The EU Growth Challenge and the Investment Plan for Europe

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• The EU competitiveness Challenge
• The EU Investment Outlook
• The EIB and the Investment Plan for Europe
A (slow) recovery path

Real GDP growth

Source: EC Winter forecasts 2015, EIB calculations

Real GDP growth: green if GDP level year x above 2008, Red otherwise.
A two decade long decline in competitiveness

Real GDP per capita developments in Europe, US and Japan
(in purchasing-power and inflation adjusted international dollar, 2013)

The crisis has not only had a cyclical impact on EU growth. It has also substantially reduced Europe’s long term growth potential estimates

Estimates of potential growth
(in percent)

Source: European Commission, AMECO

Source: IMF, WEO
Potential growth is the challenge

Change in real potential GDP growth  

Source: EC Winter forecasts 2015

*Nb:* Potential GDP (PGDP) is the amount of GDP that an economy is able to produce if it employs all its workforce, leaving only a small number of unemployed people (NAWRU), utilise all of its productive capital and combine these two inputs (capital and labour) in the most efficient way available to it. TFP, Capital, Workers and Hours in the legend of the left hand slide stand for contributions of total factor productivity, services of capital, number of workers and hours per worker to the growth of PGDP.
Europe’s R&D intensity is persistently lagging behind that of other leading economies, hampering the EU’s ability to innovate.

- An additional **€130bn** a year needs to be invested in R&D to meet the EU target of 3% GDP.
- More than **30% less patents** are filed per EU citizen than per US citizen.

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**Gross domestic expenditure on R&D (in percent of GDP)**

- EU
- USA
- JPN
- KOR
- CHN

**Patent Applications (Number per 1 million inhabitants)**

- South Korea
- Japan
- US
- EU

Source: OECD

Source: World Intellectual Property Organization; Comparability across countries is limited due to differing patenting systems.
Capacity for change: innovation

Heterogeneous R&D intensity...

... with the crisis having an impact on some of the leaders

**R&D intensity by Member State**
(in percent of GDP)

**Change in R&D intensity**
(in percentage points)

Source: Eurostat
EU firms are slow at absorbing new technology. Keeping up with latest technologies in the advanced manufacturing sector will require an estimated additional €90bn a year.

**Examples for modernisation needs**
- IT upgrades and transition
- Modernisation of capital stock in manufacturing sectors
- Factory automation and integration of IT systems

The share of fast growing firms is more than **25% lower** in the EU than in the US.

**Share of firms by growth brackets, EU-US comparison**

Source: Bravo-Biosca, Criscuolo, Menon (2014), What drives the dynamics of business growth, Nesta Working Paper 14/03, Europe here corresponding to the average of AT, DK, IT, NL, ES, NO, UK
The EU’s competitiveness gap is the result of wide-ranging shortfalls

The building blocks of competitiveness

Wealth creation

- Productivity
- Prosperity
- Trade

Capacity for change

- Innovation: RDI investments, Commercialisation
- Absorption: Uptake of innovation

...within firms

...across the economy

Economic dynamism: Ability to grow, Substitution of less competitive firms

Strategic sector presence

Enabling environment

- Institutions & markets: Competition, Flexibility, Regulations, Integration
- Financial sector: Financing innovation and growth, Venture capital, Capital markets
- Human capital: Skills, Health
- Infrastructure: Transport, Energy, ICT, Environment

Wealth creation → Prosperity → Trade

Capacity for change

Enabling environment
Enablers of competitiveness: financial system

Shortfalls in the ability to finance growth

- Europe’s largely bank-based and fragmented financial sectors face challenges in financing young innovative firms. Banks’ deleveraging needs exacerbate this problem.

- In Southern and some Eastern Member States, more than 20% of SMEs identify access to finance as their most pressing problem.

- Stock market capitalisation in the EU is not only about half the US size; markets are also highly fragmented.
Shortfalls in human capital development

- Europe’s economy, which is based on knowledge-intensive manufacturing and related services, will generate a growing demand for young people with excellent post-secondary training and a relevant skill-set.

- Nevertheless, the EU spends only slightly more than 6% of its GDP on education compared to the US and South Korean education spending of around 7.3% of GDP.

- Despite its importance for a knowledge-intensive economy like the EU, the gap is most pronounced in tertiary education, where EU spending is more than 40% below US or South Korean levels.

Source: OECD
The EU’s competitiveness gap: infrastructure

### Annual shortfalls in infrastructure investments

- **Additional € 100bn** to upgrade energy networks to integrate renewables, improve efficiency and ensure security of supply.
- **Additional € 50bn** to upgrade transport networks to reduce congestion costs and trade bottlenecks.
- **Additional € 55bn** to reach the EU’s Digital Agenda standards in broadband and data centre capacity.
- **Additional € 90bn** to rehabilitate environmental services and ensure water security in the face of climate change.

### Examples

- Reinforced and smarter grids
- Improved interconnections
- Energy efficiency of existing buildings
- High-efficiency combined heat and power
- Offshore wind capacity
- Motorway reconstruction & widening
- Urban bypasses
- Rail corridors
- New container and LNG terminals
- Airport capacity and air traffic management
- Fibre-based and mobile (4G) broadband
- Open networks in thinly populated areas
- Large and secure data centres for intra-EU IP traffic
- Secure ICT applications for SMEs and public administration
- Flood risk protection
- Water network, waste water treatment and water efficiency
- Material recovery
The EU’s competitiveness gap is the result of wide-ranging shortfalls

**Annual shortfalls – examples**

<table>
<thead>
<tr>
<th>Category</th>
<th>Example</th>
<th>Estimate (EUR bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Innovation and modernisation</strong></td>
<td>R&amp;D investment:</td>
<td>130</td>
</tr>
<tr>
<td></td>
<td>Industrial modernisation:</td>
<td>90</td>
</tr>
<tr>
<td><strong>Finance for growth</strong></td>
<td>Net bank lending:</td>
<td>55</td>
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<tr>
<td></td>
<td>Venture capital financing:</td>
<td>20</td>
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<tr>
<td><strong>Human capital development</strong></td>
<td>Educational facilities:</td>
<td>10</td>
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<tr>
<td></td>
<td>Educational operational spending:</td>
<td>90</td>
</tr>
<tr>
<td><strong>Infrastructure investments</strong></td>
<td>Broadband and data centres:</td>
<td>55</td>
</tr>
<tr>
<td></td>
<td>Energy:</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>Transport:</td>
<td>50</td>
</tr>
<tr>
<td></td>
<td>Environmental rehabilitation:</td>
<td>90</td>
</tr>
</tbody>
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*Compared to pre-crisis flows

**Compared to US VC financing flows

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Depressed investment, below depreciation

- structural impediments
- lack of confidence
- need of reallocating resources
- low risk bearing capacity in the system
- in some cases impaired access to finance (SMEs)

Source: EIB Investment and Investment Finance 2015
A world of low interest rates

Yield Curves

Eurozone AAA Sovereign Bonds
Index various dates

- 04/06/2014
- Pre QE announcement (1/21/2015)
- Post QE announcement (1/23/2015)
- Post Start QE implementation (3/10/2015)

Source: Bloomberg
The current need to provide risk-bearing products varies across Europe

Depicted variables and sources:
**Short-term fiscal**: Sovereign ratings (S&P, Moody’s and Fitch)
**Medium-term fiscal**: EC medium-term sustainability indicator (2014)
**Banks**: Capital adequacy ratio under the ECB asset quality review adverse scenario
**Corporates**: Private sector deleveraging needs in Europe as estimated by Cuerpo et al. Journal of Economic Modelling 2015
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The EIB at a glance

- Shareholders: the 28 EU Member States.
- Raise funds on the international capital market and pass on favorable borrowing conditions to clients.
- Support projects that make a significant contribution to growth and employment in Europe.
- Activities focus on four priority areas: innovation and skills, access to finance for smaller businesses, climate action, strategic infrastructure.
- Some 440 projects each year in over 160 countries.

The EIF at a glance

- Shareholders: EIB: 62.2%, European Commission: 30%, Financial institutions: 7.8%.
- EU specialised institution for SMEs risk financing.
- Debt finance: structuring and guaranteeing portfolios of SME loans/leases and microcredit.
- Equity finance: venture capital and mezzanine (fund of funds).

- Multilateral Development Bank (MDB) status, Basel III 0% risk weighting, Aaa/AAA/AAA ratings (Moody’s/S&P/Fitch).
Lending priorities

20.6bn EUR
STRATEGIC INFRA-STRUCTURE

25.5bn EUR
SMALLER ENTERPRISES

19.1bn EUR
CLIMATE ACTION

14.7bn EUR
INNOVATION AND SKILLS
Lending outside EU in 2014: EUR 8bn

Total EUR 77bn

- European Union EUR 69bn
- Outside EU EUR 8bn
  - EFTA & Enlargement Countries EUR 2.5bn
  - Eastern Neighbours EUR 1.2bn
  - Africa, Caribbean, Pacific, South Africa EUR 1.2bn
  - Southern Neighbours EUR 1.7bn
  - Asia and Latin America EUR 1.4bn
The Investment Plan tackles all those - a concerted action to create an environment conducive to investment

- Generate an environment conducive to investment
  - Structural reforms to generate an innovation and investment friendly environment
  - European market integration (institutionally and physically), creating competitiveness enhancing investment opportunities

- Public support, via the EFSI and EIB activity, can help to kick-start
  - Public stimulus targeting competitiveness-enhancing investments with positive spill-overs like research, development, innovation, skills and infrastructure
  - Targeting commercially sound, economically and technically viable projects and trying to avoid market distortion (new focus on smaller projects, not only targeting market leaders)
  - Turning grants into catalytic financial instruments. As public stimulus will cover for some of the risk taking, abundant market liquidity will be attracted in an easier way
  - Advisory and coordination of project preparation
Going forward: European Fund for Strategic Investments (EFSI)

EU Guarantee EUR 16bn

EIB EUR 5bn

EFSI - European Fund for Strategic Investments EUR 21 bn

Infrastructure and Innovation Window EUR 16bn

Deployed by EIB

Financing: approx EUR 49bn

Final investments EUR 240bn

SME Window EUR 5bn

Deployed by EIF

EIB Group leverage

Catalytic effect

Financing: approx EUR 12bn

Blended multiplier effect of x15

Final investments EUR 75bn
Concerted approach of the “Investment Plan for Europe”: fiscal sustainability, structural reforms, and the European Fund for Strategic Investments (EFSI)

Bundling of 21 billion EU level equity (supporting risk-absorbing financing volumes of around EUR 60 billion), of which EUR 16 billion EU budget guarantee that will require some provisioning from existing budget lines (max. EUR 8 billion) (from grants to loans).

Enhanced EC-MS-EIB cooperation including through initiatives like the “project identification task force”, closer cooperation with national promotional banks and a reduction of red tape in the use of EU funds.

Evolution of financial products mix offered by EIB group: complementing classic high-volume/low-risk EIB products with more capital intensive higher risk-bearing financial products providing a higher catalytic effect, ranging from high risk senior debt to equity.
Evolution of the financial product mix of EIB group

Ratio of total supported investment cost over employed EIB capital (multiplier)

**EIB “Standard”**
- Internal leverage on EIB capital: 6x
- Catalytic effect of EIB financing: 2.5x
- Final multiplier: 15x

**“Special Activities”**
- Internal leverage on EIB capital: 3x
- Catalytic effect of EIB financing: 5x
- Final multiplier: 15x

**Equity type**
- Internal leverage on EIB capital: 1x
- Catalytic effect of EIB financing: 15x
- Final multiplier: 15x

Focus of capital increase activity*

Focus of EFSI supported activity

* With some increase in special activity, actual multiplier of capital increase supported activity is now expected to be greater than 18x

** Quoted multipliers are for illustration only
Does it matter?

- The investment plan is just **one of various elements** to support investment.

- It concentrates on a specific subset of investments – investments in **merit goods**.

- EUR 105 bn is
  - 0.8% of GDP
  - 3.9% of investments
  - 25.9% of public investment
  - **11.8%** of investment in target areas (sum of R&D, technology adoption, education infrastructure, transport, energy, environment, broadband and data centres).

- Structural reforms
- QE and oil prices helping on growth.
Thank you!
Potential benefits from EU market completion

- Achieving an integrated market for goods & services, capital and labour has the potential to improve EU consumers’ welfare and firms’ competitiveness, and attract FDIs through several channels:
  - increased size of the market: efficient global value chains, larger pool of consumers, economies of scale, improve investment opportunities…
  - stiffer competition encouraged by lower entry barriers: exit of less efficient firms, lower prices, wages and borrowing costs, diversification of products leading to enhanced quality and R&D…
  - direct cost reductions due to the abolition of border formalities and national regulations: harmonisation of standards facilitating intra-EU trade…

- Estimated impact on EU GDP:
  - Structural reforms in EU and EA could increase output by around 7% after 10 years, with higher employment and improved fiscal positions.
  - In the short run labour market reforms (increased participation, active labour market policies, and benefit reforms), tax reforms (shifting taxation towards indirect taxes) and product market reforms (higher competition in services sector and lower entry costs) have the largest effects
  - Skill-enhancing and R&D promoting policies have a major impact on GDP in the very long run, and account for more than one third of the long-term GDP effects. (See Varga and Jan in’t Veld, 2014).
  - EC estimates better integration of renewable energy: +EUR 15.5 to EUR 30 bn per annum.
Key institutional changes following the crisis in Europe

**Financial crisis**
- European System of Financial Supervision (ESFS)
  - European Insurance and Occupational Pensions Authority (EIOPA)
  - European Securities and Markets Authority (ESMA)
  - European Banking Authority (EBA)
  - European Systemic Risk Board (ESRB)

**Debt crisis**
- Banking Union
  - European Stability Mechanism (ESM) (formerly EFSF) — EA MS only
  - European Financial Stabilisation Mechanism (EFSM) — all EU MS
  - European Financial Stability Facility (EFSF) — replaced by ESM

**Macro prudential supervision**
- Single Rulebook
- Single Resolution Mechanism (SRM)
- Single Supervisory Mechanism (SSM)
Key institutional changes following the crisis in Europe

Addressing the financial crisis

• Creation of the European System of Financial Supervision (ESFS). Two levels:
  1. **Micro prudential** supervision ensured by three European supervisory authorities (ESAs)
     • European Banking Authority (EBA)—bank supervision and recapitalisation
     • European Securities and Markets Authority (ESMA)—supervision of capital markets (e.g. credit rating agencies and trade repositories)
     • European Insurance and Occupational Pensions Authority (EIOPA)—insurance supervision
  2. **Macro prudential** supervision ensured by the European Systemic Risk Board (ESRB)

• Creation of the Banking Union made up of the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the Single Rulebook
  • stronger supervision and easy resolution in case of failure for banks operating in Euro area MS

Addressing the debt crisis

• Safety nets for EU MS available conditional to a macroeconomic adjustment program agreed with the Commission, in liaison with the European Central Bank (ECB):
  • European Financial Stabilisation Mechanism (EFSM)—financial assistance to all EU Member States in financial difficulties
  • European Stability Mechanism (ESM) which replaced the former European Financial Stability Facility (EFSF)—funds available to EA MS only (from IMF under EA MS guarantee)
  • Balance-of-payments programme (BOP)—assistance to non-EA MS