European Investment Bank
The EU bank

Investment and Investment Finance in Europe

KEY FINDINGS

2015

Investing in competitiveness

Key findings

EIB Economics Department

European prosperity depends on the productivity of EU firms and their ability to compete and perform high value added activities within integrated global production systems. Competitive markets, investments in tangible and intangible assets and the efficient reallocation of resources to high productivity firms and activities are critical enablers for productivity growth. However, investment in Europe remains depressed, with infrastructure investment flagging and more investment needed in R&D and other intangible assets that are increasingly important to competitiveness. Europe has shortcomings in the efficiency of labour and capital reallocation, while the impact of the crisis on the investment environment is aggravating these structural failures. A complementary structural and counter-cyclical approach is needed that addresses both the immediate outlook for investment and the long-term competitiveness of the EU economy.

Investing in competitiveness – getting the conditions right for firm productivity growth

Europe is as competitive as its firms. Competiveness depends on firm productivity, which depends on innovation, and reallocation (creative destruction). In an increasingly open world, it is becoming ever more important that firms are able to perform high value added activities within global integrated production chains.

Competitive and flexible markets promote productivity growth. Institutional conditions such as ease of firm entries and exits, flexible labour markets and open markets for goods and services are essential conditions creating incentives for high productivity growth.

Investment plays a critical role in enhancing competition and providing foundations for high value-added activity. Competitiveness-enhancing areas of public and private investment include: research, R&D, education and training, and other intangible assets; and infrastructure investments, particularly in sectors like energy and ITC (broadband networks) that can both improve efficiency and remove barriers to competition.

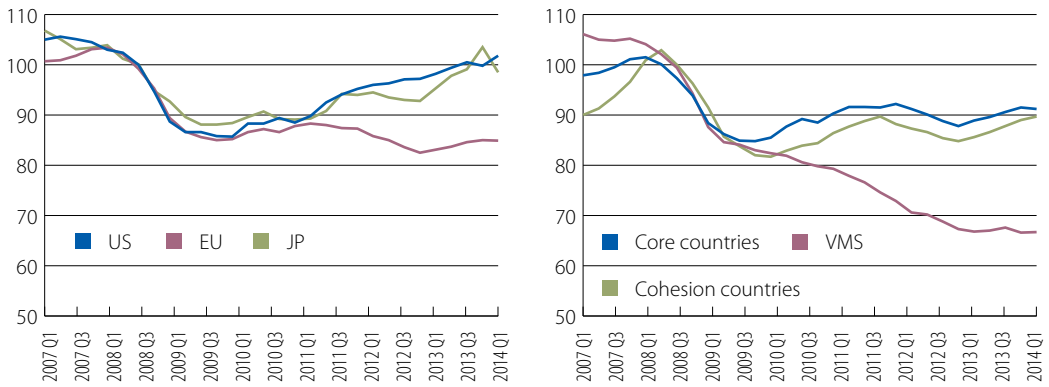
A well-functioning and diversified financial sector is crucial for the efficient reallocation of resources towards more productive activities. The innovation process requires not only finance for activity such as R&D within established firms, but also risk-taking finance adapted to the needs of innovative start-ups and growth stage firms and that can focus financial resources efficiently on growth opportunities. Targeted and well-managed risk-absorbing finance is also needed to ensure long-term investment in public goods such as infrastructure.

Is Europe investing enough?

European investment in tangible assets remains weak…

EU gross fixed capital formation (GFCF) remains weak relative to GDP levels, despite picking up slightly in 2013. Its growth remains about one half of the rate of increase in the US. Depressed investment in dwellings and other structures including infrastructure continues to weigh heavily on overall investment figures. Public investment continues to fall, particularly in the vulnerable Member States (since 2009) and cohesion countries (since 2011).

Figure 1 **Evolution of GFCF in the EU, US and Japan**

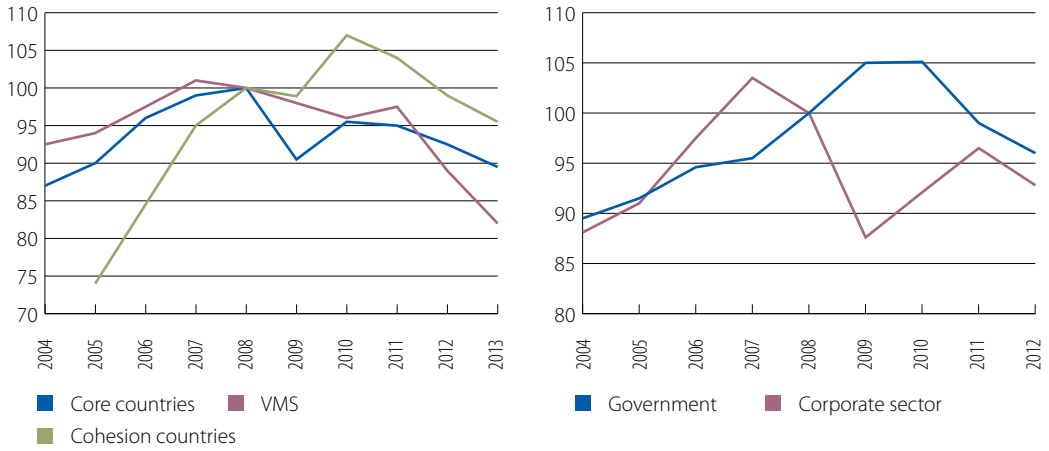


Note: Gross Fixed Capital Formation. Index average 2008 = 100. Source: Eurostat, OECD.

…with infrastructure investment falling

Latest figures suggest a continued decline in infrastructure investment, with both government and private investment in this sector falling in parallel since 2011.

Figure 2 **Real infrastructure investment**

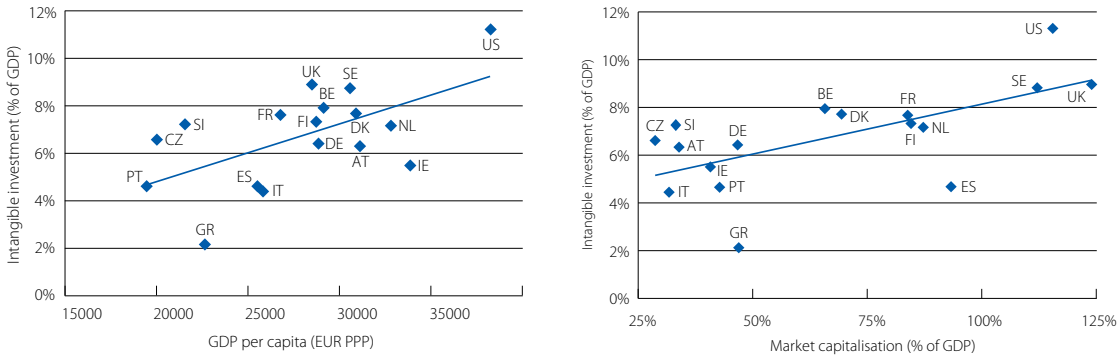


Source: Eurostat, EIB staff calculations.
Notes: "Core countries" include Austria, Belgium, Germany, Denmark, Finland, France, Luxembourg, the Netherlands, Sweden and the UK; "VMS" includes Cyprus, Greece, Spain, Ireland, Italy, Slovenia and Portugal; "Cohesion countries" include Bulgaria, the Czech Republic, Estonia, Croatia, Hungary, Lithuania, Latvia, Malta, Poland, Romania and Slovakia.

More investment is needed in intangible assets…

Productivity growth and competitiveness is increasingly linked to investment in intangible assets such as software, data, R&D, designs, advertising, worker training and new organisational processes. Investment in these assets is closely linked to GDP per capita and to the ability of firms to compete globally in high-tech, high value added sectors, and also to the diverse financing opportunities provided by well-developed capital markets. EU firms – particularly SMEs that also invest less in intangible assets than larger firms – report that high investment costs, limited public financial support and unfavourable tax treatment are the main barriers to greater investment in these assets.

Figure 3 **GDP per capita, market capitalisation and investment in intangible assets (2006-2010)**

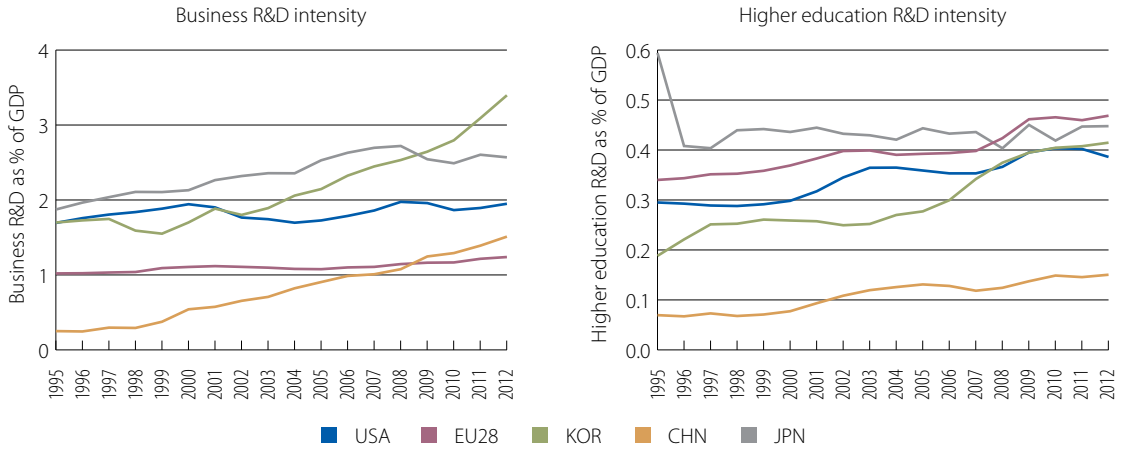


Source: INTAN-Invest, AMECO and Eurostat.

…including R&D

At 2% of GDP, R&D expenditure remains well below levels in other advanced economies such as the US and Japan, and well below the EU 2020 target of 3%, undermining the ability of EU firms to compete at the high value-added technology frontier. EU business investment in R&D remains low because of continued relative specialisation in medium-tech, and because there are relatively few young leading innovators in high-tech sectors. EU government and higher education R&D intensity is comparatively high, although fiscal constraints have started to weigh on this investment, and industry-science links and specialisation in strategic technologies are said to be weak points.

Figure 4 **Evolution of business and higher education R&D intensities in selected countries**



Source: OECD, Main Science and Technology Indicators

What is holding back investment?

Weak incentives for risk-taking investment, amid ample liquidity

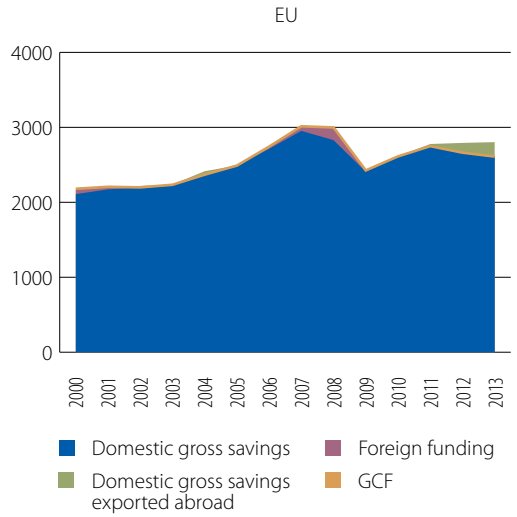
The EU became a significant net exporter of capital in 2011, and exported 7% of gross savings, or around EUR 200bn, in 2013. This reflects market perceptions of low risk-adjusted returns in the EU and deleveraging by non-financial corporations which have become net-lenders to the rest of the economy. Main drivers of weak investment include:

- Weak expectations of demand.
- High levels of uncertainty.
- High levels of NFC leverage (particularly in relation to expectations for firm growth).
- Reduced banking sector appetite for risk posing a potential constraint on recovery.
- Underdevelopment of risk-bearing capital market and equity-based financing alternatives.

SMEs, in particular, face a difficult investment environment

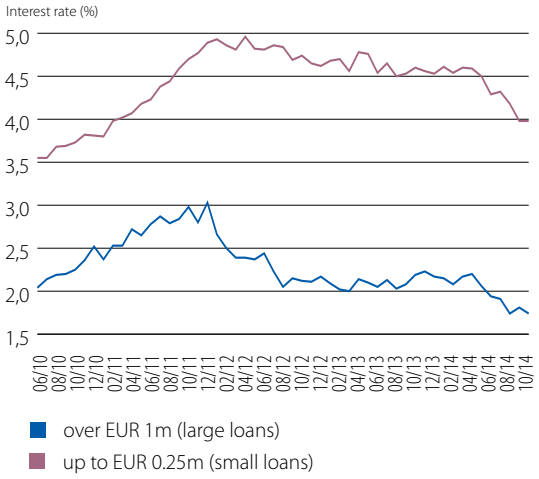
Perceptions of the risk of lending to small businesses have increased, with the spread between Euro Area retail interest rates on large and small loans showing little sign of contraction following its dramatic rise in 2011-2012. SMEs suffered further from their overwhelming dependency on banks for external finance and the relative lack of equity financing options in most European countries. Unsurprisingly, SMEs are most likely to report access to finance constraints in those European countries where banking sectors have been hardest-hit by the crisis.

Figure 5 **Gross EU savings and net foreign funding (EUR bn)**



Source: AMECO.

Figure 6 **Euro Area interest rates on new large and small loans to NFCs**



Source: EIF, ECB.

The structure of EU economies needs to keep evolving to maintain competitiveness…

The structure of EU industries and exports has been evolving to keep pace with global trends:

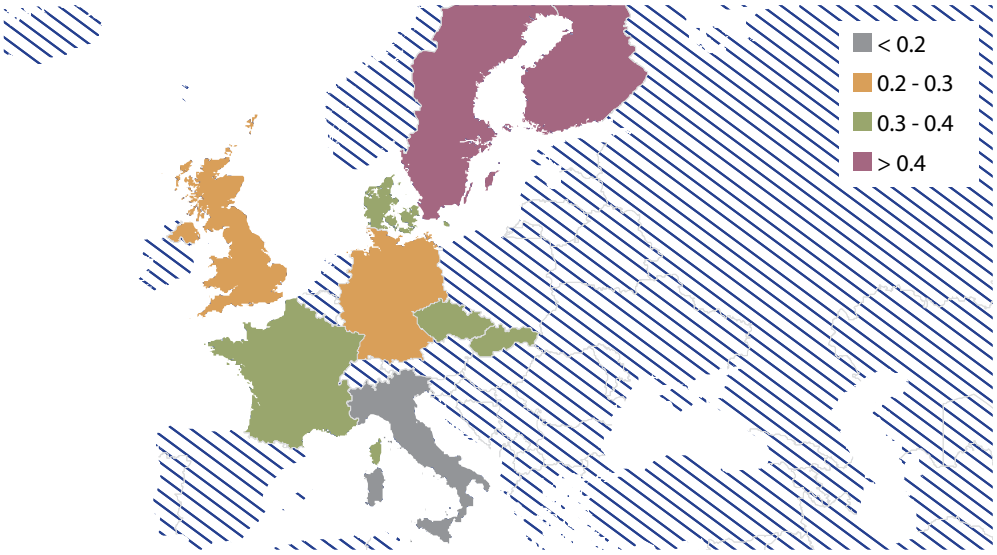
- An EU-wide shift from low-tech to high tech industries, led by Germany and central-eastern Europe and in line with the shifting composition of world trade.
- The rising share of business services in GDP and value added exports, partly because high-tech industries have a stronger carrier function for services.
- Increasing integration within global value chains, with manufacturing job losses largely offset so far by the increased role of services.

Future productivity growth and trade performance will depend on continued restructuring and a greater focus on high value added activities. Maintaining competitiveness in labour-cost sensitive medium and low tech industries (still prevalent in southern Europe) and in low-tech activities (such as assembly) within high-tech industries will become increasingly hard.

…yet the efficient reallocation of resources to higher productivity firms and sectors remains a key challenge for Europe

Enhancing competitiveness entails reallocating labour and capital resources from less productive firms and sectors to more productive activities, including young innovative firms. There are wide variations across Europe in allocative efficiency, a measure of the relative concentration of resources in high productivity firms. Allocative efficiency appears lower in all EU countries examined (apart from Sweden) than estimates for the US. Reasons may include institutional barriers to firm entries and exits, labour market inflexibility, over dependence on bank finance and relatively less developed (private) equity markets.

Figure 7 **Allocative efficiency in selected EU countries, 2005-2011**



Note: Allocative efficiency estimates the percentage increase in aggregate productivity compared to a situation where activity is randomly allocated to firms. EIB calculations based on Bureau van Dijk: Orbis data.

How can we enhance competitiveness?

To compete in an increasingly open world, a dynamic economy is critical. This means innovation to be at the technological frontier or to move towards the frontier, and an economy that can respond rapidly to new growth opportunities. Public intervention needs to create the right environment for this process.

There is scope in Europe for a complementary counter-cyclical and structural approach which can generate the right incentives for investment to restart. Counter-cyclical policy can be well-justified if, for example, it targets the maintenance of competitiveness-enhancing investments over the cycle.

There is a role for both "horizontal" and "vertical" industrial policy to address structural issues. Horizontal policies need to include:

- Structural reforms to enhance competition and the reallocation of resources to more productive firms, such as deepening the internal market or promotion of labour mobility.
- Greater investment in research, education and infrastructure – especially where this enhances market competition.
- Financial market reforms to encourage better provision of risk-bearing financing for young innovative firms and other innovation activities, including through venture capital, high quality securitisation and greater use of credit guarantees.

Vertically targeted intervention is important, but how it is done matters:

- It is needed to address externalities and financing constraints and to ensure that strategic long-term issues – such as climate change or the need to be at the frontier in key emerging technologies - are addressed by the innovation process.
- It should create incentives for firm-level innovation without undermining product market competition. This can be achieved by targeting activities, not specific firms, with clear and verifiable criteria for selecting activities and good governance to prevent capture.

About the report

Investment and Investment Finance in Europe: Investing in Competitiveness – 2015 is a major annual research report by the European Investment Bank (EIB) Economics Department, produced to accompany the 2015 EIB Economics Conference. It responds to the need for a better understanding of the role of investment policy in enhancing economic competitiveness.

Combining in-house research and work by leading academics, the report assesses the continuing impact of the crisis on investment in tangible and intangible assets, and on the financing of these investments. It also examines what competitiveness means in an increasingly open and integrated global marketplace and the key principles that competitiveness enhancing economic policy needs to follow.

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The European Investment Bank

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About the Economics Department of the EIB

The mission of the EIB Economics Department is to provide economic analyses and studies to support the Bank in its operations and in the definition of its positioning, strategy and policy. The Department, a team of 30 economists and technical staff, is headed by Debora Revoltella, Director of Economics.

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