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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.

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. ●