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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. ●