TO THE COMMISSIONER RESPONSIBLE FOR INVESTMENT

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* You take office at a time of strengthening aggregate investment, and corporate investment in particular. Nevertheless, you face major challenges to foster strategic investment that will raise productivity and develop a carbon-neutral economy. Among your tasks will be addressing the shortcomings of policies you inherit: the Investment Plan for Europe and the Capital Markets Union (CMU).

The successor to the Investment Plan for Europe will be InvestEU. You should make further improvements, in particular by reinforcing the additionality criteria in the choice of projects that can benefit from the EU guarantee. On CMU, you should push and persuade national regulators and encourage cross-border integration, while emphasising equity finance for smaller companies and companies in periphery and cohesion states.

Your overarching goal should be to develop a financial ecosystem of diverse and cross-border funding sources, in which investment funding is less vulnerable to banking crises.

* INVESTEU
* CAPITAL MARKETS UNION
* CROSS-BORDER FUNDING

1 STATE OF AFFAIRS

In the wake of the crisis, European public and private investment declined dramatically. The previous Commission recognised this was damaging the European economy by exerting a drag on growth and employment through the fall in aggregate demand in the short term, and was undermining Europe's growth potential over the longer term. The two main drivers behind the fall in investment by non-financial corporations in the EU were low domestic demand after the crisis and significant financing constraints (Döttling *et al*, 2017). Surveys (for example, ECB, 2014) underlined how vulnerable small and medium-sized companies (SMEs) were, given their strong reliance on bank financing.

*INVESTMENT RECOVERY

However, aggregate investment, and corporate investment in particular, has strengthened steadily throughout Europe amid a belated recovery. The significant investment gap has been partly closed in the last five years and capital expenditures are now almost back to pre-crisis levels. From an aggregate-demand perspective, investment no longer seems to be a major brake on growth.

Financing constraints on investment have also eased in recent years as credit growth finally recovers and interest rates on loans are at record lows. But dependence on bank finance and the fragmentation of the single market in financial services remain key vulnerabilities. This is a particular problem for SMEs, which are less likely to access financial markets, and for innovative companies seeking to finance intangible investment. Capital market fragmentation is also a weakness for the euro area, which has yet not fully addressed vulnerabilities in its banking system, and which lacks effective mechanisms for risk sharing.

* BREXIT

In addition, with the exit of the United Kingdom from the European Union, the EU27 will become separated from its preeminent financial centre. The risk is that Brexit will disrupt access to a deep pool of financial expertise and capital, and that the alternative financial centres that are emerging will lack the required scale and innovation.

Overall, therefore, you take office at a relatively favourable time as far as investment is concerned, but there are still major challenges ahead of you to build a more resilient financing environment.

In dealing with these challenges, you inherit the policies of your predecessor, whose main achievements were, first, delivering the Investment Plan for Europe promised by the Commission president as a tool to boost growth and jobs in the EU and to speed-up the recovery (Juncker, 2014) and, second, contributing to building a Capital Markets Union (CMU), which would maximise the benefits of capital markets and non-bank financing for the economy, in particular for SMEs. As you will rely, at least partly, on these inherited policies, you will also have to address their shortcomings.

1.1 The Investment Plan for Europe

* JUNCKER PLAN

The Commission's Investment Plan for Europe (widely known as the 'Juncker Plan') was intended as a short-term demand stimulus and, given the Commission's limited resources, anticipated substantial leveraging of private financing.

The main tool is the European Fund for Strategic Investments (EFSI) to address the financing constraints that riskier investment projects face and, more generally, to stimulate investment and maximise private sector investment. EFSI received a €16 billion guarantee from the EU budget and €5 billion of the European Investment Bank's own resources. This was intended to enable the EIB Group to invest in inherently riskier projects or take a more junior position among other creditors without risking its AAA rating. The combined Commission guarantee and EIB capital was supposed to generate at least €315 billion of additional investment before mid-2018 by crowding in private investors.

Both the speed with which projects would be mobilised and the leverage factor of 15 struck some observers as ambitious. Undeterred by the operational and financial complexities, the Commission in 2017 extended EFSI until 2020 and increased the combined guarantee to €33.5 billion (€26 billion from the EU guarantee and €7.5 billion from the EIB) with the goal to mobilise €500 billion of additional investment by 2020.

However, it is very difficult to assess if the Juncker Plan really contributed to this reduction in the overall investment gap. For

Five years into the CMU initiative, European capital markets remain underdeveloped and fragmented, and banks still dominate the funding of European companies

instance, the European Court of Auditors (2019) and Claeys and Leandro (2016) were sceptical about the additionality of investments made under the plan.

* ADDITIONALITY

According to the European Court of Auditors (2019), at least one third of the projects of the Plan were not additional, ie they could have been done without EFSI, either by the EIB without EU budget support, or with alternative private financing sources. Another issue with the plan comes from the slow disbursement of the funds. According to the EIB's own model (EIB, 2018b) the peak impact of the plan will be in 2020-21, six years after its design and 12 years after the beginning of the crisis. The Juncker Plan could not function as a stimulus tool. At best it has increased the effectiveness of the EIB by pushing it to invest in riskier and more innovative projects that have some difficulty finding other sources of financing, and has reduced its potential crowding out effect.

1.2 Improving financing for investment: The Capital Markets Union initiative

* CAPITAL MARKETS

The Capital Markets Union (CMU) agenda is aimed at building a new financial ecosystem in the EU, diversifying the forms of finance available to companies and integrating national capital markets. After a slow start, ten directives or regulations planned under the legislative programme were either adopted or agreed at a political level during your predecessor's term.

CMU is a long-term project of regulatory reform. Shifting financing patterns will be a gradual process so it might be too early to assess it based on indicators of market development and integration. Nevertheless, five years into the initiative, European capital markets remain underdeveloped and fragmented, and banks still dominate the funding of European companies. External equity, either from public markets or from private asset managers, still plays a marginal role in company financing. This risks depriving European enterprises of much needed capital, innovation financing and expertise in corporate governance.

2 CHALLENGES

2.1 Substantial investment needs remain

The encouraging observation that the aggregate investment gap has been closed in the last five years should be qualified. There remain overall substantial and pressing investment needs.

* SUBOPTIMAL INVESTMENT

First, the level of investment is still below what should be expected based on the historical trend (even when accounting for the possibility that there was overinvestment in some countries in the years preceding the crisis), and is also much lower as a share of GDP than before the crisis.

Second, despite some improvement, there are still major differences across Europe: capital expenditure is still very low compared to its pre-crisis level in some EU countries, in particular in the south of the euro area (eg in Italy and Spain).

Third, despite the recovery in investment in the last few years, underinvestment has persisted for almost a decade, meaning the capital stock has been depleted and has not been fully replaced or maintained. This is the case for non-financial corporations, which might not have invested enough to adopt new technologies. This is detrimental for their own productivity but also for potential growth overall. The public capital stock has also depreciated as public investment was slashed heavily during the crisis and remained depressed, especially in the countries heavily hit by the crisis.

Finally, historical levels or trends provide only simple benchmarks: the investment levels needed in coming years to achieve certain strategic goals might be much higher, in particular if the EU wants to raise productivity and develop a sustainable economy.

* RESEARCH AND DEVELOPMENT

The EU has major economic ambitions to foster research and development, scale up innovative SMEs and develop ICT and digital infrastructure (eg broadband networks), in order to boost productivity and improve its growth prospects. This requires a lot

> *The dependence of European companies on bank funding will undermine resilience in the next downturn*

more investment than what is currently undertaken. For instance, looking at the detail of non-financial corporations' capital expenditures, investment in intellectual property products (ie investment in R&D, databases and other intangibles) is much lower in terms of GDP than in the United States, where it represents above 5 percent of GDP, while it represents only 3 percent in countries including Italy and Spain, and is below 4 percent in Germany.

* CARBON NEUTRALITY

The other EU top priority is the transition towards carbon neutrality. This implies mobilising significant resources and redirecting financing from brown towards green activities. Massive and urgent investment will be necessary in energy storage, public transport and energy efficiency in buildings[1] to meet the targets agreed in Paris in 2015. For the energy transition in the EU up to 2030, €11.2 trillion will have to be invested, according to the EU High-Level Expert Group on Sustainable Finance (2018). Currently the EU falls short by about €177 billion annually – €1.77 trillion for the whole period 2021 to 2030.

2.2 Financing of investment is still an issue

The funding of European companies remains characterised by a bias towards debt (and in particular bank credit), and against external equity. This is problematic for investment for two reasons.

* DEPENDENCE ON BANKS

First, the dependence on bank funding will undermine resilience in the next downturn. EU corporate debt ratios have declined only modestly since 2008 (and have in fact increased slightly in some core euro-area countries). Less-leveraged firms appear to be more resilient in terms of capital investment in times of economic downturn. In the European financial crisis, the most severely impacted economies were also those with the shallowest equity bases.

Second, limited funding sources will also impact productivity growth. A bank-based financial system is less likely to fund innovation (Rajan, 1992) and young fast-growing SMEs without collateral (Philippon and Véron, 2008). Equity investors seek out companies that are growing but are capital constrained. By establishing significant stakes, these investors support the expansion of firms over extended periods. Private equity investors in particular exert a positive impact on the performance of firms, which will subsequently fund themselves in the market.

This debt bias is particularly acute for SMEs, which account for about 57 percent of EU value added, and which are even more prominent, and smaller, in the EU periphery and in central and south-eastern European countries. For SMEs, external finance from public equity or bond markets is marginal. This is not surprising, given the lack of transparency and other information problems. But the scarcity of IPOs relative to the US market is pronounced for smaller companies in Europe, even when taking account of lower growth in these companies. Moreover, the fixed costs of issuance and the ongoing compliance costs seem to be particularly onerous in the EU.

*EQUITY FINANCE

Stock exchanges are the most visible aspect of capital markets. But net funding from listed equity issuance has declined in recent years as large companies have withdrawn their listings. Markets in many member states are highly illiquid. Efforts to develop public markets in all member states and prepare SMEs for issuance have shown limited success. However, private equity has rapidly expanded and is back to pre-crisis levels. This is on the whole a welcome development. Compared to public equity, private equity is accessed by a wider range of smaller companies, though excess leverage within portfolio companies has become a concern.

*VENTURE CAPITAL

Start-up finance and venture capital remains particularly underdeveloped in the EU, but could play an important role in funding businesses that scale up to become more established firms. Venture capital investors have the risk appetite and have developed tools to cater to firms with technology that is yet not ready for commercial application and for which returns are highly uncertain. Given the numerous market failures and risks, national

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Obstacles to a more developed equity base and other risk capital are rooted in national policies

development banks account for a significant share of funding, as do the EIB's private equity operation and regional development banks. A liquid pan-European venture capital market still does not exist.

Obstacles to a more developed equity base and other risk capital are rooted in national policies, many of which have not been touched by the CMU agenda. Company law and corporate governance practices often deter dilution of control by established owners. Minority shareholders tend to have weak rights. The shield for interest payments is a feature of tax systems in most of the EU, though some member states have designed innovative schemes to encourage equity financing.

*HOME BIAS

In addition to its debt bias, capital market financing in the EU is also constrained by a strong home bias. Private equity funds, which are most relevant for SMEs, remain heavily dependent on funding from within home countries. In the euro area, the indicator for total cross-border financial exposures remains below its pre-crisis peak.

*FRAGMENTATION

Capital market fragmentation is a particular constraint in countries where institutional investors, such as pension and insurance funds, are poorly developed. This is a key concern in the cohesion countries of central and south-eastern Europe. Elsewhere in the EU, legislation on insurance, such as Solvency II (Directive 2009/138/EC), has complicated access to private equity and venture capital. Such regulations seem to unduly limit risk exposures for long-term investors. New laws, such as MiFID II (Markets in Financial Instruments Directive, 2004/39/EC) and the Market Abuse Directive (2014/57/EU), have addressed integrity issues such as insider trading. This might have come at the cost of complicating access to public funding by smaller companies, because issuance costs are higher and research coverage might be scarcer.

Finally, the United Kingdom will remain Europe's preeminent centre for asset management in the near future. In private equity alone, it is home to about a fifth of the firms in Europe, and accounts for nearly half of the assets under management. The UK industry seems to play a crucial intermediary function in investments across the EU. The loss of UK firms' passporting rights within the single market could prove highly disruptive to fund allocations by European institutional investors, and therefore to the equity funding of European companies.

3 RECOMMENDATIONS

3.1 Refocus the CMU agenda to build a financial ecosystem conducive to investment

In order to build a financial ecosystem that will raise investment in innovative and risky projects, you should focus on two key aspects: strengthening the equity base, and fostering SME and start-up finance.

Ownership of, and ambition for, the CMU agenda among member states and their private investors and issuers should be strengthened. Many national capital market development strategies, in particular in central and south-eastern Europe, seem to pay little regard to the changes in European markets and legislation. You should be closely engaged in national debates, pointing out the potential for capital market integration across the EU and the emergence of new investors. Your presence could underline how the CMU agenda will underpin national growth strategies centred on innovation and SME support.

*NATIONAL MARKETS

Liquidity in the markets of smaller countries is inherently limited as few sizable issuers or institutional investors exist. National capital markets in small countries are unlikely to develop sufficient liquidity, and home bias in funding will diminish only gradually. Overcoming this fragmentation through cross-border risk sharing will be doubly important for the euro area. The future CMU agenda should therefore target regulation that hinders cross-border integration.

> *The next phase of the Capital Markets Union project should emphasise to a greater extent equity finance for SMEs and for companies in periphery and cohesion states*

*EQUITY FINANCE FOR SMEs

* REGULATORY UPDATES

A crucial building block would be joint post-trade infrastructure among groups of countries in the same region. Also, you should make the identification of impediments to equity finance and market integration a greater focus of the European semester, while offering the EU's Structural Reform Support Service to member states to build capacity. The ongoing work on pricing indices for EU cross-pools of securities should be speedily concluded.

The next phase of the CMU project should also emphasise to a greater extent equity finance for SMEs and for companies in the periphery and cohesion states. The post-crisis period has seen much EU legislation aimed at containing risks for professional investors and retail investors, including those with considerable experience. But large institutional investors, such as pension and insurance funds, should not be discouraged from taking greater exposures to long-term and riskier assets, including in private equity and venture capital funds. Legislation aimed at market integrity might have come at the cost of access to market-based finance for smaller issuers. Here, the balance between these two objectives should be redrawn in favour of encouraging the latter.

Specifically, the review of the Solvency II Regulation, which will be completed during your term, should adapt the risk calibration and market valuation requirements that have so far disincentivised long-term investment in private equity. MiFID II should be reviewed with the aim of sustaining research coverage of smaller issuers. Overall, proportionality should be the guiding principle in a comprehensive review of recent EU capital-markets legislation. This could help adapt legislation to the requirements of member states with large SME sectors, or with under-developed capital markets.

*SUPERVISORY AUTHORITIES

You should also lend your full support to the ongoing review of the European supervisory authorities. Supervision of investment funds is still largely a national competence. Integration of powers in supervision and strengthening the European Securities and Markets Authority could lead to greater efficiencies and market integration and help dismantle national barriers to the cross-border distribution of investment products.

The UK remains the deepest pool of capital and plays a key role in funding enterprises across the EU. Post-Brexit, it will be in the EU's interest to continue to draw on skills and capital in London. A reliable regime for determining regulatory equivalence and passporting rights for third-country investment funds could accomplish this.

*FINANCIAL CENTRES

Several smaller financial centres are now jockeying for the pole position in the EU27. They should compete based on factors such as skills, but not on laxer national supervision. A key part of your portfolio will be to ensure a level playing field, while facilitating conditions that will help alternative centres for asset management and investment banking services to emerge. You should lend your weight to a common regulatory system and warn against the dangers of a regulatory race to the bottom.

3.2 Instruments to foster strategic investment in the EU

Your overarching objective for the next five years should be to develop a financial ecosystem of diverse and cross-border funding sources, in which investment funding is less vulnerable to banking crises. However, establishing a genuine capital markets union will take time, so, in the meantime, how can the EU foster investment and finance innovation, R&D, digitalisation, and the energy transition to fight climate change?

* INVESTEU

'InvestEU', an upgraded version of the Juncker Plan, is supposed to be part of the next Multiannual Financial Framework (MFF) for the period 2021-27. This will be your main tool to steer investment.

Despite its flaws as a stimulus plan, the Juncker Plan was a smart way to try to leverage the limited EU resources with private capital markets. Moreover, improvements were made when the plan was renewed in 2017, and others are part of the InvestEU

*EUROPEAN INVESTMENT BANK

proposal[2]. The objective is to put less emphasis on volume and more emphasis on solving market failures and on investing in the EU's top priorities, including fighting climate change and promoting innovation to boost productivity and growth.

However, to ensure that InvestEU fulfils these objectives, you should make additional changes to the programme and its governance to overcome the shortcomings of the original Juncker Plan. In particular, you should improve the additionality criteria in the choice of projects that can benefit from the EU guarantee.

First, to ensure that these projects are additional, they need at least to be riskier and more innovative than the usual EIB projects. The internal rating of the EIB currently plays an important role in determining if projects can be submitted to the independent committee in charge of granting the EFSI label. However, the ratings themselves are provided by the EIB team, creating a risk that the EIB has an incentive to under-rate projects to make them eligible for the EU guarantee and to reduce its own risks. As a safeguard against this, the rating could be delegated to an independent team. In addition, to ensure that financed projects are different from traditional EIB projects, other changes could be considered, such as the systematic use of subordinated instruments or of instruments with longer maturities.

Second, to be truly additional, InvestEU should focus on projects that lack financing options. In particular, for innovation and SME scale-up, the EIB should seek other partners than banks, which might not be the best placed to finance these activities. The Commission should push the EIB and other national promotional banks that will participate in InvestEU to envisage partnerships with other types of private financial institutions. The substantial fund-of-funds programme in venture capital managed by the European Investment Fund has started promisingly. Based on an early evaluation, this scheme could be replicated.

A more radical option would be to try to convince the EIB board of governors–the finance ministers of the EU – to change how the EIB functions and the projects it invests in. A duplication of investments already made using national budgets or the structural funds, or that could be financed by the private sector, is not the best use of limited EU funds and EIB expertise. Instead, the EIB should be refocused on two objectives:

- Financing investments that are 'strategic' in the energy transition, in R&D and innovation, or that have a cross-border significance; and
- Solving market failures by financing valuable projects that face financing constraints because their social desirability arises from positive externalities that are not internalised by private investors, or arise beyond the maturity of traditional financial instruments (which is particularly the case for green and R&D investments).

For investment in R&D and innovation in particular, two other EU programmes play an important role and offer some financing: EU research funding through Horizon Europe should total €100 billion in the next MFF, while the European Regional Development Fund also invests heavily in innovation (which represented 20 percent of its €200 billion budget from 2014-20). Other commissioners are responsible for these programmes, but you should at least ensure that these initiatives to foster investment are coherent and complementary. There should be a comprehensive strategy for all elements of EU financial support, crucially including the structural funds.

*PUBLIC INVESTMENT

Finally, from a quantitative perspective the most powerful public policy to boost investment is to use public investment. However, given the small size of the EU budget, most public investment is done at the national level. Therefore, the strategic orientations and the funds devoted to them are in the hands of member states and not under the control of the EU. If the European Commission wants to foster strategic investments and in particular to boost innovation and accelerate the energy transition, it must encourage public investment in member states and steer it towards strategic objectives using indirect measures. The two main tools to do this are: 1) the country-specific recommendations made under the European Semester, which have recently highlighted the need for investment in some particular sectors at the local level to fulfil common objectives including the fight against climate change (European Commission, 2019); and 2) the European fiscal framework.

*FISCAL RULES REFORM

In particular, a much-needed reform of the fiscal rules could aim at influencing public investment or at least at deterring countries from slashing public investment when they consolidate their public finances, and ensuring they are able to take advantage of low interest rates to invest in public goods. One way to do that would be to include some form of golden rule in the European fiscal framework to allow the financing of investments through issuing of debt. Alternatively, as proposed in Claeys *et al* (2016), public investment could be accounted for in the same way that corporate investment is accounted for: its costs could be distributed over the whole service life of the investment, rather than smoothed over four years as is the case now. In addition, given the importance of investment in the business cycle (and the willingness of the previous Commission to use investment as a stimulus tool), another way of boosting investment in downturns in particular would be to put in place countercyclical co-financing rates for the regional funds so that European funds devoted to investment can be used during downturns, even when national public finances are under stress.

NOTES

1 See the memo to the commissioner responsible for climate action and energy.

2 See http://www.europarl.europa.eu/news/en/press-room/20190410IPR37569/investeu-programme-big-boost-for-jobs-growth-and-investment.

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