Institute of International Finance

Economic Advisory Committee – Spring 2013 Meeting

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Special address, speaker: Werner Hoyer, President, EIB

Ladies and Gentlemen,

Introduction

Welcome to the European Investment Bank. It is our pleasure to host the Economic Advisory Committee of the Institute of International Finance. You represent the leading private and public institutions of the global banking sector. Having so many economic experts together will contribute to our common understanding of the trends, issues, challenges and opportunities that international finance currently faces. A quick look at the very interesting –and dense – agenda shows that there is plenty to discuss. Clearly, this period of crisis provides quite some excitement to the professional life of a Chief Economist.

But before talking about economics, I would like to take you back to a curious event that happened in the year 1741. Back then, it were also chaotic times in Europe. Various wars were being fought. On his way back from the front, a young lieutenant and his horse got stuck in a swamp. No-body could hear his cries for help as he was sinking deeper and deeper into the mud. But then this young soldier, whose name was Baron von Munchausen, did something remarkable: he pulled himself out of the swamp by pulling on his own bootstraps![1] Now this is quite something indeed!

What does it take to do such an extraordinary thing as getting out of a precarious situation entirely by one's own efforts? This question is of relevance for Europe too, as I think we can all agree that Europe should not blindly and exclusively rely on global economic developments to solve its problems. Clearly, the Baron was very determined and believed in himself, which are very helpful qualities for Europe as well. But above all he was lucky to have the right

[1] Note: In the German version of the story he pulls himself up by his pigtail (which is equally extraordinary).

conditions: the right type of mud and proper boots! And here comes the difference with Europe: we can ***create*** the right conditions!

And we are very busy doing so: we are working on institutions and institutional settings, implementing structural reforms, addressing financial market fragmentation and creating the conditions for growth. We are fighting the crisis at different fronts and we are extremely determined – and I am confident that we will succeed in lifting ourselves out of the mud.

So, let me first briefly discuss the swamp Europe is in now and the coordinated response of EU institutions. I will then turn to the importance of establishing sustainable growth. It is here where my own institution, the European Investment Bank, plays an important role since creating the conditions for growth is in fact one of our main aims.

Recent economic events

The last five years have been characterised by various spells of financial and economic turmoil. Over time, the crisis has hit many countries while its centre of gravity moved across different parts of the economy. We have witnessed the meltdown of leading financial institutions in the US and Europe, a global economic slowdown, countries getting into severe financial difficulties and even, at some moments, concerns about the survival of the European Monetary Union.

Today, the situation in Europe is still delicate. The rather fragile state of the banking sector and the deteriorated financial conditions of countries are at the core of everyone's attention - and rightly so. Structural reforms in the EU periphery are needed to restore competitiveness. At the same time, however, it is more and more evident that the protracted recession reduces public support for widespread changes. The crisis has also shown that even within the Union or the euro area, countries can come under intense market pressure once the sustainability of their public finances is questioned. Market confidence is still feeble, capital flows to some countries remain under pressure and access to finance is strongly constrained in a number of countries.

While times remain challenging, I am impressed by the extent of the European response. Coordinated by the European Commission and the "Eurogroup", the Eurozone countries are undertaking major adjustments to consolidate national budgets and to improve competitiveness. Deep structural reforms are at the core of current programs in Ireland, Portugal, Greece, Cyprus and Spain, but are also figuring prominently in all other countries of the Union.

To ensure a lasting correction of imbalances and sound public finances, new policy rules have been agreed and 25 EU countries have committed to proactively coordinate budgetary policies. Financial fire fighting capacity has been increased considerably. The European Central Bank has taken a very pro-active role with the Outright Monetary Transactions to fight against fragmentation of the European financial market. The European Financial Stability Facility and the European Stability Mechanism have been created, providing a combined firepower of EUR 700bn. At the same time, Europe is working on structural institutional solutions – the Banking Union is a paramount project which will deliver single supervision to banks, a single resolution framework and probably, even if more in the long run, some form of coordination in deposit protection schemes.

But we should not forget that solving the current problems depends crucially on the ability to establish sustainable growth in Europe. And I am not just talking about growth for the region as a whole, but about a broad-based, all inclusive growth. We need this growth, not only because it helps to solve the other problems, but also because it reduces the large internal disparities in Europe and in the euro area. Hence, we should not be distracted from a long-term focus on growth.

Potential Sources of Growth

So, how can Europe be put back on the track of sustainable growth? Clearly, it is not a given that just waiting to be saved by the outside world will work. Looking to domestic sources for growth, though, immediately highlights the importance of balance sheets. Some European countries do not just suffer from over-extended government and bank balance sheets, but also from over-extended household balance sheets. In many cases, this stress is sufficiently large to be a drag on domestic demand. A recent analysis of IMF staff[2] finds a striking, negative relationship between pre-crisis indebtedness and post-crisis growth.

What does this finding tell us? Firstly, it suggests that at least part of the incurred debt was not used to finance productive investment, but instead was spent on consumption and possibly speculation. It also indicates that the impact of balance sheet problems is not disappearing overnight. In turn, corporate and household financial problems are worsening the interdependence between growth, public finances and banking health. Vicious circles are like swamps: it is not easy to get out of it.

Governments have to balance their wish to stimulate the economy with the need to cut their debt levels. Households facing increased risks of unemployment and a decrease in the value of their real estate have good reasons to lower their consumption. Companies are understandably reluctant to undertake substantial investments given the uncertain economic outlook.

Role of Banks

Banks can play an important role here. History has shown us that recessions that are accompanied by banking crises take longer and are more severe. The link between banks and the real economy is not only playing a role at the onset of a crisis, but equally much in

[2] R. Moghadam (2013) "A missing piece in Europe's growth puzzle", iMFdirect.

resolving it. A recent paper by Bruegel,[3] the think-thank, shows that while creditless recoveries have taken place before, they are rare in high-income countries with well-developed financial markets. As European companies depend to a large degree on bank loans for their financing, it appears that restoring normal lending is a crucial element for a recovery. For that, the current easy monetary policy would have to be better translated into lower lending rates.

This immediately brings up the demand versus supply debate. And, of course, demand factors certainly exert a drag on bank lending volumes, but one cannot completely ignore the supply side. Indeed, the latest ECB survey on the access to finance[4] finds that SMEs continue to perceive a low willingness of banks to provide loans. Constrained access to finance has a direct effect on the long-term growth potential: several academic studies have found that companies with reduced access to finance tend to cut future-oriented investments in order to survive for another day.

It is precisely for this reason that the EIB can make a difference. As access to financing is constrained, as future returns are highly uncertain and as the overall risk-perception has increased, long-term investments are disproportionally hit. Let's have a look at some types of investment and see how they have fared so far and how they compare with countries outside the EU.

Gross fixed capital formation

Gross fixed capital formation over GDP in the EU is now some 15 per cent below its peak of 2008, even when housing is excluded. As GDP growth is the main driver of changes in investment levels, it is no surprise that the crisis has such a severe and protracted effect. However, the extent is remarkable. Previous recessions that followed a systemic banking crisis saw an average drop in investment of around 10 per cent and a recovery within three years. This time, investment has fallen much further and according to the latest industrial investment survey[5] it still has to bottom out.

The decline in investment is broad-based. On average, public sector investment has fallen less than that of the private sector. Of course there are clear differences across countries, with the largest fall in investments as a share of GDP observed in the cohesion countries and the new member states. When looking to different asset types, we see that investment in machinery and equipment has started to recover, but progress is slow. On the other hand, investment in, for example, non-residential construction is stabilizing at best.

Investment in infrastructure has held up quite well during the beginning of the crisis, partly reflecting stimulus programs, but has recently started to be affected by the austerity measures.

[3] Z. Darvas (2013) "Can Europe recover without credit?", Bruegel policy contribution 2013/03.
[4] ECB, "Survey on the access to finance of SMEs in the euro area (SAFE)", coverage up to 2012 Q3.
[5] European Commission, "Investment Survey", results of October/November 2012.

It is important for Europe's competitiveness that we don't fall behind with long-term investments as they are a main driver of future growth. Investments over GDP in the EU are consistently lower than in Japan. And though they are still higher than in the US, the difference is getting smaller as US investments are already recovering since 2010.

R&D Investments

Let's now turn to the financing of knowledge. R&D spending in Europe has withstood the crisis relatively well. However, there is a structural gap in R&D spending between the EU and competitors such as the US, Japan and South Korea. Moreover, new rivals such as China are closing in. Lagging behind in R&D spending means lagging behind in innovation, productivity, competitiveness and long-term growth. Boosting R&D expenditure and in particular R&D expenditure of businesses would not only address a weak point of the EU, but would also have the advantage of being directly linked to new products, growth and jobs.

Due to the particularly uncertain returns of R&D projects, arranging financing is not obvious. Currently we see that access to finance is an issue for some sectors with a high R&D intensity such as Chemicals and pharmaceuticals, Telecoms and software and Mechanical and electrical engineering. The situation is worst for small firms and midcaps in countries hard-hit by the crisis, but even in better-performing countries midcaps face considerable challenges in accessing finance.

Role of EIB

What is the role for a public bank like the EIB in this climate? One reason that the banking crisis is so severe in Europe is its reliance on bank-based financing. The EIB is stepping up its activities to fill up the increased finance gap. One way is to provide more long-term funding for SMEs and midcaps through commercial banks. But we are also increasing our direct lending to larger companies and public authorities. Both infrastructure projects and investing in knowledge generate positive externalities, which makes them a priority for a public bank like the EIB. It is through the provision of long-term financing for sound projects that the EIB contributes to creating the right conditions for sustainable economic growth.

Due to our size and nature, we have a unique position in the European financial sector. Our annual lending in the EU amounts to some 3 per cent of non-residential gross fixed capital formation.[6] Moreover, our lending is complemented by a substantial amount of co-financing as we typically provide only a third of a project's financing needs. Our recent capital increase allows us to respond to the crisis by expanding our annual lending to some EUR 65-70bn in the years to come.

[6] EIB signatures as a share of non-housing GFCF in 2009: 4.4 per cent, 2010: 3.8 per cent, 2011: 3.2 per cent and 2012: 2.6 per cent.

Let me give you a quick overview of our activities. Last year alone, the EIB lent some EUR 9bn to innovation projects – covering basic research, product development and support for the commercialisation of new products. In infrastructure, key areas are fixed and mobile broadband networks as well as transport projects to improve intermodal connectivity such as large ports. We are also actively financing renewable energy projects, smart grids and interconnectors that link electricity grids of individual Member States. Throughout, we closely cooperate with the Member States to identify their national, regional and local growth priorities.

I would also like to mention that the EIB Group provides risk finance to SMEs across Europe through the European Investment Fund with the aim of promoting entrepreneurship, innovation, R&D and ultimately growth and employment. Finally, together with the European Commission we have developed a number of joint financial instruments which promote private sector investment in key EU priority areas by blending EIB finance with EU budgetary resources.

Closing remarks

Let me conclude here on a positive note. Companies in Europe are overall in a good financial state. They have the capacity to spend and private investment thus holds significant promise as a driver of recovery. However, it is not a good strategy to wait until the global economy lifts us up. Instead, we should "pull ourselves up by the bootstraps". That effort is well underway. It should by now be clear that Europe's response to the crisis is supporting the rebalancing of the euro zone economy and that it has ensured the integrity of the euro. One critical element of the answer is the role played by my own institution. At the EIB we are supporting the creation of the right conditions for sustainable growth in Europe.

While pulling yourself out of a swamp makes for a nice and entertaining fairy-tale, the story of how the EU gets itself out of the crisis is perhaps more twisted but no less uplifting!

Thank you for your attention and I wish you two interesting days with enriching discussions!