EIB Economics Conference 2017

Conference Report[1]

The 2017 EIB Economics Conference took place in Luxembourg on November 23rd. It was once again organized jointly with SUERF, the European money and finance forum. This invitation only, high-level event attracted leading policy makers, academics and representatives of private and public financial institutions, with an impressive range of speakers and around 170 participants in total. The one-day conference was organized in three panels. It was opened with welcoming remarks by President Hoyer of the EIB and a policy address by Klaas Knot, President of the Dutch central bank.

The conference saw the launch of the EIB's flagship *Investment Report 2017/2018: from recovery to sustainable growth*.

Key Outcomes

Speakers' interventions were very much aligned in calling for policies to enhance European competitiveness and sustainable growth, to be implemented at the EU and single country level. The recent strengthening of the investment recovery should not justify complacency, it was argued, as long as structural weaknesses of the European economy remain. The recipe formulated includes:

- Re-prioritisation of high quality infrastructure spending, as well as climate-related investment
- Enhanced support for intangible investments and firms' innovation capacity, and improvement of the business environment
- A particular focus on skills, to close skills gaps and mismatches
- Strengthening private sector risk-sharing mechanisms through completion of the Banking Union and Capital Markets Union, allowing for a diversification of funding sources for firms.

[1] Prepared by Tim Bending, Atanas Kolev, Barbara Marchitto and Debora Revoltella of the EIB Economics Department. The conference took place under the Chatham House rule. The views expressed in this publication are those of the authors and do not necessarily reflect the position of the EIB or speakers at the conference. For details of the conference and speakers presentations see: http://www.eib.org/infocentre/events/all/annual-economics-conference-2017-investment-and-investment-finance

Opening

In his opening remarks, **President Hoyer** stressed his own views for the future of Europe, calling for a three-pronged EU response to address the structural needs of the EU: financial sector integration, improving EU competitiveness, and strengthening cohesion and convergence. With respect to financial sector integration, President Hoyer highlighted the need to quickly advance with the completion of the Banking Union and the Capital Markets Union. Following up on **Klaus Regling**'s remarks at the speakers' dinner, he also stressed the complementarity between the ESM and the EIB. The European Stability Mechanism provides the backstop funds in crisis times for Eurozone members. The EIB plays the role of an investment facility for the EU, which in difficult times can act counter-cyclically to quickly channel investments where they are needed most, and which in normal times can address the structural weaknesses of the economy.

Next, President Hoyer stressed the importance of a greater policy focus on creating a competitive Europe and discussed the role of the EIB in improving European competitiveness. He described how, in the context of perceived investment needs to address structural challenges for the European economy, the EIB lends to bankable projects that comply with strict economic, technical, environmental and social standards, with the result being high quality capital stock that yields tangible results and improves people's lives. Traditional EIB lending and the further contribution allowed by the European Fund for Strategic Investment, or EFSI, have an impact on the European Economy. President Hoyer noted that the EIB and the European Commission have estimated that the investment supported by EIB lending in 2015-2016 will lead by 2020 to EU GDP that is 2.3% higher and a net increase in 2.3 million jobs.

Reinforcing economic and social cohesion and convergence is an important priority for Europe and the EIB is one key European instrument to accomplish this goal target, according to President Hoyer. The EIB helps to deliver growth, jobs and cohesion in Europe, he said, by addressing economic and social imbalances, by promoting the knowledge economy, skills and innovation and by linking regional and national connectivity. The EIB supports the implementation of EU regional policy and often co-finances projects alongside EU funds, helping to attract other investors to maximise the impact of EU financing.

The welcoming remarks of the President of the EIB were followed by a policy address by **Klaas Knot**, President of De Nederlandsche Bank, the Dutch Central Bank. President Knot confirmed the concerns associated to the level of investment in the euro area, he underlined the drivers of business investment and finally, remarked on the contribution of public support to sustainable growth.

The level of investment in the euro area is still below pre-crisis levels due to still subdued public and residential investment, he noted. Business investment, on the other hand, has recovered and has exceeded historical averages. Favourable financing conditions and high levels of cash holdings by the corporate sector, however, may warrant even higher investment levels. While it is difficult to identify the exact reasons for this, Klaas Knot argued that foreign demand, weak balance-sheets and tight credit for SMEs have been key factors restraining investment since 2013.

While public investment has been rather subdued in the past few years, raising public investment should not be a goal in its own right, he argued. Public investment should take place as long as there is a positive net social benefit and private actors fail to achieve the desired outcomes. That said, President Knot argued that in two areas there is an obvious need for increased public investment: human capital accumulation and mitigation of climate change.

Panel 1: Investment and investment finance in Europe: a policy perspective

The first panel was chaired by **Debora Revoltella**, Director of the EIB Economics Department. It was devoted to discussing the drivers of investment trends and the potential need for policy support.

Dr Revoltella began the session by presenting the key findings of this year’s EIB Investment Report. Among other points, she noted that:

- The investment recovery has firmed and became broad-based.
- While the cycle has turned and access to finance has been improving, there remain significant structural problems at the European level and in most EU countries, calling for further policy action in the form of a focus on structural reforms and targeted support to investment.

- Years of under-investment in public infrastructure and in climate change mitigation call for a re-prioritisation and focus on planning and technical capacity. The competitiveness challenge calls for a focus on intangible investment, innovation and skills, as well as improvement in the business environment, to reduce labour, product and especially service market regulation. More diversified sources of finance available for firms are crucial to strengthen the system and allow more innovation to take place. However, with only 1% of firms asking for more equity, changing the incentive framework remains the priority, as well as completing the Banking Union and Capital Markets Union and addressing the remaining legacies from the crisis.

The speakers in this panel were **Marco Buti** (Director General, DG ECFIN, European Commission); **Vitor Gaspar** (Director, Fiscal department, International Monetary Fund); **Catherine Mann** (Chief economist, Organisation for Economic Co-operation and Development); and **Peter Praet**, Member of the Executive Board, European Central Bank. A surprisingly strong alignment of views emerged from the panel, with the general policy recommendations presented in the EIB 2017-2018 report reconfirmed and being alternatively stressed by panellists. To say it in the words of one of the panellists “we are in a world of trade-offs, but in the case of investment there is a convergence rather than a trade-off, which makes it easy for policymakers to spend political capital. Investment indeed can help the stability of the EU, but can also address structural challenges, if well targeted.”

The upside potential of service sector harmonisation was remarked upon, as well as the completion of the EU single market in general. Digitalisation was regarded by all participants in the discussion as critical for the future. It is expected that in 20 years’ time it will become as ubiquitous and important for the functioning of the economy as is electricity is today. This calls for increased efforts by policy makers to remove barriers and incentivise the penetration of digital technologies in aspects and sectors of the economy. The digital single market was singled out as a very important condition for increasing the competitiveness of European firms. It was predicted that digitalisation will transform the world economy, and it was argued that it is important for economies to be early adopters and to shape how digitalisation works.

Government investment was another key topic for discussion, prompted by the findings of this year’s EIB Investment Report that public and infrastructure investment has remained at subdued levels in the aftermath of the financial crisis and the phasing out of the fiscal stimulus in 2010-2011. It was recognised that public investment should be guided by considerations about creating net social benefits. Quality of delivery in public sector infrastructure is crucial and requires further attention also at the European level. Nevertheless, policy makers should realise the importance of refraining from reducing capital expenditures pro-cyclically during economic downturns. On the contrary, good infrastructure and public investment projects, if preserved, can make the ratio of government investment to GDP move counter-cyclically and provide crucial help to aggregate demand, when needed. Two speakers singled out the importance of improving administrative capacity to implement investment projects. Project selection, appraisal and management appear to be weaker in the EU compared to other advanced economies.

Finally, some participants in the discussion talked about the issue of zombie firms and misallocation of resources, calling for more speedy action in addressing inefficiencies. The rule of monetary policy in addressing stabilisation was underlined, as well as the need of more structural policies to address misallocation of resources. Some participants voiced concerns about the resilience of the recovery to the withdrawal of policy support, again offering an opportunity to stress the importance of structural reforms, to be implemented at the national level, but also to prevent the single market fragmentation.

Panel 2: The role of innovation and skills in boosting investment activity

The second panel was chaired by **Natacha Valla**, Head of Policy and Strategy in the Economics Department of the EIB. The panel discussed the impact of human capital, innovation, technology advancement and uncertainty on investment. The speakers were **Eric Bartelsman** (Professor, Vrije Universiteit); **Yuriy Gorodnichenko** (Professor, University of California Berkeley); **Sergei Guriev** (Chief Economist, European Bank for Reconstruction and Development); and **Jan Svejnar** (Professor, Columbia University).

Participants in the discussion agreed that investment in skills, and more general in human capital, is instrumental for inclusive growth both in advanced economies and in middle-income countries. Such investment varies significantly across countries in Europe and government policy should provide market incentives for acquisition skills, and human capital in general, and to apply these in the market economy.

It was underlined that what matters for growth is not just increasing the average number of years spent in education. The quality of education that results in the acquirement of relevant skills is much more important. Policy makers should reassess the wrong incentives provided by non-market distortions, because distorted incentives result in inefficient use of skills.

One of the panellists pointed out that boosting investment in human capital and other intangibles is good not only for improving future productivity and wellbeing, but also for reducing the impact of future uncertainty on investment.

As in the first panel, increased trade openness was pointed to as one measure to address the slowdown in productivity and the convergence of middle-income economies to advanced ones. More trade openness will help improve job relocation to more productive industries, thereby increasing aggregate productivity.

Efficient reallocation of resources was another subject of discussion at this panel. Participants acknowledged that innovation is essential for productivity growth and modern innovation should be complemented with the appropriate skills. Economic efficiency requires that resources flow to the most productive and innovative firms, but this is not unlimited. The limit is reached where marginal products are equalised across firms.

If the limit is breached, capital and labour are misallocated and aggregate investment in human and physical capital falls and innovation declines. Capital and labour misallocation varies across the EU substantially. This points to large potential gains to be reaped, especially for countries with a high degree of capital and labour misallocation. This can be done by improving institutions and the business environment. The focus on structural reforms was again bought back in the debate and considered crucial. Too stringent business and labour market regulation not only directly affects firms' behaviour, but is also a constraint to efficiency-enhancing reallocation of resources; it might impede firms' capacity to react to uncertainty and constrains innovation. In this way, indirect feedback loops add to negative direct effects, substantially reducing economic prospects.

Panel 3: The European financial landscape and access to finance

The final panel session was chaired by Barbara Marchitto, Head of Country and Financial Analysis Division in the Economics Department of the EIB. She opened the session by pointing out that

while financial conditions are broadly favourable in the EU, the EIB Investment Survey shows that pockets of tight access to finance remain in several European countries and in specific segments of the enterprise space that may prove crucial to promoting innovation, and hence productivity and long-term growth. The panellists were **Sebnem Kalemli-Özcan** (Neil Moskowitz Endowed Professor of Economics, University of Maryland); **Mario Nava** (Director for financial markets monitoring and crisis management, European Commission); **Boris Vujčić** (Governor, Central Bank of Croatia); and **Reinhilde Veugelers** (Professor, University of Leuven and Bruegel).

A first panellist argued that the sluggish recovery of corporate investment in Europe is closely related to the type of prevalent investment finance: excessive reliance on debt, particularly short-term debt, as opposed to equity, has generated a debt overhang problem, rollover risks and insufficient risk-sharing, ultimately leading to a misallocation of capital and low total factor productivity. By referring to the analysis presented in the Investment Report the nexus between different sources of financing and different types of investment was explained, showing that diversified forms of finance are necessary to support investment in intangible capital. Indeed, firms finance tangible assets mostly with external finance (short and long term bank loans); firms who have more than 50 percent of their total financing from external sources increase investment more in the aftermath of the crisis. This result corroborates the importance of access to external finance, particularly during downturns:

- SMEs use internal finance to fund intangible investment; and
- Trade credit was an important source of finance both for SMEs and large firms during the crisis.

Two key policy lessons follow:

1. SMEs need to move from internal to external finance for their intangible investment, especially R&D.
2. National regulations should be enhanced to allow more cross-border asset/equity ownership.

A second panellist provided an original overview of Europe's corporate innovation landscape and access to finance, showing a strong link between lack of young innovators and the rather conservative nature of the EU financial sector. The lack of young leading innovators in the EU, especially in new innovative sectors, was associated to issues related to access to finance and cumbersome business regulation. To address these constraints, innovation policy should aim at enhancing the investment environment and encourage firms to take more risk and develop new projects. This would also require the further development of private capital markets – particularly in the high-risk, early stage segments. Public funding can also be warranted to solve market failures faced by young, innovative firms. Evaluating the effectiveness of policies is key to learn from best-practices.

The discussion followed with the consideration that financing constraints no longer represent a major obstacle to corporate investment growth, while deleveraging pressures have been abating.

However, legacies from past excessive leverage still exist, including zombie firms and associated zombie banks, particularly in the construction sector where most of the non-performing loans (NPLs) are recorded. Against this backdrop, the financial resilience of corporates faces a number of challenges:

- Corporate leverage (debt-to-equity ratio) remain an important determinant of corporate resilience;
- Firms' fixed assets are mainly financed by bank loans. As such they represent a burden to financial statements and increase credit riskiness of companies (as they are difficult to divest in times of troubles); and
- Late collection or inability to collect receivables increases exposure to liquidity and credit risk of corporates, with thousands of SMEs going bankrupt yearly across EU because of cash flow disruptions induced by late payments.

To address these challenges, a number of solutions can be considered, including:

- Implementation of active and mandatory risk management based on the role model implemented in financial sector;
- Raising provisioning requirements particularly in situations where signals of debt overhang are emerging;
- Reinforcement of financial discipline with a view to increasing short term liquidity (and decrease days sales outstanding and days payable outstanding, resulting in reduction of trade credit balance);
- Promoting incentives for firms to hold more equity, thus reducing leverage, by strengthening contract enforcement (legal security increases the usage of external financing) and tax incentives; and
- Normalisation of monetary policy that will contribute to making equity less expensive compared to debt.

The final speaker focused on a review of the policy responses and challenges. Europe's normative environment has strengthened considerably along with the economic and financial outlook, particularly with reference to the bank resolution framework. Banks' fundamentals (capitalisation, leverage, liquidity) have improved. However, pockets of risk remain (especially idiosyncratic ones) and there is no room for complacency, particularly so long as the Banking Union (BU) and the Capital Market Union (CMU) are not complete. Regarding the former, three issues are crucial:

- NPLs – given the sheer magnitude of the problem, both push measures (higher provisioning) and pull measures (bring book value down) are needed. The development of a secondary market in the context of the CMU and securitisation would be beneficial to this effect;
- It was noted that in the context of the European Deposit Insurance Fund (EDIFSS), negotiations are stalled on the back of legacy risks (largely NPLs);
- As for a backstop for the potential issues emerging from the deposit insurance fund – a single resolution fund was deemed important at the EU level.

Closing

The conference was brought to an end with closing remarks from **Andrew McDowell**, Vice President of the EIB.

Reflecting on some of the key lessons from the day's proceedings, he noted that the recovery is turning a spot light onto a number structural issues that have been somewhat neglected in a period more concerned with fire-fighting. He pointed to the issue of competitiveness and the need to address slowing productivity growth, and the need for greater investment in all kinds of intangibles, including skills. He also emphasised the need for accelerated investment to combat climate change and the necessity of reprioritising infrastructure to support Europe's long-term prospects. He described how the scaling back of counter-cyclical support has implications for the EIB, but should also signal a return to a situation in which the EIB has an even more "natural" role to play as the dedicated EU institution for support to sound long-term investment, to addresses market failures and structural needs that would not otherwise be addressed by the market.