Growing Out of the Crisis: DIW Berlin Proposes European Investment Fund

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An investment fund should temporarily improve the capital stock of small and medium-sized enterprises as part of a comprehensive agenda
- In the euro area, there is an annual investment gap of approximately two percent of GDP or 180 billion euros - Many sectors both in the manufacturing and service industries are showing signs of a significant lack of investment, especially the energy sector
The German Institute for Economic Research (DIW Berlin) is proposing a comprehensive investment agenda to tackle the European crisis. The core elements of this agenda should be a temporary investment fund, in particular for small and medium-sized enterprises, improved competition policies, investment-friendly tax policies, and the promotion of cross-border joint ventures. "Structural reforms alone are not sufficient to break the vicious circle of banking, debt, confidence and growth crises," say a team of researchers led by the President of DIW Berlin, Marcel Fratzscher. According to the team, "Europe has a growth problem that can only be overcome through investment. What we need is not more government intervention but significantly more growth impetus for the private sector, more market, more innovation and more competition."
In a study consisting of several parts, the economic researchers analyzed the actual volume and development of investment in the individual countries of the EU and the euro area prior to and during the crisis and compared them to estimated levels that would be appropriate according to given overall economic conditions. The finding was that investment levels in some European Union countries were already too low in 2008, before the outbreak of the economic and financial crisis, while in others they were too high. Since the outbreak of the crisis, the situation has deteriorated dramatically: gross fixed capital formation slumped by around 14 percent across the EU, and even by as much as 15 percent in the euro area. Compared to an appropriate, long-term investment level, there is currently an investment deficit of approximately two percent of GDP in the euro area. Investment in industry is particularly weak. According to the DIW research team, "Even the manufacturing industry, which is key to Europes resurgence, is affected by a lack of investment."
An eleven-person team of DIW researchers analyzed the volume of investment based on annual data on the use of GNP as well as on values for gross fixed assets, or capital stock. While the former allowed them to examine all the figures right up to the present day, the latter allowed them to perform a segmented analysis of each sector. The research team concluded: "The reluctance to invest is not a phenomenon specific to individual countries. It is now occurring in virtually all EU member states and threatens growth in the coming years."
According to a partial study by Martin Gornig and Alexander Schiersch, even before the crisis, Europe was already investing much less in terms of capital stock than many other OECD countries. Between 1999 and 2007, European countries invested some six trillion euros less, relative to total capital stock, than non-European OECD countries including the US, Canada, and Japan. In the euro area, this deficit was actually even higher at 7.5 trillion euros. As a result, gross fixed assets consisting of production plants, equipment, and buildings are considerably more dated than the EU average. And growth in almost all sectors is also slower. This applies, in particular, to the health, education and manufacturing sectors. "It is not therefore sufficient to implement individual investment programs in southern European countries to overcome this lack of investment," say DIW researchers.
An analysis by Guido Baldi, Ferdinand Fichtner, Claus Michelsen, and Malte Rieth based on data from the national accounts has shown that the problem has worsened since the outbreak of the economic and financial crisis. The investment rate in the euro area has fallen since 2008 by almost four percentage points, while it is increasing again in the US. In some EU countries, especially Germany, the Netherlands, and Finland, investments have been low for many years. The researchers determined "optimal" investment rates using econometric estimates for each country and compared them to actual rates. Since the beginning of the debt crisis in the euro area, from 2010 to 2012, the actual rate of investment in the euro area was about two percentage points below the model estimate. The estimate also shows that, before the crisis, more was invested periodically in housing construction, particularly in Italy, Portugal, Ireland, Spain, and Greece, than was really appropriate. With the collapse of the construction sector, investment has fallen significantly below its optimum level.
According to DIW researchers, this is caused by a vicious circle resulting from mutually reinforcing crises: the economic crisis, the bank crisis, the debt crisis, and the crisis of confidence. "These are preventing the reforms carried out to date at national and European level from impacting the economy positively," explain the researchers, concerned that this may lead to stagnation. Despite the expansionary monetary policy of the European Central Bank, banks will not issue enough new loans if the economic climate is weak and too many bad loans exist. Governments, on the other hand, will have to continue their programs of fiscal consolidation if they are to remain credible and deliver on their promises. "In this situation, there is not enough economic impetus to break this cycle," the DIW team explains. But this does not give grounds for relaxing the rules of the Stability Pact. Instead, Europe has to attempt to stimulate private investment with a comprehensive investment agenda. "The money is there. As a whole, the euro area now has annual net savings in excess of 250 billion euros; the net savings for companies and households are even greater. What matters now is mobilizing these financial resources and channeling them to companies that will utilize them productively."
The purpose of the agenda proposed by the DIW research team is, inter alia, to promote competition, particularly in highly regulated sectors such as education and healthcare, and to create fiscal conditions that are more investment-friendly. The third key component would be to create an investment fund, within the framework of the European Investment Bank (EIB), for example. This fund would promote small and medium-sized enterprises, in particular, with the aim of alleviating the deep uncertainty that is prevalent and minimizing microeconomic risks. A European Investment Fund already exists under the auspices of the EIB, although this has rather moderate financing volumes and operates solely in the area of venture capital financing. "The fund could be refinanced on favorable terms with guarantees from the EU member states and those attractive conditions could be passed on to companies. Especially in crisis countries, this would result in better loan offers as well as increased demand for credit. "
According to the DIW researchers, this fund should not be subject to strict regional or sectoral regulations. "What matters is pushing productive private investment, regardless of the EU member state." It is vital that private investment capital is funneled into economic sectors that create good opportunities for growth. One possible focus could be investment in the energy sector. According to a study by DIW energy experts Christian von Hirschhausen, Franziska Holz, Clemens Gerbaulet, and Casimir Lorenz, annual investment totaling 150 billion euros will be needed in this sector in the years to come.
WHAT THE EXPERTS SAY
Marcel Fratzscher (President of DIW Berlin): "For Europe, the risk of years of economic stagnation accompanied by high unemployment is more than real. What Europe needs to emerge fully from this crisis is far more growth. And to achieve this, it isn't more government and more government subsidies that are required, but more market, more competition and, crucially, more private investment."
Ferdinand Fichtner (Head of the Department of Forecasting and Economic Policy, DIW Berlin): "In the current crisis climate, investment activity in the euro area, which was already rather poor, has slumped even further. In recent years, the estimated deficit in investments was almost 200 billion euros per year. This diminishes the growth in production opportunities by an average of 0.2 percentage points per year."
Martin Gornig (Deputy Head of the Firms and Markets Department, DIW Berlin): "The investment fund can be - and indeed should be - designed to strengthen Europes key position as a center of industry by also investing in small and medium-sized enterprises. A shrewd competition policy in Europe would promote innovation and investment, thus securing long-term growth potential."
Christian von Hirschhausen (Research Director, DIW Berlin): "On the path to a sustainable future, investment in the energy economy is very much needed - in Germany, and also elsewhere in Europe. Of particular importance here is cross-border cooperation in the infrastructure sector in order to guarantee sustainability and safeguard energy supply."
DIW Economic Bulletin 7/2014: "An Investment Agenda for Europe"
Interview with Marcel Fratzscher: "We Need to Give Impetus to the Private Sector"
Interview with Claus Michelsen: "Europes Investment Slump"
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