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Investing in Europe

A sobering medium term outlook for the EU economy

Short term economic prospects for the EU have brightened over the last twelve months. The strengthening of recovery led the European Commission to revise upwards its growth projections for 2015 and 2016, with an expected growth rate of 1.8% for 2015 and 2.1% in 2016 for the EU as a whole.

The EU economy is benefiting from a number of favourable tailwinds: low energy prices, favourable liquidity conditions created by the ECB, improved export performance stemming from a lower exchange rate. Meanwhile, fiscal policy is broadly neutral and thus is no longer acting as a drag on the economy.

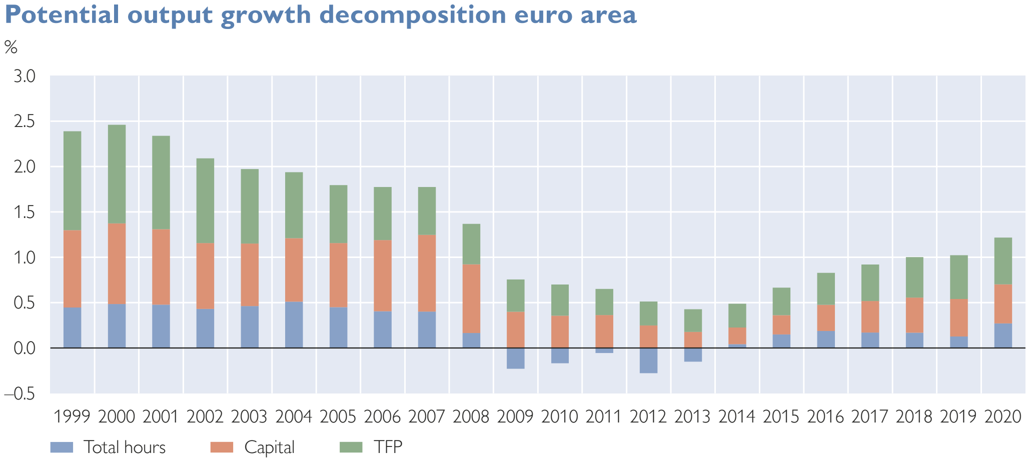
But the medium term outlook points to considerable challenges. With unchanged policies, the European Commission estimates that the potential output growth will remain well below pre-crisis levels and barely above 1% in 2020.

When decomposing the development of potential output until 2020 into the contributions of labour, capital and total factor productivity, the low growth performance is the outcome of a lack of dynamism in each of the three components: Due to ageing, the population of working age will increase more slowly and will start to decline at the EU level from 2022 onwards; capital accumulation has suffered from the drastic fall in investment ratios since the inception of the crisis and total factor productivity is on a downward trend. The decline in productivity growth is not a new development and reflects to a large extent a steady decline in total factor productivity since

the early 1990s. These already unfavourable trends have been compounded by the crisis itself. The crisis has markedly slowed down the pace of capital accumulation and has left many outside the labour market for a protracted pe-

Chart 1

Potential output growth decomposition euro area



Source: European Commission (2015).

riod of time. This reduced pace of physical and human capital accumulation will continue to weigh on the output trajectory. The low medium term growth prospects in the EU have a number of worrying ramifications. They imply in particular that the EU is falling further behind the USA, while other economies are rapidly catching up with the EU economy.

Policy response: the need for a renewed commitment to reform

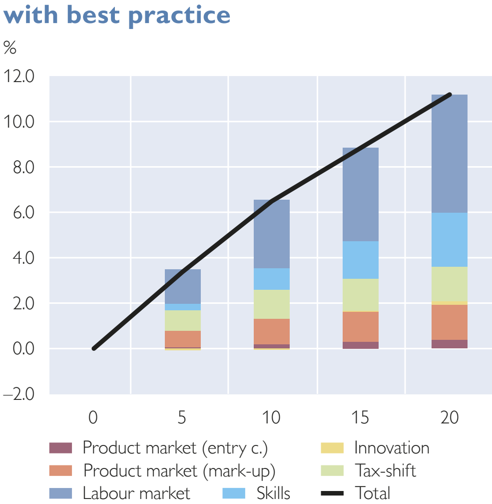
The macroeconomic policy stance is broadly appropriate in the current juncture. The use of unconventional monetary tools has been important to mitigate the risk of a deflationary spiral. The current broadly neutral fiscal policy stance strikes the right balance between the objectives of fiscal sustainability and stabilisation in the phase a nascent recovery. However, while offering a welcome reprieve in the short run, monetary and fiscal policies are not sufficient to address the more structural challenges the EU economy is facing and to reverse the declining trend in total factor productivity (TFP) growth. This requires a renewed commitment to reform as well as a convincing investment drive.

Structural reform progress has been mixed and somewhat uneven across countries and areas of necessary reforms. While some euro area member states have launched important reform packages under the pressure of financial markets and often as part of the financial assistance programmes, reform efforts have been much more moderate in the rest of the EU, including in the newer Member States. In the vulnerable economies of the euro area, the reforms though significant, still fall short of the needs: Indicators on labour and product markets for these economies, like the OECD Product Market Regulation indicator or the Employment Legislation indicators still point to higher than average regulatory obstacles in the euro area economies. Substantial reforms in these countries addressed the labour market rigidities, in particular those linked to wage setting mechanism, differences in employment protection between permanent and temporary contracts to mitigate segmentation, and active labour market policies. Product market reform and improvement of the business environment have progressed in a patchier and slower way, though actions have been taken to modernise public administrations. A renewed commitment to structural reforms in the EU is essential for Member States to grow out of debt and to stimulate the creation of more and better jobs. Progress at national and EU level in areas like services, energy, telecoms and the digital economy, as well as in improving conditions for business create new opportunities for jobs and growth. Cutting „red tape" at the European and national level as part of the Better Regulation Agenda is essential to create the right regulatory environment and promote a climate of entrepreneurship and job creation. This requires national ownership and commitment at the highest government level as well as by national parliaments.

These reforms can have significant effects on productivity and growth. The European Commission has reviewed various reforms undertaken by the euro area member states most hit by the crisis and brought evidence that the microeconomic transmission channels of product market reforms and improvement in the business environment were bearing fruit.[1] In addition, signs of competitiveness gains through moderate unit labour cost increases and better export performance have helped macroeconomic rebalancing in the euro area in the last four years. The strength of the recovery in countries like Spain and Ireland also reflects a better macroeconomic dynamism after reforms.

Chart 2

GDP effects of closing half the gap with best practice



Source: Varga and in't Veld (2014).

The European Commission has simulated the GDP effects if each Member State closes half the gap vis-à-vis best performers.[2] The EU GDP after 5 years could be as much as 3½% higher and after 10 years even 6,5% higher. The positive effects of reforms take time to materialise, depending on the nature of the reforms. The effects of a tax shift (away from labour) materialise relatively fast, while the effect of labour market reforms aiming at increasing labour participation take longer to materialise. Reforms aiming at stimulating innovation and improving education have the longest lead times but the highest potential. The benefits of convergence to best practice are potentially large for all countries, but for some countries more than ever. The key take away is that there is nothing inevitable about the observed low levels of growth. To a large extent it is a political choice.

The investment plan for Europe

Structural reforms and investment are two sides of the same coin. Both are needed to modernize the European economy. They are mutually reinforcing and need to be implemented in parallel. Investment has suffered during the crisis and this has had a negative impact on both short and long term growth. This is why President Juncker proposed on 26 November 2014 an Investment Plan for Europe aiming at the mobilisation of EUR 315 billion (i.e. 2% of EU GDP) for strategic growth-promoting projects over three years, by providing a new risk-bearing capacity to the European Investment Bank.[3]

[1] *European Commission. 2014. Market reforms at work in Italy, Spain, Portugal and Greece. European economy 5/2014.*

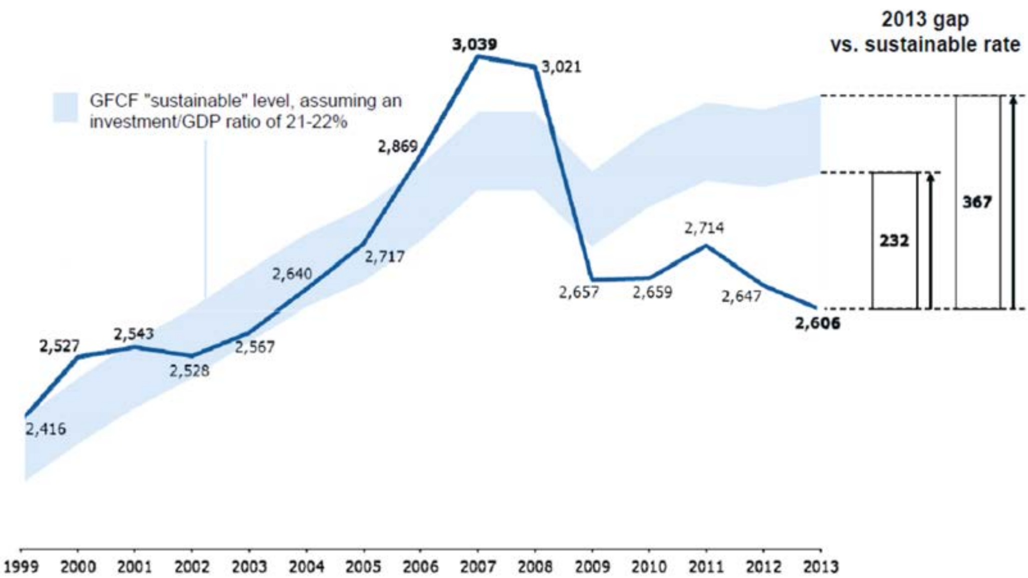
[2] *Varga, J. and J. in't Veld. 2014. The potential impact of structural reforms in the EU – a benchmarking exercise. Economic papers 541. December.*

[3] *European Commission. 2014. An investment plan for Europe – Communication to the European Parliament, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions, the European Investment Bank – COM(2014)903.*

Chart 3

EU-28 real gross fixed capital formation in 2013 – Observed trend versus „sustainable level“

EUR billion



Source: European Commission.

The plan was predicated on two important observations: First, there is no lack of liquidity, but the abundant liquidity is not translated into real investments. Financial fragmentation across the EU, the corporate debt overhang in some countries, the lack of demand and a lack of confidence have been bottlenecks to investment. Second, there is not a single explanation for the drop in investment and hence a comprehensive approach to stimulating investment is called for.

The plan comprises three pillars: first the mobilization of EUR 315 billion in additional investment finance through the creation of the European Fund for Strategic Investments (EFSI) within the European Investment Bank; second, the creation of a strong pipeline of investable projects, inter alia by making available technical assistance through the newly established European Investment Advisory Hub (EIAH); third, the creation of an environment conducive to investment. The last pillar is part of the structural reform and aims at improving the regulatory framework, at national as well as European level, to make it clear and predictable, and to incentivise investment. It includes measures to develop new and alternative sources of long-term financing for the economy and to move towards a Capital Markets Union. It will also benefit from the recently adopted EU initiatives of the Energy Union and the Digital Single Market.

The overwhelmingly positive reception of the Plan and a common understanding on the issues at hand permitted an accelerated legislative process. As a result the EFSI has been established as early as mid-2015. By autumn 2015, all necessary structures will be in place to start implementing the initiatives on the ground. Meanwhile the EIB had already started to finance projects, which are being transferred to EFSI. In other words, the investments have started already. EFSI will amount to EUR 21 billion, building on a EUR 16 billion guarantee from the EU Budget and a EUR 5 billion commitment of EIB funds. It will generate large investment effects thanks to an expected multiplier of 1:15 which is based on conservative estimates from past experience of EIB funding and EU programmes.

Investment projects will be selected on their own merits, without any sectoral or geographic pre-established allocation, so as to maximize the value added of the Fund. They will need to be economically and technically viable, be consistent with Union policies, maximise where possible the mobilisation of private sector capital and provide additionality. The EFSI will also have the possibility to support together with Member States and/or private investors investment platforms at national, regional or sectorial level.

A preliminary exploration has allowed identifying significant investment needs across the EU, in particular in infrastructures, notably in the transport, energy and electronic communication sectors. The move to a low carbon economy makes energy efficiency projects a policy priority. The modernisation of the EU economy requires investments in education, health and research. The plan will also provide financing to SME and mid cap companies. It is foreseen to generate overall about EUR 240 billion of long term investments projects and an amount of roughly EUR 75 billion for SME cofinancing.

The investment plan is expected to deliver benefits which go beyond the investment boost over the next three years: It will increase the risk bearing capacity of EU funding; it will provide the EU a fully horizontal funding instrument without sectoral or geographical pre-allocation of funding; it will provide channels for the European economy for crowding in private investment in times of persistent budget constraints in the Member States. But the benefits of the investment plan will only materialise if supported by ambitious structural reforms at national and EU level and by an adequate policy mix with responsible fiscal policies.