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The Levers of a European Investment Strategy

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The investment gap that arose during the crisis partly explains the reduction of potential growth in European countries. It results in ageing of company equipment and infrastructures, in particular in the South of the Eurozone.

An increase in investment in Europe, as planned in the “Juncker package”, which provides for the mobilisation of 300 billion euros in investments, will have both a medium-term effect upon supply and a short-term effect upon demand, and therefore upon growth.

The choice of these investments needs to be guided by several objectives:

– selecting additional investments which would not have been implemented in the absence of European and national initiatives;
– avoiding projects with insufficient socioeconomic returns (of the “white elephant” kind, which prove more costly than beneficial) or based upon barely-stabilised technologies, which carry the risk of being imminently condemned to obsolescence;
– anticipating these investments when possible, that is to say to accelerate their implementation in order to obtain short-term effects for business (renovation and renewal of existing infrastructures for example).

National and European authorities have several roles to play:

– ensuring a certain stability of the fiscal and regulatory framework: this will give greater visibility to investors and, by means of regulation, also enable improved planning of devaluation of capital stock, therefore facilitating its renewal;
– mobilising public debt funds, capital holdings and guarantees, in order to “activate” private resources that are afraid of excessively high levels of risk;
– putting appropriate European governance into place for the selection of future projects.

These conditions will open the possibility of moving from a situation in which reduction of State debts is synonymous with weak investment and weak growth, to one in which debt reduction is enabled by strong growth, catalysed by large, high-quality capital stocks.

What actions in which sectors?

Instruments	Sectors			
Regulatory	**Energy**	**Transport**	**Digital Technology**	**R&D**
Financiale	**Major role** *(price of carbon, building norms intra-EU* integration)*	**Partial role** *(E.g. renovation of rail network, intra-EU integration)*	**Major role** *(norms, intra-EU integration)*	**Secondary role**
	Partial role *(supporting of high-risk projects)*	**Secondary role**	**Major role**	**Partial role** *(PIA** type governance)*
Budgetary	**Secondary role**	**Partial role** *(E.g. renovation of road network)*	**Secondary role**	**Major role**

* European Union ** Investments for the Future Programme (*Programme d'investissements d'avenir*).

Source: France Stratégie.

*Economy and Finance Department - English version of « Les leviers d'une stratégie européenne d'investissement », *La Note d'analyse*, n°17, November 2014

INTRODUCTION

In July 2014, in his guidelines for the new Commission[1], the President-elect Jean-Claude Juncker announced the "mobilisation of 300 billion euros of investments" over a three-year period in order to contribute to the return to growth in Europe.

This *Note d'analyse* is intended to clarify the objectives and, therefore, the terms of this mobilisation[2]:

- the investments need to have an effect upon medium-term supply and short term demand and be made in a small number of key sectors in priority;
- the reduction of regulatory and fiscal uncertainty is essential, as is the long-term consistency of public initiatives;
- appropriate European governance is also a pre-requirement in order to "activate" private investment expenditure, while ensuring that a part of the risk is borne by the States or the European Union;
- where its role is essential, public investment needs to be ringfenced.

RECONCILING SHORT AND MEDIUM-TERM EFFECTS

The "Juncker Package" is aimed at the recovery of European potential growth. It is a question of preparing for the future and, in priority, putting right the harmful effects of six years of crisis upon the potential growth of the economy.

In 2013, the European Commission estimated that almost half a percentage point of the reduction in potential growth during the crisis was due to the slowdown in investment[3]. In spite of the tenuous nature of this kind of estimate, it reveals the importance, for medium-term growth, of a return to normal patterns of investment.

These years witnessed a deterioration of physical and human capital stock. The slowdown of investment observed throughout Europe, and in the South of the Eurozone in particular, produced an ageing of company equipment and infrastructures. The growth of unemployment, of a long-term nature and among young people in particular, also led to a pronounced deterioration of human capital.

Finally, with regard to world competition for leadership in research and innovation, the European countries lost ground as a consequence of the reduction in public budgetary resources and the slowdown of company investments.

Identifying Additional Investments

It is essential to think in terms of additional investments in relation to existing investments – or even in relation to already projected increases of investment. The objective is not to improve, by artificial means if necessary, the conditions for the financing of investments which would in any case have occurred, but rather to generate additional investments in the areas with the highest expected impact upon potential growth.

Avoiding "White Elephants"

High standards of governance are required in order to avoid the reappearance or creation of public or private projects that are not currently implemented because of insufficient socioeconomic returns and financial constraints. This is particularly the case with regard to infrastructure projects, due to the highly political nature of the conditions of their implementation, even when subject to detailed socio-economic assessments.

Since the disappearance of these kinds of project has been one of the positive effects of national budgetary adjustments, should the European investment programme promote new bridges to nowhere, those opposed to a voluntarist policy aimed at filling the investment gap would thereby be strengthened.

Anticipating Investments

Although medium-term potential growth is the principal objective of the package, the current macroeconomic situation within the European Union also means that the short-term impact upon business needs to be taken into account. The risk of deflation facing the economy of the Eurozone and the likely limits of the effectiveness of action on the part of the European Central Bank argue in favour of maximum anticipation of new projects.

However, it is appropriate to be extremely cautious as far as the concrete capacity for rapid implementation (in a few months) of high-quality investments is concerned. In particular, the time required for the deployment of infrastructure projects — even when the latter are finalised — is incompatible with the ambition of making a

1. "A new start for Europe: My agenda for Jobs, Growth, Fairness and Democratic Change", political directions for the next European Commission, http://europa.eu/rapid/press-release_SPEECH-14-546_en.htm?locale=en
2. Cf. also "Has there been an investment gap in France and Europe since 2007?", English version, *La Note d'analyse* No. 16, September 2014, www.strategie.gouv.fr.
3. http://ec.europa.eu/economy_finance/eu/forecasts/2013_spring/box1_potential_output_en.pdf

rapid impact upon the economic cycle. Conversely, investments for the renovation and renewal of existing infrastructures can be implemented very rapidly, with major effects upon employment and potential growth. Investments of this kind have been identified in the transport and energy sectors in particular in several major EU Member States.

As far as new projects are concerned, the speeding-up and selecting objectives should give priority to those based upon mature technologies. Indeed, there is a risk of rushing into projects involving technologies that are undergoing rapid change, resulting in rapidly outmoded technologies. The promotion of investments whose profitability is very sensitive to the risk of appearance of competing technologies needs to be avoided. The production of solar energy constitutes an example of this kind of problem.

Targeting a Few Key Sectors

These priority sectors are well known: energy and the energy transition (production, storage, transport; improvement of energy efficiency in buildings in particular); telecommunications and the digital economy; transport; training, R&D and innovation chain as a whole. The first three sectors are fields that generate future growth, great potential exists with regard to them for the development of truly European infrastructures.

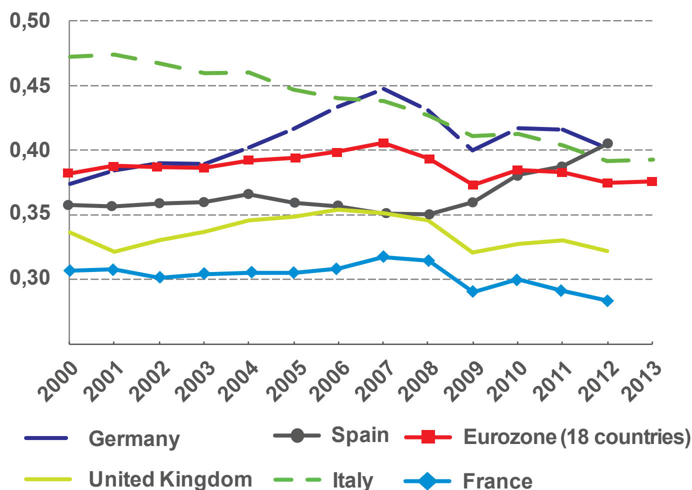
BREAKING DOWN THE BARRIER OF UNCERTAINTIES

Although the profitability of non-financial companies deteriorated slightly during the crisis, their financial position is now very comfortable, in the sense that they often have large cash reserves, which are not invested on the continent. According to a study by Deloitte's EMEA[4], non-financial companies in the Europe, Middle East and Africa region thus apparently have almost 1,000 billion euros of cash assets not invested in the region's economies.

THE PROFITABILITY OF COMPANIES IN EUROPE

The profit share (gross operating surplus/ gross value-added) provides an initial indication of the profitability of non-financial companies. However its level is very dependent upon the sectoral structure of the economy. In France, the profit share of non-financial companies is structurally weak as compared with that of its partners. In addition, it has been following a downward trend since 2010, with the exception of Italy.

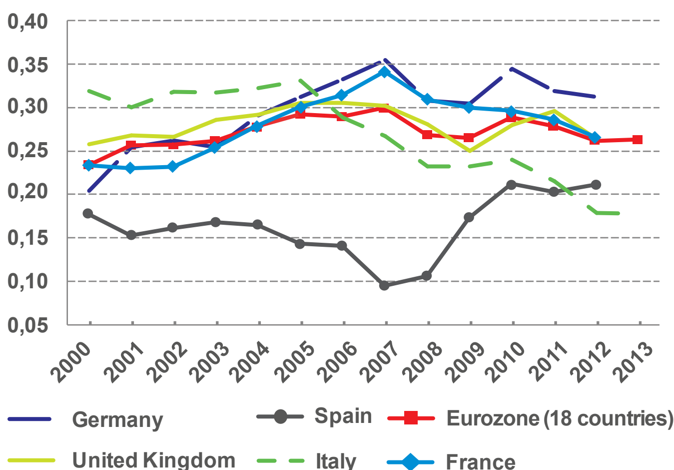
Profit share of non-financial companies*



* After current taxes on income and wealth / net value-added (in %).
Source: France Stratégie, from Eurostat.

An additional profitability ratio may be calculated by dividing the net income of non-financial companies by their net value-added. Company net income is closer than gross operating surplus to the concept of earnings before taxes in company accounting, since it includes income from financial assets held, and expenditure for payment of interest on loans as well as rents are subtracted therefrom.

Net income of non-financial companies*/net value-added



* Gross operating surplus/ Gross value-added (in %).
Source: France Stratégie, from Eurostat.

The level of the French position is much better, although a fall as compared to its partners is observed from 2008-2009. France is positioned within the Eurozone average.

4. Deloitte's EMEA (2014), "Cash to growth – Pivot point" survey, An EMEA research report, Luxembourg, September.

Several factors of a fiscal or regulatory nature, liable to constitute obstacles to investment in Europe, may be identified. The uncertainty to which they give rise means that greater appetite for risk is required in order for investment to take place.

Stabilisation of the Fiscal and Regulatory Framework

Uncertainty with regard to the development of the fiscal and regulatory framework may have a sterilising effect upon investments that might be undertaken in a world perceived as being more stable – or at least more predictable. An example at the French level is the instability of capital transfer taxes and capital gains taxation and the effects thereof upon land availability, and therefore upon housing investments.

In the energy field, and in this case at the European level, the complete uncertainty with regard to future carbon prices is a major obstacle to assessing the profitability of investment projects. Clear conditions for progressive and predictable increase in the carbon prices would, for example, enable the sector's actors to anticipate decommissioning of the power stations responsible for the highest emissions and plan investments in renewable energies.

Furthermore, predictability of the regulatory framework makes it easier to plan capital stock devaluation, thus encouraging private investment. This is the case with regard to schedules for the application of new building norms (environmental and energy norms, access for disabled persons). It also applies to setting up the progressive implementation of green taxation, increasing over time. The introduction of new regulations is likely to "artificially" render obsolete and destroy capital: a machine which is no longer in compliance with norms no longer has any value. If wisely used, this ability of the authorities to downgrade capital stock in an accelerated manner would be a key factor in the renewal thereof, supporting short-term investment and improving the quality of the productive equipment stock.

Replacement of capital stock involves a cost that is partly borne by the consumer or user. This negative impact on supply is costly in political terms, hence the difficulty of giving credibility to a course of (fiscal and regulatory) capital depreciation. Courses of action of this kind need to be staggered over time in a credible manner, in order to enable their impact to be absorbed under good conditions.

Taking Advantage of the the Single Market Potential

Major investment projects, in energy and interconnections, only make sense insofar as a certain visibility exists with regard to the size of the market and the organisation and integration thereof. In this field, uncertainty unfortunately continues to reign. Whether with regard to the internal energy, telecommunications, digital technology, or even transport markets, it is difficult to gauge the time-scale within which the single market will be completed and what the specific conditions of its operation will be. A young European digital technology entrepreneur develops a "French", a "German" and an "Italian" product, whereas his competitor in California knows that he will be able to market his application programme in New York, as well as Chicago without any difficulty. Where the size of the market is a condition for the profitability of the investment, this situation constitutes a major obstacle and a powerful incentive for a certain wait-and-see policy.

In practice, the completion of the internal market is coming up against the pressure exercised upon the national authorities by stakeholders (administrations, companies, regulators and unions). The establishment of a banking union, a real federalist revolution in the European banking field, is instructive both with regard to the obstacles that are to be expected and the possibility of success.

CONDITIONS FOR THE CARRYING OF RESIDUAL RISK BY THE EUROPEAN UNION MEMBER STATES

The European financial sector, which is in the course of a process of transformation and subject to new prudential constraints (Basel III/Solvency 2), is no longer able to take on the risks connected to investment, often of a long-term nature, in the sectors that give rise to growth and employment.

In this situation, consideration must be given to methods for ensuring better risk spread – residual risk being borne by the States. Whether with regard to debt or capital, using the possible tools means consumption of public resources in order to "activate" the private resources that are available, but discouraged by excessively high levels of risk.

In practice, the range of instruments is wide, encompassing debt as well as capital holdings. As far as debt financing is concerned, the European Investment Bank (EIB) and the network of national investment banks provide a natural and tested channel.

What actions in which sectors?

Instruments		Sectors		
Regulatory	**Energy**	**Transport**	**Digital Technology**	**R&D**
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* European Union ** Investments for the Future Programme (PIA *Programme d'investissements d'avenir*).

Source: France Stratégie.

However, the granting of guarantees (backed by the States, or by the EU budget), repayable advances and equity loans constitute other channels through which a public "risk budget" can be mobilised.

Beyond the modes of financial engineering that they involve, all of these tools are based upon the general idea of contributions from the assets of public institutions (States, European Union) to the financing of investment projects, with considerable exposure to risk of losses (the seniority of these tools is weaker than in the case of loans, which always have to be paid back first). The highest level of such exposure is direct equity stakes. With regard to financing in the form of stakeholding, the European Investment Fund (EIF) is the most comprehensive tool for SMEs and innovative high-risk projects.

Apart from modes of finance, two major and often underestimated constraints need to be recalled. On the one hand, the lack of relevant projects for presentation to financial bodies is often quoted, alongside applications for credit, as being the most substantial constraint. On the other hand, the human capital resources required to achieve the desired pace of design and launching of projects also constitutes a constraint, of a more qualitative (certain project finance skills are rare) than quantitative nature, which becomes stronger the further removed the project is from the chain production of simple products (standardised loans).

However, certain sectors, in particular R&D and training, probably require direct financing from the Member State and EU budgets. It needs to cover them when necessary.

The above table offers a reasoned classification of the available instruments and of the role that they are able to play in the various different sectors.

How to Select Forward-Looking Projects?

The supply of mature projects, ready for financing, constitutes the main problem from which investment in Europe is suffering. In France, the Investments for the Future Programme (PIA) is an example of governance for project selection that could be taken up. It integrates good governance (calls for projects, minimisation of institutional capture) and places emphasis on long-term projects producing efficiency gains.

THE INVESTMENTS FOR THE FUTURE PROGRAMME (PIA)[5]

Launched in 2010, the Investments for the Future Programme (PIA – programme d'investissements d'avenir) follows on from the Juppé-Rocard Commission's report: "Investing for the future (Investir pour l'avenir)". Public authorities need to target their actions in favour of sectors, fields, technologies and categories of companies likely to ensure the long-term competitiveness of the French economy.

As compared with usual practices in France, "future investments" are relatively original due to their modus operandi:

- *projects allocated according to a bottom-up approach;*
- *mode of financing that does not simply rely on subsidies: it involves both consumable allocations and non-consumable allocations (the beneficiaries only receiving the interests thereof);*
- *granting of funds by tranche, in order to be able to end the financing of projects in case of failure;*
- *a powerful expected lever effect: the public funds should give rise to additional private investments in the fields concerned.*

5. Section drafted by Rémi Lallement. Cf. also Lallement R. (2014), "*Innovation: le rôle des investissements d'avenir*", unpublished, France Stratégie; Dhont-Peltrault E. and Lallement R. (2011), "Investissements d'avenir et politique industrielle en Europe", *La Note d'analyse,* No. 236, Centre d'analyse stratégique, September.

The 35 "initiatives" undertaken are subject to agreements signed between the General Investment Commission (CGI - Commissariat général à l'investissement) and the ten public operators in charge of conducting the selection process. Governance of the Commissariat général à l'investissement, which comes under the authority of the Prime Minister, is one of the key elements of the future investments programme.

Establishing a European System of Public Investment Banks

Public investment banks constitute a powerful tool for the financing of investment at both the Member State's (national banks) and European levels (EIB). The four major Eurozone States possess institutions of this kind (KfW in Germany, CDC/BPI in France, CDP in Italy and ICO in Spain).

Nevertheless, the ecosystem constituted by these banks and the EIB continues to be organised in an *ad hoc* manner – in particular, many Member States do not have such institutions. Under these conditions, beyond the extension of the EIB's activities, the problem of the organisation of a European System of Investment Banks araises. This would presuppose giving a central role to a radically reformed EIB and implementing a convergence of the objectives and structures of the National investment banks. Valla *et al.* (2014) describe what a system of this kind could be at the Eurozone level[6].

The putting in place of such an organisation is all the more necessary insofar as the capacity of the EIB to extend its traditional activity (loans from its own assets) is restricted by the absence of local intermediaries. Yet, the EIB hopes to move away from standard activities in order to engage in fields of higher risk or stronger granularity (SMEs). Once the activity of the EIB and its national counterparts has been fitted into a suitable framework, the growth of their balance sheet could be planned in a secure manner.

Although the economic conditions exist for the emergence of projects eligible to be financed by the EIB, there is a need to make sure that the latter only takes action where private investment is insufficient (to avoid the substitution of rare public finance for available private finance). In particular, the EIB could assume the role of acting in projects involving greater risk than is currently the case – with a resulting deterioration of its risk profile.

Creating a European Fund Devoted to Future Investments

In numerous situations, the brake upon investment is not so much the capacity to finance the latter through debt, and senior debt in particular, as the question of raising the required capital that is liable to compensate any losses. The process is therefore blocked by the shortage of actors prepared to take responsibility for the risk entailed by investment.

Under these conditions, a part of public initiative also needs to be concerned with capital and guarantees. The expected lever effect (the quantity of private finance mobilised per unit of public finance) depends upon the structuring of guarantees. As a general rule, it is highest when public guarantees are called upon more quickly, that is to say when the latter take the first losses alone.

A European Future Investments Fund could be put in place with a broader ambition than that of the current EIF, created in 1994, but using the same model of governance[7]. This fund would have the role of taking direct and indirect (fund of funds) stakes in officially-labelled European investment projects in the priority sectors identified above, the objective being to attract private capitals while bearing part of the risk.

The financing of this facility would be recorded in the books outside of the Stability and Growth Pact, by contributions from Member States. This method compares with the proposal made by Mario Monti (to exclude investments from the calculation of public deficit), but presents the advantage of being indirect and thus avoiding possible statistical arbitrage behaviours on the part of Member States. If necessary, the facility could be financed from own resources.

An ambitious, but more demanding option, would be to propose that Member States which inadvertently outperform their budgetary paths should automatically supply resources to the Fund. A mechanism of this kind would have the advantage of re-establishing a certain symmetry within the Stability and Growth Pact, which currently provides an incentive for excessive virtue and places a systematically restrictive bias upon officially approved budgetary policy in the Eurozone.

In the short-term, the Fund could also be financed *via* the EU budget, by means of debt, according to the same principles as the EFSM[8] used in order to provide assistance

6. Valla N., Brand T. and Doisy S. (2014), "A New Architecture for Public Investment in Europe: The Eurosystem of Investment Banks and the Fede Fund", July, Policy Brief, CEPII.
7. See proposal 3 of Dhont-Peltrault and Lallement (2011), *op. cit.*
8. European Financial Stabilisation Mechanism.

to Ireland and Portugal. This involves issuing European debt, limited by the ceiling placed upon European budget resources. This part of funds would be reserved for genuinely transnational projects. In order to reduce the constraints in terms of human resources emphasised above, the Fund would also need to act as a fund of funds.

PUBLIC INVESTMENT, A CONDITION FOR GROWTH AND DEBT REDUCTION

Improvement of the articulation between public funds and private finance, in infrastructure in particular, should not lead to the principle of public investment being called into question. There are two sides to the issue: on the one hand, that of relaunching investment within those Member States that have wide budgetary margins of manœuvre; and, on the other hand, that of ringfencing it amongst those that are pursuing rapid adjustment of their public finances.

Those States which have budgetary margins of manœuvre, i.e. whose budget balance is well over the balance required to stabilise their debt, need to raise the question of the best long-term debt reduction strategy. One such strategy consists of anticipating weak future growth, and relying upon deficit reduction (or even surpluses) in order to rapidly reduce the country's gross debt. This could be referred to as a "low debt, low assets, low growth" approach. It is the strategy followed by Germany, though it is now subject to debate. An alternative "high assets, high-growth, low debt" strategy would count on the recovery of potential growth in order to open the way for a less demanding course of action in terms of deficits and enable the financing of investments giving rise to higher potential growth of this kind.

Research on public investment conducted by the IMF[9] simulates these different approaches and concludes that the second strategy is in principle practicable, in particular in a situation such as that currently prevailing, in which the risk of private funds being crowded out by public finance is relatively weak. For the IMF, the condition for the success of this approach is precisely the quality of the proposed investment projects.

States which are still carrying out large budgetary adjustments need to resist the temptation to reduce their public investment, in particular in fields that are vital for the future. Fundamental research and training, as well as certain areas of innovation (military R&D for example) are decisive fields.

Apart from this, the maintenance of existing public facilities, which often constitute a factor of attractiveness for the territory (e.g. secondary roads), is also a field in which reduction of public investment is likely to have extremely harmful effects. At the national level, the ringfencing of public investment requires the organisation of precise assessment of the socioeconomic usefulness of the various different options (e.g. maintenance of the RER C line of the Paris area rapid-transit rail network *vs.* the Limousin TGV high-speed train service) and the permanent establishment of research budgets *via* schemes of the "laboratories of excellence" (*Laboratoires d'Excellence*) type, put in place within the framework of the Investments for the Future Programme (PIA).

CONCLUSION

For the mobilisation of additional resources in order to increase European investment, several pitfalls need to be avoided: the financing of "white elephants" and projects based upon poorly-stabilised technologies, in danger of becoming quickly obsolete, and use of public money for projects that would otherwise have been supported by the private sector.

The promotion of investments which have an effect upon both medium-term growth and short-term demand is a realistic objective: restoration and renewal of existing infrastructure can be quickly launched, targeting a small number of key sectors (production and energy efficiency, transport, digital technology and R&D) in priority, with changes to the regulatory framework in order to accelerate renewal of the private equipment stock.
Moreover, in order to support investment at the European level it is necessary to:

- **draw upon the European Investment Fund, which constitutes the most successfully-completed tool for financing and provision of stakeholding capital for SMEs and high-risk projects;**
- **propose the creation of a European Future Investments Fund with a more far-reaching ambition than that of the EIF;**
- **promote the emergence of an ecosystem comprising national investment banks (KfW, CDC/BPI, CDP) and the EIB, before raising the question of increasing the balance sheet of these institutions.**

Keywords: investment, European Union, European Investment Bank, infrastructure.

9. "Legacies, Clouds, Uncertainties", *World Economic Outlook*, IMF, October 2014.

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