is needed to overcome market failures and balance sheet constraints.

Regulatory reform should aim to improve the single market for both services and capital.

Support to be effective during the recovery needs to be directed to productive and growth-enhancing sectors, rather than shielding companies from necessary adjustments when facing oversupply. The bulk of policy initiatives will have to be based on structural and regulatory reforms. Investment support and regulatory reform have both a national and European dimension. European efforts complement national measures in providing support to ensure a level playing field.

The New Generation EU and the Recovery and Resilience Fund will be instrumental. Regulatory reform should aim to improve the single market for both services and capital. Advancing Banking Union and Capital Market Union should facilitate the necessary private sector funding and risk-sharing across countries. ●

Mario Nava

Director General, DG REFORM,
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Technical Support, DG REFORM and the recovery and resilience of EU Member States

On 27 May 2020, the European Commission put forward a very wide-ranging package combining the future Multiannual Financial Framework (MFF) and a specific Recovery effort under Next Generation EU (NGEU)[1] in order to respond to the impact of the coronavirus pandemic. A key element of the proposed Recovery effort is the Recovery and Resilience Facility (RRF). The special European Council of 21 July 2020 agreed on a comprehensive package, which includes the proposed RRF. Of course, this Council Agreement is a very important step opening but not the end of the road as the European Parliament still has to vote on the whole package of the MFF and the Recovery Instrument.

The proposed RRF will provide large-scale financial support to reforms and investments undertaken by Member States, with the aim of mitigating the economic and social impact of the coronavirus pandemic and of making the EU economies more sustainable, resilient and better prepared for the challenges posed by the green and digital transitions.

The support will take the form of up to EUR 360 billion in grants and up to EUR 312.5 billion in loans and will be demand-driven. To access the proposed RRF, Member States should prepare recovery and resilience plans setting out their reform and investment agendas for the subsequent four years, until 2024. These plans should comprise both reforms and public investment projects through a coherent package.

Following the 21 July agreement in the European Council on a powerful, modern and revamped 2021-2027 long-term EU budget with NextGenerationEU at its heart, a Recovery and Resilience Task Force was created within the European Commission's Secretariat-General. Under President von der Leyen's authority, the Task Force supports Member States with the elaboration of their recovery and resilience plans, ensures that plans comply with the regulatory requirements and deliver on the objectives of the green and digital transitions and monitors the implementation of financial support and coordinates the European Semester in this period of time.

However, as we know all too well, money alone will not ensure recovery. Investment and reforms are both essential components of the economic recovery and of the strengthening of the economic resilience. Member States will require support in designing and implementing such investments and reforms. The Commission created in January 2020 the Directorate-General for Structural Reform Support (DG REFORM), which took over the mandate previously carried out by the Structural Reform Support Service.

DG REFORM supports EU Member States carry out reforms to stimulate job creation and sustainable growth. EU Member States can ask DG REFORM for tailor-made support and expertise in a wide range of policy areas covering EU priorities and EU law or areas of national interests and initiatives. The support offered covers the whole reform cycle, from identifying needs to implementation, monitoring and evaluating outcomes. Today, DG REFORM is engaged in over 1 000 projects in all 27 EU Member States.

To deliver the support to Member States, DG REFORM has been managing a dedicated programme – the Structural Reform Support Programme (SRSP) – with a budget of EUR 222.8 million for 2017 to 2020. The Commission proposed to replace the SRSP as of 2021 by a new proposed Technical Support Instrument (TSI). The proposed TSI puts particular emphasis on support to the recovery and resilience of Member States, including support to the green and digital transitions. It also provides, as a matter of priority, for the support to the preparation and implementation of recovery and resilience plans.

The European Parliament will soon vote on the EU Council of 21 July affirming that the Technical Support Instrument (TSI) will improve Member States' administrative capacity to design, develop and implement reforms, and that TSI will be available for all Member States with a financial envelope, for the period 2021-2027, of EUR 767 million. ●

1. COM(2020) 456 final.

Thomas Westphal

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Beyond the crisis – Conditions for the relaunch

The Covid crisis has put a heavy strain on the European economies. The slump in GDP in the first half of 2020 is of historic proportion. While current economic indicators point to activity moving towards pre-crisis levels in many sectors, uncertainty about the further course of the pandemic and thus the economic recovery remains.

The EU and its Member States have responded to the challenges with unprecedented determination and speed. In the area of financial and economic policy, we have activated the general escape clause in the Stability and Growth Pact so that Member States can take timely, temporary and targeted action to deal with the ▶

social and economic consequence of the pandemic. At the same time, the EU Commission adopted a Temporary Framework for State Aid Measures. With the pandemic crisis support of the ESM, liquidity support from the EIB and SURE as a temporary support instrument to mitigate unemployment risks in an emergency, we have adopted first building blocks of a Covid shield for Europe. In July, we achieved another major breakthrough with the European Council's agreement on the recovery programme Next Generation EU with its main spending tool, the Recovery and Resilience Facility (RRF), which goes beyond emergency measures, balancing the need for immediate economic support with the need to provide sustainable and inclusive growth. A key project of the German Council Presidency will be to finalise the RRF and make it operational.

Governments of individual member states, EU institutions and the EU as a whole have assumed a special and extensive role in this specific situation. In the acute phase of this crisis, governments stepped in to provide companies with liquidity, to keep people in employment and, overall, secure the confidence of people and companies. With these measures, governments help to build a bridge over the deep crisis, avoiding long-term damages to the economy and laying the fundaments for sustainable and inclusive growth. To enable a swift recovery, we will also need to improve the access of companies to financing via more integrated financial markets. This will also be a key priority of our Presidency.

It is now important to take the right decisions to strengthen the resilience of our economies and the EU and more specifically to increase Europe's growth potential. I am convinced that there is higher acceptance for change in the current crisis. We have to make use of the momentum and make the European economies fit for the future.

Challenges that already existed before the crisis are still relevant today: in particular, the need to address climate change in the context of a broader sustainability agenda as well as digitalisation. Demographic change and its effects on, among other things, the sustainability of public finances will also continue to concern us in the coming decades. We have started to address the question of strengthening investment and future orientated spending already before the crisis. This is about high quality public investment, but also about the right institutional setup for private investment. The crisis has highlighted weaknesses in our economies and structural framework. Nevertheless, it has also accelerated transformation processes; just think of the increase in cashless payments, smart working and video conferencing.

How can we get there? With the significant funds of the Recovery and Resilience Facility, we should address country-specific challenges identified for each country in the context of the European Semester. If we strengthen the forces of sustainable growth, a major step towards recovery and greater resilience will be possible.

The combination of national and European measures now gives us an opportunity that we have to seize. For all the suffering that this virus has brought upon us, it has also clearly shown that we stand and are stronger: Together. For Europe's recovery.

Dorothee Blessing

Co-Head EMEA Investment Banking & Chief Executive Officer, J.P. Morgan AG, Frankfurt, J.P. Morgan

Relaunching productive investment in Europe

The impact of COVID-19 as an extraordinary health and economic shock will likely be felt for months and years to come, with the long-term socioeconomic repercussions still unknown. As Europe pivots to a recovery phase, a strengthened banking sector, a continued drive towards Capital Markets Union (CMU) and preparing workforces with skills for the future will serve as the foundations for relaunching investment, and reigniting growth and job creation.

Throughout the crisis, banks such as ours have stood ready to help governments, our employees and our communities across Europe. In the first half of 2020, we prudently raised $1.2 trillion of extensive credit and capital globally for consumers and businesses of all sizes aimed at working capital and general corporate purposes, and provided governments with business expertise to help the recovery. In short, this demonstrates how banks, including those with headquarters outside the EU, fulfill a vital role in supporting the economy.

Yet concerns remain around the impact of non-performing loans (NPLs) on banks' balance sheets. Experience tells us that dealing with NPLs and ensuring banks' financial strength is critical to economic recovery. An improved EU securitisation framework, as recommended by the European Commission's High Level Forum (HLF), could help. When developed in such a way as to be responsible, prudentially sound and transparent, securitisation can act as an important vehicle to increase the capacity of bank lending and investors' access to European credit products. This is no less the case for NPLs, and could help banks de-risk their balance sheets.

We appreciate there remains a degree of scepticism surrounding securitisation as a consequence of the global financial crisis over a decade ago. However, the HLF, of which my colleague Vittorio Grilli was a member, outlines how the securitisation framework can be improved through better credit underwriting standards and NPL reduction, providing an increased scope for synthetic securitisation and a clearer role for Competent Authorities in Significant Risk Transfer assessments, as well as increasing clarity around disclosure and due diligence requirements, including in relation to third-country securitisation issuance. There is also the opportunity for the EU, alongside other global prudential regulators at the Basel Committee for Banking Supervision, to revisit the capital and liquidity treatment of securitisation issuance.

Critically, as well as encouraging cross-border investments, a better securitisation framework could specifically support the financial needs of SMEs, the growth engines of Europe, as well as acting as the bridge between the Banking Union and CMU.

We are also supportive of the HLF's broader CMU recommendations, in particular the need for a review of disclosure rules to improve retail investors' decision-making, strong infrastructure to ensure that financial markets maximise their role in funding the real economy, increasing Europe's role in developing a coordinated and consistent global regulatory framework, and improving financial health and literacy across Member States to increase retail participation.

It is worth bearing in mind that productive investment and growth are not just enabled by the traditional financial services domain of banking, lending and markets activity. They are also driven by a competent and diverse workforce equipped with the relevant skillsets for a changing world of work, which is also essential for rebuilding economies and supporting communities most affected by COVID-19.

At J.P. Morgan, part of our philanthropic efforts in Europe focus on helping adults adapt to the future of work through reskilling and upskilling for the digital transformation, supporting young people with skillsets for career readiness and providing upskilling pathways for vulnerable workers. We welcome the launch of the European Skills Agenda to upskill and reskill young people and adults for a digital and green world of work and to unlock public and private investment in educational and vocational training.

As the crisis recovery continues to evolve, the financial industry must continue to work in partnership with local organisations, governments and civic society to lend our resources and expertise toward solutions for recovery and help relaunch investment across Europe.

Jonás Fernández Álvarez

MEP, Committee on Economic and Monetary Affairs, European Parliament

Paving the final way for a historic EU response to the COVID-19 crisis

In July, the European Council reached a political agreement to make feasible the issuance of European debt of €750bn. This decision marks a monumental step in the project of (re)building Europe. The common fiscal response is a historically unprecedented move and addresses demands made in the resolutions adopted by the European Parliament (April and May 2020) which preceded the formal proposal of the European Commission. The additional resources of the Next Generation EU will be vital in order to relaunch the economy following months of confinement due to covid-19. The EU has supported member states both with fiscal (SURE, EIB, ESM, etc.) and monetary, through the new debt purchasing program of the European Central Bank, measures. However, this political agreement must now be confirmed through a legislative procedure in which the European Parliament will make efforts to review at least three fundamental aspects.

Firstly, the European Council agreement substantially raised the amount of national rebates for some member states at the expense of lowering expectations for the Multiannual Financial Framework (MFF) 2021-2027 and key programs for the Parliament, such as Horizon 2020 or Erasmus+. In addition, this agreement increased the amount of money available for member states through the Recovery and Resilience Facility, reducing the finance available in the Next Generation EU for Community programs. This translates into a dramatic reduction in the funding proposed by the Commission for InvestEU, Solvency Support, Just Transition, EU healthcare or foreign policy. In doing so, the European Council has cemented its position regarding the reduction of funding available for specifically European-based programs.

Secondly, the European Council has increased its key decision-making powers in terms of governance of the Recovery and Resilience Facility, which will now channel €672.5bn of the total debt issuance for the Next Generation EU. While the initial legislative proposal of the Commission left the Parliament with a minimized role, the agreement of the European Council has left the Parliament in a residual position. However, MEPs cannot allow one-third of the European budget (MFF and Next Generation EU) to be managed without democratic control. Therefore, I presume that the Parliament will have a clear, contrasting position regarding this point that must be negotiated before the end of the year with the Germany Presidency of the Council of the EU.

Thirdly, the Parliament is expecting to clarify the framework of European own resources in order to service the debt. The European Council has signed a lax and insufficient agreement which does not clarify the resources available for this purpose. The Parliament aims to eliminate any uncertainty regarding the resources available for European-based policies for the period 2028-34. This requires a strong position concerning the development of new European taxes that cannot increase the tax burden but must address current levels of fraud and tax avoidance. In addition, this requires the ability to tax more mobile tax bases at the European level in order to guarantee the efficiency of general tax systems.

In view of these circumstances, the Parliament welcomed the political agreement reached by the European Council. However, its formal approval faces new challenges. The Parliament has the power of veto on the MFF and full legislative competence on the Recovery and Resilience Facility. Thus, negotiations with the Council are pending, in order to consolidate all of these details and to pave the way for a true and significant European response to this crisis.

Laurent Zylberberg

Chair, European Long-Term Investors Association (ELTI)

Let's preserve Long-Term Investment!

In times of such incertitude, the role of National Promotional Banks and Institutions (NPBIs) and more globally of Public finance seems more obvious than ever.

Sustainable development, demographic changes and now health crisis are, in a way, the best incentives we could have for investment, especially for public long-term investment. This environment reinforces the diagnosis and considerably amplify the investment needs in social infrastructure, digital technology, health, innovation or sustainable transport. Since 2008, when constraints were put in place, the context have dramatically changed. We are now experiencing low interest rates, availability of liquidity, national downturns and the gigantic threat of global warming.

There is an imperative need to continue investing for the long-term. Our economic vehicle does not need a repair but a profound transformation for preventing any further breakdown. Our economies need strong public financial actors. They are enablers for investment as they trigger high leverage effect. Priority must be given to the functioning of the economy by favoring both debt and capital financing. This requires an easing of prudential measures which, in the current situation, risk leading to the financial embolism that we experienced in 2008. Then, it is necessary to take incentive measures, for example by financing the deferral of repayment of debt in favor of riskier investments, either because they are long term, or because they contribute to the general interest without necessarily having immediate financial returns, like social infrastructure (hospitals, affordable housing, educational establishments...).

In Europe, banking system is the main source for financing the economy, therefore the role of public finance is key for earmarking funds in the direction of the general interest needs. We need to think again, in this new environment, the meaning and the enforcement of prudential rules for the different actors and the different assets. This will be the price for having a tailor-made financing system. As countercyclical actors, NPBIs have to play an active role. If the EU wish so, they are prepared and ready. In Europe, their size (a total consolidated balance sheet of €1,700 bn for the 30 member institutions of the European Association of Long-Term Investors) and their prudent management give them the means to act.

Very responsive in the deployment of the Juncker Plan, they make a crucial contribution to relaunching investment. In this context, it is essential that they benefit from the active support of European actors and European tools. The Council of the EU agreement in July 2020 send contradictory signals with more solidarity between States and less means for European instruments managed by the European Commission. Among expected clarifications, restrictive measures on public funding should be alleviated by generalizing and simplifying the possibility of mixing European subsidies and investment with public capital.

More than ever, it is crucial today to give long-term investors the means to invest for tomorrow! ●

Carsten Brzeski

Global Head of Macro Research and Chief Eurozone Economist, ING

Fiscal policy to the rescue

Since the financial crisis in 2008/9, investment in Europe has remained low in comparison with pre-crisis levels. There are several explanations for this underperformance. Let's focus on two main themes: the lack of funding and too much uncertainty, ie weak growth prospects. An often-heard explanation for weak investments it the complicated access to risk capital and start-up funding. In this regards, fragmented financial markets, the unfinished banking union and high dependence on bank lending could be the reason why low interest rates and accommodative monetary policies have not kick-started investments. Despite so many measures by the ECB, the transmission of low interest rates to the real economy looks still hampered.

Indeed, even though external funding has been available excessively, it was mainly available to companies with direct access to capital markets and focused on few sectors like technology. Here, low interest rates and high-risk appetite have indeed reduced the cost of capital market funding. However, very accommodative monetary policies and low (to negative) interest rates have not at the same extent translated to lower costs and availability of bank credit. As a result, smaller sized companies face tighter financing conditions than large firms. Still, while small firms are typically most finance-constrained, their contribution to aggregate investment is generally relatively small. In addition, if only small firms had good investment opportunities but only large firms had access to funding, then some form of financing cascade could be expected to develop. Consequently, the

(lack of) access to funding cannot be the only explanation for weak investment.

A second explanation is uncertainty and low investor confidence as a reason why companies do not invest even though they do have the financial means. It is uncertainty ▶

about future economic conditions and whether the possible return on investment will actually justify its cost. In this regards, structural factors like ageing societies, fragmentation of growth and financial markets, euro break-up risks and the lack of a common fiscal policy seem to weigh on future returns on investment. With economic prospects often higher in other parts of the world, Europe has become less attractive for both domestic and foreign investors. As so often, there is no single explanation for such a complex phenomenon as weak investments in Europe. In reality, it is a combination of factors, which have kept investments weak. In addition to the above-mentioned factors, do also think of the lack of outstanding and symbolic future and high-tech oriented sectors in Europe like Silicon Valley in the US.

Looking ahead, given the complexity of weak investment, there also is no one single solution to finally unleash investments in Europe. Instead, Europe needs a multi-layered strategy. A strategy which does not only provide ambitious words like the old Lisbon strategy but a strategy which actually delivers and increases Europe's competitiveness in the global economy. Such a strategy needs to define a few sectors of excellence. The transition towards a carbon-neutral European economy as well as boosting digitalisation could be the unique-selling-point for Europe and trigger for investments, both from the public and private sector. The initiatives started by the new European Commission since late-2019 point already into the right direction. It is now up to national governments to take over the baton and implement measures and initiatives, in a coordinated matter.

In general, to unleash investments in Europe, governments and fiscal policy are currently key. Particularly as monetary policy has reached the limits of the lower bound. Making cheap money even cheaper will not kick-start investments. It needs fiscal policy, be it by creating (financial) incentives, be it by implementing structural reforms to increase European growth prospects or be it by defragmenting financial markets by finalizing the capital market union. The Covid-19 crisis has shown what governments and fiscal policy are able to achieve and deliver in an unprecedented crisis. Europe needs more of this if it wants to survive global competition.

Jean-Jacques Bonnaud

EUROFI

Europe must take charge of its strategic interests

Long term and productive investment is essential for economic growth. However, corporate, infrastructure, energy investments and R&D are higher in large economies than in Europe and real GDP growth and productivity gains in the euro area have failed to catch up with US, China and Japan over the past two decades.

In 2018, the EU invested EUR158 billion in climate change mitigation. At 1,2% of GDP this figure is marginally less than the United States (1,3%) and little over a third of China's performance (3,3% of GDP). Moreover, the Investment Report of the EIB (2019/2020) shows that the European Union is risking a gradual loss of global competitiveness with slow innovation, adoption of digital technologies and productivity growth. As of the end of 2019, Europe was not home to any of the world's 10 largest internet companies and only one European company were in the worldwide digital top 20. Europe is adding an Artificial intelligence (AI) gap to its digital gap. In June 2020, Europe had only 5% of the world's 483 unicorns – private companies with a value of at least $1 billion – compared with 47% for the US. China had 25% of unicorns (CBInsight, 2020).

The Covid -19 pandemic and the induced global lockdown have caused a sharp slump in the global and EU economies. This crisis also worsens economic disparities across the EU. In such a context, the big fiscal deal agreed at the European Council in July 2020 is a welcome and significant step forward which should strengthen the European Union. This move towards fiscal cohesion and solidarity is real and reassuring. For the first time, the EU will collectively borrow the plan's full amount from the financial markets and repay it from the EU budget over almost 40 years. The shock absorbing role for the EU is a real novelty and this EU fiscal deal may set a precedent for future crises to be met with collective debt.

But Europe also needs much more to fill its infrastructure gap, the goals of climate change, the rise of senior generations and other sustainable goals. Given its size and its duration, the Next Generation EU plan will only partly cover these needs. More will be needed for Europe to escape the current trap of low trend growth. The EU plan is not designed to cover all investment needs but to help low-income countries narrow their gap.

Among other key policies that must be delivered are European Banking Union and Capital Market Union (CMU) without which the EUs' key political priorities will not be able to be implemented. Faced with the "technological war" between the United States and China, Europe must lay the foundations of its sovereignty for the next 20 years. In the field of security and defence, reinforcing technological autonomy is essential. Sovereignty must also be exercised in the field of green technologies, and Europe must become the leader in this area. Technological challenges require a European industrial policy and strategy for technology funding. A holistic industrial policy marrying finance, research, industry, competition, trade, existing local eco systems and education is vital and urgent. The choice is simple: unite our forces to give Europe its economic independence or allow our industrial base and capacity to disappear. In this way, we need to rethink the EU competition policy in order to better protect our critical companies.

Such an EU approach also requires that Member States accelerate their homework and implement strong and credible domestic reforms in order to improve the business environment, the potential growth and the competitiveness of SMEs, facilitate the shift to renewable energies, promote digital services, education and skills and attract private investors whose savings are frozen or misallocated due to uncertainty and lack of confidence.