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The need for investment-led recovery for Europe

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Part of the **MISSION FINANCE SERIES**

This is a guest post, co-authored by Giovanni Cozzi, economic advisor at the Foundation of Progressive European Studies (FEPS) and Stephany Griffith-Jones, financial markets director, Initiative Policy Dialogue (IPD), Columbia University, in which they are argue that more investment could lead to a significant decline in the government debt ratio of southern Europe.

There is growing consensus that it will prove impossible to restore growth on a sustained basis in the EU without stimulating investment.

The European Council of Heads of Government firmly asserted that the Union needs to take bold steps to increase investments and create jobs. They called for immediate mobilization of the right mix of private and public funding.

Furthermore, Commission President Juncker stated his commitment to make much better use of the EU budget and the European Investment Bank (EIB), to stimulate investment.

Juncker argues this should "allow the EU to mobilise up to €300bn in additional public and private investment in the real economy over the next three years".

More specifically, Juncker recommends "new, sustainable and job-creating projects to be identified and promoted".

To make such projects happen, however, more effective financial instruments and a further increase in the EIB's capital must be considered.

In a recent study we made a specific proposal for how an additional expansion of EIB capital and lending, accompanied by new instruments, could lead to a major boost in investment in the EU.

This would both, on the supply side, encourage long-term growth and competitiveness, as well as contribute to stimulate aggregate demand for more rapid growth, and higher employment, especially in periphery countries.

There are two promising paths to use limited public resources to achieve important gains in terms of investment. The first is to increase paid-in capital of the EIB and the second is to achieve leverage within the EU budget.

In mid-2012, in a visionary step, all EU leaders doubled paid-in EIB capital by €10bn. The measure was very successful, and led to the EIB increasing its level of lending significantly; EIB EU lending went up in 2013 by almost €20bn, that is by 42 per cent, if compared with 2012.

Lending aimed at SMEs almost doubled. Therefore, because the measure was successful and because private credit is still severely constrained, especially in countries most hit by the crisis, we suggest a further increase of another €10bn of the paid-in capital of the EIB.

This would allow another increase of up to €80bn of EIB lending, and a total increase of up to €160bn of total lending and private investment for the next years.

Such additional lending could be applied more, but not only, to countries hit by the crisis.

Because EU countries are so integrated through trade, increased growth in the periphery would benefit all EU countries. The second route to achieve leverage is with the EU budget.

Large projects can be co-financed by the EIB alongside with investment from pension funds and insurance companies. A small part of the EU budget could be used as a risk buffer to allow the EIB to lend additional resources.

A very small amount (as proportion of the EU budget), equal to €5bn euros annually could be allocated to such purpose. This would allow the EIB to lend an additional €10bn annually for financing infrastructure projects (project bonds) and to promote innovation, which could generate up to €40bn of investment.

If both these avenues were pursued the EU could increase lending and investment by approximately €300bn during the next few years. What would be the impact of such a strategy on EU growth, employment and investment, as well as on debt-to-GDP ratios and fiscal deficits?

Using the Cambridge-Alphametrics Model (CAM) we estimate that such a lending and investment plan would lead to the creation of an additional 5mn jobs in the EU!

This investment strategy would also lead to favourable results in terms of both government debt-to-GDP ratios and fiscal deficits. In the absence of a serious investment plan, debt-to-GDP ratios for the South Eurozone (Greece, Italy, Portugal and Spain) are projected to increase to over 140 per cent by 2020 as a result of poor growth.

Instead, our proposed investment strategy would not only lead to increased growth but also a significant decline in government debt ratio, to 100 per cent of GDP in the South Eurozone by 2020.

In addition this investment scenario would not lead to a further deterioration of fiscal deficits despite the fact that public investment would be maintained.

Instead these would gradually decrease to reach the 3 per cent threshold imposed by the Fiscal Compact.

The results generated by our proposed investment strategy would lead to far higher employment in Europe. They are consistent with what EU authorities are beginning to propose.

These measures, above all, would give a sense of hope to the millions of unemployed in the EU, and contribute to a rebirth of enthusiasm for a Europe that delivers for its citizens. They need to be implemented urgently!

MISSION FINANCE SERIES

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