European Investment Bank
The EU bank

Investment and Investment Finance in Europe

KEY FINDINGS

2013

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Key findings

EIB Economics Department

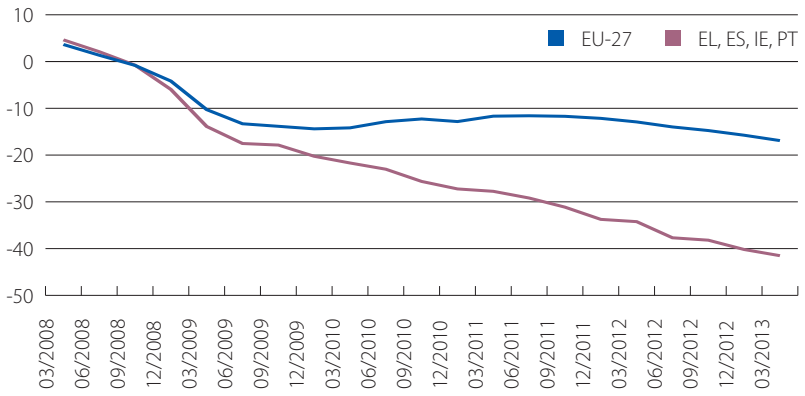
Europe faces an on-going investment crisis. The long-term misallocation of investment across sectors and countries is at the heart of the problem, whilst the most important immediate cause of investment decline during the crisis has been uncertainty. The supply of finance is not the main cause of investment decline; nevertheless it remains a serious constraint for some firms, sectors and countries. Many factors are less important than might be expected. Policy action is needed to resolve uncertainty at the EU level and encourage a shift of resources towards more productive sectors, to be accompanied also by targeted interventions to ease financing for infrastructure, innovation and SMEs.

Europe faces an on-going investment crisis

Europe faces not just an on-going economic crisis, but also a crisis of investment that has potentially serious implications for the economic future of the continent. Chapters 1 to 3 of the report examine investment trends in Europe and the impact of the crisis on investment in fixed capital and research and development (R&D). Data reveal that the economic crisis caused a historically unprecedented collapse in fixed capital investment in the EU. Nearly six years after the beginning of the financial crisis and the recession, investment levels are about 17 per cent below their peak in 2008. Investment continues to be depressed, particularly in the most crisis-hit old Member States – Greece, Ireland, Portugal and Spain (Figure 1).

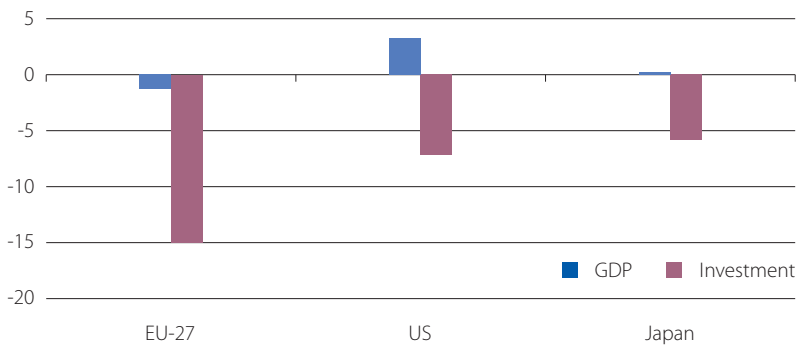
The decline in investment in Europe between 2008 and 2012 was double that in the US and Japan (Figure 2). Reversing the decline will be critical to achieving recovery and sustainable growth over the longer term.

Figure 1 **Decline in total investment in the EU and crisis-hit States**



Source: Eurostat.

Figure 2 **Change in investment and GDP between 2008 and 2012 in EU, US and Japan**



Source: Eurostat.

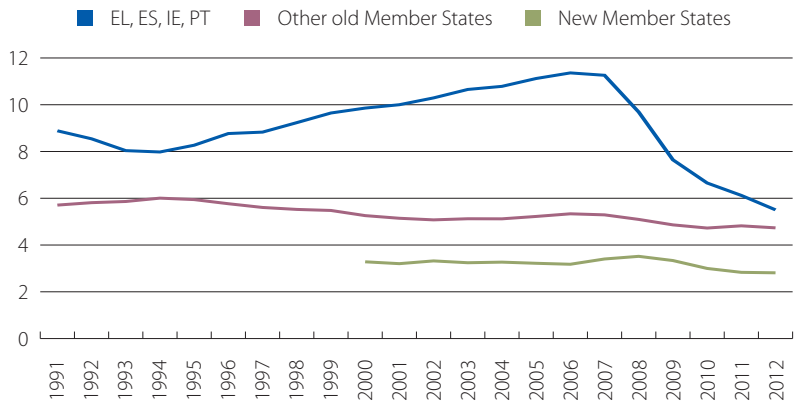
What went wrong?

The long-term misallocation of investment across sectors and countries is at the heart of the problem

It is important to emphasise that the crisis in investment can ultimately be related to a legacy of structural imbalances, including overinvestment in sectors that have not proven a good basis for sustainable growth. In the run-up to the crisis, some countries saw an unsustainable expansion of borrowing from both domestic and foreign sources. This led to excess consumption and overinvestment in sectors such as real estate (Figure 3). Overinvestment in residential construction has been a hallmark of the old EU Member States most affected by the crisis, particularly Spain and Ireland.

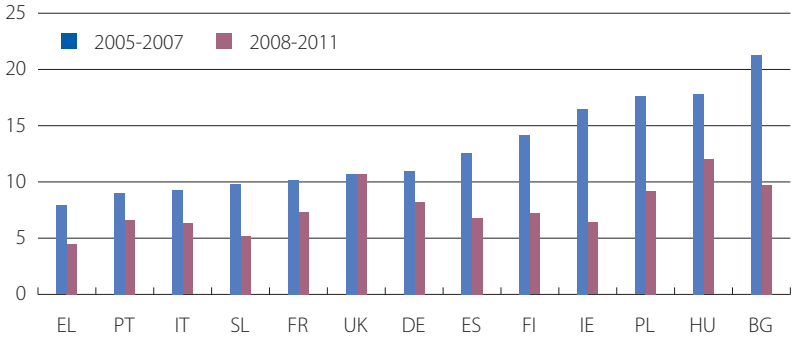
Overcapacity has contributed to low returns, discouraging investment. While investment returns have fallen substantially across the EU, large differences can be observed between different countries (Figure 4). Returns have been lowest in Greece, Slovenia, Italy and Portugal, and highest in many of the Eastern European new Member States. Sectors suffering most from overinvestment, such as construction, have seen the largest decline in returns, helping to account for the notably large falls in returns in Ireland and Spain.

Figure 3 **Investment in housing in the EU (% GDP)**



Source: AMECO. No data for Latvia.

Figure 4 **Nominal annual returns on investment in selected EU countries (%)**



Source: Own calculations based on Bureau van Dijk's Orbis database and Eurostat.

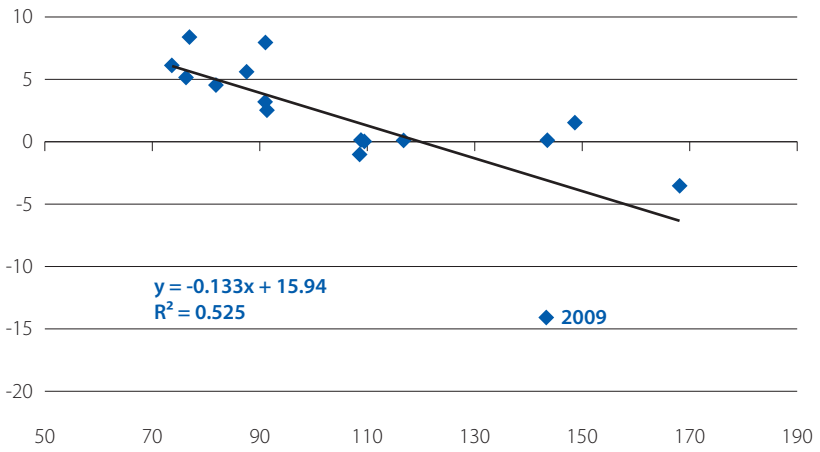
The most important immediate cause of investment decline has been uncertainty

Of all the different factors impacting on investment, the research shows that uncertainty about the world economy and the resolution of the European financial and sovereign debt crisis is probably the main culprit.

Fixed investment by firms is not typically continuous or gradual but "lumpy" and hard to reverse. Faced with uncertainty about policy changes or the wider economic situation, managers often adopt a "wait-and-see" attitude, postponing major investment until uncertainty is resolved. Correlating business fixed investment with an index of policy uncertainty, Chapter 2 suggests that policy uncertainty could account for as much as 53 per cent of investment decline in Europe (Figure 5).

The fear that unaccounted for bad debt still held by banks might lead to another credit crunch is one of the main causes of uncertainty. It is one of the main reasons why corporations have sought to hoard cash rather than invest. Together with uncertainty about the ability of some euro area governments to repay their debts and rescue large banks without becoming insolvent themselves, it has also led to the financial market fragmentation of the Eurozone, reducing cross-border capital flows and contributing to the financing difficulties of some firms in crisis-hit countries.

Figure 5 **Correlation of economic policy uncertainty with rate of change in business fixed investment**

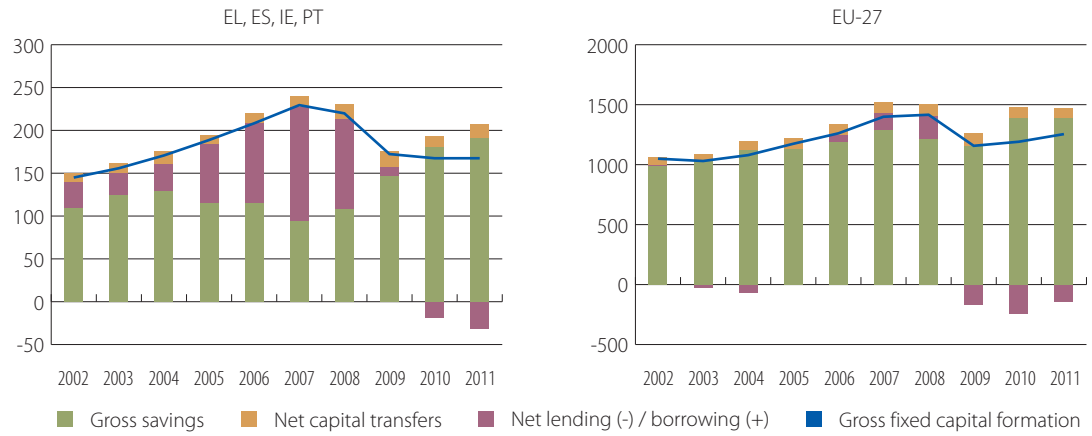


Source: *Baker, Bloom and Davis at www.PolicyUncertainty.com, Eurostat.*

The supply of finance is not the *main* problem across the board…

The report shows that the investment crisis did not result from a generalised lack of finance. As Chapter 4 shows, non-financial corporations have actually increased their savings through cost-cutting and lower interest and dividend payments. Europe-wide, they are not overburdened by debt. Instead they have become net lenders, particularly to governments (Figure 6). Generally speaking, firms have access to the funds they need for investment.

Figure 6 **Investment and savings by non-financial corporations (in EUR bn)**

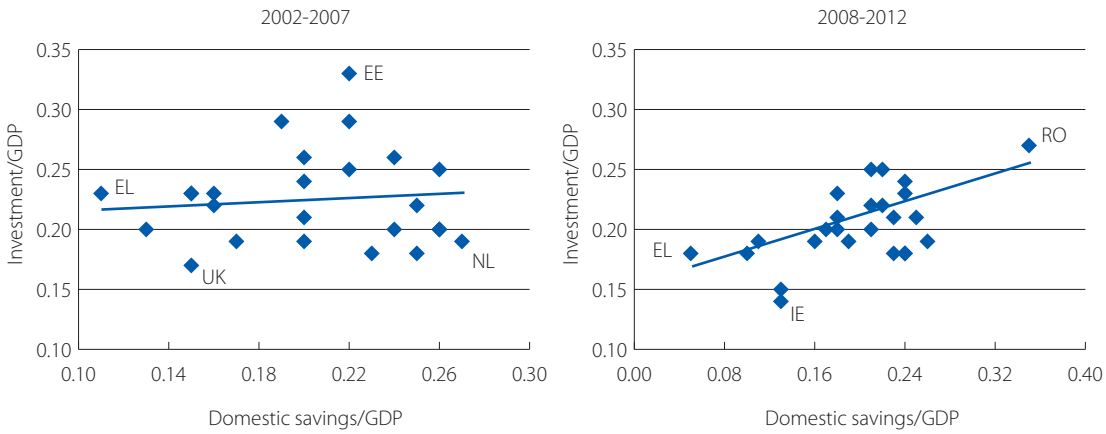


Source: Own calculations, Eurostat.

…nevertheless, it remains a serious constraint for some firms and countries

However, the abrupt disruption of cross-border, intra-EU capital flows has made countries more dependent on domestic saving, possibly constraining investment in some countries (Figure 7). Small and medium-sized enterprises – market segments most dependent on bank lending – innovation and infrastructure have been hardest hit. Chapters 9 and 10 examine how bottlenecks for financing SMEs and young innovative firms have been created by heightened risk aversion and the scaling-back of important alternative financing options including SME securitisation and venture capital. Bank deleveraging also correlates most strongly (and negatively) with investment by smaller, non-listed firms that are more dependent on bank finance.

Figure 7 **Correlation of national investment and saving rates, before and during the crisis**



Infrastructure has also become harder to finance, despite significant, though variable, infrastructure needs across the EU. This report's most conservative estimates show that Europe needs to invest EUR 470bn a year in economic infrastructure. This presents a real challenge as bond markets for infrastructure projects have dried up, private long-term finance is harder to find and strong fiscal consolidation is taking place in many countries.

There is less clear evidence on the negative impact of other factors

Parts 2 and 3 of the report investigate the different factors that have contributed to the slump in investment. Many factors have played a role, but evidence for the impact of some of the "usual suspects" is less clear:

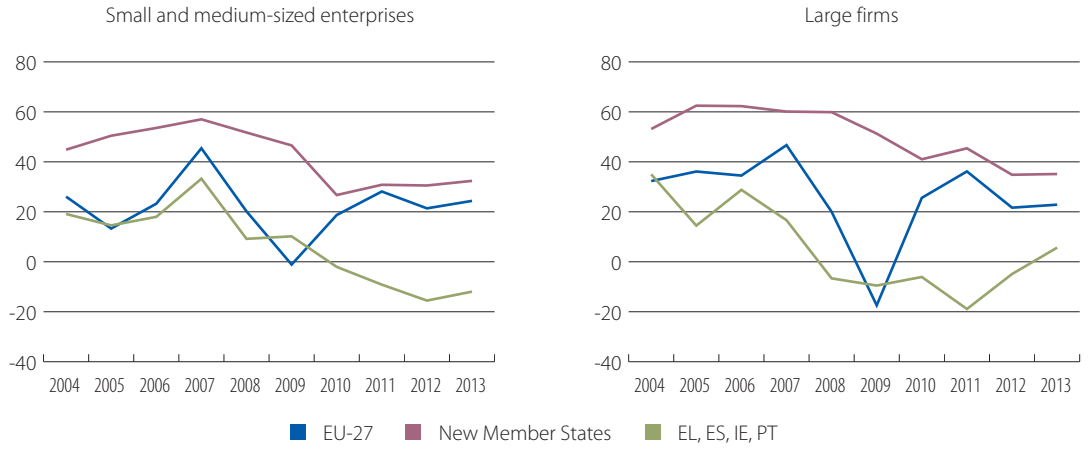
Returns on investment – As shown in Chapter 5, real returns on investment have fallen across Europe, sometimes strongly. But these falls have been substantially offset by lower borrowing costs. Regression analyses show that lower returns can only account for about 25 per cent of the decline in investment.

The fragmentation of European financial markets – The crisis has caused the integration of Europe's financial markets to go into reverse (Chapter 7), with less cross-border borrowing and the re-emergence of significant national differences in borrowing costs. However, this "disintegration" appears to account for less than 10 per cent of the investment decline.

Bank deleveraging – Despite warnings that new capital and liquidity requirements would force banks to cut back their lending, this hasn't happened yet. Most EU banks have not deleveraged yet, except in the new member states, and even here, Chapter 6 shows that bank deleveraging has not had a statistically significant effect on investment. In Chapter 8 it is argued that the negative impacts of new and proposed regulatory reforms will be small, and much outweighed by the long-term benefits.

Demand expectations – The European Commission's investment survey suggest that demand expectations were a major factor depressing investment in 2008 – 2009, but that expectations have recovered substantially since 2010 and cannot explain much of the continued investment slump. Only in the most crisis-hit member states – and particularly for small and medium-sized enterprises – are low expectations of demand still reported to be a major problem (Figure 8).

Figure 8 **Reported positive or negative impact of demand on investment decisions**



Source: *EC Investment Survey. GDP-weighted averages of country indices. Numbers show net balance of firms' views (in % of answers) on whether sales prospects and rate of capacity utilisation are stimulating for investment.*

What needs to be done?

Resolving uncertainty needs commitment and rapid progress on the institutional reform of European banking

Credible commitments to implement current proposals for a banking union would go a long way towards reducing uncertainty, mitigating financing bottlenecks where they exist and encouraging investment. However, setting up the institutional structures of a banking union will take time and cannot replace urgent *ad hoc* measures to restore confidence in the financial system.

Sustainable growth requires structural reforms and a shift of resources towards more productive sectors

Structural reforms that encourage a shift to more productive sectors by reducing obstacles to the reallocation of resources are crucial not only for the most crisis-hit countries, but also for the rest of Europe. With some sectors suffering from low investment returns, intervention to promote investment should be properly targeted.

Targeted public intervention is needed to ease financing for infrastructure, innovation and SMEs

Public policy should seek to enhance bank lending to SMEs and innovative business ventures where there is evidence that they face funding constraints. As long as risk aversion remains a major constraint on bank lending, this could also involve greater use of loan guarantees and securitisation. A key lesson from the financial crisis of 2007-08 is that more diversified financial markets reduce the likelihood of borrowing constraints for the corporate sector. Companies with access to deep capital markets managed to replace bank loans by borrowing directly on those markets. The financial system of continental Europe is likely to remain bank dominated. Nonetheless, economies that are over-reliant on banks to provide credit should aim to diversify their financial systems so as to gradually increase the share of local bond and equity markets in the external finance mix of the corporate sector.

For investment in infrastructure, bank lending and corporate capital expenditure will need to continue to play a central role. An effort can be made to increase the relevance of pension and insurance institutions as a source of finance for infrastructure projects in the future, but their role is likely to continue to be overshadowed by more traditional players. There is, however, scope for the further development of alternative sources of finance such as public-private partnerships and project bonds.

About the report

Investment and Investment Finance in Europe – 2013 is a major research report by the European Investment Bank (EIB) Economics Department, produced to accompany the 2013 Economics Conference. It responds to the need for a better understanding of the impact of the crisis on investment in Europe, and a better understanding of how Europe can be put back on a sustainable growth path.

Combining in-house research and work by leading academics, the report assesses how the crisis has impacted investment across the non-financial sector, in small and medium-sized enterprises (SMEs), in infrastructure, and in R&D and innovation. It explains why and where investment has declined, looking at the impact of structural imbalances, policy uncertainty, new capital requirements for banks and the fragmentation of Europe's financial markets. In terms of policy options, it warns against poorly targeted responses and provides, instead, support for key policy interventions at the European level.

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The European Investment Bank

The EIB is the bank of the European Union. As the world's largest multilateral borrower and lender, we provide finance and expertise for sound and sustainable investment projects, mostly in the EU. We are owned by the 28 Member States and the projects we support contribute to furthering EU policy objectives. Under our external mandates, we also help to implement the financial pillar of the EU's foreign policy.

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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