Addressing Europe's investment needs

The Chair stated that Mario Draghi published a report on the economic challenges facing the EU, which is struggling to keep up with dynamic productivity growth. This is linked to the challenges of aging populations, climate, digital transition, geopolitical risk and market fragmentation. The report recommends a step change in the levels of public and private investment. Private investment is substantially below the levels seen prior to the global financial crisis and Covid. Public investment has improved as a result of NextGenerationEU (NGEU) since 2019, but Draghi recommends substantially higher levels especially of private investment.

1. Europe suffers from a lack of skills, economic invertibility and energy costs

The Chair noted that European firms have underinvested in productive capacities relative to US peers since 2008 and is losing ground relative to fast growing emerging economies. Over this period, EU firms have faced a macroeconomic, financial and regulatory environment that has proved less favourable to investment and innovation.

1.1 The easy monetary and fiscal stance of the last 20 years has discouraged productive investment in the euro

A market expert observed that economic disparities in living standards between euro areas have widened considerably since the launch of the euro as investment has lagged behind. Europe lags behind the US in terms of productive investment, research and development, and size of firms. Only 40% of NGEU funds have been disbursed, and this is partly due to the lack of private sector projects. There has been a slow deterioration as states have opted for economic models that are detrimental to the supply side of their economy. This has contributed to a loss of economic dynamism and has consolidated Europe's position behind the US in terms of growth, productivity and investment. Since the 2008 financial crisis, most member states have focused on stimulating private demand through public spending. Fiscal policies have sought to preserve household consumption at the expense of productive investment, leading to a slowdown in productivity growth.

With interest rates remaining at zero for an indefinite period, investors have been discouraged from investing in risky projects and have turned to high-yielding speculative assets. Low or negative interest rates induce a state of mind that decreases the propensity to invest. In what John Maynard Keynes called the 'liquidity trap', investors play safe by placing savings in short-term instruments as longer-term low interest rates generate inadequate returns for higher risks.

A significant proportion of European savings has moved outside Europe, in particular to the US, where interest rates are consistently higher. Despite interesting and valuable initiatives, the situation is deteriorating to such an extent that the large additional investment recommended by Draghi may not materialise.

1.2 Europe has lost the IT revolution

An industry representative cited Mario Draghi's suggestion that Europe needs €700 billion to €800 billion annually to face its ecological, economic, security-related and sovereignty-related challenges. Europe's 2023 savings surplus was €370 billion, representing 2.6% of GDP. However, most of these savings are invested in the US and need to be redirected.

The difference in growth between the US and Europe can be explained by the gap between investment in new technologies, which amounts to 5.8% growth in the US versus 2.8% in Europe. Furthermore, the gap with China is becoming more obvious. China is dominant in 57 technological research areas. The principal reason for the gap with the US is that it is less risk averse than Europe. 80% of US institutional portfolios are invested in equity versus 40% in Europe.

Europe's savings need to be channelled more effectively, with a focus on long-term investments. This can be achieved by providing the right incentives (standardisation, simplification and improvement of the quality of available financial and extra-financial information, appropriate regulatory framework, financial and tax incentives where necessary), while ensuring the necessary protection in return for increased risk-taking.

1.3 Europe has lost the IT revolution

One IFI representative said it was positive that investment was a top priority for the new Commission. The EIB is one of a number of institutions that have stressed the need for more productive investment in Europe.

The main obstacles to public sector investment are planning and implementation capacity, not a lack of public resources. The Recovery and Resilience Facility (RRF) and other resources could be used. In the case of renewables, slow and complex permitting procedures in Europe and the US are hampering the deployment of new technologies. Draghi also says that the size of the EU market matters. More integration is needed, which means regulatory harmonisation, consolidation of companies and coordinated procurement.

When it comes to private sector investment, the EIB's recent survey of companies points to three main obstacles. The first is the lack of skills, economic uncertainty and energy costs. This means that new technologies and innovations are not used and activities in traditional sectors are not developed. The second is business regulation, which is cited as the main obstacle by 60% of companies surveyed. Regulations and consumer laws have made it difficult to trade across borders in the single market. The third is the ability to finance scaling up. Companies in Europe targeting valuations between €500m and €10bn are constrained by

the lack of availability of finance. As a result, companies often list in the US or are acquired by US investors. Instruments are being explored to support the growth of these companies in Europe.

1.4 Europe lacks venture capital investment

An official explained that 99% of EU businesses are SMEs, employing around 100 million people, or a third of the workforce. Start-ups and SMEs in Europe rely on bank financing. In the US, companies find angel investors and then sell shares to grow the business, which increases their valuation. The EU needs a funnel of angel investment, venture capital, private equity and IPOs. This flow has dried up and there are fewer IPOs.

Europe lacks venture capital investment, which is five to seven times greater in the US. To get money into European companies, you need to invest pensions. Some European countries have pension systems that channel money through defined contribution schemes, but many countries have defined benefit schemes.

Insolvency regimes need to be sorted out. Winding up and getting money back is different in each European country. On securitisation, the US has projects to buy yellow and pink paper from SMEs, which are high-risk, high-return investments, which is not happening in Europe.

1.5 Unfavourable demographics and structural rigidities limit business dynamism and undermine productivity in Europe

An industry representative pointed out that Europe is ageing and older people are more risk averse, which is one reason for the problem of risk taking and long-term investment. There has been a relentless production of norms, standards, procedures and regulations that have demonstrated the extent to which fear of risk has permeated society.

A central bank official said that recent research on productivity outcomes after the pandemic points to some striking differences across countries. US productivity has grown quickly because labour productivity has traditionally been countercyclical in a recession, rising there while typically falling in other countries. Another key development is investment: US has seen quite robust activity while a gap relative to pre-pandemic trends opened up in others, including Europe.

A key driver of these differences is that the US has a dynamic and flexible economy. This is evidenced by structural measures, labour flexibility and the ease of starting a business and access to credit, all of which are designed to generate churn and stimulate the economy. There was a general shock during the pandemic. The US approach was to extend unemployment benefits. Other countries used job retention schemes to maintain relationships between employers and employees. In the medium and longer term, if the shock is not permanent and there are no further shocks, there are productivity benefits from job retention schemes because there is no erosion of skills. However, with the energy shock in Europe, the cleansing effect of firing and hiring and the reallocation of resources across sectors became more important. Resources had to be reallocated. The lack of reallocation and dynamism hurt productivity in Europe.

2. Policy recommendations for the next EU political cycle

Speakers focused on European solutions to revive productive investment in Europe. A stable and predictable macroeconomic environment is essential. Deepening the Single Market significantly reduces constraints on business growth and should be prioritised. Progress on the Capital Markets Union (CMU) is also essential to ensure that capital can flow where it is most productive.

The main challenge is the misallocation of available funds, which is hampered by the prohibitive costs of operating in different jurisdictions, complex regulations and tax treatments, accounting and bankruptcy frameworks and supervisory rules. These costs are a particular problem for start-ups in accessing venture capital and scaling up. The RRF could encourage public and private productive investment. In addition, it would be valuable for Europe to design and implement a real industrial recovery plan.

2.1 Investment requires a stable and predictable macroeconomic environment

A central bank official stated that central banks aim to maintain and preserve macro-financial stability. Without low and stable inflation and a predictable macroeconomic outlook, Europe cannot have well-functioning, resilient financial markets and investment. Central banks have a powerful tool in monetary policy, but it is possible to do too much and face unintended conserquences. Pushing the economy too hard through fiscal policy creates vulnerabilities, misallocations and the risk of a financial crisis. The sound policies that central banks and fiscal policymakers can implement are the foundation for economies to achieve their potential, but structural policies are the key to prosperity.

2.2 The EU must address critical investment needs through a comprehensive economic strategy

One official said that there seems to be a consensus about the diagnosis regarding the EU's deteriorating competitiveness. The right therapy, however, is still to be agreed. The discussion on European competitiveness cannot be limited to the financial sector, because finance is a tool rather than the goal of improved European competitiveness and productivity.

The Hungarian Presidency's planned competitiveness package to be presented in the coming months will be based on three pillars. The first aims at promoting a clean and digital transition, in which the improvement of the internal market is key. Connectivity and infrastructure links within the EU is an underdeveloped European public good, it must be improved. The first pillar also includes a targeted industrial policy, which should be combined with well-focused support policies. Burdensome over-regulation should be streamlined and made transparent and predictable.

The second pillar addresses labour shortages and demographic challenges and promotes innovation through targeted investment in research and education, extension of Erasmus and Horizon programs to all students and researchers

The third pillar deals with public and private financing. Cohesion policy, as a regional and cross-border equaliser in the single market, should be one of the main channels for competitiveness. Underdeveloped regions are an obstacle to greater EU competitiveness, as a more homogeneous economic area will mean a more competitive background.

Better mobilisation of European private savings for investment could improve productivity by accelerating the CMU and the Banking Union (BU). The CMU process should take into account the need to better educate EU citizens about investing, the different levels of capital market development and the diverging investment cultures and patterns of savings and. €250 billion a year leaves the EU on net basis due to a lack of good investment opportunities. This should be kept within the EU that would be an achievement.

2.3. Implementing the CMU

2.3.1 The use of pensions and private savings, supported by a standardised infrastructure and harmonised tax procedures, can bridge the gap to a more effective market system

One industry representative commented that a key mistake in comparing US and European financial and capital markets is to focus too much on public sector interventions such as the Inflation Reduction Act (IRA) and the NGEU. The depth and breadth of private sector capital in the US is the key to what is needed in Europe, not public sector spending. Europe should not aspire to the US public sector. The answer is private capital.

The Letta report says that €300 billion a year leaves Europe and is mostly invested in the US, largely because there is no harmonised European approach to workers' pension savings going into European stock markets. This is a policy measure that could be taken. You can argue about what market infrastructures should look like, including the CMU and the number of central counterparties (CCPs), but these ownership decisions are difficult to correct from a political point of view. A European pension product would unlock much of the €300bn. Letta suggests that a savings and investment union would be easier than a CMU. A pan-European pension scheme would unlock private capital and not require public spending.

2.3.2 Delivering bigger, more efficient and more liquid capital markets will eliminate some of the major obstacles on the road to greater productive investment

An industry representative noted that there has been movement on productive investment and better underwriting across the EU, but there is still work to be done. The US has a deeper and more developed securitisation market. Doing the same in Europe for SME loans and commercial bank loans would help move forward the CMU that the EU needs to complete. For BNY to operate in each custody market, individual custody licences and depositories are required. This means that small, medium and some larger European markets will not be served.

For cross-border investments within Europe, a company investing in more than one country will face different procedures for reclaiming cross-border tax certificates. This can be resolved politically and has been resolved in relation to VAT, where there is a European framework that works very well. Adjustments for VAT on cross-border transactions cannot currently be made for equity and bond investments.

One official suggested a common European approach to market supervision to support CMU and safe assets. The ESM, EIB and the EU are issuers of safe assets, with a figure of €1 trillion in the market since April 2024. If all of the NGEU and ESM were used, a figure of €3 trillion could be reached.

A central bank official agreed that the Banking Union and the CMU need to be completed as a priority.

2.3.3 Pioneering new financing instruments to serve as building blocks for a CMU

An IFI representative explained that the EIB had adopted a new strategic roadmap. More than 50% of the EIB's annual business is related to climate action. The roadmap also includes the need to promote increased competitiveness, security and defence, digitalisation and innovation, as well as more traditional elements such as strengthening cohesion policy and mobilising funding for agriculture and infrastructure.

The new Commission will have new investment initiatives and legislators will develop frameworks that are simpler, less bureaucratic and easier to implement, allowing for stronger partnerships with actors such as national or regional development banks. There is a need for initiatives that allow the creation of products that can be scaled up on a pan-European basis.

The European Investment Bank Group will launch new financing programmes to support investment in cutting-edge technologies and infrastructure. The Strategic Tech-EU programme aims to strengthen Europe's strategic autonomy, home-grown innovation and productivity growth.

The Strategic Roadmap will replicate the model of standardised financial instruments to leverage private investment. With public finances under pressure, Europe needs to ensure that all public funds have an impact. The European Investment Bank Group has a unique capacity to leverage public and private investment. With a paid-up capital of EUR 22 billion, the EIB Group has mobilised EUR 5 trillion of investment. There is a new momentum for the CMU that should be harnessed. Lessons from pioneering innovative finance can also catalyse private sector investment. Experience with green bonds has led to new products that will make it easier to face external competition.

2.4 The Recovery and Resilience Facility (RFF) is reinforcing Europe's competitiveness

A policy maker explained that the Recovery and Resilience Facility (RFF) was created to support the recovery from the Covid crisis and to make Europe more resilient. In the spring of 2024, the European Commission published a mid-term review and assessment of its implementation. Bond spreads narrowed when it was announced that the Commission would issue joint EU bonds to finance the NGEU, helping to avoid fragmentation within the single market. The gradual funding of Member States as they

implement the measures has helped to maintain or increase public sector investment. Allocations to Member States have varied according to their economic situation.

Member states have invested in EU policy priorities: digital, green, infrastructure, transport and skills. Under the Recovery and Resilience Plans, key public sector investments will be implemented until 2026 and funds will be disbursed to Member States as they implement reforms. The main reforms affecting public investment are public procurement reforms, simplification of public administration and public services, digitalisation of administration to simplify procedures, reforms to support the green and digital transition and key structural reforms.

Overall, the RRF maintains and increases public investment. More than €265 billion has been disbursed and Member States are on track to implement the reforms and investments that will help Europe become more resilient

One lesson is that public investment is not all that is needed. The NGEU has provided direct financial support to around 1 million enterprises, but the business environment is even more important. Some Member States are introducing reforms to create a business-friendly environment, reducing regulatory and administrative burdens and barriers to entry to stimulate competition. Investment in skills is also needed. The Commission is considering incentives for such investment. The Important Projects of Common European Interest instrument has been funded, stimulating investment in hydrogen, micro-enterprises, cloud infrastructure, health and other areas.

2.5 Promoting productive supply policy

A market expert said that the aim was to reverse the trend towards under-competitiveness, under-use of available financial instruments and under-investment. Investors must be rewarded for the risks they take. Businesses need to be able to propose projects and innovate. Start-ups need help to scale up and find buyers in Europe.

A favourable environment for business and private capital is needed. This requires a change of criteria in competition policy, which has so far focused on assessing effects on the European market. The global market needs to be taken into account in strategic sectors and European champions need to be encouraged. Europe has an Integrated Policy Crisis Response (IPCR) that needs to be strengthened and used. Many proposals have been made to extend and enforce the CMU. It is also important to promote securitisation procedures to help banks play their role in the right capital market. The aim is to have a real supply-side policy and a selective industrial policy. This implies a complete change of paradigm.

One industrialist noted that liberal economists and business leaders have called for the withdrawal of the state and public bodies from the economy. However, public and semi-public authorities have an important role to play. National development banks and institutions (NPBIs) are a bridge between policy objectives, targets and market practices. Public money should be a catalyst for private money. There can be no sustainable growth without social harmony. Regional cohesion is key to growth in Europe and will be part of the challenge in the future.

2.6 The new fiscal rules agreed at the European level are compatible with supporting adequate levels of public investment

An official stated that the new fiscal framework is more supportive of public investment than the former ones. It allows a return to the required deficit and debt level at a slower pace, as a trade-off between growth and the cost of corrective measures. New public investment can increase growth and three years additional time may be "purchased". Recognising the potential medium-term benefits of public investment in improving the fiscal stance is a step in the right direction. But there are risks involved. The scheme has been rushed through and not all the details have been worked out precisely, leading to a 'learning by doing'. There have been some worrisome experiences with the NGEU and the RRF identified by the ECA. Thus, the foreseen combination of the fiscal governance reform, the European Semester recommendations and the RRF could lead to a more bureaucratic and less efficient outcome. The bilateral dialogue between the COM and the MS about the fiscal path my lead to bias. National ownership remains key, the new rules seem to be more flexible in this regard. However, application of double standards vis-à-vis Member States should be avoided. It is crucial to ensure equal standards for each member state in implementation of the new rules.