Shifting Europe from austerity to growth: a proposed investment programme for 2012-2015

FEPS – IPD – ECLM

Policy Brief

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This paper is focused on finding a policy approach that quickly facilitates and stimulates future growth, and thus goes well beyond austerity. Increasingly, as economic performance has deteriorated in most European countries, EU public opinion and leaders have begun to stress with increased urgency the need for far greater emphasis on growth. Meaningful actions on a sufficient scale have however not yet been taken.

In this paper we aim to make specific proposals on how one key and successful EU institution, the European Investment Bank, (EIB) can expand its lending significantly, in ways that will make a meaningful contribution to growth, particularly in the countries, whose economies and citizens have suffered most from the sovereign debt crisis; we will also examine the role which EU Structural Funds can both on their own, and especially as a complement to EIB lending, further contribute to EU growth. After outlining in some detail the type of measures that can be taken, as well as their scale, we model the likely impact on GDP and employment, which would be significant. One important advantage of our approach is that with fairly limited public resources, it can achieve a very large impact, due to the benefits of leverage.

1. Policy Context

There is growing consensus that it will prove impossible to lead the EU out of crisis without stimulating sustainable growth. For example the recent downgrading of Spain is already mainly driven by the lack of growth perspectives in the near future. A downward spiral for banks, enterprises and consumers needs to be urgently avoided. A widespread resolution of the sovereign debt crisis will only succeed with a significant growth impulse. To ignore this is not only bad arithmetic and worse economics, but also ignores the clear lessons of history.
There is the need for an additional growth-promoting financing strategy which:
- produces rapid and significant effects;
-enhances productive capacity, encouraging present and future sustainable growth by financing economically sustainable projects and activities;
- supporting the growth of both existing and new competitive small and medium sized enterprises. Particularly these enterprises are suffering severe lack of access to private credit, which has been stagnating during the crisis or, worse still, declining.

There is the need for a proposal that is not only desirable but also feasible. A sound initiative, which has real chances of success, therefore needs to be:
- Feasible to implement quickly. Time is short; every day 4000 additional Spanish citizens are entering unemployment.
- Have sufficient size to make a meaningful contribution, to help kick start growth and reduce unemployment;
- Be cost effective in terms of large impact with relatively limited additional public resources; the measures we propose provide significant leverage

The historical experience of the Marshall Plan after World War II can serve as a valuable reference concerning the proper size of such a program. The plan for Europe consisted of a total of $13-14 billion in currency of that period.. That represented yearly additional investment of about 0.5% of European GDP, over about 5 years, altogether about 2.5% of GDP. A similar order of magnitude would be relevant today.

2. The Dimension of the EU-budget

The EU budget approximately equals to 1% of European GDP annually. To generate a significant growth impulse, it is important to use the EU budget in an effective way, which maximizes its impact via leverage. Increased lending by the EIB, as well as project bonds, are ideal instruments for these aims, as is increasingly recognized. A key challenge is to deploy such instruments on a meaningful scale and do that rapidly, as it is so urgent to re-start growth, as well as to channel them towards efficient investment.

Regarding the dimension, our proposal would involve additional budgetary resources that represent only a very small proportion of the total EU budget allocated to growth; however, as we will show the impact on growth would be very large, given the multiplier effects provided by leverage.
The European Commission plans expenditure of €1000 billion for the seven years from 2014 to 2020, of which 38% are assigned to structural funds, 9% to employment and social matters and 8% to research and innovation. (see Figure 1).

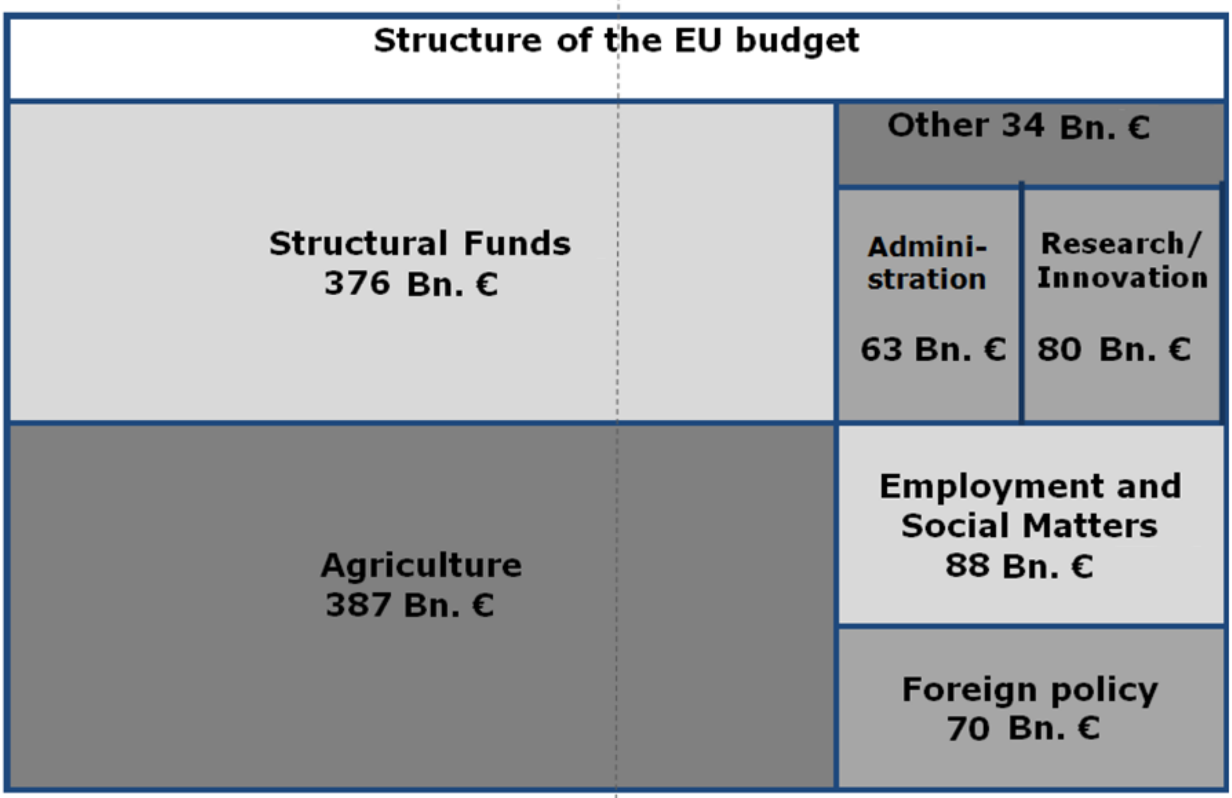

Figure 1: Dimension of the EU-budget according to the EU Commission for 2014-2020.

3. Additional resources; use of EU-structural funds which were not drawn down

Structural funds provide between two to three percent of GDP to regions with developmental deficits. The draw-down of these funds has been especially difficult since 2007, being slowed down by the crisis. For that reason, a big sum of pledged, but not drawn down, funds will be available in 2012 and 2013 (including final down payments until 2015). For the time being some 25 % of the Regional Funds are not even allocated. Even more important, not all the volumes being allocated will be drawn down because of delays and difficulties linked to the crisis. In the framework of an immediate program to recover growth, the task ought to be to rededicate these funds and channel them for activities for growth. It has been estimated that up to € 80 billion are available for such re-use. To achieve this task, more flexibility by national and European administrations is required. What is also needed is targeted regrouping of funds into economically viable projects, especially "shovel ready" ones in areas such as:

- energy efficiency and renewable energy;
- promoting competitive, preferably export-oriented enterprises
- financing of small and medium sized enterprises that are credit rationed;
- financing of innovation in enterprises and enterprise spin-offs.

The re-channeling of available resources should be designed to not just provide funds, but combined with technical support to assure the appropriate draw-down of funds. This technical support should include help with preparation of application documents, support with bidding processes and project management during implementation.

4. Dimensions of an immediate program from the EU-budget

If a concerted effort is made using re-channeling, €15 billion annually can be easily pooled from the existing European budgets (until the end of 2013) for direct use in such a growth initiative in an immediate program. This volume could be raised from the new budget for the period 2014 to 2020 to about €25 billion per year.

Looking at the special case of Greece, it becomes immediately clear that we are talking about a long-term economic reconstruction process, which will require persistence. Even the maximum value of €25 billion from the EU budget represents merely 0.25% of EU GDP. It will be possible to apply a higher percentage to countries with economic adjustment programs and lower ones in countries, which can achieve growth on their own. For that reason, a corridor, between 0.5% of GDP at a maximum and 0.125% of GDP at a minimum suggests itself. However, even growth-projects in stronger countries will generate positive effects for growth in all of Europe.

This investment volume must be complemented with money from other sources, including national and private ones, and be increased as much as possible by its multiplier effect. However, it will not be possible without the EU-budget.

5. Achieving leverage effects with the EU-budget

Achieving leverage with the EU budget is in effect the easiest and most promising path to put the European Investment Bank to a better use.

The basic mechanism is to use a part of the EU-budget as a risk buffer. Thereby EIB-loans for projects become less risky, which permits either higher volumes or lower interest rates, sometimes facilitating otherwise impossible financing. The leverage effect with the most mature product (innovation) was projected to be five, thereby having one billion Euros from the EU-budget facilitating 5 billion Euro of credit in innovation. De facto, a factor of six was realized via the EIB, actually a bit better than planned. As losses were considerably below prudent forecasts, most of the one billion Euro were not used, but instead returned to the EU-budget.

Thus, in this area empirically verifiable experiences exist. Examples are in the financing of innovation (RSSF) and in regional financing (JESSICA, JEREMIE) EIB schemes. The recently signed initiative for SME's in Greece is likewise similar. The planned EU-project bonds, which do not represent EU-borrowing, but instead expand EIB-activities, also veer in this direction.

6. EU-project bonds and the EIB

According to the project bonds proposal, large projects could be co-financed by the EIB alongside with private capital from pension funds and insurance companies that currently do not fund large investment projects, due to too high risks. Before the financial crisis, these risks were absorbed by large mono-line insurers (such as AIG), with the help of which the financing of such projects were transformed into triple-A bonds. After the crisis, this insurance is no longer available.

The project-bonds would work in similar ways. Private investors would advance 25% in equity. The EIB would finance the next 25% as mezzanine tranches. The final 50% (senior tranches) would hopefully reach a rating of BBB+ or A-, thereby becoming an allowed investment class for pension funds and insurance companies. Regarding the mezzanine tranche, the EU would absorb half of the risk using the risk buffer, which is liable for first losses.

The EIB remains a part of financing for the entire time of the project, thereby adding an additional element of quality for the insurers and pension funds.

The risk of financing for the EIB is thereby reduced- compared to the risk if the EIB were to do it all on its own. If the EIB receives this risk buffer, it can lend up to four times the amount of low-risk loans as compared to independently realized projects.

If one wanted to reach, for example, a loan volume of €160 billion in four years, and € 40 billion per year, this corresponds to additional EIB financing activity of €10 billion per year, and €40 billion for the four year period. To finance the €40 billion from the EIB (25% of 160 billion) for four years, €20 billion from EU-budgets for the risk buffer, and €5 billion yearly, are needed.

7. Increasing the equity of the EIB

If the EIB is to play an even more active role in the framework of a large-sized growth program, the injection of new money will be necessary - which may not be possible for all EU-member states.

Why is that the case? In the past, paid-in equity injections from member-countries were financed by the cumulative profits of the EIB. Of the officially subscribed equity of the bank of € 232.4 billion, only € 11.6 billion are actually paid-in. In addition to these sources, the EIB, during all the years of crisis has managed its financing activities well, increasing its annual profits from € 1.4 billion to €2.3 billion most recently. Thanks to retained profits of decades additional equity of € 42.5 billion has been generated, increasing the robustness of the EIB and its capacity to bear risks.

Rating agencies require now a simple leverage ratio of eight to be also applied to the EIB, in the same way as applied to private banks.

If paid-in equity of the EIB is doubled, paid-in capital would only have to increase by around €12 billion. This, given a leverage of eight, (which is high in comparison to other instruments) would generate an ability for the EIB to increase loans by around €95 billion in total during the next few years. If the loan increase is distributed over four years, it could for example lead to increased lending of € 10 billion during 2012 , to €35 billion lending growth in 2013, and to €25 billion annually in 2014 and 2015(all these figures are for lending above that which would have happened without the capital increase).

Thus a leverage ratio of "only" eight represents a notable multiplier effect and better than what can be achieved with EU-budgetary means, where the effect resides between four and six. The focal point of financing activity, as always with the EIB, will be economically viable projects. Such an earmarked capital injection could be dedicated especially to targets of focused pro –growth and employment policies, from the financing of innovation, to the promotion of SMEs, to economic landmark projects, such as a cable connection from the most suitable European locations for solar energy production in Crete to the mainland, an investment which is economically viable but finds no financiers.

Doubling equity will be possible, if EU member governments that wish to do so, (unanimity is not required) inject a relatively small amount of paid –in capital, of around € 12 billion. Compared to the massive sums injected to save the private banks, this is a fairly small amount, with a huge multiplier effect on growth.

It seems appropriate to emphasize the selectivity and earmarking for the equity increase of the EIB. For this reason, the money should be returned after 12 years through a special dividend payment (distributed over several years).

8. Additional proposed EIB and EU growth program.

In summary, two additional effects can be obtained with the help of the EIB. One is based on a selective, earmarked equity increase of around € 12 billion from member countries willing and able to commit. This will permit extra loans annually of € 10 billion for 2012 and € 35 billion for 2013, going down to €25 billion annually for 2014-2015. The second source stems from the use of EU-budgetary means for risk buffers to finance infrastructure projects (project bonds) as well as projects to promote innovation. Devoting annually €5 billion from the budget to risk buffers facilitates additional €10 billion in EIB loans per year. We are assuming a four year initiative with respect to the financing of risk buffers

Adding the different measures together, the proposed growth impulse (summarized in Table 1 and Figure 2 below) consists of:

- In 2012 €15 billion of activities funded by the EU-budget (structural funds rededicated) as well as €20 billion of extra EIB loan activity (10 billion financed by EU-budgetary means for risk buffers, €10 billion financed by the capital increase); this implies altogether €35 billion for 2012.
- In 2013, €15 billion funded by EU budget (again rededicated structural funds) as well as €45 billion of extra EIB loan activity (€ 10 billion financed by EU budget for risk buffers, €35 billion financed by capital increase). This implies all together € 60 billion.
- In 2014 and 2015, €25 billion of activities funded by the EU-budget and €35 billion in annual EIB loans (again €10 billion by budgetary means for risk mitigation, and €25 billion of extra loans supported by the capital increase); this totals €60 billion per year.
- Thus over the 2013-2015 period, we have an average of €60 billion a year additional EIB lending and EU budget injections to finance extra investment and working capital; this corresponds to about 0.5% of EU annual GDP. As discussed below, this could have a major impact on EU growth and employment.
- From 2016 to 2020, there would be continued €25 billion of additional activities funded by the EU budget.
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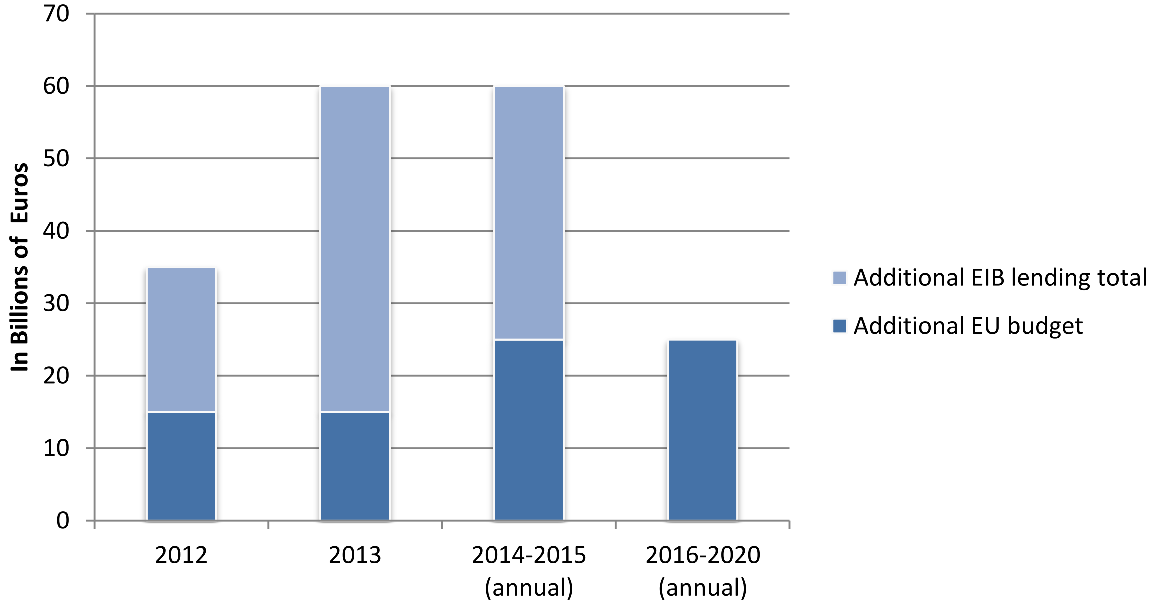
Table 1: Additional proposed EIB and EU growth expenditure programme (in billion Euros)

	2012	2013	2014-2015 (annual)	2016-2020 (annual)
Additional EU budget	**15**	**15**	**25**	**25**
Additional EIB lending total	**20**	**45**	**35**	
-- Risk buffers	10	10	10	
-- Capital increase	10	35	25	
Grand Total	**35**	**60**	**60**	**25**

Figure 2: Additional proposed EIB and EU growth expenditure programme (billions of Euros)



It is both feasible and important to set-up as soon as possible a reliable investment program of this size, in order to foster a credible, sustainable growth impulse that carries Europe forward.

Though slightly smaller, with a total dimension of about 2% of GDP, but with quite important front-loading, this current plan could -like the Marshall Plan- contribute to a significant renewal of growth dynamic in Europe.

9. Investment multiplier of the program for growth

The advantage of the outlined program for growth also lies in the fact that it attracts other financing partners, notably from the private sector. So an additional leverage or multiplier effect is created.

The most evident multiplier can be found in the risk buffered activities of the EIB related to project bonds, where the explicit purpose is to bring private finance to work for infrastructure projects. The multiplier for this product is four. The promoter brings in some 25 % on equity, EIB with the budget support of EC money provides the next risky 25 % as a kind of very junior or mezzanine loan and in addition EIB commits itself to an originate and hold strategy. The private investors are invited to come in with 50 % of the financing as a senior loan (or in the form of project bonds). The resulting multiplier is four looked at from the view of the EIB lending. The resulting multiplier is eight looked from the view of the EU budget. The multiplier for the risk buffer for innovation can be calculated in the following way. As the EIB finances up to 50 % with the regular loans to innovation and in some exceptional cases up to 75 % a multiplier of two on average seems appropriate. For the EU budget the multiplier is in between four and six for the risk innovation buffer. These two different products are described above together.

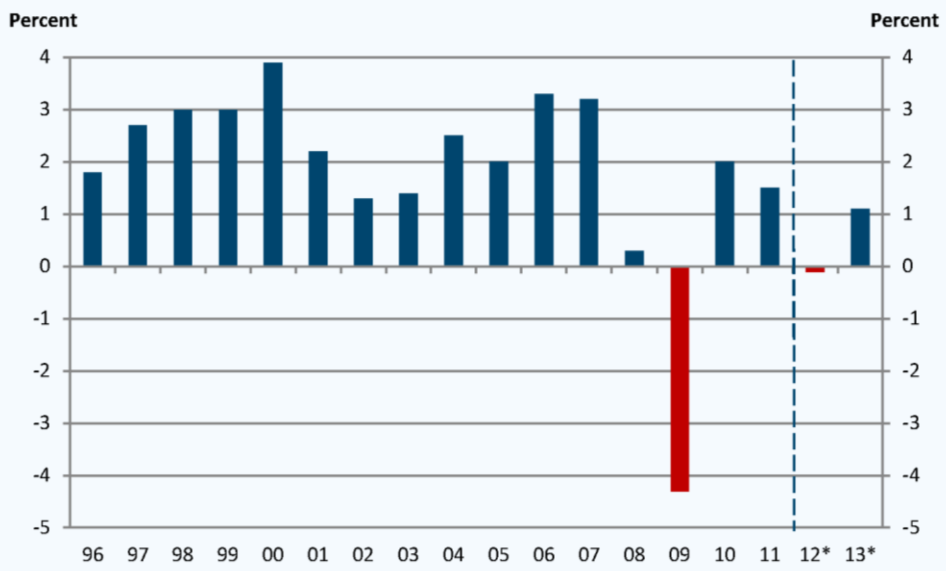
The second pillar of the program is the additional EIB lending based on the selective and targeted capital injection. The lending of EIB on average contributes a financing share of 50 % and another financing partner (or a group of) with the same size of 50 %. This average reflects some rather lower participation shares, notably with very big projects such as offshore wind-farms and higher participation shares where the anti-crisis-component is higher or where the innovative impact requires a higher share of EIB than 50 %. So the multiplier is calculated as an average of two. If the additional lending of the EIB based on the capital injection is front loaded for the first four years, the respective figures are € 95 billion of additional EIB lending for the first four years, resulting in total investment of up to € 190 billion.

Besides multipliers achieved by leverage of EIB and co-financing with the private sector, further multiplying effects can be achieved by the EIB co-financing with increased lending by national development banks where these exist; a very successful example is the German KfW.

10. Estimating impact: EIB lending and EU expenditure creates 1.2 million jobs in Europe

In spite of the fact that the crisis broke out almost 4 years ago, Europe has still not regained its momentum and the EU is expected to go into recession in 2012 (see Figure 3). Growth prospects for the Euro zone are even gloomier. Growth in Europe in 2013 is expected to be in the range of 1 pct. which is still below the historical growth rate. These figures could be significantly worse if the crisis deteriorates, as looks quite possible at the time of writing.

Figure 3. GDP-growth in the EU, 1996-2013



Note: *= forecast

Source: AE on the basis of Eurostat (historical data) and Consensus Economics (forecast data).

The gloomy growth prospects point to a Europe that is clearly not yet past the crisis. 24 out of 27 EU countries are under the EUs Excessive deficit procedure and are recommended to tighten fiscal policy. This has led the leaders of the EU to focus on restoring balanced budgets in an attempt to "cut-back" their way out of the crisis.

Recently, the European leaders are starting to realize that economic upturn is far from self-generating and a coordinated European growth package seems likely to become a reality. The key question in this matter is how the growth package should be financed. A consensus is starting to form, viewing an expanded role of the European Investment Bank (EIB) and of EU Structural Funds as one key of increasing investments in Europe. This view is supported by the European Commissioner for Economic and Financial Affairs, Olli Rehn: "*With the European Investment Bank, the EU has a powerful institution to support growth and employment. But it is reaching the limits of what it can do with its current capital base. To allow the EIB to do more for growth and jobs, its capital needs have to be addressed.*"[1].

How big a capital infusion is needed into EIB is the next question. If EIB's called up capital is doubled by € 11.6 billion, and some €5 billion are injected as risk capital into the EIB, as well as additional resources are provided from the EU budget (see Table 1 and Figure 2, and detailed discussion above), additional resources corresponding to €60 billion or ½ pct. of EU GDP can be made available over the next 3 years, due to the benefits of leverage, starting in 2013. An additional resource of € 60 billion annually also has been mentioned by a number of European key officials.

In what follows we report the results from model calculations using the international macroeconomic model HEIMDAL. The results will illustrate the GDP and employment effects created by a European Investment bank expansion in investments and the additional EU contributions like the ones previously described. A more detailed description of the calculations can be found in Box 1.

Box 1. A European investment pact

In the model calculations it is assumed that the size of EIB lending and EU additional contributions are increased, which is equivalent to ½ percent of EU GDP. It is however uncertain how much of the 60 bn. Euro that will go to investments and when.

The model calculations focus on the part of the additional EIB lending and additional EU contributions that will go to investment and the calculations shows the effects for the years 2013 and 2014.

In the following it is assumed very conservatively that it is half of the additional EIB lending and additional EU contributions in 2013 that will go to investment and two thirds of the additional EIB lending and additional EU contributions in 2014 that will go to investments. This corresponds to an increase in investments in the EU of 1/4 percent of GDP in 2013 and 1/3 percent of GDP in 2014.

Furthermore, it is assumed that the most crisis affected countries in southern Europe (Spain, Italy, Portugal and Greece) are more likely to use the new EIB and EU funds, as priority would be given to lending to them for economically viable investment and working capital of SMEs, as well as making EU budget transfers . Concretely, it is assumed that these countries increase investments twice as much as the remaining countries (measured in percent of GDP).

The calculations are based on increased borrowing as previously described, corresponding to an increase in investments in the EU of 1/4 percent of GDP in 2013 and 1/3 percent of GDP in 2014. If effects in 2012 and 2015 were included the accumulated impact on growth and employment would be even higher. If the contributions from increased lending by the private sector were further includ-

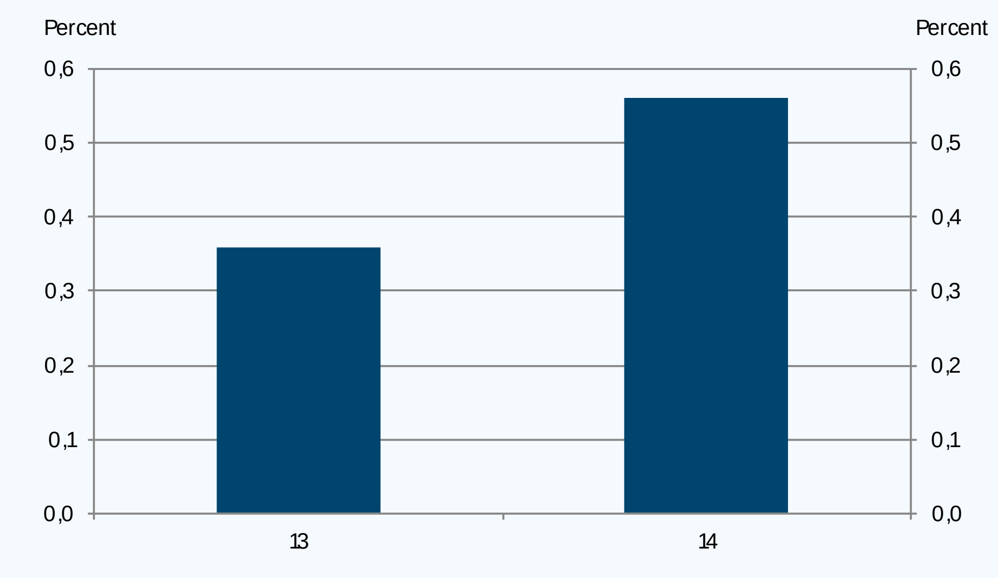
[1] Olli Rehn's speech on the 5th of May 2012.
http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/12/330&format=HTML&aged=0&language=EN&guiLanguage=en

ed, the impact would also be higher. It is assumed in the calculations that primarily the southern European countries will benefit from the increase in investments.

Figure 4 shows the estimates of the effects on the European GDP-level with the investment pact,- that is the additional resources. It is shown how the investment pact increases GDP. In 2013 GDP growth increases by 0.36 percentage points, meaning that if GDP is expected to grow by just above 1 percent without the investment pact GDP, it will grow by close to 1.5 percent if the investment pact is realized.

By 2014 overall GDP in the EU has accumulated an increase of almost 0.6 percent due to the investment pact. The additional effect on GDP growth in 2014 corresponds to an increase of 0.2 percent.

Figure 4. Accumulated effects on the European GDP-level with the investment pact



Source: ECLM on the basis of the international macroeconomic model HEIMDAL.

The calculations on the model show that the pact will create at least 1.2 million jobs towards 2014 on an EU level. In figure 5 it is shown how more than ½ a million jobs are created already in 2013, increasing to more than 1.2 million new European jobs by 2014.

Figure 5. Accumulated effects on European employment level with the investment pact

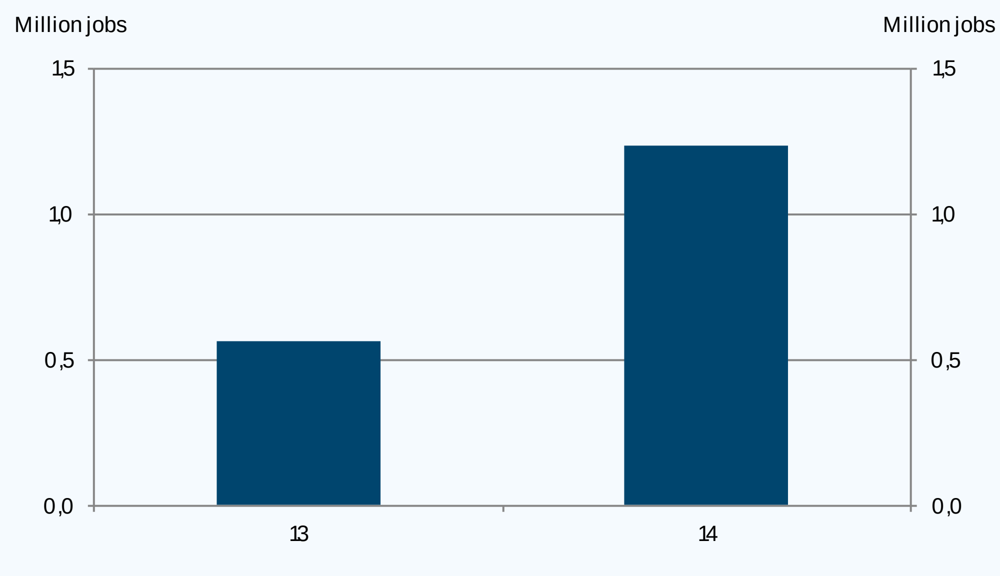


Table 2 below reports the accumulated GDP and employment effects in a number of European countries by 2014. The investments will increase GDP in the range of 0.3-0.8 percent, depending on country specific multipliers and investment shares. Naturally, we observe the largest effects in southern European countries such as Spain, Portugal and Greece where the investment shares are increased the most.

However, an open country such as Germany will also benefit highly from the coordinated investment pact, due to the fact that Germany is a very export orientated economy that will benefit highly from the increased inter-country trade. The largest spill-over effects and benefits from a coordinated pact will therefore be seen in small countries or countries that depend highly on trading with other European countries.

At the overall level the EU GDP will increase by 0.56 percent as a result of the investment pact.

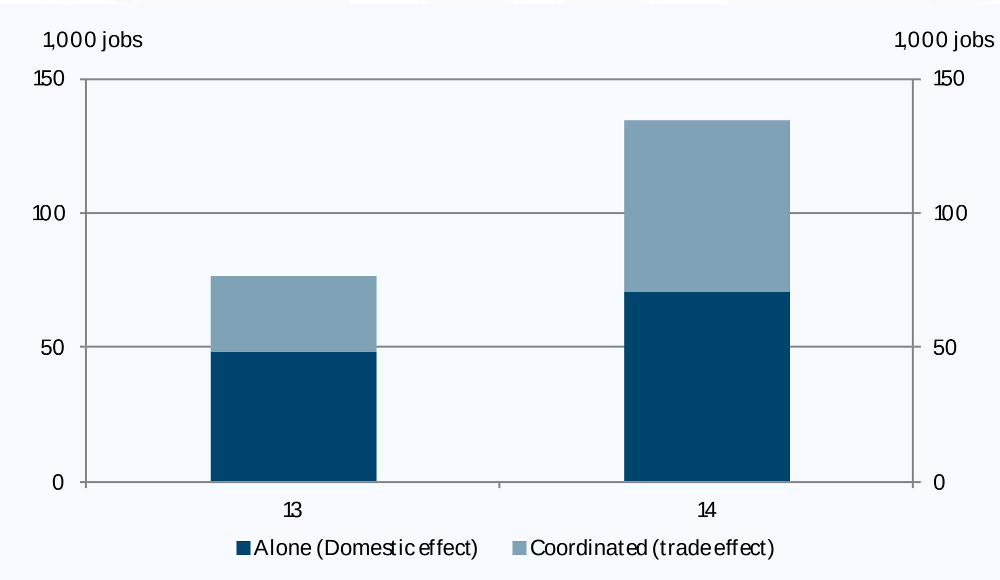
Table 2: Effects of Investment Pact on GDP and employment			
	GDP effect (Percent)	Employment effect (1.000 pers.)	(Percent)
Germany	0.63	278	0.67
Poland	0.50	72	0.44
Finland	0.53	11	0.46
Denmark	0.55	14	0.51
Sweden	0.43	17	0.35
Great Britain	0.45	102	0.35
France	0.33	99	0.38
Southern European countries with increased investment shares			
Spain	0.71	135	0.75
Portugal	0.81	40	0.86
Greece	0.62	26	0.65
Italy	0.46	121	0.52
EU-27	0.56	1,241	0.57

Source: ECLM on the basis of the international macroeconomic model HEIMDAL.

The effects of an investment package on European economies are particularly large because the countries are highly integrated. Figure 6 illustrates an example comparing where Spain increases investment by itself only and together with other European countries.

The figure shows why cooperation is so important. In the figure for Spain the total job creation with an investment pact is divided into the effect stemming from domestically created jobs and the effect stemming from increased trade with other European countries. Out of a total of 135,000 jobs created, 64,000 of them stem from increased trade. Put differently, the positive trade effects account for 50 percent of the jobs created.

Figure 6. Job creation in Spain decomposed into domestic and trade effect



Source: ECLM on the basis of the international macroeconomic model HEIMDAL.

Looking forward, the challenges facing Europe are not only to curb the debt crisis, but just as importantly to create growth and jobs. Indeed, by supporting growth, such measures will help ease the sovereign debt crisis. Hopefully, the fiscal pact can create some confidence, but it is of great importance that the coordination of policy is stretched further by stimulating growth and employment. An investment pact as described can help catalyze an economic upturn in Europe.

In the figures above only the direct effects from increased investments are pictured. It is very likely that the investment pact will increase consumer and investor confidence in the private sector. It is also likely that the investment pact could help lower spreads on sovereign debt in southern Europe, especially if aided by a more active effort from the European Central Bank.

Increased investment can additionally have important supply side effects in the future on EU's competitiveness and ability to grow in the long term. If confidence is increased and interest rates decreased as a result of the investment pact, then the positive effects on growth and employment will be even larger.

11. Further effects of stabilization and creation of jobs by financing of working- capital

Above we have reported estimates from modeling effects on increased investment. .The SME related parts of the program will further both stabilize jobs and partly create new ones. The main effect on SMEs comes with building and re-building the access to finance for those who have to pre-finance supplies. If no access to finance is available, the respective companies have to reduce staff or to reduce their growth path. In several countries of the EU - including Portugal, Italy, Greece, Ireland and Spain - the access to finance is at least partly blocked.

With this typical anti-crisis component a job could be kept (or be created) for one year with a loan of €40000 of a loan, of which half would be provided by a commercial bank, as EIB loans are co-financed. If the part of the EIB financing not spent in investments , went to SME credit(as has done in the past), this will keep or create an additional large number of jobs in the EU 27 with greater focus on the countries heavily hit by the crisis.