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The debate over how public investment banks in Europe can promote growth

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In June 2013 the International Monetary Fund (IMF) concluded that the role of fiscal multipliers had been underestimated in terms of GDP growth. This sparked a new debate on the negative effects of austerity measures and a discussion of the need for more public spending. In this context, the idea of increased investment financing through public investment banks has gained momentum in Europe. The European Investment Bank (EIB) is well placed to fill the existing investment gap through favorable loans, particularly to small and medium-sized enterprises (SMEs).

The economic situation in Europe

The aftermath of the 2008 global financial crisis and the ensuing Eurozone crisis from 2010 onward revealed high levels of public and private debt. Persistent unemployment and stagnating growth pose further challenges to policy makers. Though Eurostat announced in August that GDP had grown in the Eurozone by 0.3 percent in the second quarter of 2013, after six quarters of negative growth, the recovery remains shaky and there is still a large gap between north and south. According to the IMF World Economic Outlook update of July 2013, the Euro area will remain in recession in 2013, with overall output activity decreasing by over .5 percent. The IMF predicts that growth will rise less than 1 percent in 2014—lower than previously predicted—due to a more protracted recession.[1]

Efforts to respond to the economic and financial problems of such economically troubled Eurozone countries as Greece, Portugal, Spain, Ireland, and Cyprus has often focused on deficit reduction and structural reforms. These have provoked complaints from governments and members of civil society that the so-called "austerity agenda" is detrimental to growth, inspiring anti-German and anti-EU sentiments. The prevalence of a high level of public and private debt, however, has narrowed the ability of governments to adopt an alternative approach.

Austerity versus deficit spending: the debate over fiscal multipliers

Discussion of how to find a way out of the crisis has often been reduced to the dichotomy austerity versus growth. In fact, the real dichotomy faced by policy makers is fiscal adjustments (austerity) versus deficit spending. Both austerity and deficit spending have the same objective, namely long-term growth. In general, the short-term focus of fiscal adjustment is on deficit reduction, intended to regain investors' confidence and thereby trigger growth.[2] Theoretically underpinned by Harvard economist Alberto Alesina in a briefing for the ECOFIN Council, fiscal adjustment as a preferred crisis response has gained more influence in the Troika programs.[3] In contrast, the proponents of deficit spending generally criticize the supporters of austerity policies for wrongly assuming that public spending cuts are counterbalanced by the private sector. In their view, high private debt and low consumer confidence only lead to even lower investment and lower spending. This in turn reduces economic output and deepens the recessions in economically troubled countries.[4] More public spending, they argue, is therefore needed in order to enhance growth and shrink the debt-to-GDP ratio in the long run. This faction is grounded in Keynesian thinking and powerfully represented by Nobel Laureate and Princeton economics professor Paul Krugman.[5]

Controversy over these two approaches revolves around the issue of fiscal multipliers—and around one question in particular: how positive is the impact of public spending on growth, or, correspondingly, how negative are the effects of austerity measures on the GDP? Alesina and others claim that the impact of fiscal multipliers on growth is negligible and that the multiplier value is most likely less than one.[6] This means that the negative effects of raising taxes and cutting public spending on the GDP is low. In contrast, the IMF concluded in its June 2013 evaluation of the program for Greece that the effects of fiscal multipliers had been underestimated; instead of a multiplier of .5, it was twice the original estimate.[7] According to the IMF, this means spending cuts have damaged GDP growth in Greece more than had been originally predicted. If the fiscal multiplier is one, then GDP is reduced by the exact amount of the spending cuts. This debate is central in the ongoing discussion in Europe on how to achieve growth.

Europe: “golden rule” and public investment banks

The debate on fiscal multipliers has sparked a new discussion of how to achieve growth. Recently, the idea of deficit spending has gained more influence again. In July 2013 José Manuel Barroso, president of the European Commission, stressed at the European Parliament that the Commission was considering excluding public investment expenditure from the deficit requirements in the Stability and Growth Pact. The aim was to address the problems some crisis countries are experiencing by drawing on the EU’s structural and cohesion funds. Funding is only available through EU budget programs for co-financing—specifically, under the “Structural and Cohesion policy,” “Trans-European Networks,” or “Connecting Europe Facility”—to which both the EU and the member state have to contribute.[8] This could be difficult for indebted countries. The proposed changes would enable those countries to spend more money on public investment—through projects carried out in collaboration with the EU’s structural and cohesion funds—without violating the budget deficit rules.

The Commission’s demand is not new. In a memo on the monetary union from 1990, it agued that “the Golden Rule of Public Finance … appears the most satisfactory [fiscal rule] from an analytical point of view.”[9] The Golden Rule of Public Finance allows room for deficit spending—as long as it is used to finance investment. However, those member states that have used a Golden Rule in the past have changed their fiscal frameworks in the meantime. The UK suspended its Golden Rule in 2008,[10] and Germany replaced its Golden Rule of Article 115 Grundgesetz with the so-called “debt brake” in 2011, which later became the model for the Fiscal Treaty.[11] There seems to be growing political consensus that this form of fiscal rule gives too much discretion to governments. Other concerns involve worries that public investment could crowd out private investment.[12] However, if the proponents of deficit spending are right about the effect of fiscal multipliers, this would deprive governments of a powerful instrument to stimulate growth.

To avoid this dilemma, the attention in Europe is now shifting to banks to fuel growth in times of crisis. Since some European countries do not have the funds to increase their spending, the European Commission has additionally focused on “new schemes … developed by the Commission and the EIB with the involvement of the ECB” as a means to finance investment.[13] The problem—generally referred to as the “broken transmission mechanism”—lies in the fact that the [exceptionally] low ECB key interest rate—currently 0.5 percent—is not reaching the real economy.[14] Banks can borrow very cheaply from their central banks but are reluctant to pass the credits on to businesses. According to a study by the Brussels think tank Bruegel, the annual growth rate of credit in the Euro area has not exceeded 2 percent, in comparison to 10 percent before the crisis.[15] Public investment banks are well placed to fill this existing credit gap.

In this context, the European Investment Bank (EIB), which was created in 1958, has gained wider

attention. The EIB is owned by EU member states, whose shares depend on their respective economic weight within the EU (GDP) at the time of their accession. The EIB raises money through issuing bonds and has the highest credit rating, as its borrowing is guaranteed by the member states. The EIB can therefore dispose of large sums, which it can leverage to achieve an even greater impact when it lends to the real economy. These loans are given at very favorable terms.[16] Altogether, the EIB has six priorities for projects: These include SMEs, regional development, environmental sustainability, innovation, trans-European networks (transport), and energy.[17] In all, 90 percent of the EIB loans go into EU member states. Projects in 2013 included loans to a research and development (R&D) program for exhaust technology (Germany); loans to school building projects (Ireland) and campus development (UK); loans for investment in the electricity grid (Spain); and loans for R&D in Polish research institutes, universities, and businesses.[18]

The EIB has now been assigned a central role in the "New Investment Plan for Europe" launched by the European Council at its June 2013 summit. Already in June 2012, EU member states agreed to increase the EIB's capital by 10 billion Euros in order to raise its lending capacity by 60 billion Euros (2012 "Compact for Jobs and Growth").[19] In addition, at the June 2013 meeting, the European Council called for an increase of EIB lending in the EU by at least 40 percent over the years 2013 to 2015.[20] Here the European Council put a special emphasis on SMEs: "Given the importance of SMEs for the economy, especially in terms of job creation, measures to support SME financing will be a priority."[21] A joint EIB-Commission report laid out modes for the EIB to alleviate the financing constraints of SMEs. These include joint SME guarantee instruments as well as joint securitization instruments.[22]

The EIB-Commission report furthermore aims to increase the collaboration between the EIB and public investment banks in member states.[23] National public investment banks have equally been given greater responsibility in supporting economic activity by their governments. The German government is currently developing a strategy in which the German public investment bank KfW would play a role in supporting SMEs in Spain and Portugal.[24] In France, a public investment bank did not exist until recently but was created by the government of François Hollande in 2012.[25] Similarly, Denmark has set up a state investment fund.[26] The consultancy PricewaterhouseCoopers suggested that the creation of a national public investment bank similar to the KfW would also be helpful in Greece. In July 2013, German finance minister Wolfgang Schäuble went to Athens together with Ulrich Schröder, CEO of the KfW, to discuss the creation of a Greek development bank called "Institution for Growth."[27] In this respect, it is interesting to mention another detail of the joint EIB-Commission report: In the case of Greece, unutilized funds from the EU's structural and cohesion funds were passed on to a guarantee fund designed for EIB lending to SMEs.[28] This proliferation of the model of the German public investment bank KfW is a good example of the export of German economic institutions.

Conclusion

Europe needs more measures to support investment and innovation. In this regard, the role of public investment banks, both on the European and on the member state national levels, has been enhanced by recent EU-level initiatives. While strict fiscal adjustments are becoming increasingly untenable and public deficit spending faces many constraints—such as the Troika conditionality and market rates—public investment bank funding has emerged as a possible alternative. Public investment banks such as the EIB are well placed to provide affordable loans, particularly to SMEs, in order to foster growth in Europe. Yet the EIB needs more than a capital increase of 10 billion Euros to fulfill this function. European member states should consider additional capital for the EIB to fund competitive projects. In this context, it is also important that the internal procedures allow for fast investment decisions.

There are nonetheless two caveats to include in the discussion of whether the EU can and should invest its way out of the crisis. There are many causes for the present crisis in Eurozone countries

that do not stem from a lack of investment (e.g., Spain). Structural reforms and debt reduction in individual EU countries are also needed to tackle the crisis. From an economic point of view, it is also necessary to ensure that the renewed lending activities through public investment banks do not lead to overinvestment and thereby create new macroeconomic imbalances. If it proves to be effective, the macroeconomic imbalance procedure can be used as an oversight and to provide checks and balances.[29] Viewed from a political perspective, it is the lack of transparency and democratic accountability of public investment banking that causes concern. Taking the responsibility for economically vital investment activity out of democratic governments and placing it into the hands of unelected institutions represents a technocratic shift that is not welcome everywhere. There is an increased desire for more transparency on the part of central banks and public investment banks. In February 2010, the EIB established a new transparency policy with improved access to documentation of EIB projects. Still, much needs to be done with regard to stakeholder participation.[30]

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Notes

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