# Relaunching productive investment in the EU: is NGEU the gamechanger?

## 1. Europe is in a vulnerable situation and is facing a challenging monetary and financial environment at a time when it must achieve considerable investments related to the energy and digital transition

### 1.1 Europe is vulnerable

The Chair stated that Europe is in a vulnerable situation, not only due to Covid, but also because between 2008 and 2020 most advanced economies accumulated piled-up debt, both public and private. Moreover, real gross domestic product (GDP) growth and productivity gains in the euro area have failed to catch up with the US, China and Japan over the past two decades. Productivity gaps across member countries remain significant.

He added that global debt was at an all-peacetime record even before Covid. The debt situation has been worsening with Covid. Public and private global debt, public and private debt of advanced economies, and public and private European debt are higher than before the Lehman Brothers crisis. This vulnerability is occurring when Europe is at an inflection point regarding the green transition. The savings glut will be over after several years. Indeed, Europe has so many investments to produce that the probability of having an excess of savings is very meagre.

### 1.2 A challenging monetary and financial environment

The Chair observed that Europe has a change regarding the monetary and financial environment. Inflation is back in the US and Europe, with the probability of having inflation entrenched for a number of years. It has consequences in terms of real rates because of the progressive evaporation of the savings glut in terms of inflation, which will be much higher than in the past. Nominal interest rates should be higher. Europe, the advanced economy and the global economy are in a very, very demanding financial environment. There is not much importance to the fact that the pickup of inflation puts the real short term rates very low.

### 1.3 Medium to long-term growth depends on today's level of investment

A public representative stated that private investments remaining at a standstill would hamper future growth potential and the EU's economy risks entering a vicious circle. Lower growth potential would cause tighter fiscal rules imposed to governments, leaving them less space to spend and forcing them to cut investments. Higher rates of bankruptcies would generate higher levels of unemployment, making social expenditure more important and generating even more pressure on public productive investments. The rise in unemployment would produce a loss of human capital, hampering the economy's growth potential even more. It is important to act fast.

### 1.4 The growth impact from the green and digital transition may be too optimistic

An official noted that the results from the European Investment Bank (EIB) investment survey suggest that the expectations towards the more permanent growth impact from the green and digital transition may be too optimistic. Regarding green investment, firms require clarity on the decarbonisation path at the national and EU level. The fact that very few Member States committed to structurally change incentives for the green transition suggests that there is room to attract private investors to green activities. It is important not to oversell green investment and digitalisation. Europe's economy is at a critical junction. There may be a tipping point where the savings glut reverses because certain generations will start to retire and draw on their savings. Investment is needed into the green transition and digitalisation; green investments do not add to the capital stock but change the composition of the existing capital stock. That increases inflationary pressure.

An official explained that the second element is timing. By overselling the need for green investments and selling or having incentives that may be right but not well timed, Europe may run into a situation where it underinvests in conventional energy forms. That will create a scarcity, but at that time Europe may not have the capacity of green energy production to fill up the gap. That will create an increasing inflationary push and a problem for European companies needing cheap energy sources.

### 1.5 It is time to accelerate the green and digital transition

A public representative observed that investments into the EU green and digital transition are estimated by the EU Commission at nearly €650 billion per year until 2030. The green transition is complex and has to be taken very seriously by private and public investments. If Europe comes to a situation where it is faced with an energy crisis then the situation will be worsened if it does not have enough alternative sources because it has delayed investment for too long. Europe should not keep delaying the transformation towards a transition.

An expert emphasized that the key challenge is global warming. One of the major dimensions of the European long-term strategy designed by NextGenerationEU (NGEU) is climate. NGEU cannot be disassociated from the Fit for 55 package. Decarbonisation of the planet requires a huge amount of long-term investments. In sectors like steel, petrochemicals, and fertilisers it is urgent to put agreements in place at the global level to phase out refrigerants and important threats on climate change.

## 2. NGEU: a decisive European policy response to the crisis which needs to be completed

The Covid crisis has been tough but the economic policy response has been remarkable. However, the NGEU recovery plan will not be enough to meet the huge amount of investments required for the energy and digital transition. Accelerating private investment is key to make Europe ready for the future. Therefore, the main barriers to investment such as the availability of skilled staff, labour regulation and energy costs need to be addressed. A new EU strategy is also required for financing these investment needs.

### 2.1 NGEU is a unique opportunity to push ahead with structural reforms and fill investment gaps

An official remarked that the crisis response in Europe was forceful and exceptionally successful. Europe saw a strong rebound in 2021, and despite the Omicron wave and global tensions, a strong recovery into 2022 and 2023 is planned. This is an exceptionally good development when examining labour market issues. The NGEU fund has been one important element of the recovery effort. In the short term the NGEU fund helps and supports aggregate demand, fills the investment gap and supports public investment. The NGEU fund also focuses on green and digital transformation. The green and digital transformation of the economy is extremely important. It is expected that there will be an increase in productivity and potential growth. It is estimated that the output levels will be pushed up by 1.5% of GDP in the long run, but the difference will be seen in productivity.

An IFI representative agreed that the EU response was appropriate, relevant, and well designed. The first phase of the response to the crisis was focused on national governments bringing support to companies and providing a backstop to the economy when everything had been shut down and there had been a real risk of collapse of the economy. The EU recovery package focused more on the long-term, key structural issues such as climate, digital and inclusion. The significant challenge is to well implement the package and to use the money well. The EBRD is very active in EU member states in the central and eastern Europe (CEE) region, especially in countries where productivity is lowest and are among the largest recipients of EU recovery funds as a percentage of their gross national income (GNI), such as Greece, Croatia, Bulgaria, and Romania. In 2021 the EBRD invested €2.9 billion in its 12 countries of operations in the EU, almost 100% of it in the private sector.

### 2.2 The implementation challenges NGEU faces remain huge, particularly in CEE

An IFI representative noted that CEE's capital markets are still fragmented, illiquid and need further streamlining to channel the additional private sector funding required to finance necessary infrastructure projects. A robust green recovery and improved access to finance for underserved sectors will be less effective without better technical and digital solutions and further significant capital market reform. The EBRD is well placed to support capital market development and efficiency. It is assisting CEE countries in strengthening capital markets infrastructure, diversifying the local investor base, crowding in private sector investors, and promoting the expanded issuance of securities in domestic markets and in local currency. In Baltic countries the EBRD supported the consolidation of the local stock exchanges and the creation of a pan Baltic capital market. In Poland the EBRD supported the design of a Capital Market Strategy and worked with the Warsaw Stock Exchange to develop new ESG guidelines for companies that want to list on it.

An IFI representative added that the transition to low-carbon economies will be particularly felt by CEE countries, who are highly reliant on coal and fossil fuels. Energy intensity in the CEE region is almost twice as high as the EU average. The main priority and challenge for CEE countries will be supporting a transition that is ambitious but fair. In CEE close to 80% of the EBRD's investments support the green transition.

An IFI representative suggested that NGEU must be an opportunity to tackle key priorities such as institution building to develop project preparation, absorption capacity of the public administration, and the need to adapt regulatory ecosystems to create an enabling business environment. It is equally important that EU resources are channelled towards the most innovative and riskier technologies that require concessional funding and avoid distorting markets.

### 2.3 The creation of an EU Climate Investment Fund (CIF) should help countries meet their common climate goals (CCGs)

An official stated that the undertaking of public investments needs to be executed, including at the national level. When fiscal space becomes thin and when political headwinds flow there may be a step back from public investment. As part of the new fiscal rules framework many people have proposed to protect public investment in green and digital through a golden rule, but a better proposal is to have an EU CIF. A CIF will allow identification and coordination of cross border investment with the highest rate of return where the investments should go. It will protect investments achieving the fastest reduction at the lowest cost. The CIF should have borrowing capacity, because the curve of public investment on climate should be frontloaded. This borrowing capacity will help to protect member countries in their fiscal space and will continue to increase safe investments. Europe needs a strengthening of green public financial management systems.

A participant noted that it is vital to channel more savings and investment into climate and infrastructure as fast as possible. He asked an official to what extent he sees value added to the existing, efficient institutions which are channelling that on behalf of the EU, such as the EIB and the EBRD, and whether setting up a new institution or fund will take time. The official explained that the concept of a CIF and how it is formed are two different things. When countries are being confronted with a political headwind and a lack of fiscal space then public investments may not materialise, so the advantage would be to think about a more central organisation.

### 2.4 More is needed to meet investment needs, as well as additional steps to include private investment

An official noted that the NGEU has a focus on climate, but it is insufficient in terms of supporting the climate transition. Total annual investments of 3% of GDP are needed for the foreseeable future. Most of these investments will come from the private sector, totalling 2% to 2.5%, and the incentive structure for those investments needs to be in place. 0.5% to 1% of GDP annually is expected to come through public investments from the public sector. NGEU has a 0.2% annual contribution for five years.

Another official underlined that additional steps may be needed to crowd in private investment, notably with a view to addressing skills gaps and inefficiencies in labour and product markets and the public sector. Mobilising private capital through further developing equity and venture capital markets and increasing the efficiency of insolvency systems is also important. Clarity on the path towards CO2 reduction and appropriate tax incentives are key to capitalise on the stimulus from NGEU.

An IFI representative observed that it is important to avoid crowding out the private sector in the implementation of the package. Last year's EBRD transition report shows that a return to the state is being seen in many countries. A last resort financer is needed, but Europe needs to be careful that it is not crowding out the private sector. Public money is important but private sector financing is also needed. Europe needs the development of capital markets, which is a very important theme in the context of Eurofi.

An IFI representative added that the EBRD is intervening in countries where financial market financing is very limited. The focus is to develop the policies, but also to intervene in terms of how small and medium-sized enterprises (SMEs) or private-sector companies can be supported to access the market and have capacity through equity. More equity is needed. The EBRD also intervenes in financing bail in-able debt, because that is a huge obstacle for implementing the banking union regulation and post 2008 crisis regulation in many countries.

### 2.5 Addressing the main barriers to investment is critical

An official explained that he has directly talked with industry and private companies in trying to find out what is creating obstacles for companies to engage in productive projects. To make a project profitable and to show some return, several factors are needed. Factors that are deterring companies at the moment include inflation, especially in raw materials, inputs becoming too expensive, energy, a lack of skilled labour and supply bottlenecks.

### 2.6 A new EU strategy is required for financing the huge investment needs

A public representative stated that everyone wants to move in the same direction but a different strategy may be needed. At the beginning there was an impetus driven by certain emergencies when the Banking Union was created, but in the past few years it has come to a standstill. Europe has a huge need of investments. When the pandemic started Europe realised how impossible it would be for many sectors to move forward without a certain degree of digitalisation. Urgent policy objectives are in place. NGEU was made to support these processes. Investments needed for the ecological transition and digital transition are in the range of 600 billion per year, of which 125 billion is for the digital transition. Europe needs to think about how to fill the gap in investments and about ways to continue supporting governments and public investments.

A public representative added that the approach should be focused on the problem and the objective, and not only on the instruments, on the tax and on the labels that have been dividing Europe in recent years. That has been seen with the NGEU and with the Recovery and Resilience Facility (RRF). Europe has billions and billions in savings that can be channelled towards these objectives, but it is vital to find the ways to use it and to create the infrastructure. Incentives are needed to channel these resources.

## 3. How to relaunch investment if savings are not remunerated or even taxed?

An expert does not see the incentives to push investment in the coming years. Long term interest rates in Europe are very low. 25% of bond stocks are still negative in terms of remuneration. If Europe maintains a very low interest rate environment it is difficult to see how the private money will come in. The key question is to get private money in those large investments. Finance is always a balance between risk and remuneration. The higher long term risk, the more a company has to receive remuneration. Buying back shares does not produce anything in terms of long term investment.

An official noted that what was just described is a version of the liquidity trap. Risk premiums are so compressed that it does not make sense to invest in risky projects because the returns are not commensurate. The situation is changing, which should also change the yield curve. Regarding the Capital Markets Union (CMU), Europe has investigated whether a bank based system or a market based system is better for growth, but there is no conclusive evidence one way or the other. If an economy wants a lot of risky, innovative firms that people invest in then a market based system does the job better, but a bank based system is better at intergenerational risk and return smoothing.

An official added that Europe will see a decompression of risk premia with the normalisation of monetary policy. However, real interest rates have decreased for the last 30 years. Lower real interest rates are expected for the future, but the decompression of the risk premia through the normalisation of policy is something that is also expected to happen.

The Chair is unsure whether real interest rates in the next 30 years will be where they were in the last 30 years. The real fall of real interest rates is more recent.

The central banks of the advanced economy had to cope with exceptional circumstances in the last 12 years, but the US and Europe are now in a different universe. The purchase of credible securities will stop at the end of March in the United States. There will be a more normal financial environment with the combination of inflation of real interest rates potentially picking up.

An expert observed that one of the most complicated issues for economists is how the interest rate is formed. The interpretation given by both economists and policy makers is that Keynes stated there was a lack of investment and a savings glut. That approach led to demand push and consumption push policies, meaning that there must be a reaction when there is a downturn.

## 4. The price of carbon over time is a key success factor

### 4.1 The need for a stable and predictable price of carbon

An expert stated that the EU has set a model for the world to fight climate change as it intends to put in place a carbon border adjustment mechanism (CBAM). The European platform for climate is of major interest for the EU because it creates the best environment to launch long term net zero investments. One of the most important conditions for success is to have a stable and predictable price of carbon over time. It is not possible to exclude the scenario of an economic downturn and downward pressure on the price of carbon. The EU should not allow the price of carbon to go down; the best policy for climate change would be for Europe to maintain the long run price of carbon at €100 per tonne. The European CBAM needs to be put in place by 2026 in order to be the trigger for the rest of the world to adopt a similar device for decarbonisation of the main carbon emitting industrial sectors in the world.

An official noted that CO2 pricing is a way of dealing with externalities as it employs market forces.

An IFI representative agreed that the energy transition will be extremely difficult without a carbon price, because that is the market mechanism that makes investment bankable. If there is no carbon price then subsidies are needed, which Europe cannot finance.

The Chair emphasized that it is important to be practical and not to create a complex scheme that will not work with the private sector. All speakers have observed that pre Covid Europe had a high level of savings and a current account surplus, but that is not the kind of investment that would fit with the excess of savings that has been observed. Europe had an excess of savings but did not do what it should have done.

### 4.2 The Carbon Border Adjustment Mechanism is an essential tool for climate change

An expert underlined that more public investment for climate is needed. If Europe does not find the right incentive for the private sector to be mobilised very decisively then it will fail. There are constraints on public finance, given the level of public debt. There will always be reasons to limit the amount of public investment, even for climate. The problem with climate is that it is a very long-term problem. It is vital for the European Commission to use the CBAM[1], as it can be a lever of extreme strength to push the rest of the world in the sectors concerned to go in the right direction of making an investment to start decarbonisation.

An IFI representative highlighted the challenge of being alone in this field in terms of competition, which is why the CBAM is vital. The CBAM is very technical and complicated. The practical impact is uncertain, but in countries such as Turkey and Ukraine a discussion about CBAM creates a strong incentive for companies to adjust, to improve their energy efficiency and to deal with this issue in order to be ready.

The Chair thought more discussion would have taken place regarding medium term impacts such as monetary policy changing in all advanced economies, real interest rates picking up due to the functioning of the global economy, and inflation being entrenched at a higher level. The hope is that in the medium term the advanced economy will be at 2%, because that is the joint definition of price stability by all important central banks in the advanced economy. In Glasgow the International Sustainable Standard Board (ISSB) was created to address environmental, social and governance (ESG) standards. It is important to have a consensus of the international community on the ISSB, which would be located in Frankfurt, Montreal, Beijing, and Tokyo.

1. Designed in compliance with World Trade Organisation (WTO) rules and other international obligations of the EU, the CBAM system will work as follows: EU importers will buy carbon certificates corresponding to the carbon price that would have been paid for the goods been produced under the EU's carbon pricing rules. Conversely, once a non-EU producer can show that they have already paid a price for the carbon used in the production of the imported goods in a third country, the corresponding cost can be fully deducted for the EU importer. The CBAM will help reduce the risk of carbon leakage by encouraging producers in non-EU countries to green their production processes.
The CBAM will initially apply to imports of the following goods: cement, iron and steel; aluminium, fertilisers and electricity. To provide businesses and other countries with legal certainty and stability, the CBAM will be phased in gradually and will initially apply only to a selected number of goods at high risk of carbon leakage: iron and steel, cement, fertiliser, aluminium and electricity generation. A reporting system will apply from 2023 for those products with the objective of facilitating a smooth roll out and to facilitate dialogue with third countries. Importers will start paying a financial adjustment in 2026.