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Jump-starting Investment

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The European Union is facing a severe investment crisis and this might seriously affect both its economic and social future. The most recent data show a collapse of fixed capital investment to the extent that six years after the crisis began and with the ensuing recession the level of investment is still 16.9% lower than that of 2007 [1]. Public investment has contributed to this falling to 2% of the GDP.

An increase in potential growth entails reviving investment and in the current circumstances the private sector will not do this on its own. The erosion of public capital, with often obsolete infrastructures and inadequate maintenance, justifies boosting public investment, including in Germany, where although research expenditure has been incorporated into investment spending, public investment (142€/capita) is still inferior to the euro zone average (226 €/per capita) [2]. Backed by sound arguments the IMF has just called for this. In the present situation of extremely low interest (for the first time in history French OATs' and Belgian OLOs' yields are below 1%), many public investments have an economic return higher than their financing costs. Short term they impact demand positively. Mid-term, if investments have been well chosen, it is the offer effect that prevails. Here the domino effect on private investment is vital due to a rise in productivity triggered by investments in infrastructure, R&D and human capital.

In this paper I shall defend seven proposals. Intentionally, by virtue of political realism, these proposals are based as far as possible on existing institutions and instruments. I have also intentionally avoided starting with financing even though there are serious resource allocation issues, because I believe that a regulatory, incentive-based framework is a vital precondition.

1. CONTINUATION AND IMPROVEMENT OF SPECIFIC MARKET REGULATION

Investment means taking our societies toward the future. Investment has to anticipate future needs and products. To do this an attractive market has to be created to encourage businesses to develop socially desirable goods and services, to propose them under the best terms and to invest with this goal in mind.

Nobel prize-winning economist Jean Tirole has long ago demonstrated that beyond the general laws of competition there is a need for specific measures for specific industries, particularly network industries (electricity, telecommunications, and transport). These industries are built on infrastructures that grant their operators a "natural monopoly": indeed their high cost means that their duplication is undesirable and this impedes any true competition - in this segment of their activities at least.

Hence the need for specially adapted, more incentive-based regulatory methods, based for example on ceiling prices rather than on the reimbursement of costs, to encourage the optimisation of the latter whilst monitoring the quality of the services provided.

In addition to this, in certain cases, the fact that the internal market is incomplete and that it is still fragmented due to a lack of standards harmonisation and/or a lack of coordination of national policies, is an obstacle to investment. Miguel Arias Canete, the new European Energy Commissioner, stressed this in his first interview. It is also a point that the Commission quite rightly insisted on in its Communication on the Juncker plan [3].

Finally we might also underscore the importance of the continuity of regulation if we want to encourage the private sector to invest long term. "Stop-and-go", so often seen in energy market regulation, is one of the surest ways to discourage investment.

2. EXPLICITLY INTEGRATING THE ISSUE OF PUBLIC INVESTMENT IN THE "EUROPEAN SEMESTER."

This would pursue two objectives. On the one hand, it would aim avoiding that, in view of reaching their deficit target, Member States would sacrifice vital investment spending. The temptation is strong and many governments have given into it: since the Stability and Growth Pact makes no distinction between current

1. However the use of 2007 as a reference year should be qualified since a significant share of investment at this time was linked to the real estate bubble, notably in Ireland and Spain.

2. Even the orthodox Otmar Issing admits: "Public investment is seen as too low. Infrastructure shows signs of decay,; streets and bridges need repair. No doubt, these and other deficiencies are strong arguments for increasing public investment" (Financial Times, 24/10/2014)

3. See section 4.3 : "Reinforcing the level-playing field and eliminating barriers to investment in the Single Market".

expenditure and investment spending, it has been decided to reduce the latter, since it is safer from an electoral point of view to cut research or infrastructure investment than to reduce benefits or operating grants. As part of the "European Semester" the Council addresses recommendations to each Member State; these should include a recommendation concerning the minimum level of public investment to maintain mid-term (not necessarily the same for each Member State). Then in the opinion it has to give to each Member State regarding its draft budget for the coming year the Commission could check whether this recommendation has been respected. On the other hand the more systematic and deeper examination of public investment in the European budgetary cycle might facilitate improved coordination of national investments. This would be particularly useful in the transport sector.

3. REVISING EUROSTAT RULES SO THAT THEY DO NOT PENALISE PUBLIC INVESTMENT

Several governments have noted this bitterly: the impact on public investment of the strict application of European SEC 2010 accounting standards has been extensive. Indeed it is now obligatory for investment spending to be charged directly and entirely to the deficit of the year of expenditure. It is no longer possible to consider that these investments will be amortised over several years. If we have to charge to one single year the cost of investments previously amortised over six, it might be feared that with a constant deficit public investments will decrease by a factor of six. An excellent example of European schizophrenia!

4. DEFINING A PRIORITY CATEGORY OF PUBLIC INVESTMENTS which would not be counted in the application of the deficit reduction rule set by article 4 in the TSCG (the difference between the actual debt to GDP ratio and the reference value – 60% of the GDP – has to be reduced over three years at an average pace of one 20th per year).

To enter into this category a public investment would have to satisfy three criteria simultaneously:

i. A criteria of European interest: the investment must be deemed to be of common European interest according to the Commission's communication of 13th June 2014, which notably means that it contributes to the achievement of one or several of the EU's goals and that it is of a transnational nature – possibly with the participation of several Member States;

ii. *A criteria of economic profitability*: the investment must achieve a minimum ERR (economic rate of return), calculated according to the method set out by the European Investment Bank (EIB);

iii. *A criteria of sustainability*: the investment must include the use of the most advanced technologies that reduce the consumption of natural resources and the emission of greenhouse gases to a minimum.

An European Budgetary Committee should check that these criteria are met; it could comprise representatives of the national independent authorities responsible for ensuring the respect of the TSCG rules (the "Haut Conseil des Finances Publiques" in France; the "Conseil Supérieur des Finances" in Belgium). This committee would be accountable to the parliamentary conference set out in article 13 of the TSCG (a conference convening the representatives of the European Parliament and national parliamentary committees involved).

In fact the adoption of this proposal would mean a return to a limited, supervised version of the true "golden rule": a Member State cannot borrow to finance its current expenditures; however it can borrow to finance productive investments which increase the mid and long term growth potential of its economy.

Proposals 2, 3 and 4 are just as important even post-launch of the Juncker Plan. Indeed private investors often have no interest in investing in a public good whilst the public authorities do, notably because they can glean future profit in the form of fiscal revenues if these investments increase the economy's growth potential. It is clear that this type of investments (schools, hospitals, railway infrastructures) can be financed only with public funds (or by borrowing private funds that benefit from a public guarantee offering the lenders a protection which is greater than that provided for in the Juncker Plan and which would likely be included in the debt of the public authority providing the guarantee).

5. POOLING EIB AND NATIONAL PUBLIC BANKS (NPB) RESOURCES AND COMPETENCES.

Some NPB's have a significant balance sheet – of around

20% of their country's GDP. They were built according to different financing models, often channelling popular savings. But with the exception of KfW and some more recent initiatives, they remain ensconced in their own "territory" unaware of cross border externalities.

One of these initiatives is the Marguerite Investment Fund put together by the EIB, the French CDC, the German KfW, the Italian CDP, the Spanish ICO and the Polish PKO. This experiment should be extended to other joint projects - and why not to the European Investment Fund? The EIF is a subsidiary of the EIB which holds more than 60% of its capital, the remainder being held by the Commission and for a small share by a few financial institutions. Why can't the major national public institutions enter into the EIF's capital? This would be advantageous in two ways: on the one hand it would increase the EIF's means in support of start-ups and SMEs without requiring any additional budgetary resources; on the other hand it would structure cooperation between the EIB and the NPB's by turning them into co-shareholders.

If this proposal seems too ambitious or if they fear domination by the EIB, the NPBs that are interested might use the new European regulation governing the ELTIFs (*European long-term investment funds*) and would put together a Fund between themselves which would invest in addition to the new Fund provided for in the Juncker Plan (EFSI - *European Fund for Strategic Investments*- see proposal No.6). Of course if this suggestion is to be of interest to the NPBs, the ELTIF should enjoy the same support from the European budget as the EFSI, potential contributions made by the Member States should be handled in the same way as their contributions to the EFSI in view of the rules in the Stability Pact. There should also be a clear link between the EFSI and the ELTIF to ensure that their intervention is complementary.

As suggested in the Juncker Plan the EIB and the NPBs might also launch an Investment Advisory Hub with the Commission by pooling technical and financial expertise and by creating a single entry point for project promoters who are seeking assistance [4]. A joint website shared by all participating institutions would provide vital information on all expertise available. Indeed the lack of well-researched, well-structured projects is one of the reasons for the lack of public investments. Many public authorities are unable to identify, prepare and structure projects to make them bankable. The hub would be able to guide them towards technical assistance regarding project design and preparation and guide them to the most appropriate financing sources and instruments.

6. ATTRACTING PRIVATE FUNDS BY OFFERING FINANCIAL INSTRUMENTS BASED ON SHARING OR THE GUARANTEE OF CERTAIN RISKS.

This is the basic idea behind the "*project bonds*" (which should not be confused with "eurobonds"). A company responsible for the completion of an infrastructure project issues bonds to finance it. In order for these bonds to reach a ratings level that leads to subscription by institutional investors (insurance companies, pension funds, sovereign funds, etc.), a subordinated tranche is taken by the European Commission (whose first loss risk is capped from the beginning) and by the EIB (which takes on residual risk).

This formula, which the European Commission submitted to public consultation, was the focus of great interest on the part of institutional investors who were seeking long term, quality investments. However the new Solvency II prudential rules should not discourage this type of long term investment. On the initiative of former Commissioner Michel Barnier, the entry into force of Solvency II, initially planned for 1st January 2014 was postponed until 1st January 2016 and the directive was modified in order to introduce measures that limited excess volatility when holding investment products until maturity. Are these changes sufficient? Some experts, including Jacques de Larosière, doubt it; they believe that the directive continues to penalise long term investment with an excessive capital constraint (see also proposal No.7). Moreover insurers have asked the IASB, the international private body to whom the EU has delegated the initiative concerning accounting standards, to review their recent standard project IFRS 4 because, as it stands, it does not correctly reflect the backing of assets to liabilities and would therefore lead to excessive volatility.

The experimental phase of the "project bonds", for which 230 million euro have been set aside in the European budget, might enable the financing of 4 billion euro in infrastructure investments. We see that the leverage effect based on a relatively modest budgetary provision

4. *See section 3.2: "A single-entry investment advisory « Hub » will be set up to bring together sources of expertise and strengthen technical assistance at all levels."*

is extremely important. But this formula is only applicable to investments that rapidly generate enough revenue to guarantee the service of project bonds (motorway tolls, "captive" railway link between airport and city centre, etc.).

Other risk-sharing formula exist already or might be launched in areas other than infrastructure. This is particularly the case in R&D. Following a first positive experiment with the "*Risk Sharing Finance Facility*" (RSFF) which highlighted the interest of risk-sharing in terms of financing R&D projects (1.2 billion € guarantee by the Commission and the EIB leading to 11.3 billion € in loans by the EIB for 30 billion € investments in research), the Commission and the EIB Group (EIB and EIF) decided to launch a more ambitious programme, both in its size (nearly 3 billion euro in guarantees that should lead to more than 18 billion € in EIB loans (3X6) for 48 billion euro in investments (18x2,6)) and its scope (it will be able to finance research from the initial stages to the market). To this we might add the "*InnovFin SME Guarantee*" managed by the EIF: this provides guarantees and counter-guarantees (9 to 10 billion euro over 7 years) to financial intermediaries to help them finance SME innovation investments without consuming too much of their regulatory capital. The InnovFin programme is part of "Horizon 2020". Again I highlight the greater leverage effect of this type of programme in comparison with the traditional system of subsidies. Undeniably the new programmes based on risk-sharing are a much more efficient use of the European budget's limited means. With the same sum the European budget supports a lot more investment projects.

With these experiments in mind, Jean-Claude Juncker proposed the creation of the "EFSI" (European Fund for Strategic Investments) with an upfront payment of 21 billion euro (16 billion euro recovered from the European budget and 5 billion from the EIB own funds). Hence he hopes, via leverage, to release 315 billion euro in additional investments across the entire EU; the EIB would lend 63 billion (3X21), thereby catalysing private financing to reach a total of 315 billion euro (5X63). The Commission's initiative comes just at the right time. Indeed there is a two-fold development of a liquidity surplus and a severe reduction in terms of alternative investments. The Juncker Plan should enable private investors to find both risk diversification and decent remuneration, and should therefore be received favourably by the markets.

Although undeniably there is abundant available capital seeking productive purpose, the plan put forward by Jean-Claude Juncker does however raise three important questions:

I. For it to impact the economy the investments financed via EFSI have to be additional. Will this be the case? A still undefined share of the 16 billion € taken from the European budget will come from the "Connecting Europe Facility" and from the Horizon 2020 programme; this involves a transfer of resources that have already been budgeted to support financial instruments which would effect major leverage. How do we know that by transferring them to the new Fund, these very same resources will generate a distinctly higher volume of investments? The Commission says that it will monitor this, but it does not explain how. On the other hand how can the EIB be prevented from financing investments via this Fund that it would have financed as part of its ordinary operations anyway? The criteria must be the degree of risk. Even though it has changed in this respect the EIB is still relatively "risk averse" for fear of losing its AAA rating and this is understandable [5]. But the establishment of EFSI only makes sense if the EIB accepts that the 63 billion euro in additional loans are to be granted for investments with a higher degree of risk. This should be possible given the latitude the EIB enjoys following the recent increase in its capital. At the end of 2013 the EIB had a solvency ratio – i.e. a ratio of own funds (58 MM.) to risk-weighted assets totaling 26.1%, in other words a ratio that was far higher than the one of the best commercial banks.

II. The leverage effect – of 1 to 15 – seems quite high, especially if it is planned to finance more innovative, but higher risk investments. In my opinion the factor 15 will only be possible on two conditions which have not been made explicit in the current version of the Juncker Plan:

a. The fund provides a total guarantee on the "first loss", up to 1/15 (i.e. 6.7%) of the total investment cost;

b. This guarantee is given to private investors and not to the EIB or, alternatively, as with the project bonds, the EIB accepts to subordinate the reimbursement of its co-financing to that of the private co-financiers.

If a 6.7% guarantee is given to private investors one would think that it would make the investment more attractive. Experts from the think-tank Bruegel have calculated that

__5.__ Some believe that the EIB places too much importance on maintaining the AAA rating. However downgrading to AA would not be without its dangers:
- The EIB bonds would no longer be considered as "High Quality Liquid Assets" in the sense of Basel III and would no longer meet the conditions required by central banks' "risk guidelines" But the world's central banks are the main purchasers of EIB bonds.
- A great number of EIB bond holders (450 billion outstanding) have to assess their portfolio "marked to market". The downgrading of the EIB's rating would lead to a reduction in the market value of their stock; they would often be forced to sell a share of them because their risk management limits would be reached. In this case the possibility of selling them further emissions would be compromised.
- The dimension of the AA bonds market is unknown. It is possible that the EIB would be unable to issue 75 billion per year.
In all events a downgrading of the EIB's rating would lead to an increase in its financing cost (at least 20bp) and therefore to an increase in costs for its borrowers.

if a project has a 10% default potential and an expected 60% loss, the guarantee is equivalent to a reduction of 75 bp of the rate of return asked by investors if they are to participate in a risky project instead of investing in safe assets [6]. This should prevent any pointless increase in financing costs and therefore a reduction in the financial profitability of the projects.

Even if both conditions mentioned above are defined and met, the announced leverage effect concerning the private sector's contribution is still very ambitious.

III. How can private investors, whom the Juncker Plan wants to attract, be prevented from only investing in countries where they are most at ease, where they feel they will run fewer risks, where they are expecting greater stability? Isn't there a risk of too high a concentration in a few countries? This is a problem that the EIB has already encountered with the RSFF.

Of course, for very good reasons, the Juncker Plan rules out any geographical pre-allocation. However this aspect is one that the project selection committee cannot ignore because it would be unacceptable if a European plan was to widen the North-South gap. Economic and social cohesion is still one of the EU's major goals.

7. PROMOTING THE SECURITIZATION OF COMMERCIAL BANKS' HIGH QUALITY DEBTS SO THAT THEY CAN MAKE MORE LONG TERM LOANS.

Many investments can be financed by commercial banks. However these soon reach a limit due to prudential rules, since capital ratios set on banks are based on the idea that the long term is necessarily risky. Hence the necessity of securitizing these debts in the shape of assets that might be acquired by institutional investors in quest of excellent, long term products. Naturally a highly standardised generation of these assets will have to be provided for, possibly under the supervision of the ECB. The CRD IV and the Solvency II rules, which penalise the holding of securitized products, will have to be revised. Indeed, although a good quality asset only leads to low capital constraint, this is not the case with an asset of the same quality but resulting from securitization, even if it has been approved by a Central Bank. Equal in quality, i.e. with a possible default rate of 0.4% over more than three years, it costs eight times more in capital. The only reason for this comes from the poor reputation of securitization in the wake of the subprime scandal. But it is perfectly possible to provide standards and procedures that guarantee the quality of securitized products. The rule should be: equal quality, equal capital charge. This seems so obvious to me that I am as surprised as some specialists like Jacques de Larosière (BNP Paribas) and Samir Assaf (HSBC): how is it that this regulatory lock (which also impedes attempts to securitize SMEs loan portfolio) has still not been removed?

These seven proposals are undoubtedly not the most structuring –the choice of projects will be decisive in this regard – but from a technical budgetary and financial point of view they are vital in order to jump- start investment.

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6. See the demonstration in G. Claeys, A. Sapir and G.B. Wolff : "Juncker's investment plan : No risk– no return "», Bruegel, 28 November 2014

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