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Investing in productivity growth in Europe

Report on a conference jointly organised by EIB and SUERF
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Conference Report

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The SUERF – EIB Conference on **"Investing in productivity growth in Europe"** took place on November 17th in Luxembourg, at the EIB headquarters. A whole day conference, organised in 3 panels, was the occasion for the launch of the EIB Annual Investment Report and for an in depth discussion of investment and investment challenges in Europe, with focus on an understanding of investment dynamics and constraints, an assessment of financial sector issues and a more in depth discussion of the finance-investment nexus, investigating how financial frictions impact investment decisions of firms.
Welcoming remarks from the President of SUERF, **Urs W. Birchler**, were followed by opening speech by EIB President, **Werner Hoyer.**
President Hoyer stressed that in order to improve the economic environment for investment a concerted action is needed in three directions: (i) structural reforms to strengthen competitiveness; (ii) financial sector reforms to improve banking sector resilience and further develop capital markets; (iii) public support for investment.
The EIB plays a key role in supporting and complementing efforts of Member States and European institutions to provide public support for investment. It helped realise investment projects worth roughly 230 billion euros last year. This has a big impact: preliminary estimates suggest that this may increase the EU's GDP by around 1.1% by 2030, adding about 1.4 million jobs.
The Investment Plan for Europe undertaken by the European Commission and the EIB further enhances the EU policy response to relaunch investment and restore EU competitiveness. It consists of three main pillars: (i) the first is support for regulatory and structural reform to remove bottlenecks and ensure an investment-friendly

environment; (ii) comprehensive technical assistance in the sourcing, preparation and development of investment projects; (iii) enhancing the EIB Group's capacity to address market failures in risk-taking that hold back investment.

The first panel, **Investment in Europe – a matter of supply and demand**, chaired by **Debora Revoltella**, Director of the Economics department was devoted to discussing recent developments in European investment and, in particular, the factors that continue to hold down private and government investment in Europe.

Debora presented the key findings of the new EIB annual report on investment and investment finance. The report is developed as a tool to regularly analyse and monitor investment and investment finance dynamics in Europe. A special feature of this year included an analysis of the interaction between financial frictions and allocation of resources through the recent crisis, as well as the preliminary results of the new EIB survey on Investment in Europe, which covers on an annual basis some 12,500 firms, being representative for each and every of the 28 EU member states.

The EIB Investment report shows that Investment is recovering, but at a slow pace. Investment dynamics are also very divergent among countries in Europe and among asset classes. Throughout Europe, Government infrastructure investment is stemming out as lagging behind in the recovery largely impacted by the way in which the fiscal consolidation was implemented in various countries, largely penalizing gross fixed capital formation. Corporate investment is the driver of the investment recovery, but is growing slowly, particularly when the current monetary conditions are taken into account. Interestingly, there seems to be a gap in quality of capital rather than quantity. Low return on investment and low total factor productivity suggest the need of pushing for more reallocation of resources, innovation and work on impediments that present efficiency of the system (structural reforms at the national and EU market level).

The report suggest a number of policy conclusions, ranging from completion of the banking union and capital market union, advancement with structural reforms, as well as targeted public support to productivity enhancing investment.

The first panelist to speak on this panel was **Catherine Mann**, Chief Economist of the OECD. She has reiterated the findings of the EIB investment report that investment recovers very gradually and linked this weak performance with declining growth of potential output and productivity. Drawing on recent work in the OECD on productivity performance, she explained that productivity growth has been slowing down because productivity advances do not diffuse throughout the economy: most of the firms fail to adopt existing and readily available cutting edge technologies that could increase their productivity. This so-called diffusion gap manifests itself in growing wage dispersion that further increases social inequality. The problems in the financial system further aggravated diffusion gap as they suppressed the growth of small and young firms. The firms on the two sides of the growing diffusion gap differ in their ownership of knowledge-based capital and managerial quality.

Catherine Mann argued that strengthening competition and economic dynamism of firms should reduce the diffusion gap. Housing policies that promote geographical reallocation of people and thus encourage labour mobility may act as an additional catalyst to reducing the diffusion gap. Tackling the reasons that allow non-viable firms to continue operating will further improve resource allocation and reduce the diffusion gap. Regulatory certainty, or lack thereof, has a huge impact on deployment of digital innovation.

The OECD sees historically low interest rates as an opportunity to create additional fiscal space especially for high-debt countries. They estimate that by rolling over government debt to make use of declining interest rates will result in substantial budgetary gains. These are expected to have substantial gains, both in the short and the long term, provided that governments carefully choose the areas where they employ the gained fiscal space. Public investment has seen as having a significantly positive growth impact.

Catherine Mann thought public spending related to EFSI should not be included in the calculations for SGP. She noted that pro-cyclicality of public spending in Europe remains a wide-spread problem and should be addressed. Special exceptions granted by the Commission in its fiscal surveillance exercises further exacerbate the problem. She believes that the Commission should condition increases of public spending on the margin on regulatory harmonization with the EU. Finally, she expressed the view the public investment targeted to encourage private investment that addresses climate change should be seen as way to provide public support to corporate investment.

Servaas Deroose, Deputy DG ECFIN, provided and overview of the investment outlook, the factors that have the most significant impact on investment, the Juncker plan and the necessary public policies. The EC corroborates the view that the interplay between several supply and demand factors has resulted in a weak investment recovery. On the demand side, the investment accelerator might have had not only short run effects during the crisis, but also longer term effects due to post-crisis hysteresis. Falling general government investment has reinforced this effect. Deleveraging and overcapacity that was built-up before the crisis have had negative impact on investment demand as well as uncertainty, both economic and policy. Supply side factors relate to bottlenecks to investment and structural rigidities of EU economies. These have been present already before the crisis, but their effect may have been exacerbated since 2008. Finally, the banking sector and, high NPLs in particular, have also had negative effect on investment both during the crisis and in the recovery phase.

EFSI shows positive results but there are still some drawbacks in Commission's view. These relate to an uneven geographical coverage, low or no additionality of projects and too little technical assistance.

Contrary to the OECD, EC does not see viable options to increase fiscal space. Deroose, stressed nevertheless that fiscal space should be used where available. He expressed reservations to excluding investment from the constraints of the stability and growth pact (SGP) as this may create wrong incentives for governments to relabel other spending as investment.

Policy measures to improve regulation, competition and efficiency of administration are seen as the most important to address bottlenecks in investment. Special focus on network- and energy-related industries is seen as a priority. Regarding public support for corporates, Deroose suggested that increasing public investment will improve the overall economic environment which should impact positively corporate investment.

Jeffrey Franks, Director of IMF Europe Office, offered the view of the IMF, with interesting benchmarking of Europe vs the US. He reiterated that investment recovers but is weak and the recovery varies widely across countries. Public investment is seen as one of the stumbling blocks for investments, but fiscal space does not allow for a significant increase so governments should carefully review spending priorities and adjust the composition of public spending to reflect the need for higher public investment.

NPLs are seen as a substantial constraint to credit growth. NPL levels in European countries are much higher than in the US, while the write-off rate is much lower. Given that most of European SMEs are dependent on bank credit, they have contributed disproportionately more to the decline of investment in Europe and have been a drag to the investment recovery since 2012. **Sebnem Kalemli-Özcan** noted that comparisons between the US and Europe should also reflect the much higher dependence of the European corporate sector on bank lending.

Productivity is seen as a much bigger problem in Europe than in the US. European productivity compares unfavourably to global peers and this divergence is explained mostly by a larger gap in productivity of the services sector.

Public policy should address the composition of government spending, address problems in the banking sector and make the services sector more dynamic, thereby raising its productivity.

Efficiency of the European financial sector in allocating finance was the topic of the second panel during which four presentations took place.

Natacha Valla opened the session with a presentation on credit conditions in Europe. Despite very accommodative monetary policies, EU countries are on a slow recovery path during which investment seems to underperform compared to previous recoveries. Banks and NFCs look stronger now that deleveraging has taking place. However, the current level of rates is likely to be not sustainable for the financial system and there is a need for more structural policy, such as those contributing to the capital market union.

Philipp Hartmann, ECB DG-Research, presented the results of an analysis on cross border financial risk sharing in the euro area. He stressed the welfare properties of private risk sharing, especially in a monetary union. Given that in the euro area, countries are sometimes hit by asymmetric shocks but that monetary policy is symmetric and fiscal risk sharing is absent, private risk sharing is especially important. It enables private agents to diversify, to smooth shocks on domestic income stream with external income stream. But going beyond, the presenter introduced the notion of quality of risk sharing. In this regard, more equity is even better as, compared with debt, such asset is more state contingent. Also, longer-term assets are better than shorter-term assets as they reduce the rollover risk. P. Hartmann then presented a tool to monitor risk sharing in the euro area. The estimations show that risk sharing increased after the launch of the euro but has been going down since the crisis. In this context, EC initiatives on retail credit (the green paper) and capital market (which address issues primarily related to pension system, contract enforcement, and insolvency harmonisation) are very welcome.

Mario Nava, EC FISMA, recalled the role of the EFSI package at the current juncture, with the EC president having managed to structure such a program only three weeks after entering in function. He emphasized that the plan is well on track for meeting the targets. He described it as a tool for risk sharing between the EIB and the EC (where the latter takes three quarter of the loss piece and the former the remaining). Somewhat differently from the traditional presentation of the program as a demand support tool, he presented the program as providing a safety trap and structuring a safe asset, especially relevant at the current juncture. He stressed the complementarity between capital market and banks. At this occasion, he reminded the key role the CMU had to play, especially given that banks, highly leveraged institutions had acted as shock amplifiers rather than absorbers. Reducing the incompleteness of market and increasing risk sharing in Europe would improve the allocation of resources, and therefore increase TFP.

Reza Moghadam, Morgan Stanley, supported the view that challenges of CMU has grown up with the Brexit. He recalled that London is the first financial centre in the world, larger than New York. 80% of the firms which use passporting do it from London. One of the reasons is the legal framework provided by English law. Indeed, there is an ecosystem in London with all the compartments of the financial sector present. In this regard, the potential for a fragmentation would result in a loss of expertise (for example in the case of model validation).There is a need to coordinate the strategy to rethink the European financial system and reduce competition across candidate centres. Moving the balance sheet of financial institutions is costly and the transfer will pump up the cost of capital.

Boris Vujčić, Governor of the Croatian Central Bank, emphasized the improvements in Europe. He suggested that the low interest rate environment was conducive to the maintenance of NPL. In Croatia, supervisory policy provided a strategy and timetable to achieve NPL resolution, with a planned increase in provision each six months. Two years after, coverage ratio was high enough

so that NPL portfolio could be sold and the NPL ratio declined from 16% to below 10%. Looking ahead, Europe has to develop a culture of equity financing. Incentivising it is already happening through low deposit rate which pushes investment towards equity funds. Finally, the presenter concluded on the need to solve overbanking. The banking sector may be too large and not concentrated enough, so that its overall profitability remains slow and the price to book ratio of bank stocks is low. Banks and borrowers may benefit from an orderly restructuring.

Making European NFCs more resilient – lessons from the financial and sovereign debt crisis, was the topic of the last panel of the Conference. **Pedro de Lima** opened the session, pointing out that productivity growth in the EU was undermined by the credit boom before the financial crisis and the binding financial constraints and reduced efficiency of the financial system in the post-financial crisis period. He stressed that the big challenge is how to make Europe's financial system fit for the future. **Sebnem Kalemli-Özcan** argued that the structure of corporate balance sheets matters for the observed investment weakness, regardless of supply and demand factors. Excessive debt holdings lead to debt overhang and banks refuse to refinance it, which results in lower investment. In addition, if debt is predominantly short-term the firms also face rollover risk, which reduces investment. This effect is worse in periods of low demand and high uncertainty. Due to financial constraints, too much debt creates capital misallocation, lowering aggregate TFP. Too little equity financing, on the other hand, endangers cross-border equity ownership, reduces risk sharing and increases uncertainty.

In her paper for the EIB Annual investment report, she argues that in order to capture the detrimental effects of debt overhang one has to focus on average rather than aggregate developments, because developments of a few large firms may obscure the dynamics of smaller firms that make for a large part of the European economy.

Before the crisis there was a big increase of financial debt in the euro area, which was predominantly long-term in the core and short-term in the euro area periphery. This resulted in too much debt, especially short term, and too little equity financing in Europe. These patterns amplified the recessionary effects of the financial crisis regardless of the impact of other demand and supply factors. In the absence of pan-European risk sharing these recessionary effects got worse: the decline in output translated one-to-one into lower investment, income and consumption.

Gianmarco Ottaviano illustrated the post-crisis productivity slowdown using the case of Italy. GDP in most large European countries recovered, following the sovereign debt crisis, except in Italy, where productivity growth also slowed down more. This slowdown may be because most firms experienced slower growth or because of composition effects – resource misallocation. In Italy, both within- and between-sector resource misallocation have been rising over time, but within-sector is quantitatively more important. The effect on the economy from these developments is substantial. If resource misallocation were the same in 2015 as it was in 2005, aggregate productivity would have been about 20% higher. This gain is systematic across firm-sizes in manufacturing.

The rise of within-sector resource misallocation is associated with ownership structure, access to finance, workforce composition, internationalization, innovation, cronyism, and euro effect. As an example of innovation impact, firms with higher share of intangible assets are more productive and more affected by resource misallocation.

Reinhilde Veugelers observed that R&D intensity is stagnant in the EU. As a result, in 2015 China overtook the EU and the innovation gap versus global peers is growing on all indicators. Fiscal consolidation across the EU resulted in lower public spending on R&D and has worsened challenges after the crisis. Inside the EU, the divide on innovation has increased after the crisis.

Why does Europe have difficulty to improve innovation? A major reason is the industrial structure of EU economies. They fail to specialize in activities that are most suitable to innovation-driven growth – digital, pharmaceutical, biotechnologies, aerospace, etc. In addition, the EU misses the young world leading innovators or yollies. The smaller share of such companies in Europe explains about 33% of the R&D intensity gap with US, while another 55% is explained by the fact that European yollies are less R&D-intensive than their US counterparts.

The reason for having so few young global leading innovators in the EU is systemic. The structure of European financial markets is not geared to this type of risk-taking financing necessary for such companies to develop. Higher entry and exit costs reduce economic dynamism and business experimentation. Inflexible productive and labour markets put additional barriers to rapid scaling up and down of companies. Insufficient linking in and "innovation system" is another reason for a lower number of yollies in the EU. Finally government policy regarding funding and regulation plays a role.

As a result of all these problems EU yollies are more financially constrained and have lower rates of return from innovation. In order to effectively address the problem with access to finance, European economies need a broader innovation policy to ensure sufficient supply of profitable projects to fund. Then an interconnected set of policy instruments at each stage of the funding escalator is necessary, i.e. complementarity with R&D grants, support for business angels, loans, etc. In other words, governments should not replace or crowd out the private sector, but leverage private market forces. Develop a thick, integrated and open venture capital (VC) market across Europe that allows VC firms to grow.

Eric Bartelsman discussed the role of the European financial system in stimulating investment in intangible, or knowledge-based, capital. He observed that many existing superior technologies are not adopted by the majority of firms, despite the fact that this will make them more productive. Among the reasons for the relatively low investment in intangible capital are that there exist adoption costs that are related to the availability of digital infrastructure, skilled workers and of financial capital. The benefits counterbalancing these costs are high uncertainty of outcomes from combining intangibles in production chains and the ability to scale labor and reallocate capital.

Intangible investment is difficult to finance from external sources because few lenders accept intangible assets as collateral. Recent bank regulation lays further impediments for banks to accept intangible assets as collateral. Capital market integration across Europe, co-financing and leveraging of public funds should help address the problems of finding external funding for intangible investment.

The financial sector may also have indirect effects by affecting resource reallocation, by financing the exit of less productive, unviable firms, financing the firms to catch up with the technological frontier and financing growth leaders.

In order that economists help boost economic growth, they should first get rid of the mantra that it is all about structural reforms. In practice, economists need to find evidence what works. Help identify winners and losers from policies and discuss trade-offs.

Policy makers, in turn, should be clear in stating to voters the policy goals. They should embrace experimentation in order to find what best works in an economy. Most importantly experimentation should always go together with evaluation of whether a given policy works. If it does not work, then adjust and continue.

Policy makers should stimulate a change towards experimentation and innovation, building them into the education system. Lack of experimentation in Europe reduces the number of successful innovators.

Jan Svejnar observed that while it is important to improve resilience of firms, there are also negative aspects of resilience: no-one wants resilient zombie firms. The financing mix of firms is particularly important in financial crises.

Regarding the gap in the innovative capacity between US and Europe, Jan Svejnar singled out the importance of the more risk-taking attitude in the US. The importance of regulation, quality and function of the legal system has also grown and contributed to this gap.

Closing remarks

To bring the conference to a close, **Andrew McDowell**, Vice President of the European Investment Bank, reflected on many of the key messages and topics of discussion in the course of the day. “The crisis has impacted the ability of our financial sectors to allocate resources efficiently to the most productive firms,” he said, picking up on the theme of the third and final session. “This may be contributing to the persistent slowness of productivity growth, undermining our competitiveness. To compensate, we need to see strengthened public support for investment, making the best use of available EU and national financing capacities to address investment gaps, particularly through investments that enhance productivity and deepen market integration.”

Vice President McDowell expressed his thanks, on behalf of the EIB, for the excellent collaboration enjoyed with SUERF, as co-organisers of the conference. He congratulated all speakers and participants for their informative and challenging contributions and thanked them for their part in the constructive and fruitful discussions that took place.

The conference presentations and a link to the EIB Annual Investment Report are available online at:

www.suerf.org/luxembourg2016