CONFRONTATIONS EUROPE

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European Long Term Investment Conference

A NEW BEGINNING FOR INVESTMENT

THIRTY AUTHORS, INCLUDING:


ET SI DEMAIN LES TRAVAUX PUBLICS S'ARRÊTAIENT ?

INVESTING IN THE FUTURE... AT LAST?


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Confrontations Europe will be hosting a European Long-Term Investment Conference (*Assises européennes du long terme*, or AELT) at the start of December. At the same time, the European Parliament and the Commission will begin their new mandates, during which economic recovery through investment and the incorporation of mass unemployment into EU strategy will be high on the agenda.

This issue of *La Revue* focuses entirely on the conference and showcases the hard work done by our association under the leadership of Philippe Herzog. Working from an in-depth analysis of the causes of investment decline, we discuss the conditions needed to kick-start the economy through investment that are essential for our businesses' future. It is crucial that J-C Juncker's proposals (an investment plan put forward by a more collegial Commission) trigger a dynamic that involves all stakeholders and leads to a long-term strategy and visible results as quickly as possible.

Its success will depend largely on the consistency of EU and national strategies, so a number of ambiguities – maintained by a too binary public debate – need to be clarified. "Growth versus austerity" does nothing to improve our understanding of the issues. All the countries in the EMU need reassurances that the renewed confidence in the common currency is here to stay. The methods employed by individual Member States to ensure this objective are widely different. We should not write off the efforts of some and the consequences of the prevarication of others, or be too quick to judge political choices we do not agree with. We know that defending national interests without undermining the European general interest is not an easy task.

A complex balance has to be struck between reorganising public finances (the current state of which is incompatible with medium-term challenges) and funding essential public investments. Such investments should not be included in the deficit governed by the stability pact when they are necessary for future development. In theory, the responsibility for these investments should be shared by the governments in the EMU, provided they can trust each other to meet their commitments. To solve the issue of trust and credibility, the public investments deducted from a country's deficit should, at least at first, be of European interest. In other words, they should be compatible with the investment priorities established at Community level.

This strategy would call for public-private partnerships. In addition, it should encourage the implementation of convergent national policies, albeit different policies because the needs of individual countries (in terms of infrastructure for example) are not the same and because their aim is to reduce discrepancies between EU Member States.

Such a strategy would be a means of addressing the changes in our economies by stepping up human investment – training leading to qualifications, dialogue between multiple stakeholders – which would secure widespread commitment and enable innovation.

A democratically legitimate investment policy is needed to pursue the single market development process, including fiscal harmonisation and the construction of a new European base. It should also be tied in with structural reforms at national level, which should be consistent across the EU.

This initial phase of investment falls within the scope of a fundamental debate over how to manage Europe's economic and social development so that it meets the many challenges our world is facing today. True monetary stability and competitiveness are essential issues, that are difficult to solve. But they are not a European project in themselves.

Marcel Grignard, President Confrontations Europe

Contents

For our European Conference in December, a special issue on Long term investment

TOWARDS A EUROPEAN INVESTM AND A KEY FOR EUROPE'S FUTU

Five years ago, our association joined forces with the Long-Term Investors Club to address an issue that is decisive for Europe's future: the revival of investment. Our efforts have been tireless; there are many more of us today. We have to act now if we are to stave off the threat of further recession in Europe.

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Philippe Herzog
Founding President Confrontations Europe

The Commission is drafting a €300 billion recovery plan for the next three years. It wants to use available public funds to leverage private investment in projects of European interest. It's a good idea but it's just a start. We won't deny that, to pull it off, the Member States and the Union will have to make a huge effort to work together in a spirit of co-responsibility. And that in-depth reforms of market and public governance structures will be needed to rebuild confidence and boost project numbers, with the aim of achieving significant progress in the medium and long term.

The purpose of our European Long-Term Investment Conference is to initiate a dialogue between all the stakeholders, as cooperation between the public, private, business and financial sectors is a decisive factor.

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> **We would like to develop a joint, in-depth and holistic analysis of the factors underlying the investment crisis in Europe.**

Our societies are experiencing a profound crisis of confidence. Our dwindling hope in the future goes hand in hand with the fear that our social model is being eroded. The uncertainty arising from long-term geopolitical tensions and from the declining integrity of the Eurozone and the Union has increased risk aversion among businesses and investors. It is vital to establish a more long-term outlook for the Union through an investment strategy that increases growth potential and meets future needs.

The economic policy debate keeps getting bogged down in arguments for and against austerity. Public spending discipline is necessary – within reason – as unsustainable levels of debt obliterate the future. Only by increasing investment, and not consumption, can we stimulate both supply and demand. The economic and political structures of the past are now a handicap when it comes to taking risks for the future: the general level of skills and training is inadequate to meet the challenges of innovation; the internal market is still fragmented and provides neither a common space for innovation nor the scope needed to promote projects of common interest; public administrations are inefficient; and the financial system is in crisis, having created a gap between financial value and the real value of investments.

It is widely agreed that incentives and public investment are needed to restore the confidence of private investors. However, the only way to achieve this is by strengthening the market to reduce market "failures" and by promoting a spirit of co-responsibility to improve coordination between the Member States and the Union.

> **There are not enough public and private-sector projects. And projects that are proposed cannot be developed and implemented within the market and the public governance system offered by the Union at present.**

Massive investment is needed to pursue sustainable development. And stakeholders must be able to take advantage of the opportunities that present themselves: the digital revolution, low-carbon energy, changing urban and rural needs, the growth of emerging markets and so on. Yet large

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companies are not taking the risk of investing in Europe. SMEs do not have the profit margins needed to do so and are unable to obtain loans, and the infrastructure projects proposed by the Union are not getting anywhere. Costs are high and anticipated rates of return are low. The reform of the internal market, the development of industrial and training policies, and the complementarity between the public and private sectors should help by facilitating and promoting the sharing of risks and opportunities. What we are missing today is an inclusive, coherent and competitive economic union.

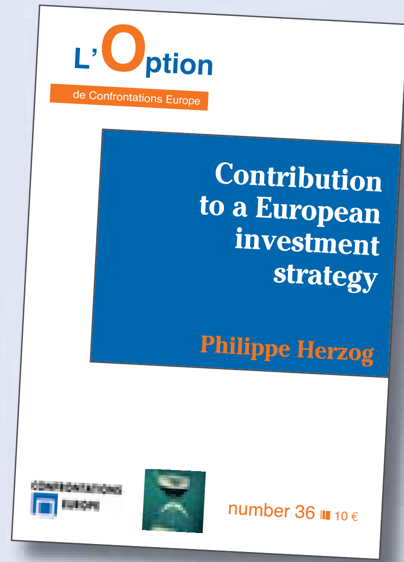
The transformation of the banking and financial system is a key aspect of the challenge. Although funds are plentiful, the European capital market does not provide the resource allocation channels or the risk assessment and sharing mechanisms needed.

A policy of supervision and regulation has been adopted in response to the economic crisis, the aim being to stabilise the financial system and make it more secure. However, savings are not being channelled into investment. Financial institutions and investors are extending finance to governments at historically low interest rates but SMEs, infrastructure companies and manufacturers are unable to obtain either the support or the funds they need to invest in the future. It is vital to restore both bank lending and market financing by setting up risk-sharing mechanisms between banks, long-term savings institutions and investors. The role played by insurers, pension funds and asset managers must be reviewed and substantially increased. This will require in-depth reforms of savings and tax policies. Europe must affirm its autonomy while attracting external investors and investing abroad itself, in a global context of fierce financial and regulatory competition.

Significant progress in the coordination of economic policies and institutional governance systems should lead to the development of a common European investment strategy.

The European Central Bank is strongly committed to supporting lending and business activity but it cannot be expected to do everything single-handedly. The coordination of national budget policies must be adjusted: the requirement to curb the rise in public debt will not be eased, but priority must be given to public investment and there must be a stronger commitment to structural reform in education systems, labour markets and government services. We must forge a common culture of public decision-making – based on principles of solidarity and democratic control – at least in the Eurozone, which is suffering seriously from the lack of a budget and financial policy.
The ability of public financial institutions to cooperate and to select and guarantee investment projects of general interest is a concrete but essential issue. Redefining the role of the EIB, creating mutual investment funds and coordinating the actions of national public investment banks with those of the EIB and the Commission are not easy tasks. The time has come to set up a European long-term investment system.
There is growing doubt about the efficiency of public decision-making. The tendency to delegate powers, the violence of conflicting ideologies, the ignorance of other cultures that is driving nations apart and market malfunctions are serious impediments. Civil societies must step up their involvement and work together to achieve objectives and introduce reforms. It is just as much an ethical and anthropological challenge as a democratic and political one.

40 proposals for an action plan



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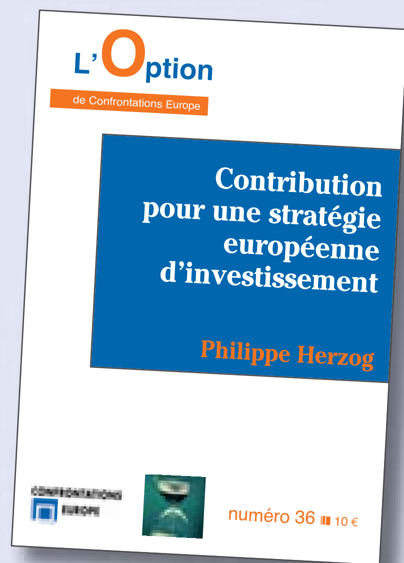

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Franco Bassanini

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Edoardo Reviglio

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Infrastructure

OVERCOMING THE INFRASTRUCTURE BOTTLENECK

Much has been done in the EU to increase the supply of finance for infrastructure. However, and this is the point we want to make, even if we manage to create the right conditions on the side of the supply of long term finance for infrastructure, we will never get a market for PPP in Europe if we do not work on creating the right condition on the demand side. By that we mean the creation of a much larger base of pipelines "investment grade" and bankable projects, for large, medium and small public works and infrastructure. At the moment this is probably the single most serious problem of financing infrastructure in Europe: lack of investable projects. We are confronting in the EU with a phenomena known as the "Infrastructure Bottleneck" (BIS, 2014).

Complexity ot the agreements

Infrastructure are characterized by certain idiosyncratic features, typical for newly constituted markets. The financial offer is abundant but the pipeline of bankable projects is still narrow, even in the most advanced markets, such as the European market. One example is sufficient: one of the largest Greenfield funds, operating in Europe decided to co-invest in equity in only 9 of about 500 analyzed projects in the sector of energy and transport in the last two years. And we are talking mostly about EU flagship TEN-T and TEN-E large and medium infrastructure initiatives. For some other funds operating in Europe the ratio of projects analyzed and projects in which it was decided to invest, is slightly higher, but in any case it remains low. This is worrying and it means that much progress still has to be made to launch on a wide scale Private Public Projects in Europe. It means also that there are players or processes representing "weak links" in the life-cycle of projects. The complexity of construction and financing of major projects, especially in sectors with high technological content or with high regulatory or macro-economic risk, requires agreement with various entities working together like an orchestra, and not for a short period of time, but in many cases for 10, 30 or 50 years. Indeed, the involvement of a wide range of parties in infrastructure projects – construction companies, operators, government authorities, private investors, insurers and the citizens – make it a complex task to design an efficient set of contracts. Even when projects seem to be financially viable the sharing of risk, the quality of institutions and the rule of law are determining factors for the success of the initiatives. And these features are not standardized and not at the same level of efficiency and quality across the EU countries members.
Here proper contractual structure are crucial. As it is also crucial a solid legal framework. Not to mention political risks. Unexpected increases in prices; new regulations; or unilateral renegotiations of existing contracts by new governments are the main political risks. These and other risks can be properly put under control, but they must be addressed with much more decision by national government and by the EU.
We must note, by the way, that the project financing market still represents only 10% of all infrastructure financed in Europe. The remaining 90% is financed either by corporate financing or by general taxes.
So the project financing market is still rather small and the potential for growth is indeed extremely high, especially in the developed economies were the fiscal burden leaves very little space of maneuver for direct public investment. Time is short. Europe needs serious investment policies and long term finance needs to find the right place to invest its money. We have all heard talks of financing infrastructure with PPP for over 20 years. Too little has been achieved so far, except for the UK and other few country-specific experiences.

Public Private Partnership: lack of progress

Let us give you some numbers (EIB, 2013). In the period 1990-2013 in Europe almost 1600 PPP projects reached the closing for a total value around 300 billion euro. In the period 2007-2013 the PPP projects have been 572 for a value of 105 billion. More than half of these projects are concentrated in the UK, 11% in Spain, and around 5% each in France, Italy, Germany and Greece. Moreover 76% of EU PPP in concentrated in the transport sector, with an average value of single project over 500 million each, followed by education and health. However, if in the UK social infrastructure have large share of the cake (35% education, 34% health, 14% public utility) in Continental Europe PPP projects in these sectors are still very few.
In fact, if we consider the share of investment financed by PPP versus those purely financed by taxpayer money they are equal to 10% in transport in the UK and 5% in Continental Europe, 20% in education in the UK and less than 1% in Continental Europe, 40% in the UK in health and 1% in Continental Europe (Wagenvoort, de Nicola and Kappeler, EIB, 2010, EIB, 2013 and EPEC, 2014).
Now, if we want long-term institutional investors to be able to invest in this type of projects, it is necessary for the projects to be standardized and collected in dedicated portfolios. This poses some challenges, which should be at the center of EU and member states' policy actions in terms of long-term investment, especially in Continental Europe.
President Juncker announced that a first priority for the new Commission is to present an ambitious Jobs, Growth and Investment Package to mobilize up to 300 billion euro in additional investment in the real economy over the next three years. Such a Program may have success only if all policymakers work very seriously on creating the right conditions for creating large bankable pipelines of projects grouped in different sizes and sectors. Otherwise the supply of finance will not meet an equivalent demand of projects. On this front we are still far from the minimum required to achieve the desired objective.

Franco Bassanini, *President*
Edoardo Reviglio, *Chief Economist, Cassa Depositi e Prestiti*

1) BIS, 2014
2) Wagenvoort, by Nicola and Kappeler, BEI 2010, BEI 2013 and EPEC 2014

Background

WHY INVESTMENT IS NOT PICKING UP IN EUROPE?

Crisis of confidence and risk aversion are deep in Europe and investment is hamstrung. Based on Confrontations Europe's work led by economists, banks and investors; Carole Ulmer and Jean-Robert Léonhard give us the diagnostic elements.


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The European Commission's President has announced a €300 billion plan for investments to bolster economic growth and jobs in Europe. Investment needs for infrastructure networks of EU are estimated at €1 trillion for the period up to 2020 and *"significant long-term investment will be needed under the Europe 2020 strategy and the 2030 climate and energy package, in infrastructure, new technologies and innovation, R&D and human capital"*. Mario Draghi himself has called on the European institutions to implement an investment recovery plan *"crucial to reduce unemployment"*.
Those objectives require economic and institutional governance conditions to be met; are they? Europe faces enormous investment needs but investment remains hamstrung. Would the lack of financial resources be the explanation? No, they are abundant.
Today, banks and investors involved in Confrontations Europe's work argue that it's not the resources that are lacking, but the projects to finance.
The European society faces risk aversion and high uncertainty. Has it to do with the supply issue? In France, the industrial sector has lost 12% of its production capacity since 2002. Investments cost- expected by the companies is very poor, lower than interest rates, which are already at a low level. In some Eurozone countries (e.g. France and Italy), companies' margins keep going down. In France, the profit margin decreased to 28.5% while European rate sets to 39%. Is it a mutation of our production system due to a Schumpeterian innovation of "creative destruction" or an attrition of the production system? It's tough to say. A comprehensive assessment of both figures of business failures and start-ups creation should be made to provide a sensible answer. Do we speak of an exhaustion of technical progress or a proliferation of bullied innovations? Some people think that this lack of productivity gains could become perennial and therefore, we might risk to face a pernicious chain such as the following: while the productivity is deteriorating, investments that could improve it are not made, therefore the productivity is deteriorating again, bolstering more and more pessimist anticipations.

A risk of deflation

Far from the wished scenario of bridging the output gap, the GNP might be pulled down, toward the level of the current stagnant GNP. Inasmuch as the difficulty to design an innovative offer often goes with the impact of the deterioration of the demand.
Indeed, after decades of debt burden, economic stakeholders (households, non-financial companies, financial stakeholders, governments) are all urged to reduce their debts. But what happens when all indebted agents wish to pay down debt and save more at the same time? The latest report of the Bank for International Settlements (BIS) gives an answer: *"Give them an additional unit of income, as fiscal policy would do, and they will save it, not spend it. Encourage them to borrow more by reducing interest rates, as monetary policy would do, and they will refuse to oblige"*. Afterwards, balance sheet recessions tend to be deeper, give way to weaker recoveries, and result in permanent output losses. But balance sheet recessions are less responsive to traditional demand management measures.
Thus, we might observe some Eurozone countries facing a risk of deflation and a risk of "liquidity trap". It is somewhat illogical when central banks have deployed a number of non-standard tools and provided the banks with unprecedented funding.
Based upon the classical theory, it would result in a twofold increase in both the activity (due to the boost of consumption and investments) and in the prices. But nothing happens. Despite low interest rates, economic agents prefer hoarding to investing or consuming.
And when a possible price decrease is announced (deflation, effective in Southern Europe), the vicious circle starts: expectations accelerate economic slowdown which in turn justifies expectations...
It's worth saying that this situation is an environment conducive to speculative bubbles.

> *"Ressources are there... What is lacking is projects to finance"*

Why investment is not picking up in Europe?

Indeed, to put its money, it's tempting to buy debt (bond bubble) in order to get dividends (stock market bubble) and housing (real estate bubble).

Role of public investments

The report "public debts in the Eurozone" issued by the Institute CDR for Research provides us with a wide, geographical and historical analysis based on the French case since 1890 and recent Scandinavian and Japanese experiences. It states that during the thirty years of Post-war economic growth as well as during the 1990's Scandinavian renovation, *"public investments played a major role"*. Today, while public expanses are cut due to the explosion of public debt, it remains important to grant some resources for public investments in France as in Germany as well as at the European level.

From contradictions to paradoxes, the current situation is truly complex. This article didn't mean to solve the problem but to list some facts on the current situation. However, solutions do exist as you will see in the coming articles.

ZONE EURO: SPECIFIC FACTORS

While investment recovery is generally hampered, the Eurozone is facing its own challenges.

Financial fragmentation

The first factor is the fragmentation of the Eurozone. The crisis in the Eurozone triggered a fragmentation of European financial markets characterized by the dramatic rise of the interest rate spreads between member states bonds.

Despite recent improvements on reducing those spreads, financial fragmentation remains high in the EU. For instance, Germany stills benefits from better financing conditions than Italy does. Today in Europe, we do not have a genuine financial integration as defined by Benoit Coeuré: (i.e. *"a situation whereby there are no frictions that discriminate between economic agents in their access to and investment of capital"*)[1]. Those frictions are undeniable, both in terms of allocation and distribution. In the euro area today it is the location of borrowers, rather than their creditworthiness per se, that matters most for access to finance, in particular for SMEs (e.g. banks' credit assessments are influenced by the health of local sovereigns; most banks are not structurally set up to provide cross-border lending). The location of lenders can also affect allocation to the extent that non-economic factors influence banks' business decisions (e.g. the connection between local banks and local interests; "national champions"). Besides, *"financial markets in the euro area do not provide much cross-border insurance"*, which can be explained by two factors: European financial firms are interdependent and, prior to the crisis, there wasn't any private insurance against banking crisis. Accordingly, we can say, strictly speaking, that European banks do not finance the European economy. This underlines that reaping the allocative benefits of a single market in capital is linked not only to having a more integrated banking system, but also having more arms' length governance of it.

The lack of a sovereign – public body, the budget issue

The second factor specific to the Eurozone explaining to the lack of the investment recovery in Europe is due to the lack of resorts for European public investments and therefore a lack of private investments. As seen in the previous article, during the thirty years of Post-war economic growth as well as during the 1990's Scandinavian renovation, "public investments played a major role"[2]. Unfortunately, the EU budget which represents only 1% of the European GNP, does not provide enough funds for growth (i.e. 9% of the EU budget allocated). Despite the EU project bond initiative for innovative infrastructure financing, the resources remain very low and insufficient to cover all the European Union's infrastructure investment needs for growth recovery (e.g. infrastructure projects in the sectors of transport, energy and information and communication technology.)

In order to meet this objective, the Caisse des dépôts recommends to *"revamp the funding framework for investments for the Future beyond the framework of the financial system via a specific European funding mechanism based on leveraging between European budgetary resources and an European financial intermediation whereby public funding and public guarantees would encourage financial private agents*[3]. *Besides, as the EU's institutions do not to collect taxes, the budget is only made of member states' contributions"*.

The current debate is exploring two leads which are worth following up: Should the EU be provided with its own resources and should the EU issue Eurobonds?

EU: first answers

Regarding those frictions, the European Commission took the lead. On one hand, the Commission replaced the EU's existing supervisory architecture with a European system of financial supervisors consisting of three European Supervisory Authorities and a European Systemic Risk Board. On the other hand, financial regulation has been a key project of Michel Barnier's DG (e.g. stronger prudential requirements, single rule book, and bail-in principle). One of the major achievements of this financial regulation is the establishment of the banking union[4].

To face the Eurozone sovereign debt crisis, the European Union brought forward emergency measures to pave the way for direct bank recapitalizations via the European Financial Stability Facility (EFSF), shortly replaced by the newly created European Stability Mechanism (ESM).

The EU has also undertaken long-term measures to better control debts and public deficits such as: the strengthening of both the Stability and Growth Pact and the European Semester.; adoption of the intergovernmental treaty on stability, coordination and governance and adoption of new supervisory tools to identify and correct macroeconomic imbalances. Nonetheless, all those measures remain below the necessary mutualization needed to both solve the public debts issue and to boost investment. The following articles list some thoughts on the possible solutions.

C. U. & J.-R. L.

1) Speech of Benoît Cœuré, member of the ECB's board.
2) www.caissedesdepots.fr/fileadmin/PDF/Rapports_et_etudes/finance/rapport_final_dettes_publiques_2013_2014.pdf
3) *Ibid*
4) See article of Marie-France Baud on p. 14, n° 106 of *Confrontations Europe La Revue*.

European Central Bank

MONETARY POLICY IN SUPPORT OF CORPORATE FUNDING AND INVESTMENT?

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The monetary policy does not directly aims at corporates and today interventions of central banks target mostly banks and the assets they issue and/or sovereigns covered bonds. An irrevocable tendency? The answer from Philippine Cour.

The European Central Bank (ECB) has taken a host of measures to address low inflation: it has lowered the main refinancing rate to virtually zero, offered targeted loans of up to four years for banks and announced far-reaching purchase programmes for asset-backed securities (ABS) and covered bonds. Is this helping to ease bank credit and foster investment?

The measures aim at facilitating credit flows to the economy, but the take-up in the first of the longer-term targeted loans last September was low and the contraction in bank balance sheets is ongoing in the euro area. In a context of low economic activity and regulatory pressure banks have seen a contraction in outstanding loans to corporates and an increase in their government bond holdings.

Since the onset of the financial crisis, the liquidity injected in banks has been used more to finance governments than corporates.

Can the ECB target corporates more effectively? This question opens a second question: how does a corporate finance itself? The main external source of funding of investments are indeed banks. And beyond investment, for its total external financing the non-financial corporate sector relies mostly on bank borrowing. Hence the ECB's choice to support credit flows to corporates via a liquidity support to banks. However, the reality at the individual firm level is quite different from the consolidated view at the sectoral level. On average, a firm in the euro area depends on corporate credit (inter-company loans and trade credit[2]) more than on bank credit for its external financing. Such corporate credit is used to finance working capital and running expenses. All the more so for SMEs and in the 'peripheral' countries, and increasingly so during the banking crisis.

Outlook

Why does monetary policy not target corporates directly? It is not because the Treaty would prohibit it. It is not because the ECB's operational framework would not allow for it or the risks are too high. In fact, a central bank that avoids taking risks on the real economy directly and prefers risks on banks and governments can eventually create more risk, for the economy like for its own balance sheet[3]. Among corporate paper, trade bills for instance are subject to multiple signatures of their guarantors and are thereby not speculative in risk terms. Rather, not targeting corporates directly is a choice.

A choice that results from the primacy given to liquid market instruments and to the difficulty in using heterogeneous corporate assets in the single monetary policy. The action of central banks today favours banks and the assets they issue and/or sovereigns through their bond issuances. The development in prudential rules has only strengthened this tendency, to the expense of firms.

An irrevocable tendency? No, because history can be repeated if one aspires to sustainable growth, one that lies on financially sound firms that can invest. Well into the xxth century the rediscounting of trade bills was the main instrument of monetary policy. It is the advent of the euro itself which led the Bundesbank, among other central banks, to discontinue the instrument in 1998. But this is reversible: in 1980-81 the Bank of England revived with success its discount facility for trade bills when its balance sheet seemed overloaded with Treasury bills. There are also other ways trade bills can be used in monetary policy, such as through the purchase of ABS backed by corporate paper or their acceptance as collateral. The development of a means of payment for corporates at the European level would contribute to financial integration in Europe. The ECB could even play there only a catalyst role, without engaging its balance sheet, by promoting the creation of an electronic trade bill. This would be possible today with the Single Euro Payments Area (SEPA) infrastructure.

"Developing a paneuropean payment instrument for corporates would contribute to finantial integration in Europe"

Philippine Cour
Principal economist, European Central Bank

1) The views expressed are solely those of the author.
2) A trade receivable or payable (i.e. trade credit) is a book-keeping entry for an intercompany sale not yet paid. A trade bill is the corresponding paper, which can be used as a payment instrument vis-à-vis a third party. See also Cour-Thimann, P. and Winkler, B. (2012), "The ECB's non-standard monetary policy measures: the role of institutional factors and financial structure", Oxford Review of Economic Policy, Vol. 28, 4, 765-803.
3) See also Cour-Thimann, P. (2014), "Monetary policy and redistribution: information from central bank balance sheets in the Euro area and the US", Review of Economics, 64, 293-324.

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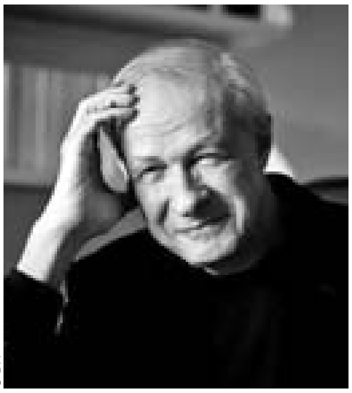
Eurozone

PROPER FISCAL POLICY TO REKINDLE INVESTMENT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Significant progress was made in 2012 with the treaty on stability, coordination and governance (TSCG)[1]. The coordination process consists of assessment procedures carried out by independent bodies, namely the High Councils of Public Finances set up in each member country of the Eurozone. National governments are still responsible for budget development but the discussions between them and the EU institutions during the European Semesters aim at alleviating discrepancies in actual fiscal policies relative to commitments enshrined in the 2012-17 medium-term stability programs . Unfortunately, the rules adopted under Germany's leadership are a hindrance. The main problem lies in the definition of the golden rule: the structural fiscal balance that every country must achieve incorporates all spending, including public investment, which means that public investment must be self-financed from an equivalent surplus on current expenditure. This is an awkward requirement since public investment generates future revenue, either directly (e.g. motorway tolls) or indirectly because it is a factor of growth (e.g. R&D, education). Every infrastructure, energy efficiency or human capital investment whose social return is over the cost of financing that is very low, pays for itself.

A European budget committee

The substance and procedures of budget cooperation must be improved. The role of the High Councils of Public Finance in defining procedures should be increased. These independent evaluation bodies, which issue opinions and recommendations, could give expert advice to governments on the possibility – under certain circumstances – of deviating from an overly-simplistic rule. Furthermore, bringing the high councils together under the umbrella of a European budget committee would be a further step towards fiscal coordination and therefore towards improving fiscal policy in the Eurozone. National parliaments could participate directly in the budget coordination process whether the evaluation delivered by the committee were examined and discussed in a conference of representatives of national parliaments. This would introduce a touch of democracy into a procedure that has been captured by an intergovernmental monitoring.

A European unemployment insurance system?

When discussing the content of the budget, it is important to remember exactly what its functions are: to stabilise cyclical fluctuations, redistribute revenues and allocate resources to the production of public goods. The fact that the redistribution of revenue is prevented by Germany's objections does not mean that the other two functions should be neglected. To stabilise fluctuations, a system of insurance against asymmetric shocks is needed. One option would be to set up a European unemployment insurance system[2]. This would require the introduction of a European, open-ended employment contract negotiated between the national governments, which would entitle the holder to European unemployment benefits in addition to national benefits. The aim would be to balance the books of the unemployment insurance system over the Eurozone's economic cycle, so that there is no net income redistribution between countries. However, such a system would be demanding in terms of European integration, as it would require some harmonisation of the labour market. Another more straightforward mechanism could be introduced[3] involving transfers between countries based on relative output gaps.

Reorganising the European budget

To fulfil its resource allocation function, the European budget must be reorganised to achieve the size and structure needed to finance the European public goods that are essential to a common growth ambition. Investing in the production of public goods (education and R&D) increases total factor productivity for the entire economy. An enlarged European budget must be developed and financed entirely by own resources. To achieve this, the European Parliament must be granted the authority to raise taxes and the Union must be authorised to issue bonds to attract presently idle private saving. Furthermore, to restore growth in Europe, a European financial intermediation capacity must be established. We must break away from the prevailing dogma that a public deficit is always a bad thing. Many long-term investment projects concern public goods to some extent. However, because the externalities generated are not automatically reflected in the capitalised value of the investment, financial entities like public development banks, pension funds and sovereign wealth funds – whose liabilities are such that the holding of long-term assets constitutes their optimal allocation – are reticent to invest. Public policy is the only means of incentivising the private sector to reorient investment projects. To finance these projects, the financial intermediation system must be reorganised around a European fund. This fund would be capitalised through the European budget. It would issue bonds by leveraging institutional savings worldwide in order to provide loans and capital to financial entities that specialize in financing innovative investments.

Such measures would send a strong signal that the member countries have the political will to put the economic crisis behind them for good and empower Europe to tackle the challenges ahead.

Michel Aglietta
Emeritus Professor of Economic Science at the University of Paris X-Nanterre
Scientific advisor at CEPII

1) The treaty defines a balanced budget as follows: a deficit below 3% of GDP and a structural deficit below 0.5% for countries with a debt/GDP ratio above 60%, and below 1% for other countries. Member countries with a debt ratio above 60% must aim, on average, to reduce their debt by 1/20 per year.
2) CAE (French Council of Economic Analysis), Note 3, April 2013
3) Notre Europe, "Blueprint for a Cyclical Shock Insurance in the Euro Area", Studies and reports, no. 100, September 2013.

Article taken from "Dette publique et politique monétaire en zone euro", Michel Aglietta, L'économie mondiale, *2014, CEPII, September 2014*

Training and skills development

INVESTING IN HUMAN CAPITAL, THE CAPITAL OF THE 21ST CENTURY

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Juncker's investment plan should include a component on "human capital investment".

Because business or public investment has a more rapid impact on growth than human capital, the latter is strikingly absent from National and Europe's various investment plans. The European Commission's new president, Jean-Claude Juncker, has made the mobilisation of 300 billion euros in investment the key focus of the next Commission's policy orientations. Unfortunately, this is not enough to boost long-term growth in Europe. The economy is sluggish mainly because the overall labour force is insufficiently skilled and because economic policies lack coordination. Obsolescence of human capital is the key challenge of Europeans. Jean-Claude Juncker's European Union investment plan needs to have a section devoted to "investing in human capital".

Progress could be made

We wouldn't be in this position if we had listened to Raymond Barre, the European Commission's former vice president, who called for the simultaneous introduction of a single currency and European solidarity mechanisms. If this policy had been applied in the early 1970s, or if the now defunct Lisbon Agenda had been implemented to make the European Union "the most competitive and dynamic knowledge-based economy in the world in 2010", the current crisis would have been much milder. Moreover, the income inequality rise could have been more limited. And, above all, there would be no doubts about the eurozone's capacity to weather the storm.

Unfortunately, even though real progress has been made, further pursuit of European construction is hampered by the rejection of coordinated economic policies due to fears of a loss of sovereignty. Yet progress could be made if the European Commission were to show proof of pragmatism. It recently managed to get the European Council to adopt a youth programme (so-called Youth Guarantee) after pointing out the excessive number of youth under age 25 who are Not in Education, Employment or Training (NEET). Even France, which considers itself the example to follow in terms of social policy, did not think it was necessary to set up specific programmes in keeping with the scale of the problem. Today, the Youth Guarantee initiative has been adopted throughout Europe. It represents social and economic progress, but it also marks an advancement in European governance. This type of initiative should be rapidly expanded not only to professional development but also to education. It is not a matter of making education an exclusive competence of the European Union, but to force Member States to improve their long-term competitiveness. Recent efforts, like those undertaken by the OECD, are based on the analysis of Nobel Prize winning economist Paul Krugman, who said that a country's competitiveness depends on its capacity to improve productivity and to ensure that average export prices increase faster than import prices. If this is not the case, then the inhabitants are only impoverishing themselves relative to their trading partners.

Northern Countries' specific policies

Of course, investment, innovation and its spread throughout the economy are the keys for sustainable growth. But they also depend on the quality of the overall labour force's initial qualifications and average skills level. Innovation comes from education, but spreads within the businesses as well as the whole economy even more rapidly when the average skills level is higher. Competitiveness depends on skills. The lack of skills and the obsolescence of human capital weigh on competitiveness. Technical as well as economic obsolescence result from insufficient use of skills, ageing, technological and organizational change, shifts in employment... and has accelerated with globalisation and NTIC development. The northern European countries clearly set up specific policies to prevent drop outs, facilitate the transition from school to the working world, and to offer professional development for the over 45 age group. In Luxembourg, for example, "mosaic classes" allow students in difficulty – identified at a very early stage – to benefit from personalised teaching to keep them from dropping out. In Sweden, Norway and Germany, high schools offer alternating work/ study programmes. In Sweden, the training ratio for the over 45 age group is 74%, compared to 33% in France. 15% of the Swedes have followed formal professional development sessions that enable them to develop their skills, and not only to boost the labour productivity, compared to 3.5% in France for the 25 to 64 age group. According to the OECD, for adults in these countries, not only their reading and writing skills, but also their calculating and math skills (numeracy), are much higher than in Spain, Italy and France.

The underlying method of the "Youth Guarantee" could be expanded to education and professional development, which is a key of potential growth. This would involve setting up a system to provide member states with funds from a specific budget line supported by European funds, which would complement national projects. France should support such an initiative since in the end it stands to gain a lot. Looking beyond the implied improvements in the functioning of the Economic and Monetary Union (EMU), such European policy would increase the employment rate of all the Member States, and thus boost Eurozone domestic demand in spite of an intra-euro battle to gain market share as currently. But it means that France accepts to integrate the best practices of other Europeans.

Mathilde Lemoine, *Economist and Professor at Sciences Po Paris*

Nanoelectronics

PPP TO DEVELOP KEY-TECHNOLOGIES

The delay of Europe regarding nanoelectronics is worrying. In response, the EU created ENIAC and ECSL[1], public-private partnerships (PPP) which contribute to merge all efforts and capacities into projects of European interest.

Using nanotechnologies to produce smaller and more powerful electronic components (chips) represents a strategic challenge in all domains: telecommunications and telephony market, electronic payment, networks management, industrial process, transports, defence, space, etc. The international competition is intense and nowadays dominated by few large groups, the investment and the innovation being drawn by Intel (USA), Samsung (South Korea) and NTC (Taiwan). The nanoelectronics firms based in Europe, which represented 10,2% of the worldwide market shares in 2001, receded to 5,7% in 2012. This decrease that begun before the crisis is now moving Europe away from the critical mass needed for research-innovation and commercializing of electronic chips. That is why Nelly Kroes, vice-president of the European Commission, declared in May 2013: *"I want to double the European production of chips to around 20% of the global production"*.

14 Pilot Lines

The common firm ENIAC has been created[2] at the end of 2007 to reinforce European efforts in this sector. Community body with legal personality, ENIAC is set up as a public-private partnership, bringing together the European Commission and European Member and Associated States with AENEAS, the association representing the R&D actors in nanoelectronics (Corporate, SME's, research institutes and universities) in Europe. Its budget for 2008-2017 was initially set up at 3 billion Euros (0.45 coming from the European Commission, 0.80 from the Member States and 1.75 from the private sector).

> *"Without cutting-edge technology infrastructure for informatics chips, Europe will remain dependant on imports"*

The activity of ENIAC is organized in 14 "pilot lines": in each of them, R&D cooperative projects between industrial representatives and research labs are, after calls for proposals and selection, supported by national authorities and by ENIAC. The total cost is estimated at 1.79 billion Euros with 265 millions of national repayment and 267 millions of ENIAC repayment.

This approach offers numerous advantages:

- It has combined a strong impulsion given by the political level (EU and Member States) with a large association of different research actors, public and private, solicited to present projects for each pilot line.
- It has generated an ecosystem favorable to the diversity of the players and it has avoided a polarization of some actors. On 616 organisms which participated to the pilot lines between 2008 and 2013, 145 (24%) are large industrial firms, 278 (45%) are SMEs, and 192 (31%) are universities and research institutes. It is likely that the relations established around the studied projects will continue and further develop in a sustainable way this ecosystem, thanks to the consolidation of efforts and capacities around projects of European interest.
- The adhesion of three countries that are not in the EU (Israel, Norway and Turkey) has confirmed the merits of the system, while opening new partnership possibilities.

A new common firm

The common firm ECSEL, created[3] in 2014 for ten years, is also a community body with legal personality, functioning as a public-private partnership. Its activities cover those previously managed by ENIAC (chips), ARTEMIS[4] (embedded computing system) and EPoSS (European platform for the system integration).

This new combination results from several observations. Without cutting-edge technology infrastructures for informatics chips, Europe will remain dependant on imports. Without the features managed by the embedded software on used equipment, the chips will not be used. And finally, without integration of the components in intelligent systems, we cannot use any application.

ECSEL is part of the Horizon 2020 strategy. It aims at:

- Supporting the European research and production activity, the implication of SMEs and the creation of new clusters.
- Securing the offer of key technologies in every large sector of the economy, to ensure the independence of Europe in the field of components and electronic systems.
- Harmonizing the strategies of the Member States to avoid duplication in the use of public funds, and to attract private funds.
- Bringing the industry to define a long-term strategy program for research and innovation.

Alain Turc, *Senior Adviser, Confrontations Europe*

1) Alain Turc based its article on the syntheses of Confrontations Europe's "task force", which organized a meeting on May 27th 2014 on the topic "Valorization of long-term investments projects: let's give the floor to the economic and social actors". During this session, six actors from four sensitive sectors took the floor (sustainable mobility, airports and transports, new technologies, digital revolution).
2) By regulation n°72/2008 from the Council, 20th December 2007
3) ECSEL has been established by the European Council regulation of May 26th 2014.
4) ARTEMIS has been established by the European Council regulation of December 20th 2014.


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Growth and innovation

A LONG-TERM VISION OF THE DIGITAL SECTOR IN EUROPE


Fabrice Marque
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Nicolas Glady
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There is one sector that can single-handedly reduce unemployment, foster innovation, generate profits and cut costs for both companies and the government, while encouraging sustainable development. That sector is none other than digital.

Digital and its positive knock-on effects

The digital sector is a growth driver that leads to synergies in other sectors. A 1% increase in the digitization of the economy drives a 0.5% rise in GDP and a 2% expansion in global trade, while a 10% increase knocks the unemployment rate down by 0.9%[1]. To give an example in the healthcare sector, Osakidetza, the Basque health authority in Spain, has deployed a comprehensive digital solution to manage chronic illnesses, leveraging electronic medical records and telemedicine and covering the entire healthcare chain from hospital care to home help. This initiative generated savings of €59.5 million in 2012, and cut pharmaceutical prescription costs by 2.5%. At European level, a similar project would represent savings of €62 billion.

This dynamic exists because the digital sector naturally creates positive externalities; whether enjoyed by one person or many, digital goods and services do not lose value or present energy problems. This phenomenon explains the participative nature of the digital economy, and has prompted the emergence of open innovation, open data and crowd sourcing.

Europe has a significant head start in this area since the necessary infrastructure is already in place and large-scale solutions can be rapidly deployed. To give just two examples at macro and micro level – the high-speed broadband penetration rate stands at 95% and half of the population already owns a smartphone. However, there is still work to be done, particularly in terms of convergence between European countries and cooperation between companies.

Regulatory convergence for a common digital market

The digital sector should be viewed as an intra-European convergence tool. Closer regulatory, market and technical convergence would rapidly facilitate major European projects. Different data protection rules make it particularly difficult to set up new services between EU member states on the Internet which, by definition, is a space that transcends borders. In a world where recent success stories such as Amazon and Google have shown that start-ups need open spaces to reach their full potential, improvements in this area would make it possible to deploy large-scale solutions.

Convergence between companies

If the regulatory framework permits, companies will be able to dive into digital innovation to develop new solutions and rapidly build up critical mass, which has become a necessity in the new economy.

Setting up clusters and consortiums is therefore absolutely essential. Innovation will hinge on partnerships between small, agile, innovative structures and large groups that can handle large-scale production. Given that innovation can get very technical and complex, research will play a key role in providing frames of reference and technical and technological solutions. A four-part alliance between governments, start-ups, big corporates and scientific research will be the driving force behind this process. This strategy of convergence will create a knock-on effect generating value that far exceeds the sum of each stakeholder's contribution. Data sharing between companies (provided it does not infringe data protection rules) will help create new solutions and services and reduce energy spending. Among the sectors to benefit, wellness and mobility are the first examples that spring to mind.

Three initiatives to facilitate European convergence and return to growth

To boost the development of our digital economy and its attendant sectors, we have to (1) standardize data regulations in European Union countries, (2) encourage partnerships between major digital players, innovative start-ups and research institutes in Europe, and (3) promote inter-company data exchange, a digital growth accelerator that will lead to the emergence of new services and markets.

The rapid and coordinated implementation of these three imperatives is now a key factor in Europe's ability to compete on the international stage.

Fabrice Marque, *Managing Director at Accenture, and*
Nicolas Glady, *Lead of the ESSEC Accenture Strategic Business Analytics Chair*

1) www.accenture.com/us-en/Pages/insight-achieving-digital-excellence-public-service-summary.aspx

"The driving force behind the dynamic, a four-part alliance between government, start-ups, big corporates and research"

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Transport

A NEW WAY OF INVESTING IN TRANSPORT INFRASTRUCTURE


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Historically, transport has always represented an essential factor in the development of civilisations. The concentration of wealth in cities over the centuries has led them to being equipped with increasingly complex infrastructure to connect one city to another.
Up until the 17th century, cities developed around ports, in the 19th century around railway stations, in the 20th century it was motorways that shaped the urban landscape and in the 21st century, airports will be key. While there is no doubt that transport is a lever for growth, it essentially remains the least profitable form of infrastructure for private investors as it poses a challenge in terms of exclusion and presents the strongest network economy.
Transport infrastructure offers the strongest general interest and is therefore predominantly funded by public bodies.
On the other hand, it is possible to think back to the financial collapse of the Channel Tunnel, solely funded by private investors.

A need for greater selectivity

In a context where public resources are under pressure, it is essential to have clear and precise rules regarding the evaluation and selection of infrastructure projects.
Their choice gives rise to increased selectivity, to tighter decision-making processes.
The robustness and relevance of criteria becomes essential in order to identify the programmes that will be the most useful to society and the most economically profitable.
The report entitled *L'évaluation socioéconomique des investissements publics* [socio-economic evaluation of public investment] assigned to Emile Quinet by the *Commissariat général à la stratégie et à la prospective* [general commission for strategy and economic foresight] updated and enhanced the methodology for socio-economic evaluation of public investment.
Nevertheless, despite increasingly enhanced theoretical and statistical tools, it remains very difficult to evaluate the actual profitability of public investment projects.
Regardless of whether they relate to the field of renewable energy, transport or education, calculating the profitability of investments relies on the complex evaluation of the value of externalities.
The different models are based on hypotheses which can be varied according to the more or less optimistic nature of the operator.
It is at this point that political decision-making should come into play.
No one will ever be omniscient when it comes to the quality of a particular project but sometimes, if there are grey areas, you must learn to trust your intuition in order to bring a project to fruition.
Greater selectivity cannot mean a lack of investment which would, all too easily, amount to sacrificing the well-being of future generations.

Facilitate investment from private stakeholders

In addition to greater selectivity in its investments, the State used an unknown lever in order to maximise its investment expenditure: finding new channels to facilitate investment from private stakeholders.
The legacy of tangible and intangible infrastructure from which we now benefit is the result of decided former investment in the 1960s, implemented in the 1970s.
This is a model which assumes a specific environment, strong social cohesion, a stable technological environment, relative homogeneity among the needs of the population and a firm belief in the future.
But the world has changed.
The State used to take the initiative in deciding to create infrastructure, as the State alone possessed the expertise and legitimacy.
The increasing willingness of individuals to participate in public decision-making and the development of companies' expertise and finance capacities have challenged this monopoly.
The new infrastructure will be collaborative.
In order to illustrate this new approach towards infrastructure, in the energy sector, there was a transition from the nuclear power plant, initiated and directed by public authorities, towards solar panels installed in the homes of private individuals with the support of the State and in conjunction with energy companies, the network operators, in a collaborative manner.
In terms of financial tools, the State can aid investment without being directly associated with it, by providing its guarantee.
As a legal entity who benefits from the confidence of international lenders, this guarantee is of real use for financing large projects which private entrepreneurs would not be able to take on by themselves.
This is a useful tool which, if used intelligently, will not have a negative impact on public finances.

Augustin de Romanet
CEO, Aéroports de Paris

> *"It is essential to have clear and precise rules regarding the evaluation and selection of infrastructure projects in order to identify the programmes that will be the most useful to society and the most economically profitable"*

1) www.strategie.gouv.fr/publications/levaluation-socioeconomique-investissements-publics-tome1

Energy Union

EXPANDING EU ENERGY INVESTMENTS SMARTLY


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Although comprehensive information on EU energy investment is limited and unreliable, it is clear that the sector has witnessed an unprecedented cyclical boom in the period 2005 to 2011, driven by renewable energy investments. Investment in renewables was around EUR 95 billion in 2011 and dropped sharply to EUR 50 billion in 2013[1]. The EIB has financed a significant part of this investment (about EUR 11bn a year in the period 2010-13). The energy investment boom, combined with the decline in energy consumption since the start of the crisis, has generated substantial overcapacity in the electricity and gas sectors. This has contributed to lower wholesale prices and corresponding lower returns, particularly for gas power stations.

Policy makers propose expanding energy investment, particularly low carbon energy investment, to contribute to both economic recovery and to achieve energy and climate change objectives. This expansion needs to be carefully considered.

Different studies by the European Commission conclude that to achieve the EU objectives, substantial investment are needed, with estimates of between 180 and 200 billion euros a year, of which 110 euros in the energy sector. Three sectors account for 90% of the needs: renewable energy, energy networks and energy efficiency (EE). Let's analyse these three sectors in turn, with a focus on the period to 2020.

To achieve the objective of 20% of energy consumption being from renewables by 2020, the investment needs are very likely lower than the level of investment in 2013. Therefore, expanding renewable investment does not seem necessary, in the context of the current renewable energy objectives set for 2020. This is due to the cost decline in most of renewable energy technologies and lower renewable energy needs compared to the past, given lower consumption.

About two thirds of the investment needed in energy networks if for electricity networks, followed by gas. A substantial expansion of electricity transmission network investment will be required compared to the past[2]. Investments in electricity distribution may also need to expand.

Overall investment in the energy sector needs to increase moderately. The investment requirements in the energy sector may be slightly higher than pre-boom level, but lower than the levels seen in the peak of 2010-11. However, outside the energy sector, in the energy efficiency area, the investment needs to expand substantially. Leaving aside transport, investment needs related to energy efficiency are expected to be around EUR 85 bn per year (about 75% of total energy sector investment), mostly in buildings (70% of the total). Current energy efficiency investment is not known, but is estimated to be a fraction of what is needed.

Issues of financing ability

Expansion of energy investment raises a variety of issues. Increasing investment in electricity transmission raises issues of financeability, as a recent study of Florence School of Regulation shows. Most of investment will need to be financed on the basis of the company's balance sheet. In order to keep adequate financial ratios allowing them to raise debt in good condition, an increase in electricity tariffs above inflation may be required, the study concludes. This is difficult. Concerning investments in renewable energy, changes introduced in many renewable energy support frameworks in recent years, notably in Southern Europe countries, have introduced substantial regulatory uncertainty. This makes hard to finance the required investment in these countries.

Expanding investments in energy efficiency is the most urgent, but also the most complex. It implies developing action across the different subsectors, as each one requiring a different approach. The list of sectors is large: private residential buildings, social housing, public buildings, SME, large industries, ESCOs and utilities (demand side obligations). The implementation of the EU energy efficiency policies should allow a quick stimulus to energy efficiency investment. However, expanding energy efficiency investments should be done in the most economically efficient way. We need to develop energy efficiency with innovative approaches that use grants very efficiently. A substantial part of the energy efficiency investment potential is profitable, but there are substantial non-financial barriers that hinder its development (imperfect information, hidden costs, split incentives, etc.). A combination of regulatory measures, information/technical assistance and finance/grants is necessary.

To sum up, the new energy investment cycle should be driven by energy efficiency, followed by investment in energy networks and renewable energy. This increase will contribute significantly to economic recovery. This expansion is not easy. Investments should be developed smartly, by minimising its cost, particularly from public budget. The EIB can play a substantial contribution to this, both by facilitating access to long term finance and by developing new financial instruments (off-balance sheet, third party finance, etc), as well as new technical assistance instruments.

Juan Alario, *Associate Director. Head of the Energy Efficiency and Renewables divisions, European Investment Bank*

1) From IEA, World Energy Investment Outlook 2014 and Boomberg/NEF.

2) See Florence School of Regulation, Financing investment in the European Electricity. Transmission Network policy brief, April 2013.

European Electricity sector

HOW TO FINANCE THE INVESTMENTS

Five years after the adoption of the "Climate and Energy Package" for 2020, opinions converge to consider that the common objectives (the famous 3x20) will be only partially achieved, and that the European electricity market is shaken by a serious crisis. The crisis translates in particular by a deterioration of the balance sheet of large incumbents, which severely limits their ability to invest in the coming years. This occurs at a time when the constraints on public budgets will also reduce their contribution, while the recently adopted rules on bank activities might compress the volumes available for long-term funding and increase their cost.
How to mobilize new resources to meet the needs of replacing a fleet of aging power plants, expansion, modernization and strengthening networks, improvement of energy efficiency in buildings, transportation, industry? Yet examples of major projects worldwide show that liquidity is available when the regulation is favourable. The challenge is therefore to create an attractive environment without creating niches such as those which promoted renewable energy in some countries, leading to the appearance of a real bubble, detrimental to the whole economy. The equation appears complicated because the number of players has increased dramatically and technological breakthroughs may occur.
In order to tap all available capital, the European Commission counts on two rules: first, give priority to the market by restricting state aid to renewable energy, second give visibility to operators by displaying targets for 2030 (this was on top of the menu of the European Council on 23 & 24 October 2014). Scepticism persists on both proposals. As regards state aid, the Commission recommends a "market premium" instead of the guaranteed purchase price (feed in tariff) for all renewable energy having reached maturity. The success of the scheme will depend on the level of the premium paid in each of the 28 States, with little coordination. Regarding targets for 2030, visibility remains very relative on several key points, such as the reform of the emission trading scheme (ETS); moreover, the desire to keep three objectives (emission, efficiency and renewable) indicates a denial of any interactions between them, when these very interactions have plunged the power sector into crisis.
More fundamentally, renewable energy and energy efficiency create two concerns associated with tipping "from a world of OPEX to a world CAPEX". On one side, there is the risk of exacerbated inequalities due to requirements of return on invested capital. On the other side, there is a doubt about the compatibility of a continued decline in energy consumption until 2050 with a sufficient level of economic growth. Should we not focus on one target, the sole reduction of greenhouse gas emissions?

A favourable investment in United Kingdom

The United Kingdom appears to be a country particularly determined in creating a favourable investment environment. Recognizing the shortcomings of the current market, the government has taken a series of strong measures: floor price for CO2, standards on emissions per MWh, capacity market, and creation of the CfD (Contract for Difference) in order to deal equally with all low-carbon technologies, leaving them exposed to market risk but limiting this risk within a range acceptable for the investor. By giving a green light to the implementation of this mechanism to the future nuclear power plant at Hinkley Point (issued October 8, 2014 for two reactors EPR), the European Commission implicitly recognizes the need to secure investment in the very long term. Here, the CfD sets the sale price over 35 years and the State will guarantee the loans.

Michel Cruciani
CGEMP - Paris-Dauphine University

1) Cf. Synthesis of the meetings of Energy group on "financing low carbon and competitive electricity".

AN ORIGINAL FUNDING FOR HINKLEY POINT

The United Kingdom appears to be a country particularly determined in creating a favourable investment environment. Recognizing the shortcomings of the current market, the government has taken a series of strong measures: floor price for CO2, standards on emissions per MWh, capacity market, and creation of the CfD (Contract for Difference) in order to deal equally with all low-carbon technologies, leaving them exposed to market risk but limiting this risk within a range acceptable for the investor. By giving a green light to the implementation of this mechanism to the future nuclear power plant at Hinkley Point (issued October 8, 2014 for two reactors EPR), the European Commission implicitly recognizes the need to secure investment in the very long term. Here, the CfD sets the sale price over 35 years and the State will guarantee the loans. M. C.

LES ENTRETIENS EUROPÉENS
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The EU's commitment to reducing greenhouse gas emissions requires considerable investment to build a new electricity system based on carbon-free power plants and networks. The new European electricity system must also enable the EU and its industry to regain its competitiveness on a global scale, offer affordable prices to all Europeans and ensure better securtity of supply. What should be done?

Les Entretiens Européens 20 high level speakers, stakeholders in the electricity sector industry, finance, local authorities and the European institutions. They explore the possible options based on the experiences and demands of electricity suppliers oon the one hand, and on the conditions required by financial investors on the other hand. They out forward recommendations for the building of an efficient market framework.

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Energy transition

MOBILISING FUNDS

A national and European investment programme is needed to finance the energy transition, argues Alain Grandjean. The potential for energy renovation in the building stock is largely untapped.

The objectives of the energy transition in Europe have been clearly identified: reduce our dependence on mainly imported fossil fuels, cut greenhouse gas emissions to limit climate change, bring down our energy bill and wipe out fuel poverty. In addition, it is an important lever for economic recovery in Europe.
Construction is a major industry and accounts for 45% of energy use in France and in Europe; its investment needs run into hundreds of billions of euros. In France, the renovation of public buildings alone (such as schools, offices and hospitals) has generated energy savings of at least €30 billion[1]. In Europe, almost €200 billion have been invested.
However, the potential is still largely underutilised. Accounting constraints are a hindrance to projects and the "traditional" means of financing them (which are said to increase the already excessive public debt). Current financing capacities are inadequate, and yet the social and economic effects of energy renovations are extremely positive: creation of local jobs via SMEs[2], injection of vitality into an industry of excellence with export potential, improvement of the trade balance[3], reduction in CO2 emissions and energy independence[4]. In France, an investment of €30 bn would reduce the energy consumption and the CO2 emissions of the building stock by 20%.

An energy transition financing company

So innovation is more necessary now than ever. The national debate on the energy transition brought to light an idea that was subsequently explored over a period of nine months, thanks to funds from a large consortium of industrial companies, local authorities, banks and NGOs. During the nine months, the practical procedures for setting up an SFTE (Société de Financement de la Transition Energétique, or energy transition financing company) were defined. The SFTE would be a semi-public company with mostly private capital, and would provide a reliable, government-backed guarantee for loans granted by commercial banks for energy renovation projects[5]. This mechanism would enable companies that develop energy renovation projects[6] to secure the best possible lending terms (interest rate and loan period), without these loans being included in the debt of the public authority concerned (state or local authority) and without the public guarantee covering the operational risk, which would be borne by the industrial company itself.

> *"Investment needs run into hundreds of billions of euros in the construction industry"*

Concrete solutions

The SFTE project requires strong commitment from all stakeholders. The public authorities must actively engage[7] in the energy transition and write into law the public guarantee for the SFTE. The EU must update the Eurostat method so that energy performance contracts are not included in public debt according to the Maastricht criterion. It must also increase the role of the EIB in the energy transition. Industrial companies and banks must take measures to increase their energy efficiency and must pursue innovation in this area. For example, financiers could develop straightforward, transparent and reliable securitisation solutions to facilitate the refinancing of very long-term loans, with institutional investors, the EIB or directly with the ECB, whose policy has shifted ostensibly towards targeted financing of the economy in 2014.
Curbing climate change and controlling energy consumption are global challenges. To tackle them successfully, everyone in France and Europe must engage actively in the development and implementation of concrete, workable solutions: obviously, this means improving the energy performance of public buildings across the European Union. Now is the time to act, bearing in mind that the economic situation in the EU is difficult and could be substantially improved by making the energy transition a central component of future European construction.

Alain Grandjean
Co-Founder and Associate Member of Carbone 4

1) 20 bn higher than the current trend, which is less than or equal to 1 bn per year.
2) Around 15 jobs for every one million euros invested.
3) France imports around 50% of the energy it uses.
4) 50% of heating and hot water systems in public buildings run on gas, and 20% run on fuel oil.
5) Mechanisms are needed to leverage private investment while improving the efficiency of public financing.
6) Private or public-law company. Current criticism of public-private partnership agreements was taken into consideration and addressed in this study.
7) Notably by signing the decree on the mandatory energy renovation of public and private tertiary buildings, which dates back to the Grenelle Environment Forum.


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European Network for Electricity

THE EUROPEAN ELECTRICITY TRANSMISSION NETWORK IS A KEY COMPONENT IN ENERGY TRANSITION IN EUROPE

Investing in the European electricity transmission network means opening a path towards a successful, less expensive, and socially responsible energy transition.


Jean Verseille

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Olivier Lavoine

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Given that the objectives for 2020 are on course to be reached, the European Commission has proposed new ambitious targets for 2030. On this basis, in October, the European Council has adopted new 2030 energy and climate goals. These include reducing greenhouse gas emissions by 40%, increasing energy efficiency by at least 27%, and bringing renewable energy's share of energy consumption in Europe to 27%. However, to strike a balance between the three pillars of the energy policy (sustainability, competitiveness, and security of supply), the Commission strongly emphasized the importance of a robust and interconnected electricity transmission network.

Means of production and consumption profiles can be mutualised through an adequately interconnected network, enabling authorities to get the most possible benefits out of the various complementary energy sources as well as limit the use of additional generating capacity and improve the security of supply at a lower cost to society. In view of the current state of storage technologies, the flexibility of the transmission network makes it the best method for integrating wind and solar energy, given that production sites of this type of electricity are often located far from consumers. Creating connections between European electricity networks helps optimise the diversity of the energy mix in Europe.

Planning a network for all of Europe

Whereas in Europe, the energy mix remains a national choice, and therefore cannot be subject to any overarching prospective, the transmission network operators, joint since 2009 in the association "European Network of Transmission System Operators for Electricity (ENTSO-E)" have been given by European regulation the responsibility of jointly establishing a ten-year indicative development plan for the electricity transmission network. This plan, which is drawn up every two years, accounts for predictable changes in consumption and production sources, on the basis of various scenarios, in order to identify the infrastructure projects needed to create an integrated European energy market. Since 2012, the plan has earmarked a list of "common interest projects", for which permitting procedures and construction have to be accelerated. Five electricity interconnection projects involving France are included on this list. In addition, each transmission network authority is planning for the investments necessary for guaranteeing its own network's security and funding the renewal of infrastructures, some of which are ageing.

Significantly more investment needed

Based on these different planning levels, one may anticipate that expanding and adapting the European network will require an investment of approximately 250 billion euros between now and 2030. This "investment cliff" represents both a challenge and an opportunity.

An opportunity: It is one of the rare instances of European consensus with regard to the needs and priorities of projects that combine proven expertise with the most innovative technologies and provide benefits to all of society; the latter will be especially true should the recognised priorities be met at the right time. Consequently, during this period of increased investment, access to funding via the markets has rarely, until now, proven to be problematic for these projects

But also a challenge: The amount of investment required for the energy transition means that network authorities, must, in order to maintain their access to funding, preserve healthy balance sheets and acceptable debt levels if they are to remain solvent over the long term. Concretely, this means that the electricity transmission tariffs of these regulated monopolies must continue to cover operating costs as well as all investment costs (amortization and financial costs), without increasing tariffs beyond a level that consumers can afford.

Looking beyond isolated, temporary solutions (i.e. financial support provided to certain common interest projects), public, regulatory, and transmission network authorities must come together to schedule investment priorities and thus fulfil stated needs, while maintaining a balanced financial situation, a stable regulatory framework, and tariff rates that are acceptable to the community.

Finally, citizen support will make all the difference in ensuring that the electricity transmission network is on time to tackle Europe's energy transition challenges.

Jean Verseille
European Affairs Director at RTE
et **Olivier Lavoine**
Financial Director at RTE (26/09/2014)

Jacques de Larosière

LET'S START BY DISMANTLING THE BARRIERS TO LONG-TERM INVESTMENT!


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According to Jacques de Larosière, former Managing Director of the IMF, advisor to the President at BNP Paribas and Chairman of Eurofi[1], it is urgent that we act now to lift the rules discouraging long-term investment. Here is how.

Marie-France Baud: ***How do you view the changes in financial regulation in Europe and the implications for long-term investment?***
Jacques de Larosière: There is no doubt that financial regulation has strengthened the capital base and made the system more secure, but it has also discouraged long-term investment. Under the Solvency II regulation, insurance companies face a capital charge of 39% on their equity investments. The capital ratios imposed on banks are also based on the idea that long-term investment is risky. So the first step is to stop discouraging long-term investment for no reason. This also applies to accounting rules, which have a very negative impact on long-term investment. Generally speaking, financial and fiscal regulation discourages capital investment and increases debt, since the interest on debt is tax deductible whereas this is not the case for dividends and capital gains. The NSF ratios1 applicable to banks, based on their medium and long-term liquidity characteristics, are defined in such a way that they shorten the balance sheet of banks and discourage long-term investment. Let's be clear, the flood of regulations both in Europe and worldwide has no doubt made the financial system more secure, but it has stifled long-term investment.

> *"The banks are lending to 'zero-risk' entities, i.e. governments"*

M.-F. B.: ***Do we need to introduce specific rules and regulations for long-term investment?***
J. de L.: Of course, but we should start first by dismantling those that prevent it. Let's take an example: a few years ago, the European Investment Bank decided to encourage the use of project bonds for financing projects by agreeing to assume a share of the short-term risk, but it didn't change a thing. Why? Because banks and insurance companies are penalised more heavily for holding 15-year project bonds in their portfolios than for holding 10-year bonds (even if they are partially guaranteed). We should stop trying to do well and start taking practical action instead.

> *"The flood of regulations both in Europe and worldwide has stifled long-term investment*

M.-F. B.: ***How can we take the pressure off the banks? Should we organise a transition towards controlled disintermediation?***
J. de L.: Given the deleveraging that is currently taking place, the banks are reducing their exposure to risk and SMEs, for example, are struggling to get loans. On the other hand, the banks are lending to "zero-risk" entities, i.e. governments. This aversion to risk has even greater economic consequences because the banking system plays a a major role in financing the economy, much more so in Europe than in the United States. In Europe, banks finance around 70% of the economy, whereas almost 70% of the US economy is financed by the market. You are perfectly right to suggest that a transition towards controlled disintermediation is the best option if the regulations do not change. Personally, I don't believe they will change because Europe has always supported its Anglo-Saxon counterparts on the Basel committee. So we need to organise a transition towards market financing. Securitisation is one option, which consists in moving business loans from the balance sheets of banks and selling them to interested investors on the open market.

M.-F. B.: ***Securitisation is of course seen as a possible remedy to the credit crunch, but didn't it cause the crisis in the first place?***
J. de L.: Securitisation does get a bad press because it was misused by American banks, which led to the subprime lending crisis in 2007. The very concept of subprime loans is outrageously paradoxical: it consists in selling poor-quality loans to households that do not have the means to pay them off, in the expectation that property prices

Let's start by dismantling the barriers to long-term investment!

will rise indefinitely and hence solve the problem. This practice backfired in 2005-2006 when property prices in the United States began to drop. The continuous climb in prices that underpinned subprime lending shattered the securitisation market and the system collapsed. Obviously, subprime lending is not an issue in Europe. Securitisation, which funds are of the very best quality and have the stamp of approval of a public institution such as a central bank. If this were the case, then the regulatory penalties provided for in Basel III and Solvency II, which are applicable to securitised products, would have to be implemented more fairly. Right now, securitised assets are subject to much higher capital con-

> *"Securitisation efforts must focus on SMEs"*

consists in transferring some risks to investors, has been around for a long time. It should be organised in a straightforward, transparent manner that does not increase the number of tranches and allows for loan rating. Subprime loans were rated triple-A despite the flaws that I have just pointed out. At Eurofi, we believe that to bring the concept of securitisation back on track, the focus should be placed on very high-quality assets. Our idea is very simple: since it is SMEs that have the most trouble obtaining loans and are the most reliant on bank lending, securitisation efforts should focus on them. The first step is to identify the best risks. We know that this can be done because the Central Balance Sheet Data Office at the Banque de France has been identifying the very best companies – or superprimes – for a hundred years now. The total amount of very high-quality loans recorded by the Banque de France is over €100 billion, which is far from negligible. Since we know how to rate SMEs and to distinguish the good ones from the bad – and those who don't know can learn – then we can ensure that the securitised assets offered to investors, insurance companies, pension funds and management

straints than similar, very high-quality but non-securitised assets. The taxes on a securitised asset of equal quality – i.e. with a 0.4% possibility of default over a period of three years or more – are eight times higher. This is completely unwarranted. Assets of equal quality should be subject to the same capital charge. This is so obvious that I'm amazed the regulatory constraints that stifle and prevent any securitisation effort on behalf of SMEs have not yet been lifted. So I

> *"We need an in-depth analysis of the increase in risk aversion"*

have come to the conclusion that talking won't get us anywhere, however good our ideas may be. We have to act now to change the regulations.

M.-F. B. : ***Will facilitating securitisation in the Eurozone to stimulate lending mean harmonising rating systems?***

J. de L. : That should be the ultimate goal, yes. But we are not ready yet. We should let the central banks take responsibility for setting up a straightforward but reliable rating system in their respective countries. We already have a system in France, Germany has the expertise and our evaluation methods are similar. If we want to develop a mechanism for evaluating SME portfolios Europe-wide, particularly in the countries that need it most – i.e. southern European countries – then we should look to the Banque de France and the Bundesbank for inspiration. If the central banks refuse or are reluctant to set up a system of evaluation in their country, then another option would be for them to delegate the task to other more willing organisations. This is doable, especially since the European Central Bank has, for several years, accepted portfolios of SME receivables as collateral when supplying liquidity to banks. It therefore has a method for classifying such assets. Of course, the goal is not to rubber stamp portfolios randomly, but to approve portfolios of very good SMEs. This would resolve your concern – which I fully share – about the stigma that is still attached to securitisation in general. With the support of the central banks and the possibility offered by Mario Draghi of directly purchasing ABS1– i.e. packages of loans granted by banks to the private sector – securitisation could make a comeback. But investors would have to be interested in the ABS market. Right now, they are not interested because of the regulatory overkill

M.-F. B. : ***What advice would you give the new Commission?***

J. de L.: I would advise the Commission to investigate the increase in risk aversion over the last seven years. There is a very easy way of doing this, and that is by looking at the balance sheet of the European banks aggregated into a single European commercial bank. I have done it myself. The balance sheet shows that banks are lending less to businesses, especially SMEs. Loans are much shorter term and new incentives have probably been introduced for holding zero-risk sovereign bonds and certain more remunerative financial products. The question is, is the 2014 aggregated bank better than its 2006 predecessor? The Commission should be asking whether these changes are in Europe's best interests. It should also be looking at another issue, which has more to do with businesses themselves than with regulation: until they recover from the recession, which was caused by the excessive tax burden they carry, their profit margins and competitiveness will continue to decline.

To sum up, two fundamental trends have emerged. The first is a structural one: the process of governing is very costly, which means a heavy tax burden is placed on the public (including businesses) to cover excessive public spending. As a result, businesses (especially SMEs) do not have the balance sheet needed to obtain a bank loan. The second trend is that banks are less and less willing to lend. Unfortunately, both trends are negative.

Interview by
Marie-France Baud,
Head of the Brussels office,
In charge of banking
and financial affairs
Confrontations Europe

1) Eurofi is a European think tank dedicated to financial regulation and supervision, and a platform for discussion between industry and public decision-makers. www.eurofi.net
2) NSFR: Net stable funding ratio.
3) ABS: Asset-backed securities.

Shadow banking

A SEA OF COMPLEXITIES

Concerns are being raised about the role of shadow banking in the array of new instruments for financing the economy. Marie-France Baud reports.

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A new animal has appeared in the financial jungle: shadow banking (SB). The term was coined by Paul McCulley, an American economist and managing director of investment management company PIMCO. It carries pejorative connotations and refers to the intermediation chain set up by and for banks to boost their business through non-banking investment vehicles, channels and structures with a high leverage effect. To put it more simply, according to the Financial Stability Board, shadow banking is "credit intermediation involving entities and/or activities outside the regular banking system." In fact, there is a broad spectrum of such entities: finance companies, securitisation vehicles, mortgage and consumer lending companies and certain types of investment funds such as money market funds, hedge funds and debt funds. SB is an indubitably shady business. Fuelled by a combination of financial regulation and innovation, its original purpose was to circumvent the so-called Basel III standards and to transfer certain activities to the non-regulated sector. By doing so, it contributed to the spread of the financial crisis. It is accused of having created new risks that undermine the stability of the finance sector and of the economy as a whole by combining massive debt leverage with over-reliance on short-term lending. SB is surrounded by other grey areas too; in fact, it is very difficult to understand and assess because it is so protean and increasingly diverse. Given the sustained development of the financial markets, the IMF estimates the size of the shadow banking system in the widest sense of the term at $60 trillion worldwide, including $15 to 25 trillion in the United States. Although it is difficult to reach a consensus about the exact amount, the underlying trend remains the the same: the shadow banking system is growing steadily, including in emerging countries like China, Brazil, South Africa and Turkey. Lastly, it is rather paradoxical that the term itself contains a semantic contradiction that almost makes it an oxymoron: being a regulated activity, a banking organisation cannot conduct its business in the shadows, as Hubert de Vauplane, a partner at law firm Kramer Levin Naftalis & Frankel points out.

Shifting attitudes

The system has become increasingly important politically speaking, as it could aid economic recovery despite its inherent risks. Both banks and public-sector players alike are keen to prevent the uncontrolled development of SB, which would be detrimental to economic activities subject to stricter regulations. So the challenge is to introduce appropriate and proactive supervision mechanisms that are commensurate with the risks being taken (as with derivatives, for example). Because certain SB activities are carried out by non-banking entities with a very different status, some of which are very tightly regulated, such as asset management and insurance companies. But the IMF has nonetheless pointed out the fact that insurance companies engage in SB activities because they extend loans, albeit very small loans, to businesses, whereas traditionally their liabilities are longer term than those of banks. The general mindset has changed since March 2012, when the Commission published its Green Paper on shadow banking: the animal has adapted to its environment. Alternative solutions are being sought to finance the economy, since bank lending has been reined in by prudential requirements. The direction taken by monetary policy has resulted in the growing disintermediation of economic investment. The tension surrounding securitisation is dissipating, following the decision of the European Central Bank to buy back securitised loans to stimulate lending in the Eurozone. The securitisation market is a source of concern in Europe because it triggered the financial crisis in the United States, but it is important to economic agents and its rehabilitation will aid economic recovery. SB is coming out into the open. What are the risks? Will it wreak havoc in the ecosystem by optimising the transformation of credit risk? The challenge is to ensure that those who are going to engage in lending activities instead of the banks do so with full knowledge of the risks, and that they do not undermine investment by taking an irresponsible attitude to security. The lending market is big enough to accommodate everyone, while striking a balance in the public interest.

Marie-France Baud,
Confrontations Europe

> ***"The shadow banking system, which is protean and increasingly diverse, is growing steadily, including in the emerging countries."***

> ***"The Commission is commited to tabling as soon as 2015 a legislative proposal"***

Testimonies

THE ROLE OF INSURANCE COMPANIES MUST BE INCREASED

Is it necessary to increase the duration of insurance liabilities, and if yes how?

Allianz and AXA

The whole French Insurance market welcomes the recent creation of the EuroCroissance contracts. This regulatory change, like the previous regulations on PERP and PERE a few years ago, is contributing positively to the increased ability of insurers to support long term corporates funding, and therefore to play their natural role of long term financing of the economy.
This evolution is going into the right direction but, as in the other European countries, there is a need to go further and to develop the appetence of French citizens for long term investment solutions and especially complementary retirement products. The main long term resource is the complementary and supplementary retirement, and we think that the development of the French market of occupational and personal retirement savings should be a top priority. The building up of individuals and corporates of retirement provisions on top of those provided by the state repartition systems will allow insurers to invest more in the long term, and will simultaneously represent an adequate answer to the ageing of the population and the difficult situation of public finances. Retirement savings are an inescapable way to guarantee acceptable/ adequate revenues to the retirees and to ensure sustainable pensions schemes in the long run. The consequence of the increase in the share of retirement provisions in the insurers' liabilities will actually be an increase in their duration.

In favour of a European regulation more oriented towards the long term?

Allianz

Solvency 2 and the IFRS accounting standards are relying mainly on the notion of economic balance sheet and air value, which makes sense, but there is an amalgam between fair value and market value. But the market can evolve in very erratic times when the market prices do not reflect any more the true "economic" value of the assets and liabilities. The market value reference introduces a very high volatility, especially for own funds and long term assets. These long term assets will be the first sold in situations of crisis, reinforcing the procyclical nature of the financial system. As a result there is a double penalty for long term investments, as they will at the same time reduce the available own funds and increase the capital requirements during stress periods. Some efforts have been been made with the long term guarantee assessment, but we need to go further. We support the possibility to derogate to the market value when it diverges too much away from the economic value, and to calibrate the Solvency 2 shocks on a longer term horizon. A specific treatment for long term investments would allow to increase their use in the portfolios.

AXA

The ongoing development of international accounting standards (IFRS) and the reform of the prudential supervision of insurance companies (Solvency 2) generalise the Mark to Market Valuation (MtoM) of the balance sheets of insurance companies. Insurers, for the sake of compromise, have accepted these regulatory changes. However, they must be compatible with their business model.
For this purpose, adjustments must be made in order to mitigate the generation of excessive volatility in the income statement and available own funds to cover the solvency margin. These standards must also take into account the long-term vision of insurers and the specificities of their assets backing liabilities. Insurers asked the IASB, the organization which has been delegated the initiative in drafting accounting standards, to review their recent draft stan-

dard on insurers' liabilities (IFRS 4). The standard, if adopted as it stands, would create excessive volatility in the income statements of insurers because they would not properly reflect the necessary asset liability matching. This is why European insurers, concerned about maintaining consistency between the valuation of assets and liabilities, recommend to the European Commission not to endorse the standard on financial assets (IFRS 9) as long as the standard on insurance liabilities has not been fundamentally reviewed. Besides, the European insurance industry unanimously requested that the Solvency II implementing measures ("delegated acts") proposed by the Commission send a clear and strong message in favour of long-term investment. Infrastructure, SME financing and the use of securitisation should be encouraged; to do so, the Commission may rely confidently on the experience of insurers, historical data, to retain adequate calibration and avoid the excessive calibration currently proposed. This would allow insurers to fully contribute to the recovery of the European economy."

What respective roles for banks and insurers on the financial markets?

Allianz

The role of banks and insurers in the financing of the economy cannot be exactly the same. The proximity with the corporates and their treasury is the core nature of the banking sector. However the financial intermediation is also performed by insurers, and the fact of lending money is equivalent to investing. The banking monopoly should not persist in its current form for corporate lending as it already disappeared through the role of the financial markets. A more liberal regulation on corporate lending would definitely make sense, to allow the insurers to finance the corporates without constraints. The time spend on credit analysis could be reduced if the terms of the loans/bonds would be more normalized, and also by the development of analysis aggregators, that could be the banks themselves, the asset management companies or the rating agencies. The public authorities should accompany this evolution by favouring the introduction of issuance norms, and also by collecting databases on issuers financials. The creation of quality labels, or even the credit enhancement of some securitizations, would also enable a much quicker development of banking disintermediation.

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Improving the intermediation of private savings towards long-term financing of the economy makes necessary an increased cooperation between banks and insurance companies which considers their respective economic models. Banks, thanks to their daily knowledge of company accounts, have a fundamental role on the retail market of small enterprises short term and working capital funding needs. They can make easier insurance investments in SMEs by homogenising and securitising individual loans. It will provide for the use of insurance statistical risk underwriting tools. On this last point, banks and insurers must work together to promote quality securitization and avoid the abuses seen before the 2007-2008 crisis.

For their part, institutional investors, due to the duration and illiquidity of their liabilities are able to provide the market with stable long-term financing. The supply of bank funding is cyclical by nature conversely to the permanence of institutional investors offer. Even in times of crisis, underwriting activity generates premiums, and stable investment flows from insurers. The alternative supply of insurance funds is thus particularly suitable for the long-term projects of companies. As well infrastructure projects with slow development require more permanence and stability.

Interview realised by
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1) www.confrontations.org

Asset management

A POST CRISIS STRATEGIC ADVANTAGE FOR FINANCING ECONOMIC ACTIVITY


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The French asset management industry is a global leader. The number of management companies has doubled in the past 15 years, reaching 613 at end-2013. More than half of them are so-called entrepreneurial boutiques, while others are subsidiaries either of French banking, insurance or financial groups (four firms rank in the top 25 worldwide) or of international groups

Bank credit accounts for three-quarters of total business financing in continental Europe at present. In future a larger share will have to come from markets. Consequently, asset managers will play a bigger part in ensuring that savings, whether from French or foreign origins, are properly channelled to benefit the economy and boost job creation.

For that reason, a strong and competitive asset management industry is a vital and strategic asset for our country. It already plays a key part in providing capital to French companies (accounting for 20 per cent of the free float in the CAC 40 index of leading shares), banks (44 per cent of certificates of deposit) and central government (more than 20 per cent of the stock of Treasury bonds).

The regulatory and tax environment needs to do more to encourage long-term saving

The legal and tax environment in which asset managers operate has deteriorated sharply in recent years. In fact, its key contribution to the effective management of clients' investments and the financing of our economy is now in jeopardy. It is high time to reverse this unwelcome trend.

From a regulatory perspective, nearly everything is now decided at European level. Naturally, regulation needed to be stricter and, above all, more consistent in the area of finance, eliminating the too-numerous areas where no law seemed to prevail. But that is no excuse for regulatory instability or for the torrent of rules and regulations that has overwhelmed the asset management industry with some 20 material pieces of legislation. Moreover, this legislative onslaught has driven up costs and heightened competitive inequities between different types of market participants and different geographical areas without delivering meaningful benefits to savers and investors or shoring up their confidence. It should be noted in particular that, unless adjusted, the Level 2 measures for MiFID 2 as envisaged by ESMA could have a devastating effect on the marketing chain for asset management products. In parallel, the recent determination shown by the European Commission to promote legislation encouraging long-term investment should be welcomed. Shifting the emphasis from punishing to encouraging is clearly the way forward!

In terms of taxation the main focus is more domestic, apart from the European plan for a financial transaction tax that, as it currently stands, would deal a lethal blow to the asset management industries of the countries that would adopt it, to the benefit of those such as the UK, Ireland and Luxembourg that will steer well clear. In France, the tax issue is clear: we need to roll back the past 15 years and openly embrace measures that foster long-term saving. Commendably, the 2014 Finance Bill makes some headway in this respect, with a slight adjustment to the ceiling on the PEA personal equity savings plan, the creation of a PEA investing in small and midsized businesses, and larger and quicker rebates on taxable capital gains on equities.

> *"Shifting the emphasis from punishing to encouraging is clearly the way forward!"*

Yet these measures are too half-hearted, as financial investment in France has fallen sharply over the past decade and is now ploughed mainly into bank deposits, savings passbooks and non-unit-linked life insurance rather than directly into securities or funds. Meanwhile, pension fund reserves have been hard hit by falling demographics and rising joblessness. As a result, the French market posted an investment outflow in 2013, an unfortunate contrast with other markets in Europe, including in the south, where equity fund investment has bounced back strongly. Fortunately, that downtrend seemed to be on the turn at the beginning of 2014.

Awareness does seem to be dawning, but more assertive and farther reaching action is needed if French savers are to play an active part in financing future growth and jobs. This can be achieved by relying on the strong, dynamic asset management industry that is a strategic asset for our country. That will be one addressed by the Paris Marketplace Committee 2020, inaugurated in June 2014 by the finance minister and administered by the Treasury and Paris Europlace. The asset management industry will play an active part in the committee's work.

Pierre Bollon, *Chief Executive, French Asset Management Association (AFG)*

Financial Industry

COMPETITIVE CAPITAL MARKETS, EUROPE'S CHALLENGE

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The markets will be instrumental as a significant source of financing for entrepreneurial risk taking. The European financial markets must trigger growth in Europe, insists Edouard-F de Lencquesaing.

As the crisis that placed stability at the heart of the political debate recedes, the question becomes how to recreate a real collective interest in risk? How to relaunch the entrepreneurial spirit throughout the European private sector and share it with the political sector and financial regulators in order to re-establish that subtle and key balance between stability and growth? We are at the heart of the financial industry's mission. The "risk factory" between entrepreneurs and investors must optimize risk-reward versus mid to long-term capital appreciation.

Up until recently this financing relied upon bank credit and, particularly in France, upon a well-developed risk culture. The crisis, triggered by poorly managed and controlled market mechanisms has affected the classic banking system. As a result, the markets will now have to be instrumental as a significant source of financing of entrepreneurial risk taking. In fact, regulation has now changed our financial model. It is not a mere technical challenge. This change carries profound repercussions for the organization of our society, its risk culture now enlarged to include more actors, and therefore on our value system as well. Isn't this what is behind shadow banking and crowd funding issues?

Already the size of Europe's financial sector has retreated compared to that of the United States and China

An Industry policy for the Financial Sector

In this new context, Europe's challenge is twofold. It consists of on the one hand deploying an industrial strategy to revive growth while relying upon priority "motors" such as energy, climate, new technology, and on the other hand defining a funding strategy with greater reliance on the markets. The financial industry determines the right balance between the use and the circulation off savings towards targeted growth sectors. This is an essential infrastructure for society: a source of "funds" energy. This "photosynthetic system transforms this energy into growth factors for both large and small companies. This capacity to efficiently and competitively transform funds into fuel for growth is not automatic. It is the result of a context created by vision and policy and from an industrial view of finance in Europe for which the principle of stability can only be a dimension, not the only dimension. Of course, any change in a model requires a transition phase. This carries the accompanying risk of a recalibration of the new parameters and the need for a road map to properly implement them. Every error and hesitation will cause Europe to lose its critical competitive position. Already the size of its financial sector has retreated compared to that of the United States and China. Now is the time to ask real strategic questions. What do we wish from our financial system: European proximity banks? European regional investment banks? Global banks? How do we accompany our European industrial giants in the wave of globalization? How do we accompany our innovation start-ups worldwide? Is the creation of a pool for European investment (such as what originally drove American finance) still important to us? These are strategic questions to ask in order to honestly face the competitive conditions of access to capital and the modalities for its mobilization. To limit our strategy either i) to think that the size of bank balance sheets is Europe's problem; or ii) to accept a disguised return to the Glass-Steagall Act with the Liikanen Project; or iii) to believe that a financial transaction tax could both complement the existing regulatory framework making markets more responsible, and contribute to the solution of public finance deficits, would be to miss an important step in our strategic reflection.

Essential Initiatives

The calibration of this regulation that emphasizes capital (CRD4, Solvency2...) as a source of stability, as armour-plating in the battle against risk, should better take into account other defense points potentially less costly for our productive economy: surveillance and risk culture. The Banking Union, banks restoration and resolutions mechanisms are essential initiatives that contribute to this protection. They will restore credibility and will contribute to optimize the cost of financial resources allocated between prudential capital and surveillance; it will also mitigate extraterritoriality temptations from countries that refuse to trust our surveillance processes. Interestingly enough as a condition to increase market efficiency between the US and the EU it justifies the introduction of financial regulation in the "TTIP" negotiation.

Vision, balance, responsibility, these are the conditions for a constructive dialogue between regulators and the private sector to make European finance and the market a trigger for growth and European competitivity. We are almost there!

Édouard-François de Lencquesaing,
Chief Executive, European Institute for Financial Regulation (EIFR)

International investment

EUROPE: THE CANARY IN THE COAL MINE?


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« The collapse of international investment flows to and from Europe is not just a question of being in the trough of a tough international investment cycle. Innovative political responses are needed. »

This paper has examined international investment trends in Europe, both in terms of inward and outward international investment. The overarching conclusion is that investment to and from Europe collapsed in the wake of the global financial crisis that began in 2008 and is showing little sign of recovery. In order to gain further insight into this collapse, and with a view to determining the extent to which this is a specifically European challenge, the investment collapse was examined from a number of different perspectives, including Europe's performance compared with other non-European industrialised countries, a breakdown between intra- and extra-EU sources of investment, a comparison of performance among EU members, an analysis of industry-level investment performance, and, finally, a comparison of international and domestic investment trends. From virtually all of these perspectives, it is difficult not to conclude that what is happening in Europe has a structural component to it, that this is not just a question of being in the trough of a tough international investment cycle (although this is clearly also a factor). Foreign investment is Europe's canary in the coal mine, and there is most definitely something dangerous going on, because the canary stopped singing quite a while ago.

From a policy perspective, the challenges of breaking out of the current European investment recession are clearly daunting. A useful starting point is the recognition that a supportive environment for productive international investment will reflect the evolving needs of international investors. Such a supportive environment has two dimensions.

Necessity of a supportive environment

First, investors generally favour predictable, open, transparent, rules-based regulatory environments, much along the lines put forward by the OECD's Policy Framework for Investment. Many of these elements are well known and widely accepted. Where impediments to investment have not been addressed by governments this often has more to do with implementation challenges rather than disagreement over principles. For example, it is widely accepted that excessive 'red tape' is an impediment to investment but in many countries this is still often cited by business as being one of the most important impediments to investment. Europe is no exception in terms of having these sorts of impediments to international investment that, for one reason or another, remain in place despite widespread recognition that they are discouraging investment. Many such impediments represent low-hanging policy fruit - relatively easy opportunities for improving the regional investment climate.

A second dimension could be more challenging and would probably call for deeper analysis. It seems reasonably clear that the global financial crisis is giving rise to important changes in the structures and patterns of global investment flows as well as in the way multinational enterprises are organising their international operations. This is reflected in new phenomena such as instances of investment de-globalisation (as alluded to in the introduction) and the phenomenon of "vertical disintegration" which has seen MNEs become more focused on their core lines of business over time and more reliant upon international contractual relationships for organizing their global value chains.

Identifying the right issues

Such structural changes in the global economy could require more innovative policy responses that go beyond the fundamentals of a healthy policy environment for investment. For example, if the organization of international economic activity at the level of the firm shifts from ownership through FDI to a more contractually-based business model, what implications might this have for domestic commercial law and contract enforcement systems? In a world in which international production continues to be broken down into more and more specialized activities, involving heightened levels of communication and logistics along the value chain, are countries investing enough in infrastructure as well as in the right kinds of infrastructure? Are financial markets sufficiently evolved and in tune with the financing needs of evolving forms of business associated with global value chains that might look different and have different risk profiles than what they are familiar with?

Questions such as these are clearly beyond the scope of this paper. Indeed, further work would probably be needed just to identify the right questions to be asking. But one thing seems fairly clear: the collapse in international investment flows in Europe, both outward and inward, is more than just a passing cyclical phenomenon. The appropriate policy response to restore investor confidence and revive investment flows will therefore likewise need to go beyond treating it simply as such.

Michael Gestrin
Chief Economist
Investment Department, OECD

1) The elements of the present article are an extract of the study: "International investment in Europe" by Michael Gestrin, September 2014. Available on www.confrontations.org

Financing options

Bpifrance: THE ROLE OF A NATIONAL PUBLIC PLAYER


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Nicolas Dufourcq explains the essential role played by Bpifrance in project finance, and highlights three measures that could increase paneuropean cooperation among operators.

The recovery expected to occur in 2014 in France and other European economies is delayed and the risks, including those of deflation, are making the likelihood of a lost decade seem more and more inevitable. The question of how to rekindle investment across Europe has therefore become crucial.

It is more important than ever that we increase our businesses' competitiveness and innovation capacity and strengthen their position in external markets to prevent the long-term loss of potential economic growth. In France, the investment conference held by President Hollande on 15 September was an opportunity to underline the urgency of the situation and to call all economic and financial stakeholders to action. If we look at the situation of French businesses, the problem is quite clear. The shortfall in productive investment that has built up since the beginning of the economic crisis, and which is comparable to that in other major European economies, including Germany, can of course be explained primarily by the drop in demand. However, the situation is showing no signs of improving and it is whittling away at our ability to bounce back. So the new investment phase must start as soon as possible.

The direction of investments

The direction of investments is a crucial issue. In France, the investment effort made by companies in the years leading up to the crisis seemed, overall, to be relatively sustained. Paradoxically, this has not stopped industrial profits from dwindling steadily over the last six to ten years. Looking more closely, investments were largely channelled into the construction industry, where prices have risen faster than basic prices elsewhere. This probably goes a long way to explaining the paradox.

Intangible investment, which is sustained by significant tax incentives, has also increased with the gradual spread of new technologies and the needs of the new economy. Yet the various indicators relative to the innovation effort of French companies show there is still a long way to go. For example, in 2013, the share of R&D expenditure in GDP was 2.2% in France compared with 3.0% in Germany (i.e. a difference of around €17 billion). Were French companies to invest an additional €10 billion, it would bring France's industrial R&D effort closer to that of Germany and the USA.

"Greater support is needed for innovation, developing start-ups, replacing and modernising production equipment and developing international business"

Overall, the shortfall in investment has made French companies less competitive. Their products are geared too much towards the medium-range market, so inevitably their profits have dwindled and they have lost market shares to international competitors. This raises the danger of a vicious circle where, price being the only adjustment variable, the pursuit of profit reduces the amount of internal resources invested in innovation capable of maintaining market power. This in turn puts more pressure on profit.

A productivity and quality challenge

The challenge today is to increase the productivity and quality of investments. Greater support is needed for innovation, developing start-ups, replacing and modernising production equipment and developing international business. For this, appropriate financing options are required. Banks, which provide almost all the loans for SMEs in France, seem to have little or no hesitation in financing what could be described as standard, tangible investments. But bank lending does not meet or only partially meets the needs of innovative projects, either because of the type of business involved (young companies) or because of the nature of the project itself (if there is no collateral, for instance).

France has a lot to offer as far as equity financing is concerned, which is essential to high-potential SMEs (both start-ups and those in a more advanced phase of growth). It has a well-established venture capital market and is the second biggest investor in Europe. However there is still a significant lack of private funds,

especially where the risk is highest, (for example, for financing the growth of young SMEs).
Given this market's shortcomings, the intervention of an organisation such as Bpifrance is essential in financing this type of project. It is essential because it has the necessary resources, and because it focuses on the most critical segments of investment projects. Above all, it has the capacity to channel private funds into these projects, which are a condition of all its interventions.

An ambitious investment policy is needed

However, France is not the only country facing such challenges. The need to restore business and investment activity is widespread across Europe, which must address the looming problem of deflation, rekindle its development potential and establish a form of convergence between different national economies. Even in Germany – which is currently reaping the benefits of the wage moderation policy introduced ten years ago and of its sound, well-positioned companies – the low rate of investment, especially public investment, over the last few years is a threat to future success. An ambitious investment policy is needed there too, not only in the interests of Germany itself, but also for the general interest.
So we can only welcome the €300 billion recovery plan announced by Jean-Claude Juncker in June, as it responds to the need to promote strategic investment in the Europe of tomorrow. In this respect, the President of the Commission has sent out a positive signal to the market. The plan – whose details are yet to be hammered out – should leverage private investment and enable the development of large-scale, long-term, innovative projects creating new jobs. The priority sectors proposed, namely infrastructure, the energy transition and SMEs, are essential for this purpose.

Three promising measures

One of the challenges of the investment plan will be to spend wisely. In addition, a set of criteria and priorities must be defined. This will mean optimising existing programmes. Three measures could be useful in this respect and merit further discussion:
Firstly, it is vital to strengthen the links between European financing programmes and those developed by national operators such as Bpifrance. This would make it possible to harmonise priorities and pool public-private resources within common instruments, to maximise the leverage effect of the European budget.
The fact that our counterparts in the European Long-Term Investors Association (ELTI), the Network of European Financial Institutions for SMEs (NEFI) and the European Venture Fund Investors Network (EVFIN) agree with us in this respect is encouraging. Like Bpifrance, our European partners – such as the KfW in Germany and the Cassa Depositi e Prestiti in Italy – have in-depth knowledge of market needs and have been commissioned by their respective governments to perform budget execution tasks. In this context, and given the constraints on public finances, the EIB and the Commission should rely more often on national operators to implement European programmes (e.g. Horizon 2020, COSME, structural funds).
Bpifrance is involved in managing Community programmes such as the RSI scheme for funding innovative businesses and the Eurostars programme for collaborative RDI. It also helps manage European Regional Development Funds alongside regions.
Secondly, the Commission should be encouraged to set up a European financial platform composed of a network of leading public and also private-sector financial players from the different Member States1. This network of loyal financiers would have a triple purpose: to investigate, alongside European institutions, the coherence of instruments already in place for providing financial support for businesses; and to share best investment practices and organise the syndication of transnational investments in large-scale projects in order to open up the market. Bpifrance and its European partners are ready and waiting to participate.
The Green Paper on the long-term financing of the economy[2], which was published in March, is very positive in this respect. It recognises the contra-cyclical role played by our institutions – particularly during the crisis – and the benefits of increasing their participation in European policy-making and in managing EU funds. It also states that "given the stabilising economic situation (...), there is a need to focus on market failures and on value-added operations".
Bpifrance agrees in substance with this analysis, as its intervention doctrine is in line with these principles. However, given the cyclical nature of the market, especially in a gloomy economic climate, it would also point out the importance of maintaining the flexibility of action of public investment banks. This is evidenced by the very broad spectrum of business models employed by these banks today.
Lastly, efforts to make EU financial instruments simpler and more flexible should continue in order to optimise synergies with existing national programmes. The terms and conditions of the financial instruments used in the COSME and Horizon 2020 programmes – notably regarding risk-sharing with the EIB group – should be more versatile to take into account the risk profile of underlying assets while ensuring the EU budget is exposed to the same level of risk.
Bpifrance is fully committed to addressing all these challenges, in close collaboration with the market players, the EU institutions and its European partners.

"Stronger links between European and national financing programmes are vital."

Nicolas Dufourcq
CEO, Bpifrance

1) Editor's note: See Natacha Valla's article on p. 35.
2) Editor's note: Confrontations Europe has been working on this subject for over three years, alongside several economic and financial players. In addition, Philippe Herzog made an active contribution to the Green Paper. See his article on page 20 of la revue n° 101 (april-june 2013).

Investment strategy

WHAT PUBLIC STIMULUS AT EU LEVEL?

The idea of developing an EU public investment strategy is back on the agenda. Carole Ulmer reports on current developments.

It has been several years now since the European Commission and the European Investment Bank (EIB) began to change their approach to budget management. According to Henry Marty-Gauquié, who represents the EIB Group in Paris, a "silent revolution" took place in 2007 with the establishment of the EU's 2007-2013 multiannual financial framework, which marked the beginning of a gradual shift in the European budget from a "culture based on subsidies to one based on economic investment." This is evidenced by the introduction of various new financial instruments (such as risk sharing, guarantees, equity and project bonds), allowing for the use of European public funds to leverage private investment in European added-value projects. These tools are more extensively used in the 2014-2020 multiannual financial framework[1]. Today, more funds are being allocated to a broader spectrum of projects (Horizon 2020 for research and development, skills and jobs for young people, SMEs, infrastructure, the environment and so on). And the first project bonds have been issued in Germany and France.

The idea that a public stimulus is needed to restore investment in the EU has been gaining ground in the last few months, following the renewal of the European institutions and under pressure from various groups (trade unions, large employers, the citizens' initiative, etc.). It is against this backdrop that Jean-Claude Juncker has put forward a recovery plan worth €300 billion over three years. A fierce debate is now raging over how the funds will be allocated. How will investment projects be selected and how will the plan be governed? Numerous proposals have been made and, in all of them, the EIB plays a key role[2]. France and Germany have developed joint proposals, while Poland's finance minister, Mateusz Szczurek, is calling for a European Investment Fund big enough to finance up to €700 billion worth of projects.Debate is also stepping up on the creation of an EIB task force that would work with national public investment banks to identify suitable projects. How should we go about selecting the projects that best serve the European public interest? Doesn't politics have a key role to play in incorporating such investments into European strategies on industry, energy, the digital economy, training, human capital, etc.?

Financing the Juncker plan

Another important question: how will the plan be financed? Will existing resources be used or new own resources introduced by Monti's high-level group? Will there be another increase in the EIB's capital? €80 billion could be taken from unallocated structural funds. In addition, the EIB has brought €60 billion worth of securities to the market, which could leverage up to €180 billion of private investment. The remaining €40 billion could come from project bonds. But the structural funds are often criticised for financing too many small projects, while EIB funding is often blocked by a lack of necessary national co-financing.The question of whether or not to increase the EIB's capital is controversial. The President of the EIB group, Werner Hoyer, is reticent: "Let's talk about projects before we talk about increasing the capital." It should be pointed out that the group's investment commitments already rose by 37% in 2013, following a decision in 2012 to increase its capital by €10 billion. Werner Hoyer is focusing on measures to improve national and European guarantees, such as the pilot project implemented in Italy to provide support to SMEs.
At the informal meeting of finance ministers on 13 September, the EIB and the Commission were tasked with identifying investment projects in need of funds and submitting an interim report at the next ECOFIN meeting on 14 October[3]. Many questions remain to be answered and a lot of options are available; concrete proposals are expected this winter. Our conference will play a proactive and influential role.

Carole Ulmer
Director of Studies, Confrontations Europe

1) See the presentation given by Hervé Jouanjean, former head of the European Commission's DG Budget, to Confrontations Europe's "European Budget" working group on 26 March 2014 at http://www.confrontations.org/fr/domaines-detudes/budget-europeen/reunions-budget
2) See Dominique de Crayencour's article on p. 36.
3) *This issue went to press at the end of September 2014.*

FIRST STEPS IN FORECASTING

Forecasting is a valuable means of creating transparency and therefore trust, and is still not used enough by the European Commission. However, the BEPA (Bureau of European Policy Advisers) is beginning to introduce coordinated scientific and technological forecasting activities under the leadership of Didier Schmitt1. A Sciences and Technology Advisory Council has been set up to advise the president of the Commission, based on a network of contacts within the Directorates-General. The Council will draw up information sheets on different technologies and will promote cooperation between the DGs over the long term. The next step will be to coordinate the activities of different national forecasting centres. Didier Schmitt has also put together a group of experts on forecast modelling, to pave the way for a systemic vision. He has ordered a Eurobarometer survey on forecasting. This work will continue with the creation of focus groups in 14 countries to take the discussions further.

1) *An ESPAS (European Strategy and Policy Analysis System) report is due to be published shortly. See* http://europa.eu/espas/ index_en.htm

Forecasting

PUBLIC & PRIVATE ACTION: A SYNERGY TO BE STRENGTHENED?

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In relation to the crisis, the share of investment in GDP has decreased in the Eurozone, both for total investment(21.9% in 2007, 17.7% in 2013) and public investment (2.7% in 2007, 2.1% in 2013). The decline of total investment has been twice as steep as in the United States or in Japan. The challenges of globalisation and technological mutations require huge investments in the coming years. It is necessary on the one hand to adress the gaps of the previous years and, on the other, to adapt to the structural changes in the world economy. Among other concerns, the action against climate change requires major investments, with appropriate methods for valuing costs, expected benefits and durations[1].

It is thus necessary to bolster the synergy between the public action and the private initiative. Economic growth depends on the dynamism of the private market sector, but public action is also necessary to meet the needs not satisfied by the market (natural monopolies, large scale infrastructures, services of general interest...) and to stimulate private investment in long term projects.

For private and public investments, the key issue is the relationship between desired objectives and expected economic return. Considering the economy as a whole, it requires a forward-looking vision and a long-term strategy, impelled by public authorities (at the level of the European Union and in the Member States) which facilitates the long-term choices of public and private investors.

"In such a cooperation, good governance and outcome evaluation are key"

The main objectives of the "Europe 2020 strategy" are employment, innovation, education, poverty reduction, energy and climate. Specific actions (like Energy 2020, Connecting Europe facility and Horizon 2020) aim to support investments in energy, infrastructures, research and innovation. However, the leverage effect of EU funding is not sufficient to cover the financing needs, especially for infrastructures.

Two procedures may facilitate the financing of major infrastructures : Public-Private Partnerships (PPPs) and Project bonds.

PPPs aim to deliver projects or services, which were traditionally provided by the public sector. At European level, 180 new PPPs were signed in 2013 for a total of 16.3 billion euros. The development is sustained by the European Commission: new directives on concessions and public procurements, increased use of EU funds, role of the European investment bank strengthened. Under the European programme Horizon 2020 for research and innovation, the European Commission has launched in July 2014 a call for projects for PPPs between EU, Member States and the private sector. This relates to 7 topic areas in research and innovation.

The initiative "Project bonds" has been launched by the European Commission and the European investment bank. The objective is an increased use of capital markets for financing European networks, information and communication technologies. In these areas, the overall need for investment is evaluated at 2,000 billion euros.

This initiative is now being experimented. The proponents of PPP projects, issue bonds in order to raise funds from institutional investors, such as pension funds and insurance corporations. By way of a subordinated tranche suscribed by the European Commission and the European investment bank, the bonds may have the rating level required by the institutional investors. 230 million euros, committed to this experimental phase, might allow to finance 4 billion euros for infrastructures.

For publicly operated investments or PPPs, it is essential to valorize properly the projects and to select them according to the risks, the financial return, the efficiency, the socio-economic impact[2]. Good governance and outcome evaluation are necessary, especially in long-term PPPs.

Alain Turc, *Senior adviser, Confrontations Europe*

1) Committee Quinet Report on the "State-imposed value of carbon, in order to reduce European CO2 emissions by 75% in 2050" Centre d'analyse stratégique, France, 2008.

2) Report of Gollier Committtee (2011) : Risk calculation in public investments. Report of Quinet Committee (2013): Evaluating the socio-economic impact of public investments.

Ambition

REFORMING THE EUROPEAN INVESTMENT BANK: A NEW ARCHITECTURE FOR PUBLIC INVESTMENT IN EUROPE


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The European System of Investment Banks, SEBI, could be decisive on long term growth in Europe.

Some five years after the severe recession of 2009, private sector investment in Europe is still dangerously sluggish. And public investment has been cut further, reinforcing a long term downward trend. At a mere 2% of GDP, it has halved over thirty years.

This is a curse for Europe. Evidence suggests that in the medium term, public investment does not hinder, but fosters, private investment. And available estimates of fiscal multipliers for public investment, for example based on the work of Larry Christiano, Marty Eichenbaum and Sergio Rebelo, are way above 1, significantly above those for other fiscal instruments. The public sphere would therefore be well advised to tilt spending towards investment in areas such as infrastructure and human capital, which represent an investment for future generations.

A new European initiative might be needed to get investment back on track and thus protect future growth. To this end, a Eurosystem of Investment Banks (ESIB) could be established by Treaty around a pan-European financial capacity that would coordinate the actions of national public investment banks (ESIB is an acronym chosen by analogy to the ESCB, the system created by national central banks and the ECB within EMU). The central node of the ESIB, the Fede Fund, would be created by restructuring the European Investment Bank into a truly federal entity. It would orchestrate the joint work of its national counterparts.

Sharing ressources

There are many such national development banks in Europe. Some are sizeable. All are well established and widely respected institutions, sometimes owning magnificent collections of art pieces, and located in prestigious historical buildings in their country's capitals. Their senior staff might belong to the national elite. But their scope of activity is often associated with the economic and strategic interest of the nation they serve.

Which mandate?

It is time for those national goals to be complemented by European ones. The ESIB would enshrine cooperation between those institutions in European Law. It would also statutorily bring public development banks and private sector investors together. But conceiving a "system" that preserves the strengths of each national model, while delivering efficient outcomes at the continental level, is challenging.

The first of all challenges is politics. The mandate, ownership and governance of the Fede Fund would be key in ring-fencing the investment process from national political agendas not linked to the promotion of long-term growth. The mandate of the ESIB could be simply to promote long-term growth, well-being and employment in Europe, reflecting a political consensus emanating democratically from the people of the Euro area member states. But ownership and governance are more tricky. A structure with both public and (possibly majority) private Fede shareholders might be needed. Shareholders would collectively elect the ESIB Board of Directors. The Fede Fund would also issue debt to finance investment at an economically relevant scale.

Europe can be ambitious. It can aim for an increase of public investment by 2% of GDP. With a 50/50 public/private shareholder structure in the Fede Fund, and respecting the EIB's 2.5 leverage rule, its financing capacity would reach 10% of Euro area GDP, so around €1tn. Food for thought.

Natacha Valla
Deputy Director of CEPII

Changing the approach

EIB: TOWARDS A NEW "BUSINESS MODEL"?

The European Parliament, the Council and think tanks have put forward proposals for developing a network of national public financing institutions structured around the European Investment Bank (EIB).

Broad consensus today exists for acknowledging that to reconcile the budgetary discipline necessary for economic and financial stability, and sustainable growth needed to create employment, it is investment – the link between short-term demand and the long-term supply – that needs to be reactivated. The current generation can no longer tolerate its number of unemployed and future generations would not forgive our sacrifying them for our well-being whether through excess debt or through lack of investment.

At the same time, this famous 'growth' cannot be the solution if it is only an increase in GDP exhausting limited natural resources. There should indeed be agreement on a measurable growth objective for well-being since it now appears demonstrated that this increases other than by the sole production-consumption of more physical goods. Investment choices must take this into account to truly gain the title 'sustainable'.

Finally, the relevant scale to take into account for these new investments is both local and European. Local initiative is in full revival at the level of living communities and very naturally responds to an approach focused on quality of life. It lacks only a framework and general political support to develop on its own. On the other hand, whether it may be digital networks, energy or transport, innovation or human capital, the stakes are European and no other dimension would enable to manage them in a globalized world.

This allows to characterize the appropriate investments according to three complementary dimensions: they must be supported by some form of economic and societal profitability, be sustainable in terms of their consumption of natural resources and European in their ambition and design. They should lastly also create sustainable employment and pave the way for entrepreneurial initiative.

How to identify, prepare and fund such investment projects?

The funding issue is at the heart of the debate since the start of the crisis in 2008. However, the main challenge appears increasingly as being the identification, promotion and preparation of a pipeline of investment projects meeting the characteristics defined above. For this, it is human resources, technical expertise and organization that we need. This expertise exists, but it is scattered and poorly used.

Whether to "pool" the funds required for project financing, or to gather essential human resources for their identification and preparation, to give effect to Mr. Juncker's 300 billion euro plan and not just 'repackage' the existing for political visibility, it has become vital to change approach.

"To give effect to Mr. Juncker's 300 billion euro plan and not just "repackage" the existing for political visibility, it has become vital to change approach"

The EIB in Luxembourg does a great job, but this shows to be primarily focused on maximizing the volume of its lending. Such an approach no longer meets current needs and may even enter into conflict with the goal of subsidiarity. The huge capacities of EIB technical assistance are not exploited as they could. Its risk taking is systematically limited by capital requirements needed to meet the demands of an AAA rating.

In this context, proposals have emerged in the European Parliament, the Council and in think tanks for a network of national public financial institutions, whose mission is to promote long-term investment, to be structured around the EIB. The European network of central banks around the ECB could serve as an example to a network of national promotional banks around the EIB in the field of investment.

Whatever the more or less institutionalised form it should take, such a network would pool together considerable financial and human resources to meet the challenges of our societies at the EU-level. The synergies created should open new approaches and give a breath of fresh air to the 'business model' of the EIB, which has reached its limits. A whole range of financial instruments and technical assistance could be implemented to provide leverage to the limited resources of the EU budget with a scale able to meet the needs of quality sustainable growth.

Dominique de Crayencour
Secretary general, Association of the long term investors (ELTI)

1) Read artical of N. Valla en p. 35.

Perception of the future

EUROPEANS HAVE NO HORIZON OF MEANING

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On the whole, confidence and hope – which have long been associated with progress – have been lacking in early twenty-first century Europe. There is a pervasive atmosphere of anxiety, which has fostered risk aversion and therefore weakened the EU's development capacity.

With the arrival of 2014 and the European elections, successive surveys have highlighted the general mood of pessimism among Europeans citizens. Their confidence in the future is dwindling, although the European Commission is doing its utmost to see the glass half full: *"for the first time in years, there are more people who believe that the impact of the crisis on jobs has reached its peak than people who think that the worst is still to come"*[1]. Does that mean Europeans are feeling more optimistic? When asked about the main issues facing the EU in the future, they mentioned unemployment most frequently. Unsurprisingly, France is one of the ten most pessimistic countries in the EU, alongside countries like Greece, the United Kingdom, Italy and Portugal. At the beginning of the year, the Ipsos Institute represented French society as being fragmented and eaten up with anxiety. And the *Commissariat Général à la Stratégie et à la Prospective* (General Commission for Strategy and Economic Foresight) described the French as being *"defeatist about their country's ability to reform"*[2]. This crisis of confidence raises questions about the collective will of a country to create the political, economic and cultural conditions needed to project itself into the future.

In many EU countries, people are very concerned about what the future holds for the generations to come. This is reflected in the 57% of young Europeans who feel that young people in their country have been marginalised and excluded from economic and social life by the crisis[3]. However, there are noticeable differences in perception between northern and southern European countries. Young Scandinavians stand out for their greater individual and collective confidence. As Swedish sociologist Mats Trondman argues, this could be accounted for by the constant renewal of the *"collective project myth"* developed by the government.

A demand for solidarity

Surveys on values are an important means of understanding long-term trends. These surveys *"show very clearly that there has been no rapprochement between European societies for 30 years,"* writes Pierre Bréchon, professor of political science at Science Po Grenoble[4]. There are still substantial differences between groups of countries, which means that the liberal and individualistic countries of Western Europe are frequently opposed to their more traditional neighbours in Eastern Europe and in some parts of Southern Europe. As regards economics, he says, *"the convergence process even seems to be going backwards, with increasing calls for state regulation and growing distrust of economic liberalism."*

There has been a growing demand for both state intervention and equality in almost every country in the EU since the 1990s. This underlying trend emerges whenever Europeans are questioned about the future of Europe[5] and its priorities: social equality and solidarity come out on top. The established trend towards the individualisation of societies goes hand in hand with a demand for greater solidarity. This is not surprising at all, given a recent survey which showed that Europeans are feeling increasingly vulnerable due to the ongoing crisis. As a result, risk aversion is growing, except, once again, in Scandinavia; the Swedish actively encourage risk-taking.

This situation is not conducive to progress and innovation. In 2010, the Eurobarometer survey on science and technology pointed to *"a general shift toward scepticism."* And the recent Eurobarometer survey on "The Future of Europe" shows a fall in the number of people who prioritise progress and innovation. As physicist Etienne Klein points out, *"progress is no longer seen as a relief but as a cause for concern"*[6]. And *"the idea that science leads to alienation rather than to emancipation (…) hinders our development capacity"* observes Jean Peyrelevade, former chairman of the Crédit Lyonnais, talking about France. According to Klein, this change in perspective marks *"the end of a long period spanning three or four centuries, during which scientific progress was enshrined in a civilisation project. That is no longer true (...) because we no longer have a civilisation project!"* And the issues we are facing now do indeed relate to the collective project that the EU is still not able to embody, and to the need to establish a new public authority with a long-term vision to rebuild progress. The attachment of citizens to the Union, and hence its (their) future, depends on our ability to solve these issues.

Catherine Véglio-Boileau
Director of the Redaction
Confrontations Europe

1) Eurobarometer, Public Opinion in the European Union, July 2014.
2) CGSP, Les enseignements du débat citoyen, quelle France dans 10 ans, February 2014, www.strategie.gouv.fr
3) Eurobarometer, European Youth in 2014.
4) *Les valeurs des Européens. Evolutions et clivages*, under the direction of P. Bréchon and F. Gonthier, Armand Colin, 2014; book based on data from the European Values Study (EVS).
5) Eurobarometer, The Future of Europe, March 2014.
6) *Les Echos, 28 Aug 2013.*
7) *Histoire d'une névrose, La France et son économie*, September 2014, Albin Michell.

Confrontations Europe

DISCOURSE ON METHOD


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This effort was driven by an overriding and obstinate determination to lend new ideas and direction to the public debate on how to revive investment and thus build the foundations of future growth. It was led by Philippe Herzog and involved men and women from very different backgrounds who were keen to reconcile economic and financial thought with societal objectives, across social and national boundaries.

What was the ultimate goal? To turn ideas into projects that will change the way we live and boost economic growth; and to mobilise the funds needed to get these projects off the ground, in accordance with a common vision of what the European and global economies should be. The information and technology revolution has forced us to look at education, business and territory in a new light. And money creates social ties. It requires a market, regulation, transparency and democracy. It forms a link between people from different countries, including manufacturers, consumers, regulators and speculators. The 2008 financial crisis forced them all to pull together in an effort to get the global economy back on its feet. These people often do not know each other and try to shift responsibility onto one another.

Through its office in Brussels and its working groups, the association is going to bring them together and work with them to develop a global analysis and put forward proposals for reform. The goal is to incorporate investment and investment funding into growth and employment strategies that look beyond narrow national and corporatist interests.

A project with very concrete implications

A "crisis" group has been set up, led by our friends Herzog and Aglietta, both of whom are former students of the Ecole Polytechnique. It will organise 16 meetings with experienced people. It will act as a macroeconomic advisor and the other groups will draw on its experience to link the economic analysis to industrial and social issues that, although more microeconomic, are no less important. They will also call for a renewal of management practices, since we have to do more than just rethink the monetary and budget policies and reform the market rules and framework. We also have to redefine the roles of banks and insurance companies and make sure that project owners, industrial companies and service providers confronted with globalisation are aware and take advantage of digital technologies, KETs, new forms of energy and new job skills.

The "bank" group chaired by Marie-France Baud is exploring the various stages in the development of a European financial market and a banking union, analysed and clarified by experts and by the responsible MEPs, such as Elisa Ferreira and Jean-Paul Gauzès. The "insurance" group – after working for three years on modifying the Solvency II Directive – is shifting its focus towards the role of insurance companies in long-term investment. It will be working alongside Axa, Malakoff, CNP and Allianz France, as well as mutuals and pension funds.

New options are emerging, which have been popularised in *La Revue* and *Interface* and verified during discussions with Jacques de Larosière, Olivier Guersent, Benoît Coeuré and others...

The question of the European budget is being investigated by a dedicated group led by Carole Ulmer and Alain Lamassoure and benefiting from the experience of highly-placed members of the Commission such as Hervé Jouanjean. Fresh efforts to integrate the single market are discussed at regular meetings of the "Internal Market" group, and the "InduServices" and "Energy" groups organise surveys and conferences on common policies in areas of strategic interest (industry, energy and services). These policies are also being addressed by a special task force consisting of representatives of Alstom, Bouygues, Airbus Group, Sanofi, Michelin, various trade unions, regional councils and Directorate Generals of the Commission. It is difficult to mention everyone here! Philippe Herzog are constantly summarising the main outputs of the working groups in order to establish joint conclusions and issue policy recommendations. Thus the association is weaving its web and, with the help of its partners, is putting together a coherent project that will culminate in 2013 with a draft reconstruction contract in which long-term investment will be one of the five main objectives.

The rewards

The association, which is often compared with the "Commissariat au Plan" (economic advisory committee), has developed a highly-respected forecasting and strategy-making capacity. In addition, its founding president has been special advisor to Commissioner Michel Barnier for the past five years. Confrontations Europe is also recognised as an authority on long-term investment by the Long-Term Investors Club created by the CDC with the EIB, the KfW and the Cassa Depositi e Prestiti. Augustin de Romanet, Philippe Maystadt and Franco Bassanini are becoming friends. All our hard work paid off with the publication of the Green Paper on the financing of the European economy. But the Green Paper was just the first step towards our goal: we need to capitalise on it now!

So Confrontations Europe has come up with the idea of a European Long-Term Investment Conference and set up a European steering committee: for a year, a team of sixty people will work on developing strong policy guidelines – if not concrete recommendations – for a 2014-2020 action plan.

Today, President Juncker is talking about mobilising €300 billion to revive investment. But we still do not have either the tools or the governance system needed to implement the plan successfully and to take things further. At the European Long-Term Investment Conference, public and private-sector players will meet and talk with each other and with representatives of the Community institutions: it could be a means of setting up a European long-term investment strategy.

Claude Fischer
Director of ASCPE
Les Entretiens Européens
Honorary President
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