



DIRECTORATE-GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT
ECONOMIC AND SCIENTIFIC POLICY **A**

Financial, Economic and Social Crisis

Beyond Economic Governance and
Financing the Real Economy
Compilation of Briefing Papers

CRIS



DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

**SPECIAL COMMITTEE ON THE FINANCIAL, ECONOMIC AND
SOCIAL CRISIS**

**Beyond Economic Governance
and
Financing the Real Economy**

COMPILATION OF BRIEFING PAPERS

Abstract

These two briefing papers mark the end of series of briefing papers supporting the meetings the Special Committee on the Financial, Economic and Social Crisis (CRIS) held in January and February 2011. In preparation for the discussions on the Committee's draft final report these meetings dealt with key questions of the crisis. The first briefing deals with the different ways of decision-making in the area of European Economic Governance; where six proposals are currently under discussion while economic governance and relative power in the EU are both in a state of flux. The second paper examines the financing of the real economy, in particular problems and policy options as regards investments that are growth-enhancing, generate employment and improve the sustainability of the economy.

This document was requested by the European Parliament's Special Committee on the Financial, Economic and Social Crisis (CRIS).

These briefing notes (for 28 February 2011) mark the end of series of briefing papers supporting the meetings the Special Committee on the Financial, Economic and Social Crisis (CRIS) held in January and February 2011. In preparation for the discussions on the Committee's draft final report these meetings dealt with key questions of the crisis. For this purpose the Committee has asked all members of the CRIS panel of experts for contributions to each topic. The complete CRIS panel of experts consists of

- Professor Luis Campos e Cunha, University of Lisbon
- Sony Kapoor, independent expert London and Brussels
- Professor Mojmir Mrak, University of Ljubljana
- Professor Stephan Paul, University of Bochum
- Professor Charles Wyplosz, The Graduate Institute, Geneva
- Professor Lorenzo de Angelis, University of Venice

Subsequently, the following briefings have been provided so far:

CRIS meeting on 20 January 2011:

- EU Public Debt Management and Eurobonds (ECON briefing of C. Favero and A. Missale)
- Building a Comprehensive Crisis Management Framework for the EU and Extinguishing the Raging Fire (extensive update of ECON briefing of S. Kapoor)

CRIS meeting on 31 January 2011:

- Compilation Global Imbalances and Global Governance (S. Kapoor, M. Mrak)
- Compilation New Global Monetary System (S. Kapoor; C. Wyplosz)

CRIS meeting on 10 February 2011:

- Increasing the Competitiveness and Sustainability of the EU: Implementing the EU 2020 Strategy by Fostering Innovation, Longterm Investment for Jobs and Growth (S. Kapoor)

AUTHOR

Sony KAPOOR, Re-Define Managing Director (www.re-define.org); additional research by Jan MOENS, Re-Define Research Associate (Beyond Economic Governance) and additional research by Nataliya TALEVA, Re-Define Research Associate (Financing the Real Economy)

RESPONSIBLE ADMINISTRATOR

Doris KOLASSA
Policy Department Economic and Scientific Policies
European Parliament
B-1047 Brussels
E-mail: Poldep-Economy-Science@europarl.europa.eu

LINGUISTIC VERSIONS

Original: EN
Abstracts: DE, FR

ABOUT THE EDITOR

To contact the Policy Department or to subscribe to its monthly newsletter please write to: Poldep-Economy-Science@europarl.europa.eu

Manuscript completed in February 2011.
Brussels, © European Parliament, 2011.

DISCLAIMER

The opinions expressed in this document are the sole responsibility of the author and do not necessarily represent the official position of the European Parliament.

Reproduction and translation for non-commercial purposes are authorised, provided the source is acknowledged and the publisher is given prior notice and sent a copy.

TABLE OF CONTENTS

BRIEFING PAPERS:

<i>'European Economic Governance: Who's calling the shots?'</i>	5
INTRODUCTION	7
1. PHASE I OF THE CRISIS: LESS EUROPE AND THEN MORE	9
2. PHASE II OF THE CRISIS: LESS EUROPE AND THEN MORE	10
3. THE EUROPEAN STABILISATION MECHANISM: EU POWER DYNAMICS	12
4. SOME DRIVERS OF THE POWER SHIFTS IN THE EU	14
The Lisbon Treaty	14
The financial crisis	15
The sovereign crisis	15
A brief discussion of other drivers	16
5. ANALYSIS	17
6. CONCLUSION	18
REFERENCES	19

<i>'Financing the Real Economy: Problems and Policy Options'</i>	21
--	-----------

INTRODUCTION	23
1. PROBLEMS IN FINANCING DESIRABLE INVESTMENTS	24
1.1. Large upfront costs	24
1.2. Scale problems	24
1.3. Split incentives	24
1.4. Policy uncertainty	25
1.5. Information problems	25
1.6. Perceived riskiness	25
1.7. Profitability issues	26
1.8. Other friction costs	26
1.9. Crowding out by speculative investments	26
1.10. Excessive short-termism in the market	26

2. SECOND PROBLEMS RELATED TO THE CRISIS	27
2.1. An overall shrinkage of funds	27
2.2. The impact of austerity measures	27
2.3. An emerging reluctance to make long-term commitments	27
2.4. Bank credit has shrunk	27
2.5. The cost of funds has increased	28
3. A SHORTAGE OF INVESTMENTS IN DESIRABLE SECTORS	29
4. WHAT EU POLICY MAKERS CAN DO ABOUT THIS?	30
4.1. Regulatory reform of the financial system	30
4.2. Increasing the availability of public funds	30
4.3. Attracting non-EU funds to the EU	31
4.4. Plugging gaps in financial instruments	31
4.5. Policies to increase the attractiveness of desirable investments	32
4.6. Reducing friction costs	32
4.7. Tackling the euro area crisis head on	32
REFERENCES	34

European Economic Governance: Who's calling the shots?

BRIEFING

by Sony KAPOOR
Additional research by Jan MOENS

Abstract

Two developments, the ratification of the Lisbon Treaty and the occurrence of the worst financial and economic crisis in a generation have had a substantial impact on economic decision-making in the EU. The increased co-decision powers accorded to the European Parliament by the Treaty has visibly made it stronger and the role of the permanent President of the European Council has sharpened the profile of the institution. The ECB has also seen its role expand dramatically as a result of the crisis. This has all led to 'more Europe' but has been counterbalanced in part by an increasing tendency of Member States, in particular Germany and France, to favour a more political intergovernmental method over a more statutory approach based on the ordinary legislative processes of the Union. Economic governance and relative power in the EU are both in a state of flux. Overall, while there is cause for some concern, 'ever closer Union' continues.

TABLE OF CONTENTS

INTRODUCTION	7
1. PHASE I OF THE CRISIS: LESS EUROPE AND THEN MORE	9
2. PHASE II OF THE CRISIS: LESS EUROPE AND THEN MORE	10
3. THE EUROPEAN STABILISATION MECHANISM: EU POWER DYNAMICS	12
4. SOME DRIVERS OF THE POWER SHIFTS IN THE EU	14
The Lisbon Treaty	14
The financial crisis	15
The sovereign crisis	15
A brief discussion of other drivers	16
5. ANALYSIS	17
6. CONCLUSION	18
REFERENCES	19

INTRODUCTION

The Lisbon Treaty introduced statutory changes to the role and authority of various EU institutions and to decision-making processes in the EU. The ongoing financial and economic crisis, the biggest in a generation, underscored an unprecedented degree of interconnectivity between Member State economies and revealed serious gaps in economic governance in the EU. The impacts of these two developments on economic governance in the EU and the relative authority of various EU institutions and Member States are substantial and still evolving. However, some effects are already clear.

The Lisbon Treaty and the crisis have both pushed us in the general direction of 'more Europe'. A greater statutory authority conferred on EU institutions has combined with the need, especially within the euro area, for a common response to the crisis to shift more economic decision-making to the European over the national level. A large number of financial regulation and economic governance related legislative dossiers, for example, are currently being channelled through what became known under previous Treaties as the 'Community method'¹.

Box: The Community method and the intergovernmental method

There is no legal or binding definition of Community or intergovernmental method; and this terminology is used with different meanings. For the purposes of this paper:

The **Community method** designates processes prescribed for in the Treaty. For instance, the ordinary legislative procedure refers to the decision making process as defined in Article 294 of the TFEU. This is characterised by

- 1) the sole right of the European Commission to initiate legislation;
- 2) the co-decision power between the Council and the European Parliament, and
- 3) the use of qualified majority voting in the Council.

Such an approach is still widely referred to as the Community method, a terminology which strictly speaking was developed in the pre-Lisbon Treaty era to distinguish the decision-making process in the then 'first pillar' from that in the 'second and third pillar' (and before the Lisbon Treaty changed the terminology from 'Community/Communities' to 'Union'). However, this definition also covers consultations e.g. under Article 126(14) subparagraph 2 TFEU, or (non-legislative) consultation procedures, e.g. Article 126(14) subparagraph 3 TFEU.²

The **intergovernmental method**, as used in this paper refers to (here economic) decision making that lies outside of this strict statutory approach provided for in the Treaty. Loosely, it is used for a more assertive political approach, particularly by the European Council and the Council. In general, the absence of the statutory process means that each Member State retains the power of veto, at least in theory. Another characteristic is that the European Parliament has a weaker, usually just a consultative, role.

Beyond the process of formulating Union legislation, the intergovernmental method as used in this paper, also refers to decisions and economic agreements that are made by EU Member States but located outside of the framework of Union law.

¹ In order to comply with the terminology that is still in general use, we use the Community method throughout this paper with the understanding that it refers to measures endorsed via provisions enshrined in the Treaty (with the respective features, e.g. initiating role of the European Commission, involvement of the European Parliament, subject to interpretation by the European Court of Justice), such as - but not necessarily limited to - the ordinary legislative procedure under the Lisbon Treaty.

² F. Hagedorn, p. 2, seems to use the term in a more narrow sense, i.e. limited to co-decision/ordinary legislative procedures.

On the other hand, because crisis related decisions have had to be taken under severe time pressure and because they have implicitly involved large fiscal commitments that are intensely political and do not fall properly under the competence of the Union, Member States have also sharply increased the use of the intergovernmental approach to economic decision-making.

The Commission, Council and Parliament have a much more symmetric power structure under the Community method than under the intergovernmental approach where the relative power of the institutions decreases from the Council, through the Commission to the Parliament.

There is a perception that Member States are increasingly using the intergovernmental approach over the Community method and this has come in for sharp criticism from a number of stakeholders including Commission President Barroso and several MEPs³. The concerns being expressed are

- 1) That this upsets the normal balance of power between EU institutions;
- 2) That this loose intergovernmental approach will not engender economic discipline;
- 3) That the selective use of this intergovernmental method is going to result in a fragmented 'multi-speed' Europe; and
- 4) That certain more powerful Member States are starting to dominate the agenda setting.

The intergovernmental approach has been defended by Chancellor Merkel who says that it too is a legitimate European approach⁴ and by the President of the European Council, Mr Van Rompuy, who suggested that often the only choices were between an intergovernmental approach and no coordination.⁵

The main questions that need to be addressed are

- 1) Are we seeing more or less Europe?
- 2) What are the main drivers of changes to economic decision-making?
- 3) Whether a perceived shift to intergovernmental decision making is real and problematic?
- 4) How the inter-institutional power balance is evolving?
- 5) Will this harm the emergence of effective economic governance in the EU?

³ <http://www.euractiv.com/en/future-eu/barroso-vows-fight-community-method-news-502047>.

⁴ http://www.brussel.diplo.de/contentblob/2959854/Daten/945677/DD_RedeMerkelEuropakollegEN.pdf.

⁵ http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/117729.pdf.

1. PHASE I OF THE CRISIS: LESS EUROPE AND THEN MORE

When the crisis first broke out, the absence of any EU-wide framework to deal with fragile cross-border or even national banks meant that the response was by necessity national. EU institutions, in particular the Commission and the Parliament, were mostly irrelevant and the large body of EU law had little to say on crisis management.

In fact, the Member States' bailouts of their banks violated the strict state aid rules that are part of EU competition policy and made a mockery of the budget discipline rules enshrined under the Stability and Growth pact. The first response to the crisis was definitely 'less Europe'. Over a period of a few months, the European Commission got its act together and helped co-ordinate some of the initial responses to the crisis such as the expansion of Deposit Guarantee Schemes across Member States.⁶ For much of the first year after the crisis broke out the Commission lost power, the Parliament was largely irrelevant and even the Council suffered as Member States were forced to make big policy decisions over very short time frames primarily with a domestic perspective.

The European Union lacked

- 1) the speed of decision-making;
- 2) the large financial resources; and
- 3) the legal instruments that were needed for an appropriate response to the unprecedented financial crisis that hit Member States.

The Commission did perform rather well in helping organise assistance for troubled Member States in Central and Eastern Europe but its stature had definitely shrunk. The European Parliament, which is primarily a legislative body, was shut out of the initial response to the crisis that was all about putting out fires not about designing a new building code.

The only EU institution that gained power in this first phase of the crisis was the European Central Bank. If the ECB had not taken a number of 'exceptional' actions, for example in the provision of uncapped lines of liquidity, the whole European banking system would undoubtedly have collapsed. The ECB was able to act with speed, could marshal enormous resources and had the advantage of a flexible legal and operating framework so it could respond constructively to the evolving crisis.

A fair assessment of the first phase of the crisis would be that it saw a sharp reversal of the slow but steady progress towards 'more Europe' that had characterized the pre-crisis years. This was less a case of an erosion of the EU's powers but much more a case of a sharp rise in government activism in Member States that left the EU looking hapless in the face of the most serious financial crisis in a generation. This did not go unnoticed by citizens and was accompanied by an erosion of trust in the EU.

Matters were not helped by the fraught negotiations over the Lisbon Treaty, the elections for the European Parliament which registered a record low turnout and by the transition from one Commission to the next all coinciding with a severe phase of the crisis.

The beginning of 2010, in many ways, marked a break from this 'less Europe' phase. By then both the failures of the EU framework in the face of the crisis but also the inadequacies and inefficiencies of Member State responses had become clear. A consensus on the need for more Europe, especially in the regulation of the financial sector had emerged. Until this point, the crisis had been primarily a financial sector crisis in most of the Member States.

The consensus on more Europe in financial regulation triggered a very substantial program of pan-European financial regulation that is still in its early phases. This for the most part is following the Community method and has reinvigorated the role of the European Commission and the European Parliament.

⁶

http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_banking/l240_12b_en.htm.

2. PHASE II OF THE CRISIS: LESS EUROPE AND THEN MORE

Then Greece reported that its fiscal deficits had been much higher than had been previously reported and this set off a new phase in the crisis wherein the health of Sovereign finances, in particular of Member States such as Greece, Ireland, Spain and Portugal, was questioned by the financial markets. This meant that their cost of borrowing gradually increased to levels that looked increasingly unsustainable. The first financial phase of the crisis, which had seen wide-spread financial contagion, developed an additional facet in the form of sovereign contagion.

The first response of other Member States was to do nothing except issue statements on solidarity, and the Commission once again lacked the tools and the financial wherewithal to act without Member State involvement. The Greek situation also made very real the big gap that existed at the level of the Union on any form of substantial fiscal support and exposed the limitations set by the 'no bailout clause' of the Lisbon Treaty. The European Parliament, which is primarily a legislative body, was once again left out of discussions on crisis management. The ECB, at least initially, was very reluctant to do anything that could look like fiscal support and so was also ineffective. There was a general feeling that the European Union was simply not up to the task of handling the Greek crisis.

Under continuing pressure from the markets and as contagion spread to the sovereign debt markets of other Member States, leaders from the euro area meeting on 25 March 2010 announced a sketch of a support package for Greece. This was drafted by the German and French leaders, a partnership that has since increasingly been setting the agenda on economic governance issues in the EU. It comprised a mix of a bilateral loan from other Member States and an IMF loan to be given under an IMF program with Commission and ECB involvement in surveillance and policy discussions. More details were given in early April and the deal was finally announced in the first week of May with a size that was more than three times as large as the initial discussions had suggested. The ECB suspended rules that would have stopped it accepting low rated Greek sovereign bonds as collateral and then in the second week of May announced the activation of a Securities Market Program to relieve tensions in the secondary bond markets of weaker Member States.

The absence of appropriate tools and resources at the level of the European Commission meant that once again Member States dominated the response and the European Council became the premier body in chalking up a first response to the sovereign crisis. Germany in particular, as the biggest contributor to any rescue package, became increasingly powerful in driving the agenda. The shift from a Community approach to an intergovernmental one and then on to one dominated by Germany and to a lesser extent France was palpable. The ECB was the only other EU institution that emerged more powerful from this with both the Commission and the European Parliament losing perceived power.

At the same time as an immediate response to the crisis was being chalked up, there was an emerging consensus that the monetary union alone without some form of a broader economic union was unworkable. Not only had the gap between the reality of economic integration and inter-linkages on the one hand and the absence of much policy co-ordination on the other helped build up substantial destabilising imbalances within the euro area but it was also hampering an optimal response to the crisis.

Two important decisions flowed out of this realisation. First, that there was a need for much stronger economic governance, particularly for the euro area. Second, there was a need to put in place a crisis management mechanism to deal with Member States that faced financial problems.

A decision on the first was taken at the full European Council meeting on 26 March 2010 wherein it, as empowered by Article 121 of the TFEU to "formulate a draft for the broad guidelines of the Member States and the Union", decided to strengthen European economic governance on a broad range of economic policies that Member States had hitherto been relatively free to decide on. A decision was also taken to have a stronger framework for euro area Member States as provided for by Article 136 of the TFEU. The European Council instructed its president Mr. Van Rompuy to set up a task force to make recommendations on reforming economic governance in the EU. This was perceived as a major step towards intergovernmental decision making and away from the Community method.

The European Commission, which despite having been working on improving economic governance had up until this point been relegated to a second tier status in the discussion, released a communication in the second week of May 2010 on its planned initiatives for improving the governance of the Union economy.

Once again, the crisis where the initial response was dominated by Member States and which exposed the inadequacies in the Union framework will result in more Europe through actions undertaken on economic governance both under the Community method and through intergovernmental decision-making. This process will inevitably strengthen the role of both the European Commission and the European Parliament.

The broad direction of the European Council's ideas and the Commission's approach has been similar and at their June 2010 summit the European Council broadly endorsed the Commission's ideas. This was followed by several developments in the European Council's approach including a Franco-German agreement on having a separate set of rules for euro area countries.⁷

The Commission, having taken some of the European Council's work into account, released a set of six legislative proposals on economic governance on the 29 September 2010. The timing of these, coming just over two weeks before the release of the European Council's own task force report was a classic case of power play between the two institutions. The European Parliament released its own initiative 'Feio report' on economic governance reform where it lays out its stance on the key issues in the debate⁸.

The Council (taking its guidance from the European Council), the European Parliament and the Commission are now engaged in the legislative process to finalise the shape of these governance reforms. This is very much a live issue and undoubtedly many new initiatives on economic governance will be issued over the next few years. Having been usurped by the European Council in the first instance, the Commission and the Parliament are now equal partners in the finalisation of this reform package and will both actually be empowered by many of the provisions contained therein.

⁷ <http://www.ft.com/cms/s/0/b1ae4e84-dbd3-11df-af09-00144feabdc0.html#axzz1EWe2TINw>

⁸ <http://www.europarl.europa.eu/en/pressroom/content/20101020IPR88588/html/Out-of-the-crisis-and-towards-European-economic-governance>.

3. THE EUROPEAN STABILISATION MECHANISM: EU POWER DYNAMICS

As the Greek crisis spilled over into other Member States and as the inadequacy of the Member States' first response to the crisis became clear, a consensus emerged for the setting up of a confidence enhancing financial support facility for the euro area. This was finally announced on 10 May 2010, just after details of the Greek rescue package were made public. The initiative, called the European Stabilisation Mechanism (ESM)⁹, was announced as a EUR 750 billion package to provide temporary aid to Member States facing financing difficulties. The IMF and the European Commission both had substantial contributions but the lion's share of the sum came from the euro area Member States who shaped the form the package took.

Some say that the Commission balked at channelling large sums of money through Union structures so gave initiative away to Member States. So while the smaller European Financial Stability Mechanism was controlled and funded by the Commission, the larger European Financial Stability Facility (EFSF)¹⁰ was set up as a private entity controlled by euro area Member States and is purely intergovernmental. This also marked a big shift in two aspects – first, the shift from the Community method to intergovernmental action and second, a major step in enhanced co-operation within the euro area. Decisions at the EFSF are taken unanimously.

The ECB supported the setting up of the package by the previously discussed actions of loosening collateral requirements, setting up a Securities Markets Programme (SMP)¹¹ for sovereign bonds and expanding its liquidity provision for banks in the euro area.

On 18 October 2010 at a meeting in Deauville in France, the Franco-German engine revved up again and they announced 1) an agreement on a need for a permanent crisis mechanism for the euro area 2) an agreement on the need for a change to the TFEU and 3) an agreement to suspend Council voting rights of euro area Member States under some circumstances.¹² This came on the same day as finance ministers were in a meeting of the Van Rompuy task force and was seen a direct statement of the increasing domination of Franco-German initiatives in setting the agenda. It undoubtedly undermined the work of the Council.

This action, together with previous and subsequent incidents of Franco-German agenda setting, such as the most recent announcement of the pact on Competitiveness in February 2011, drained power away from the Council¹³ as well as other Union institutions. An increasing number of commentators and fellow Member States are now concerned that this bilateral approach is also undermining the power and work of the European Council.

Italy suggested setting up a group of G-6, large Member States to try and mitigate Franco-German domination but was criticised by Poland for fomenting further divisions within the European Council.¹⁴ The European Council is already clearly divided and it is not clear how far the Franco-German domination can go as opposition from other Member States grows.¹⁵

⁹ <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/173>.

¹⁰ <http://www.efsf.europa.eu/about/index.htm>.

¹¹ See definition at <http://www.ecb.int/home/glossary/html/act4s.en.html>.

¹² <http://www.ft.com/cms/s/0/b1ae4e84-dbd3-11df-af09-00144feabdc0.html#axzz1EWe2TINw>.

¹³ <http://www.bbc.co.uk/news/world-europe-12368401>.

¹⁴ <http://www.ft.com/cms/s/0/7516a0fa-eea3-11df-b28d-00144feab49a.html>.

¹⁵ <http://www.ft.com/cms/s/0/792a5ace-306c-11e0-8d80-00144feabdc0.html>.

At the last summit one of the leaders asked France and Germany 'if they really thought it was right to treat everyone else in this way.'¹⁶

The discussions on setting up the permanent ESM are now in full flow and are being politically led by the European Council and being dominated by Member States. While the European Commission is providing ideas and capacity, its political influence is relatively limited since as with the EFSF, the ESM will be located outside of the statutory structures of the Union. The discussion on whether ESM decisions will be made by unanimity or some form of majority voting has not been taken but this is likely to reinforce the powers of Member States and the Council over the Commission. The European Parliament has been shut out of the process of setting up the ESM altogether and is not foreseen to have any significant role in its operation either. This is a big body blow for the institution that had only recently been given broader powers by the Lisbon Treaty.

Not only that, but the process of decision making on the EFSF and the ESM has been far more opaque and far less accountable than would have been the case if it had been channelled through the Community method instead.

¹⁶ <http://uk.reuters.com/article/2011/02/04/uk-eu-summit-idUKTRE71302F20110204>.

4. SOME DRIVERS OF THE POWER SHIFTS IN THE EU

As is clear from the discussion thus far, the EU is undergoing an unprecedented and constantly changing shift in power dynamics within the Union. In this section we discuss the main drivers of some of these changes. It is important to remember that the tension between the intergovernmental approach and a more Community method approach is not new and has existed in one form or another since the birth of the European Project.

The Lisbon Treaty

The Lisbon Treaty has introduced a number of new features that undoubtedly have shifted the landscape for power on economic governance issues in the EU. Some of the most important features are:

- 1) The European Parliament has been empowered and now has co-decision authority on a much broader array of issues than before. The Parliament is also now together with the Commission an institution that represents the Union interest. Both these measures have significantly increased its legislative authority
- 2) The European Council now has a permanent President which has given it more political power and continuity.
- 3) The Council of Ministers will use qualified majority voting in almost every single area which is expected to further increase the power of the EU over individual Member States as veto power is reduced. But this may lead to the European Council being less important than before.
- 4) The ECB has gained the official status of being an EU institution though it would make little difference to its power, and the euro is also now the official currency of the EU.
- 5) The formulation of the ECOFIN has been officially recognised for the first time and this is likely to make it somewhat more influential.

While it is far too early to judge the final impact of these changes, some things have increasingly become clearer. The European Parliament, which now has co-decision powers on almost 90% of all legislation, has emerged more powerful in terms of its influence on legislation. The European Council, driven by both the presence of a permanent President and an increasing number of Member State initiated responses to the crisis, is also a big winner in the power map of the EU. The increasing domination by France and Germany has taken away some of that power from the European Council as an entity.

The Council with a shift to qualified majority voting has gained power from Member States but lost some profile and initiative to an increasingly active European Council. It has gained legislative authority but lost political power. The power gain for many of the other EU institutions has come at the cost of the European Commission which is losing its role as the top dog in EU power plays. It is being seen increasingly by some as a 'secretariat', as a 'repository of expertise', as a 'guardian of the Treaties' but has definitely lost political power. However, at the same time that this has happened, the move towards 'more Europe' will undoubtedly put much more operational power in the hands of the Commission. The Euro Group with its new statutory status ought to have become more powerful but the domination by the euro area leaders has cast a shadow over it.

The financial crisis

As discussed previously, the financial crisis revealed both the yawning gaps in the regulation of various parts of the financial sector as well as the inadequacy and non-uniformity of financial regulation across Member States. This has provided a powerful impetus to a single-market more-Union approach to financial sector regulation. While the proposed set of regulatory reforms could be better designed and better targeted, there is little doubt that the changes are substantial.

The process, which is being technically and to a somewhat lesser extent politically being run by the Commission using the Community method, has significantly enhanced its powers, at least in this domain. The European Parliament, though it does not have the right of initiative, has also asserted its authority on a number of issues such as the negotiation of the agreements on the European Supervisory Authorities¹⁷ and the Directive on Alternative Investment Fund Managers¹⁸ and has gained power and stature as a result. The Council meanwhile has lost power in particular because a unified Commission and a less divided Parliament now face a more divided Council which votes by a qualified majority vote. The Commission and the Parliament, both defenders of the Union interest, are making sure that both the process of regulatory legislation as well as the exercise of authority empowered by this legislation is more Europe not less.

The workload on financial regulatory reform is so significant that it has somewhat clogged up parts of the economic apparatus of the Community method with the Commission's Directorate General Internal Market and Services (DG MARKT), the ECON committee of the European Parliament and the ECOFIN having a very full agenda as a result of this. The European Council has, so far, not been in the driver's seat for this agenda and the Community rather than the intergovernmental approach dominates.

The ECB, through its critical role in having protected the financial stability of the euro area as well as through its hosting of the European Systemic Risk Board has also emerged more powerful from the financial crisis.

The sovereign crisis

As highlighted earlier, the crisis in sovereign debt markets exposed both the lack of a proper crisis management framework as well as fundamental gaps in the economic governance framework of the Union. This has led to the development of a consensus for both putting in place an appropriate crisis management framework for states as well as developing more powerful economic governance structures for the Union.

Because the Commission lacked the financial resource and tools to respond adequately to the emergence of this new crisis, the European Council seized the initiative both on crisis management as well as the development of new economic governance structures. The European Council, freshly equipped with a permanent President, has retained the political initiative on these issues throughout as well as a mix of 1) crisis management funds being set up outside the statutory structures of the EU, and 2) agenda setting by France and Germany. The increasing use of the intergovernmental method has further reduced the legislative and political influence of the European Commission on matters of economic governance.

¹⁷ See http://ec.europa.eu/internal_market/finances/committees/index_en.htm.

¹⁸ See http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm, not yet published in the Official Journal.

The ECOFIN though it has lost some of the political initiative to the European Council, will become more influential particularly in its Euro Group formulation though strained relations between the Euro Group leader Junker and the leaders of Germany and France have limited its influence thus far. The European Parliament has, until recently, been left out of the process and has been unable to assert its authority. Since the euro area will have closer economic coordination and since the crisis funds are being set up only for the euro area, the Euro Group will become more important as a result of the sovereign crisis.

The concepts for economic governance are getting turned into legislation as is the case for six dossiers¹⁹ initiated by the European Commission (under the Community method) which are currently being discussed between the European Parliament and the Council. Four of the six are following the ordinary legislative procedure, so the Commission and the European Parliament in particular will be able to claw back some power. Most important, all of the legislative proposals are putting more implementation and oversight power into the hands of the Commission and the Parliament so they will emerge from the reform process with significantly more power.

A brief discussion of other drivers

Some other points that have been implicit in the discussion thus far deserve to be teased out in some more detail. EU institutions were not equipped to handle the crisis so the first response had to be led by Member States. The scope and size of Member State government action was unprecedented and both led to a sharp spike in their powers as well as an initial rise in the popularity of government action and the star of the Union fell. As the financial crisis eased somewhat, blame was apportioned, some Member States overstretched themselves and the sovereign crisis broke out, the popularity of and scope for Member State government action shrunk restoring somewhat the role of EU institutions though they did not become much more popular.

Factors such as 1) The current dominance of centre right governments in the EU which are instinctively more inward looking, 2) the backlash against politicians as the crisis remains unresolved and the austerity measures start to bite, 3) the unprecedented nature of EU interventions proposed in policy areas that up until recently had been nationally driven, 4) the large and unpopular fiscal commitments made by richer Member States for euro area crisis management, and 5) the seeming inability of political leaders to draw a line under the crisis have all made national leaders and EU institutions highly unpopular and the citizenry more nationalistic.

National leaders facing domestic pressures at home have to appear to prioritise national interests so sensible compromises struck in Brussels need to be presented as victories over Brussels or 'lazy Greeks'. This has been one of the drivers behind the increasingly vocal and political role assumed by the European Council and also why Germany has come to be increasingly prominent in setting the agenda. Appearing uncompromising and dominating in Europe plays well with an otherwise increasingly sceptical electorate.

¹⁹ See for references to all proposals http://ec.europa.eu/economy_finance/articles/eu_economic_situation/2010-09-eu_economic_governance_proposals_en.htm.

5. ANALYSIS

All things considered, a very significant transfer of sovereignty is underway and there is an increasing reach of the Union into policy areas that have so far been seen primarily as a national prerogative. In order to get to this 'more Europe' stage, it may be necessary, given the significance of the transfer of sovereign powers, for the European Council to take a more prominent role and use an intergovernmental approach.

The 'facing a difficult domestic political situation' issue is also a strong if less worthy justification for a greater politicisation of the process of economic governance reform. The choice, in many cases, may be one between action by the Council and no action rather than being a straight choice between the Community and the intergovernmental methods.

The fact that large amounts of potential fiscal transfers have been committed has also provided a strong justification for a strong role for the European Council since this falls outside of the traditional competence of the Commission.

The increasing focus on stronger euro area governance which will inevitably result in a two speed Europe also provides some justification for the increasing role of the European Council and the Council. This is so because they have the flexibility, meeting in different configurations, to separate the discussions and interests of the euro area and the non-euro area Member States. This is somewhat harder for the Commission and also potentially contentious in the case of the European Parliament where non-euro Member of the European Parliament have a vote on the affairs of euro area Member States.

The speed of the response required and the size of commitments needed together with the absence of the appropriate legal framework and resources at the level of the Union meant that Member States needed to lead the first response to the crisis both at the unilateral level and in the European Council. This hopefully will be different next time if a crisis does recur. That having been said, the speed of the response of the European Council, especially to the sovereign crisis has left much to be desired and the use of the Community method may have been faster, if politically harder to agree to.

As the financial crisis has morphed into a sovereign crisis and the issues of deep structural reform and changes to economic governance have been thrown into the mix, the need to act on multiple fronts at once has increased and the limitations for fragmented technical action have been reduced so it may be that a 'grand bargain' at the top political level is an efficient way of simultaneously tackling multiple issues. There is a need for action by the European Council here.

There is an additional concern that the unanimity of Council vote required by the intergovernmental approach might mean that surveillance and sanctions under legislation initiated by this might have a weaker 'lowest common denominator' element compared, for example, to equivalent legislation under the Community method that could have more of a bite as only a qualified majority is needed in the Council. This is a legitimate concern. The veto under the intergovernmental approach also means that any Member State can hold the other states hostage and the common joint response may lack predictability.

As we have highlighted above, the economic governance reform and financial regulatory agendas are packed and have clogged up capacity in the Community method based procedures. A shift of some issues to the intergovernmental track that is less process heavy may not be all that bad if it is able to move items through the decision pipeline at a faster pace.

Throughout this discussion we must remember to separate the power mapping for the legislative process from the power inherent in the content of the legislation. Even when the Commission and the European Parliament have lost relative power as a result of actions by the European Council and the Council, their powers are set to increase significantly as a result of additional legislation and stronger economic governance. So the direction of more Europe is very clear.

6. CONCLUSION

On balance, while there are some legitimate concerns with the increased use of the intergovernmental approach, the fears should not be exaggerated. First, this is occurring within the context of an even larger expansion of new pieces of legislation being undertaken by the Community method.

Second, the speed of action, the vast scope and depth of changes to sovereignty and capacity bottlenecks mean that there may be some good justifications for an expanded role of the intergovernmental method in the short term and more political leadership by the European Council.

Third, we must remember, that even with the use of an intergovernmental method, we are heading in the correct direction of more Europe and more operational powers for the European Commission and the European Parliament.

Fourth, the domination of decision making by Germany and France cannot continue for long if Union interests and a spirit of unity are to be maintained. For example, it has just been reported that members of parliament from Germany's ruling coalition will pass a resolution seriously limiting the room for manoeuvre that the German chancellor will have to make concessions in the European Council meeting on 25 March 2011²⁰. Such entrenching of positions by Member States can easily lead to a serious collapse of intergovernmental decision making in the European Union. Most decisions taken by the Community method cannot be held hostage to national actions in this manner.

To conclude, the recent spate of intergovernmental decision making in the EU is very clear but part of a much larger program of changes to economic governance. It is also clear that the quality of the decisions, the processes driving these, the communication towards financial markets and the accountability for decisions made under the intergovernmental process thus far has been very seriously flawed.

The political shenanigans around the so called comprehensive solution to be presented in March 2011 clearly illustrate the problems with this approach and there is little reason to hope why the quality of decisions will improve in the near future. That having been said, it is not possible to say with total uncertainty that the quality of decisions taken on the EFSF for example would have been better under the Community method or whether enough political will could have been mustered to even set up such a fund in the first place. There are some signs that the decision making process in the ESM will include some form of majority voting rather than consensus which is an encouraging sign.

The current happenings in the EU raise serious questions not just about inter-institutional relationship between EU institutions but also about relationships between euro area and other Member States and large powerful states such as Germany and France and smaller newer Member States such as Slovakia. Serious questions are also in order about the accountability of the system to citizens and citizen faith in the Union.

The direction of the evolution of intergovernmental decision making will have an impact on all of these questions and the current Franco-German approach needs to give way to a more balanced decision making and to more Community based approaches. Without this, the legitimacy, accountability, acceptability and working of the Union will be seriously affected as some Member States and citizens lose faith in the EU.

²⁰ <http://www.ft.com/cms/s/0/0a9aa552-3f79-11e0-a1ba-00144feabdc0.html#axzz1EoGAfhC9>

REFERENCES

- Devuyst, Youri; The European Union's Institutional Balance after the Treaty of Lisbon: "Community Method" and "Democratic Deficit" reassessed, *Georgetown Journal of International Law*, 2008.
- European Commission; Communication on Enhancing Economic Policy Coordination for Stability Growth and Jobs and Tools for Stronger EU Economic Governance, 2010.
- European Council; Strengthening Economic Governance in the EU, Report of the Task Force to the European Council, 2010.
- European Union; Consolidated Version of the Treaty on the Functioning of the European Union, 2009.
- Hagedorn, Franziska; The Community method vs. Intergovernmental method in the European Constitution, *Conveu 30 Conference Paper*, 2009.

Financing the Real Economy: Problems and Policy Options

BRIEFING

By Sony Kapoor

Additional research by Nataliya Taleva

Abstract

Investments that are growth-enhancing, that generate employment and that improve the sustainability of the economy are good and desirable. However, even before the crisis hit, the European Union suffered from a lack of optimal levels of investments in infrastructure, green energy and energy efficiency measures and small and medium sized enterprises. This was driven by a number of factors inherent to these kinds of desirable investments for example high upfront costs and long payoff periods in the case of infrastructure investments and a lack of policy certainty on carbon price for green investments. An additional problem was misallocation of resources by the financial sector because of excessive short-termism and crowding out by speculative investments. The crisis exacerbated the paucity of investments flowing to these desirable categories. However, policy makers have been handed a unique opportunity to address many of these deficiencies for example through a more informed reform of the financial system and through the introduction of new and innovative sources of financing.

TABLE OF CONTENTS

INTRODUCTION	23
1. PROBLEMS IN FINANCING DESIRABLE INVESTMENTS	24
1.1. Large upfront costs	24
1.2. Scale problems	24
1.3. Split incentives	24
1.4. Policy uncertainty	25
1.5. Information problems	25
1.6. Perceived riskiness	25
1.7. Profitability issues	26
1.8. Other friction costs	26
1.9. Crowding out by speculative investments	26
1.10. Excessive short-termism in the market	26
2. SECOND PROBLEMS RELATED TO THE CRISIS	27
2.1. An overall shrinkage of funds	27
2.2. The impact of austerity measures	27
2.3. An emerging reluctance to make long-term commitments	27
2.4. Bank credit has shrunk	27
2.5. The cost of funds has increased	28
3. A SHORTAGE OF INVESTMENTS IN DESIRABLE SECTORS	29
4. WHAT EU POLICY MAKERS CAN DO ABOUT THIS?	30
4.1. Regulatory reform of the financial system	30
4.2. Increasing the availability of public funds	30
4.3. Attracting non-EU funds to the EU	31
4.4. Plugging gaps in financial instruments	31
4.5. Policies to increase the attractiveness of desirable investments	32
4.6. Reducing friction costs	32
4.7. Tackling the euro area crisis head on	32
REFERENCES	34

INTRODUCTION

All economies need investments in order to grow and prosper. Investments come in all shapes and sizes and include large scale investments in public infrastructure on the one hand and small investments by Small and Medium sized Enterprises (SMEs) on the other. Investments range across 'dirty' sectors of the economy such as coal fired plants etc. to clean energy sectors such as wind turbines. What is clear is that the growth, productivity and sustainability of an economy all depend on the size and nature of investments made.

In general, investments in good quality public infrastructure help increase productivity, solid investments in high real return projects by SMEs in particular drives growth and job creation and investments in energy efficiency measures and green projects increase the sustainability of economies. Given the importance of these and the short nature of this paper, it makes sense to focus this paper on 'options for better financing of infrastructure, green and SME investments' which we collectively call 'desirable investments' for the purpose of this paper.

Even before the crisis hit, too little money has flowed into these three categories of investments discussed. Some of the factors behind this, such as the malfunctioning of the financial sector, were common while others differ across the three categories. These factors need to be tackled if financing to these desirable sectors is to increase.

The ongoing financial and economic crisis in the EU has had a substantial impact on the availability of financing for investments. While the impact is wide-ranging, the most relevant impacts have been

- 1) the overall availability of private sector investment funds has shrunk;
- 2) the accompanying austerity measures means that the pool of public sources of funds for investment has also shrunk;
- 3) investors are much more reluctant to make longer-term fund commitments so the availability of long-term funds has shrunk in particular;
- 4) the availability of bank finance has also shrunk as banks deleverage to restore capital ratios;
- 5) the average cost of financing has increased in particular because investors are more risk averse; and
- 6) the availability of funds for more investments seen to be more uncertain, untried and risky such as those in the green sectors of the economy and in the SME sector.

Clearly any negative effects of the crisis and subsequent regulatory changes on the availability of finances for desirable investments need to be addressed with urgency.

1. PROBLEMS IN FINANCING DESIRABLE INVESTMENTS

In this section we briefly look at a number of long term obstacles that these three categories of investments face. Some are common across the three categories and some are specific to their particular characteristics.

1.1. Large upfront costs

Raising large sums of money for investments is always hard so funding of capital intensive projects such as in the transport, energy and other infrastructure projects is difficult. This challenge is pertinent for normal infrastructure projects and even more so for trans-border infrastructure projects well as for many green investment projects.

The absolute size of funds involved, the long gestation periods and high construction risk all mean that raising funds for infrastructure projects is hard. Trans-border projects that may be even more ambitious in scale but almost always also carry higher construction and operational risk are even more difficult to mobilise investments for. While the funds required for green energy projects such as the installation of solar panels or wind turbines are not that large, the riskiness associated with these projects is higher so upfront funds for construction are difficult to mobilise. For investments in energy savings such as through the installation of better home insulation the outlay amounts to a significant percentage of household incomes even though the absolute sums of money involved may be small.

1.2. Scale problems

As in most other markets, financial markets too have their conventions. Transactions that are of a size and kind that fall within the range of normal market practice are easier to finance and entail lower costs. That is why transactions that are very large, for example trans-border infrastructure projects, are harder to raise funds for than normal mid-sized corporate investments. The problem is also acute at the smaller end of the spectrum where directing money towards the relatively small investment needs of SMEs may be uneconomic for several investors. Similarly, the funding requirements for carbon reducing investments such as better home insulation are too small to be of much interest to any major investor.

1.3. Split incentives

The vast majority of large infrastructure projects, especially in the transport and energy infrastructure sectors, have a large public element. Some are fully owned and operated by the public sector but often and increasingly so there is private sector involvement in the funding, ownership and operational side of these projects, the so called public-private partnership arrangement.

The construction of roads, railway lines, transmission grids etc. all deliver a significant benefit to the wider economy that is hard to capture fully in terms of private compensation even with the increasing use of practices such as user fees by using tolled roads etc. The full benefits of infrastructure projects are very difficult to capture privately so the incentives for private investors who only look the profitability that can accrue to them are different from those for the country or region as a whole since the relevant parameter in that case is the economy-wide benefits that such projects might generate.

A similar problem applies to green investments where the private profits generated for investors do not fully capture the positive externalities generated by the project in terms of

contribution to tackling global warming at least as long as carbon emissions remain under-priced.

To a lesser extent, there also exists a positive externality that comes from the intensive employment generation in the form of SME investments that may not be fully reflected in the profits that accrue to SME owners.

1.4. Policy uncertainty

The general debate about investments almost always underestimates the potential impact that policy changes can have on the profitability of investments. This is particularly true in the case of infrastructure projects which have long complex construction cycles and even longer payback periods wherein many policy parameters such as land acquisition practices, price caps, obligation of providing universal access can change with a significant impact on the bottom-line of the project.

The single biggest source of risk and uncertainty in green investments is the evolution of public subsidies, if any, and of carbon price. No other parameter determines the profitability of green projects more than the prevailing and expected price of carbon which in turn is largely the result of public policy.

1.5. Information problems

Information problems, where investors are uncertain about how to invest and/or about the details including the risk return dynamics of the underlying investment, are especially acute both in the SME sector as well as in the case of green investments. For the SME sector, the information problems arise because most of the SME's are not listed and have little public information on their businesses. In this situation, it is very costly for investors to acquire detailed information in particular because the investment itself is rather small in size.

For green investments, the biggest problems arise at two levels. First, many investors who want to go green are uncertain where or how to invest and also whether the investments that claim to be green are actually so in practice. Second, there is also a clear uncertainty and lack of knowledge about nascent and evolving green technologies and about the longer term risk return profile of investments in technologies that are still evolving.

1.6. Perceived riskiness

Infrastructure projects, once they have been built, are considered to be relatively safe investments. Energy generators, airports, toll roads and water projects all generate steady and relatively stable cash flows. Attracting reasonable cost funding for such projects is not that difficult but in the construction phase that is typically complex, expensive and takes a number of years, these projects find hard to attract the right mix of investments. A number of things can go wrong during the long drawn out building phase so the real and perceived riskiness of these investments is high.

Investing in green projects that lack a long history of established technology and a track record of life cycle cash flows for similar projects is naturally perceived to be risky by investors.

SME investments are also typically perceived to be less safe than investments in corporations that are larger and in particular also have brand recognition. This is so despite the fact that the cash flows and business models of many SMEs are in actual fact safer than those of larger more well-known businesses.

1.7. Profitability issues

The profitability of large infrastructure projects, especially those that are unable to capture positive externalities or those that are designed primarily to deliver services to the public is relatively modest. Green investments lie across a whole range of spectrum from the highly profitable investments in energy efficiency to more marginal investments in solar panels that would not even be profitable without public subsidies. Without a doubt they would all be much more profitable if there were a proper price attached to carbon emissions but this is not the case yet. While SME investments may be highly profitable, the large information acquisition and monitoring costs means that profit margins on SME investments may still be low.

1.8. Other friction costs

In addition to the problems that afflict 'desirable' investments that have already been discussed, there are also additional friction costs that make such investments less attractive to investors. The non-existence of appropriate financial instruments that match the right risk/return characteristics required by investors with the cost, duration and nature of funds needed for desirable investments is a major friction cost.

1.9. Crowding out by speculative investments

As discussed above, the 'desirable investments' often yield modest profits but offer significant real value added to an economy. As the nature of the financial industry has changed and as financial innovation driven primarily by the sell-side seeking to maximise short-term profits started dominating the financial system, speculative investments that often offer high profitability but with little real benefit to the wider economy crowded out investments that added real value to the economy.

This happened both at an aggregate level with large investors but also at the level of individuals. Faced with booming real estate markets many investors particularly in countries such as the UK, Ireland and Spain chose to put money into speculative purchase of houses that promised large (primarily because of leverage) safe returns rather than putting money into SME, green or infrastructure funds.

1.10. Excessive short-termism in the market

A parallel development to the increased innovation in financial markets has been an increasing degree of short-termism. At the level of large investors it means that the average holding periods for stocks and many other investments are now measured in months not years. Both bankers and fund managers are compensated on the basis of a quarterly or annual performance which significantly increases their incentives to maximise short-term profits. Retail investors too have become increasingly impatient and everyone wants quick profits with patience having become a very scarce commodity amongst investors.

2. SECOND PROBLEMS RELATED TO THE CRISIS

In this section we look at how the crisis, which is still ongoing, has altered the investment landscape in the European Union.

2.1. An overall shrinkage of funds

The crisis inflicted significant losses on many investors both in the fixed income and equity segments of which only some have been recovered as a result of the partial economic recovery. Banks too saw their reported loan losses increase significantly. This has resulted in a shortage of investible funds particularly in certain markets.

At the same time that these losses have been registered, governments in the EU and internationally particularly amongst the developed economies have increased their borrowing to record levels. This has possibly exacerbated the impact of the shrinkage of funds so investments in the desirable categories have undoubtedly suffered.

2.2. The impact of austerity measures

The crisis resulted first in an expansion of government stimulus programs in most EU countries. This partly made up for the initial shock to investments that resulted from the eruption of the crisis. However, since the euro area sovereign debt crisis erupted last year governments throughout the EU have embarked on the sharpest austerity programs in recent history. This has not only reduced government expenditure on procurements, an important source of revenue for SMEs, but has also resulted in sharp cut backs on government support provided to the green investment sector and expenditure on infrastructure projects. The withdrawal of subsidies provided to the solar energy industry in Spain, for example, has thrown the industry into disarray.

2.3. An emerging reluctance to make long-term commitments

After having been burnt by the crisis, many investors are sensibly cautious about making long term commitments especially as long as the European Union fails to draw a clear line under the crisis. This is an individually sensible response for investors but collectively it has a negative impact on the economy. Finding the long term market shut down or very expensive many borrowers have turned to borrowing over a shorter term. This reduced funding predictability, is unsuitable for certain kinds of investments and simply stores up problems for when the borrowing falls due.

An additional aspect of the crisis has been the drying up of equity markets (new issues) in the EU and a sharp fall in the amount of funds available in the form of venture capital, already a weak feature of the EU financial system.

2.4. Bank credit has shrunk

Faced with increasing losses, an urgent need to protect capital and new regulations that require them to build up capital, banks throughout the EU have shrunk the amount of credit they make available. Some have put this down to being a demand rather than a supply problem. Both are two sides of the same coin. There is a widespread tightening of qualitative and quantitative credit standards which has reduced the supply of bank credit at any set of loan terms. Since bank credit is a very major source of finance, especially in the EU, for SMEs and for infrastructure and green investments particularly in the construction

phase, this has had a disproportionately negative impact on our set of desirable investments.

2.5. The cost of funds has increased

At every level, the cost of funds has increased for the same nature and duration of financial contracts. This has altered the risk return characteristics and projected cash flows for a number of projects so that under the scenario of higher costs of funds some of the desirable investments are no longer commercially feasible despite the fact that their overall returns to the society in terms of impacts on growth, sustainability and employment is substantially positive.

Even though interest rates are very low, there has been a re-pricing of risk so the rise in credit spreads charged by banks and other investors has been greater than the decrease in headline interest rates. Moreover, as sovereign spreads have increased substantially especially in the weaker Member States, this too is contributing to a rising cost of credit.

3. A SHORTAGE OF INVESTMENTS IN DESIRABLE SECTORS

The previous two sections have highlighted a series of problems that exist in the current investment landscape in the European Union. Some of these are structural and have grown over time and some others are a direct result of the crisis though they may be with us for many years to come. In this section we briefly discuss why these sets of problems have a disproportionately negative impact on our category of desirable investments.

Projects with large upfront costs and long payoff periods are already hard to finance even under normal market conditions but this has been exacerbated both by an overall shrinkage of available funds and an increased reluctance on behalf of investors to make longer term investments. Large scale infrastructure projects as well as smaller green investment projects that require relatively smaller but still multi-year funding commitments have both been disproportionately affected.

At the other end of the spectrum the small but fragmented nature of SME financing needs and energy efficiency enhancing household investments mean that these fall outside of the normal scale of market financing and are chronically underfunded. As the cost of credit has increased as a result of the crisis these micro investments have come to be seen to be more risky and are being disproportionately penalised by a reduction in bank credit in particular.

The split incentive problem, discussed briefly in a previous section of this paper, seriously afflicts all three categories of desirable investments disproportionately as the full socio-economic benefits of these investments are not reflected in the risk/return landscape faced by private investors so investment levels are suboptimal.

Out of a large category of investments our subset of desirable investments in particular are highly depended on public policy. As the crisis has forced governments to embark on large scale and often unexpected changes to policy, the resultant policy uncertainty has depressed investments in desirable areas. As public subsidies are withdrawn from the green investment sector and as public authorities withdraw some of the commitments made on infrastructure, total investment levels are shrinking.

Even though many investors express a desire to make green investments they face several information and friction hurdles to doing so. If there were more easily available investment products that were vetted to be quality a lot more money would flow into green investments.

The modest profitability and perceived higher riskiness (at least in the construction phase) of infrastructure, green and SME investments penalizes them disproportionately as speculative and short term investments crowd them out.

Austerity measures as a result of the crisis have had a disproportionate impact on our categories of desirable investments since these sectors depend disproportionately on partial public investments. The decline in the terms and volume of bank credit and a secular increase in the cost of funds have affected the desirable sectors more than others.

In general, anything investments seen to be unfamiliar, or more risky or requiring a longer term commitment of funds have been shunned by investors and this in turn has had a large impact on the investments in the desirable sectors in the European Union.

4. WHAT EU POLICY MAKERS CAN DO ABOUT THIS?

While there is a huge set of micro, macro and financial sector reforms the EU could undertake to encourage what we have called desirable investments, this policy brief does not allow for discussion of most of these ideas. Instead we highlight some of the major themes that capture a large proportion of these ideas.

4.1. Regulatory reform of the financial system

We are undergoing the biggest overhaul in the regulation of the financial system in a generation. Most of the regulations being enacted are merely looking at a financial stability perspective. This is wrong. The problems in the financial system ranging from a general misallocation of resources to excessive short-termism and incentives for speculative over real investments are much larger. These other incentivising real, growth-enhancing, employment-generating, and sustainability perspectives should be factored in while revising and devising regulatory reforms.

For example, an introduction of financial transaction taxes²¹ and reforms to compensation of bankers and investment managers can help induce a longer-term perspective into finance. Mandatory carbon stress tests for fund managers and banks can induce more green investments. Reducing the risk factors for SME lending and encouraging the securitisation and pooling of SME and household energy efficiency lending will also promote desirable investments. Steps to penalise speculative investments such as by introducing tighter loan to value ratios for housing markets etc would also push the financial sector in the right direction.

4.2. Increasing the availability of public funds

As we discussed above, our category of desirable investments is disproportionately dependent on public funds. So efforts to 1) increase dedicated funds for public investments, 2) promote investments in trans-border infrastructure, 3) support green investments, and 4) catalyse support to SMEs would also be very helpful in promoting desirable investments.

Funds that the pan-EU level in particular can be used to promote much needed pan EU infrastructure as well as green investments and the priority direction of cohesion funds in the direction of desirable investments holds great promise. Expansion of the European Investment Bank's size and scope of operation as well as an expansion of its concessional lending facility could also provide a significant boost to good investments.

Stressed governments budgets means that new and innovative sources of financing, in particular financial transaction taxes, other forms of financial sector taxation, carbon and other environmental taxes, the use of EU-wide lotteries, a possible use of dormant bank accounts and renewed efforts to claw back untaxed EU citizen funds deposited in tax havens would all be very promising sources of additional public revenue particularly at the pan EU level.

Project linked Eurobonds²² and project-bond purchases by the EIB²³ for infrastructure projects are both good ideas though these could only be used to finance that are at or close to commercial levels of profitability.

²¹ www.re-define.org/sites/default/files/ReDefine%20FTTs%20as%20tools%20for%20progressive%20taxation%20and%20improv....pdf.

²² www.europeanvoice.com/article/imported/the-case-for-eu-project-bonds-/69032.aspx.

4.3. Attracting non-EU funds to the EU

At the same time as EU investor power is declining, the funds being built up by non-EU investors, particularly in Asia and Norway are increasing. The stock of commodity related sovereign wealth funds and reserves held by emerging economies easily exceed USD 10 trillion now and hundreds of billions of dollars of funds are being added every year. Attracting even a fraction of these funds to the EU, particularly into the infrastructure and green sectors that can be made attractive to these investors can help make a substantial difference in the EU.

Providing tools for credit enhancements could and making special marketing offers to large sovereign owned funds is a good way of attracting them to EU infrastructure investments. Oil related funds in particular will find pooled portfolios of green investment as well as appropriate green venture capital funds very attractive because they provide serious green diversification potential for their carbon exposed flows of new money. In fact, such funds would be willing to invest in more marginal green investments than other non commodity investors who do not enjoy the diversification potential²⁴.

4.4. Plugging gaps in financial instruments

Often investments that would otherwise have happened in perfect and well-functioning financial markets do not materialise in markets that are somewhat dysfunctional and lack the right financial instruments for risk sharing and for connecting the right projects to the right investors.

The EU is widely regarded to have an underdeveloped venture capital industry and an excessive reliance on bank finance. Projects need different kinds of financial instruments at different stages of financing and these instruments need to have different risk sharing characteristics and time horizons.

In particular the EU needs to better develop instruments for credit enhancements and risk sharing, securitisation of green and SME investments, venture capital investments and public private partnerships on infrastructure. Where the private sector is able to step in to complete the market, it should be encouraged but in its absence the EIB and other public financial institutions should be tasked with developing product portfolios that best complete the requirements targeted in particular at financing desirable investments.²⁵

As long as impact of the crisis on public revenues is not purged, it may make sense for EU governments to explore the use of public private partnerships (PPPs) that until now have mostly take place in the UK. The experience of the UK has been rather mixed but appropriate lessons can be learnt and a selectively increased use of PPPs in the EU may be no bad thing particularly when the private sector can supply financing needs that governments at this point may have a harder time mobilising. Sometimes the choice may be between no public investment in infrastructure and investment in the form of PPPs.²⁶

The introduction and expansion of vetted infrastructure and green bond and equity indices, climate awareness bonds and green deposit accounts etc would be very helpful to attract investments into these sectors.

²³ www.euractiv.com/en/euro-finance/barroso-promises-go-ahead-with-eu-project-bonds-news-500620.

²⁴ http://re-define.org/sites/default/files/1005_TacklingClimateChange_FEPS_SK.pdf.

²⁵ www.eib.org/epec/resources/guide-to-guidance.pdf & www.hm-treasury.gov.uk/ppp_index.htm.

²⁶ <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/EUEINPEXTN/0,,contentMDK:21916582~pagePK:141137~piPK:141127~theSitePK:590766,00.html>.

Private equity in the EU refers mostly to leveraged buy out (LBO) kind of deals that are not very useful for our preferred category of investments. Venture capital is very different from LBO transactions and should be put under a separate and more favourable regulatory framework. Within private equity, the public utility of public to private deals is rather limited whereas deals involving SMEs that can help create exits for entrepreneurs and retiring businessmen can be highly beneficial.

4.5. Policies to increase the attractiveness of desirable investments

The EU is still working on tightening green legislation²⁷, launched a Small Business Act in 2008 to remove bottlenecks for and encourage investments to the SME sector²⁸, has prioritised our categories of desirable investments in its EU 2020 strategy²⁹ and has ambitious plans for trans-border infrastructure. Within these initiatives there are several plans that will, for example, 1) increase the price of carbon, 2) improve the operating and financing landscape for SMEs, 3) facilitate trans-border infrastructure investments, etc. These should be pursued in earnest and will significantly increase the investments flowing to growth and employment enhancing and green friendly sectors.

Preferential tax and regulatory treatments are very useful and powerful additional tools that can help stimulate additional desirable investments in the European Union.

4.6. Reducing friction costs

Reducing other friction costs, such as those of pooling information, would also help encourage investment to flow to our desirable categories of investments. SMEs would benefit significantly if their liabilities could be pooled and securitised, if they had access to equity in specialised mini equity markets with less stringent listing requirements than standard exchanges. A credit registry for SMEs would also be very useful and could bring down their borrowing costs significantly.

Pooling arrangements for household energy efficiency loans and flexible billing arrangements that can help directly recoup some of the lower energy bills for investors can help stimulate a much needed expansion of micro investments in energy efficiency.

Similarly, approved green indices and vetted green deposit accounts can help many well-intentioned investors to translate their intentions into action by giving them easy access to making green investments.

4.7. Tackling the euro area crisis head on

When Lehman Brothers collapsed, no one knew which bank would be next. Counterparties lost faith in all measures of the soundness of banks. Under such a scenario, the only course of action that made sense was to hold one's money close to the chest. The uncertainty around the size and distribution of potential losses led to systemic collapse. Something similar has been unfolding in the euro area banking and sovereign debt crisis albeit in slow motion. The failure to draw a line under the crisis has meant that the continuing uncertainty around the size and distribution of losses in the Eurozone has been haemorrhaging our economy. Political dithering and mixed messages have ensured that no

²⁷ www.euractiv.com/en/climate-environment/30-greenhouse-gas-emissions-cut-table-news-502133.

²⁸

www.europa.eu/rapid/pressReleasesAction.do?reference=IP/11/218&format=HTML&aged=0&language=EN&guiLanguage=en.

²⁹ http://ec.europa.eu/europe2020/index_en.htm.

one knows how, when or where these losses will materialise (Source: <http://euobserver.com/7/31752>).

Under these circumstances, it has been rational for investors to keep their distance. They are penalising both sovereigns exposed to weak financial institutions and financial institutions exposed to troubled sovereigns. They assume the worst for both but this collective fear is far in excess of the worst possible realistic economic outcome. States and banks with healthier balance sheets have got caught in the crossfire.

Instead of reacting decisively to reduce uncertainty, our political leaders have done the exact opposite. Their continuing dithering has increased the absolute cost of the crisis and the resultant 'crisis overhang' has been one of the main drivers for depressed levels of investments. As discussed earlier, the uncertainty has affected our category of desirable investments more than proportionately as they have been shunned by investors under the present economic and political situation in the euro area.

EU leaders meeting on the 25th can help stimulate investments in the real economy by agreeing to draw a line under the crisis and restoring confidence in the EU capital markets. they can do this by tackling the Greek, Irish and Portuguese debt overhang, reestablishing market confidence by expanding the EFSF and putting in place an effective ESM and announcing rigorous bank stress tests accompanied by an urgent bank recapitalization plan.

REFERENCES

- European Commission; "Think Small First", A "Small Business Act for Europe, 2008.
- European Commission; Europe 2020, A European strategy for smart, sustainable and inclusive growth, 2010.
- European PPP Expertise Centre; A Guide to Guidance, Sourcebook for PPPs, 2011.
- Kapoor, Sony; Financial Transaction Taxes: Tools for Progressive Taxation and Improving Market Behaviour, Re-Define, 2010.
- Kapoor, Sony, Hogarth Ryan, Oksnes Linda, Gibson Anna, Narciso Thais; Tackling Climate Change: Tools to Fund Adaptation and Mitigation Initiatives, Re-Define, 2010.

DIRECTORATE-GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT ECONOMIC AND SCIENTIFIC POLICY **A**

Role

Policy departments are research units that provide specialised advice to committees, inter-parliamentary delegations and other parliamentary bodies.

Policy Area

- Financial, Economic and Social Crisis

Documents

Visit the European Parliament website:
<http://www.europarl.europa.eu/studies>



PHOTO CREDIT:
Shutterstock/Imagis LLC

ISBN