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Initiatives to foster investment in Europe

I shall not discuss the comparison between Europe and the US in terms of investment. We have heard this earlier. And the facts speak for themselves.

I would like to stress a few lines of thoughts.

1 – The first decisive factor behind investment decisions has to do with the behaviour of the economy.

Productive investment is not created by policy.

It it a **result** of business conditions.

If business prospects are good, if markets are expanding, enterprises are inclined to invest.

But if the economy is lagging, private investment – in spite of available financial incentives – will not take off.

In Europe, and in particular the Eurozone, the economy is sagging.

- ✓ During the period 2011-2014, the yearly growth (volume) of GDP has been lower in the Eurozone by 2% points on average compared with the US rate (1% average against 3%),

- ✓ Since 2010 productivity growth has been hovering in the Euroarea around 0 (against + 2% in the US).

Nothing surprising that European investment is poor.

2 – The causes of this situation are, in great part, structural.

When you look at the causes of European stagnation versus the US you observe different elements (more or less significant depending on each country) :

- ✓ Poor profit margins,
- ✓ Barriers to do business, to enter the market,
- ✓ High taxes,
- ✓ Labor market rigidities,
- ✓ Low level of own funds versus credit.

These, typically structural problems, cannot be corrected by more financial incentives.

3 – the third set of issues relates to financial incentives.

- ✓ ***In Europe, equity is systematically discouraged versus debt.***

This is true for taxes.

It is also true for financial regulation.

Ex : Solvency 2 is charging equity holdings by an insurance company a marginal rate of 39% of regulatory capital, while holdings of government debt instruments are charged 0, and BBB ten year corporate bonds are charged 10,5%.

But enough equity is an important factor for investment.

It is capital that allows new ventures. And the lack of equity thwarts the development of SME's.

- ✓ ***Bank lending is dwindling in the Eurozone.***

The usual predominance of banks in financing investment projects (notably in infrastructure) is receding because of financial regulation.

It is now a recognized fact that the doubling of capital charges in a very short time has led banks to reduce the denominator of their capital ratios. Indeed, the outstanding amounts of bank lending to non financial institutions have

been reduced by 2,5% per year from 2011 to 2014. With QE, the trend is now slightly moving upwards (+ 0,4% in July 2015). Given the predominant share of bank financing in Europe, we should not underestimate the negative impact on investment of the new "wave" of regulation that is hitting European banks (Commission proposals to separate investment and retail activities while US and Japan have no such rules ; consideration of additional capital charges to offset national discretions ; ECB policy of binding constraints on banks ability to distribute dividends and pay interest on subordinated debt …).

Although the Commission is improving the regulatory treatment of infrastructure assets under Solvency 2, the proposed calibrations by the Basel Committee of infrastructure projects financed by banks would have extremely negative consequences. For this type of financing the weightings in RWA's would range from 100 to 130% only because of the qualification "project financing" which the Basel Committee puts into a category of especially risky financings (which is not substantiated by evidence).

- ✓ ***Direct financing by enterprises on the bond markets*** has, of course, gone up significantly. But the financial market has not taken up the whole slack created by the banks retrenchment, and SMEs have difficult access to financial markets.

- ✓ ***The reasons are in great part regulatory. They have to do with :***

a) Securitization

Very different situation from the US :

- Too high capital charges (on the junior tranches, the capital charge can go up to 19,7% per year of duration – Solvency 2)[1],

- In the US : securitization has come back to “normal” and GSE’s have offset the reduction of bank mortgage lending. By contrast, European securitization has dwindled.

b) The creation of an Infrastructure asset class is a must.

- Some openings have been recently observed from the Commission in this field but capital charges still overweight the risks fostered by investing in infrastructure.

The, excellent, idea of the “Juncker Plan” is to attract private investors with the support of the strategic European Investment Fund.

[1] *The « additional » capital charge on a securitized instrument should not be higher than 30% (as compared with the capital charge on underlying – non securitized – assets). Under the latest proposals of EBA, the surcharge could reach 4 times and more !*

The secret of the success of this initiative is in the expected leverage :

a) Public funds

- EU budgetary funds : 16 Billion Euros
- EIB guarantees 5 Billion Euros

with a 3 times leverage, these contributions amount to 48 Billion + 15 Billion = 63 Billion Euros

b) Private investors

The private investors are expected to bring 5 times those public amounts i.e. 240 Billion for infrastructure and 75 for SMEs, start ups, mid caps ….

As of September 22nd, the ESIF has signed 46 operations entailing 1,9 Billion public funds and 15 Billion private.

Furthermore, the EIB has prepared 9 projects that amount to 3,7 Billion (of which 1,3 coming from the EIB).

Of course, this is only the beginning of the process.

But, as of now, officially approved projects show a private leverage of 2 (instead of the 5 expected).

If that were to remain, the total amount of 315 Billion Euros investments would be unrealistic.

Much will depend on the ability of the Commission to adapt regulation (Solvency 2 and securitization).

Conclusion

To conclude, the investment picture is rather bleak in Europe.

Gross fixed capital formation has been stable in GDP terms from 2001 to 2010.

It has been negative in 2012 (- 4%) and 2013 (- 2,9%) and has been hovering around 1% in 2014-2015.

Quite a bleak situation compared with the US.

As I have tried to show, most of the reasons behind this poor performance have to do with structural issues.

But on top of that, Europe has devised a regulatory setting that is far from satisfactory.

Ideas like "Capital Market Union" and Juncker Plan will not do the trick if structural issues are not addressed and if the regulatory setting remains unchanged.

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