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Policy | brief

The Case for Public Investment in the EU

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It took almost a decade for the European Union (EU), and the euro area in particular, to recover from the Great Recession. Something that has not fully recovered in the EU, nevertheless, is investment. The current debate about the status of the European economy often points to the need to boost investment. The efforts focus, on one side, on creating better conditions for the business sector to engage in more investment, and, on the other side, on changing the composition of public finances for government budgets to devote a larger share to investment. This policy brief argues that the space available for additional investment is less constrained than usually assumed and that boosting investment today is possible.

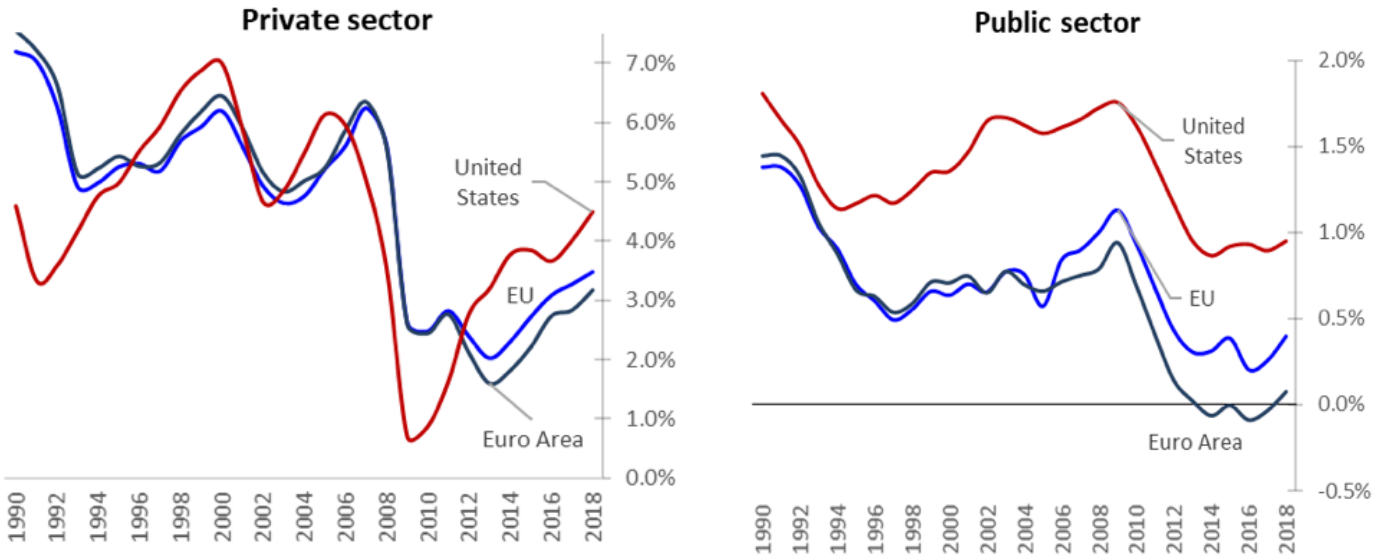
The investment gap

Total investment in the EU has decreased considerably in the past decade, by historical standards. Throughout the period following the Great Recession, both public and private investment contracted. The present situation is characterised by a chronic lack of investment. On one side, the private sector is deleveraging from past excess of debt (McKinsey, 2012; Schularick and Taylor, 2012; Haldane, 2015) and is therefore not willing to play the leading role (Eggertson and Krugman, 2010; Jordá et al. 2013; IMF, 2013); recent surveys (ECB, 2015) show that the main reason for business to refrain from new investments is the expectation of low aggregate demand[1]. On the other side, the public sector, which is expected to contribute to stabilisation in such circumstances, has been constrained by the lasting effects of the sovereign debt crisis.

This worrying trend of low levels of investment is particularly evident when we look at net investment, i.e. net fixed capital formation which takes into account the depreciation of the existing capital stock.

The fall in net investment after the Great Recession was extremely pronounced; if we take the United States as a benchmark we observe a similar trend, with some differences. First of all, when we look more in detail at the difference between sectors, we see that net investment by the private sector started to recover earlier in the US and has almost reached pre-crisis levels; in the EU and in the euro area it started to recover only after the second "dip" of the recession, and has not yet reached the average pre-crisis levels.

Chart 1: Net Investment as a share of GDP in the EU, euro area, and US



Note: Net fixed capital formation, % GDP, 1990-2018.
Source: own elaborations on AMECO data.

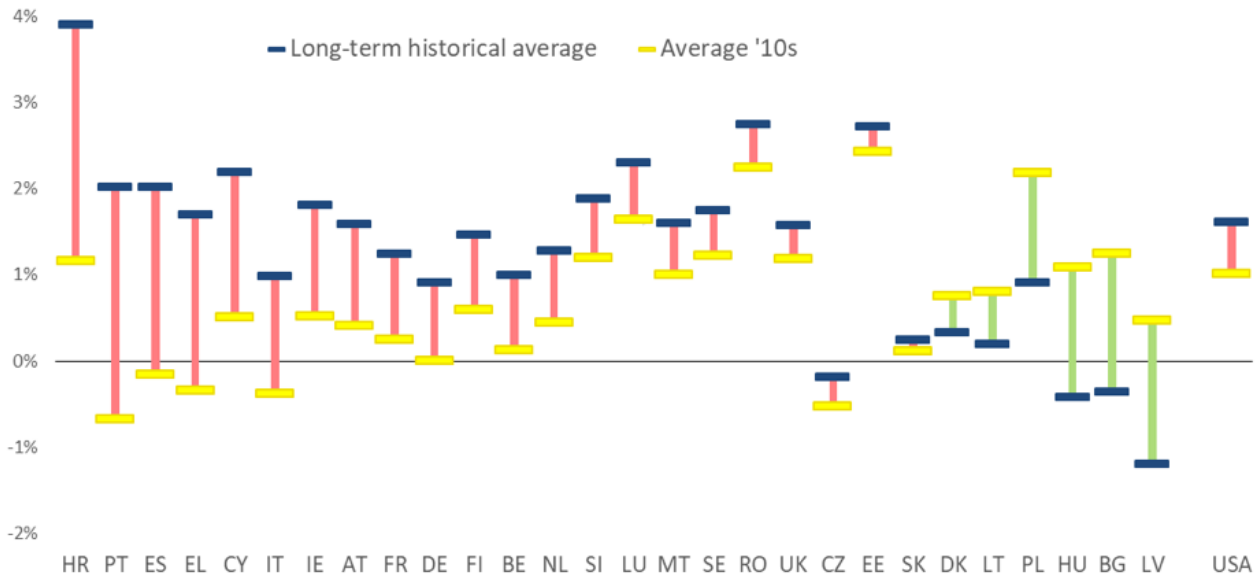
Secondly, net investment by the public sector did not recover in the EU as it did in the US; in particular in the euro area it has stagnated for years, even reaching negative values, in some years, and in some countries for even longer. Negative values mean that in those cases current investment are not even sufficient to maintain the existing capital stock, an unprecedented situation in Europe. Between 2014 and 2017 the missing amount of public investment in the euro area, needed to simply maintain the existing capital stock, was over € 21 billion.

Such low levels of investment, particularly public investment, may have important negative consequences if protracted. On the one hand, they contribute to keeping aggregate demand at subdued levels; on the other hand, they negatively affect growth potential.

In order to assess whether the current level of investment is to be considered too low or not, we can compare it with its historical average. Comparison with past levels may raise the objection that such past levels could not necessarily be optimal, for this reason we use long-term averages spanning over forty years, therefore several economic cycles, for most countries. Data exist for most countries to build time series of this indicator since 1970. Chart 2 provides this detailed information for each country.

First of all, we observe that in most Member States net public investment during this decade is considerably lower than the historical average, with the exception of Latvia, Hungary, Poland and Bulgaria, where it is significantly higher, and Denmark and Lithuania, where it is slightly higher. Then, we also observe that during this decade the level of public investment has been on average negative in Portugal, Spain, Greece, Italy and in the Czech Republic, and null in Germany.

Chart 2: Net Public Investment as a share of GDP in EU Member States since 1970



Note: Net fixed capital formation by the general government, as a % of GDP. The historical average refers to the annual average calculated over the entire period of 40 years from 1970 to 2010 for countries where the full time series is available; it starts in 1971 for Denmark, in 1974 for Ireland, in 1978 for Portugal, in 1989 for Greece, in 1990 for Latvia and Luxembourg, in 1991 for Bulgaria and Poland, in 1993 for Estonia, Lithuania, and Slovakia, in 1995 for the Czech Republic, Cyprus, Hungary, Malta, Romania, and Slovenia, and in 2001 for Croatia. The "'10s" average refers to the annual average between 2011 and 2018, for all countries.

Source: own elaborations on AMECO data.

The chart shows the deferred effects on public investment during this decade of contractionary fiscal policies implemented to face the sovereign debt crisis. There is evidence that public investment was the first "victim" of restrictive fiscal policies across the Union, and as a matter of fact we see the level of net public investment falling to unprecedented low levels in the euro area and in the EU. A negative gap can also be observed in the case of the US, but it is smaller than in 16 EU countries, among which the largest economies; Germany, France, Italy, Spain, the Netherlands, Belgium, Austria, all have larger investment gaps than in the US.

These data suggest that a considerable investment gap has developed in the EU over the past decade. Such gap is particularly pronounced for public investment, although also private investment is still below pre-crisis levels.

The fiscal space

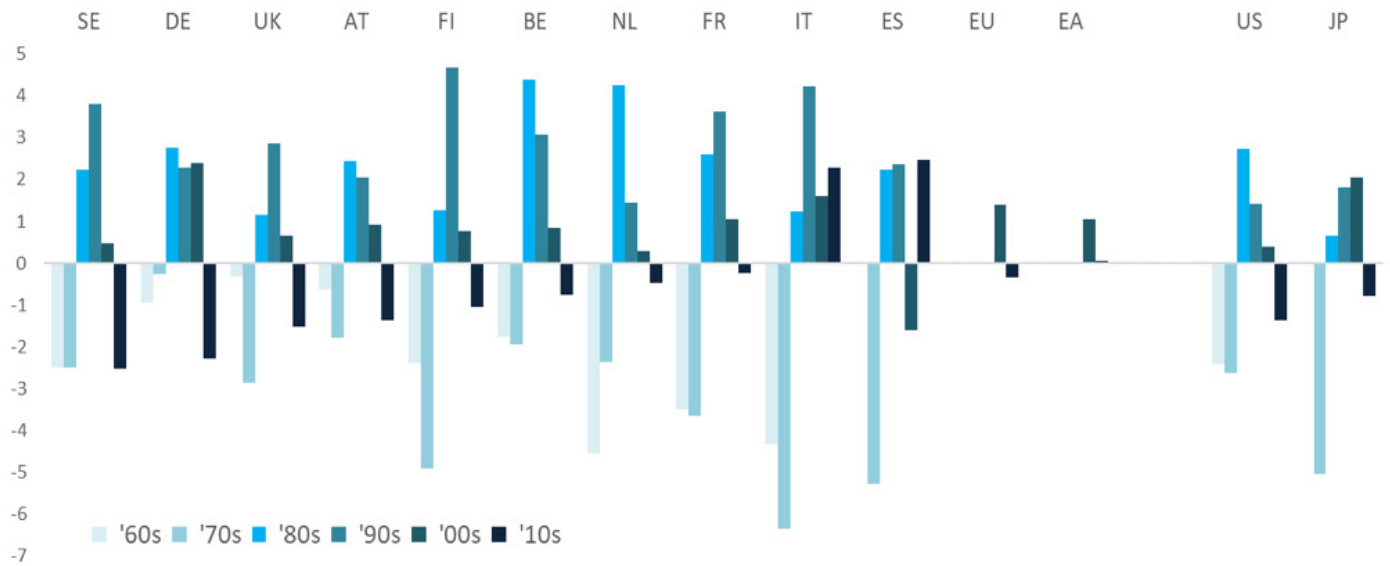
The main constraint to a strong and fast recovery of the level of public investment is often considered to be the scarce availability of fiscal space in the public finances of EU countries. A key indicator to analyse public debt dynamics and to understand the available fiscal space for public finances is the differential between the interest rate paid on additional debt and the expected growth rate. Higher values of interest rates contribute to increasing the debt ratio by expanding the deficit, while higher GDP growth rates reduce the debt-to-GDP ratio by increasing the denominator. Thus the larger the interest rate–growth differential, the faster is the growth of the debt ratio. If this differential is, instead, negative the debt-to-GDP ratio will be on a declining path even without any primary surplus, i.e. the simple roll-over of existing debt would lead to a reduction of the ratio.

The current macroeconomic context points to very low, if not negative, real interest rates. In all advanced economies (EA, US, or Japan), market expectations of the inflation rate for the next 10 years are lower than the target of 2%. This data signals that the present environment of extremely low interest rates may be prolonged; the market expectation of real interest rates over the next 10 years, in fact, is zero (Fatás and Summers, 2016) or even negative (Blanchard, 2019).

The following chart shows the long-run evolution of the observed differential between interest rate-growth over the past six decades, since 1960. It presents the annual average differential per each decade, in the main EU countries, plus the US and Japan as benchmarks.

We see that such differential between interest rate and growth was, on average, negative during the '60s and the '70s and positive during the following three decades, for the main advanced economies. An important change occurred during the past decade, when this differential turned negative for many countries and on average for the EU. This might suggest that the broad macroeconomic context has changed, concerns about public debt sustainability might be less pressing, and fiscal space might on average larger than previously assumed.

Chart 3: Actual interest rate-growth differentials over the past six decades

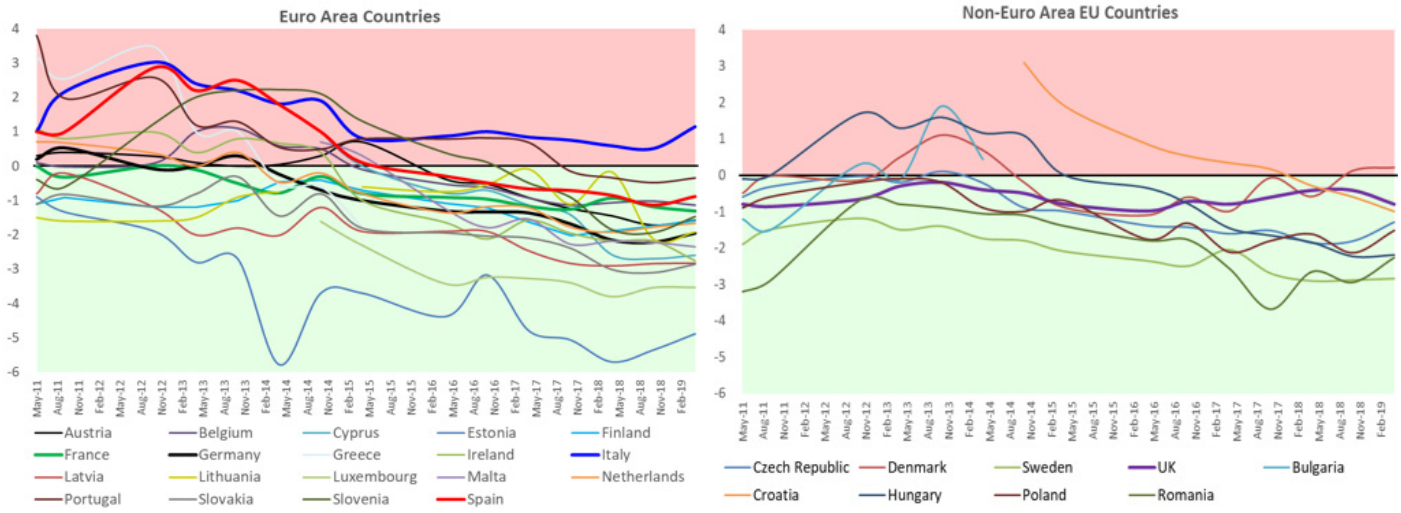


Note: the chart shows the average actual differential per decade in the major EU economies, plus the EU and euro area aggregates and the US and Japan, since 1960.

Source: own elaborations on AMECO data.

For our purposes of understanding the fiscal space available for public investment, however, we should take into account that investment is implemented over a medium- to long-term perspective, so its planning is made on the basis of medium- to long-term expectations of the interest rate-growth differentials, which may differ from what then actually materialises. Therefore, in order to better assess to what extent governments can plan a fiscal stimulus to finance additional investment we should also take into account the ex-ante expected interest rate-growth differential, and not just the one observed ex-post. The International Monetary Fund (IMF) publishes since 2009 its Fiscal Monitor, in which it surveys and analyses public finance developments and projections, with a view to sustainable public finances. Since 2011 it publishes also twice per year the indicator relative to the projected interest rate–growth differential, over the following 5 years, for each country. The following chart assembles all the subsequent vintages of the IMF Fiscal Monitor presenting the projected interest rate–growth differential over the following 5 years. It shows one striking trend, common to all advanced economies: the continuous decline in such differential, which now is negative territory for virtually all EU countries (with two exceptions, for which nevertheless the differential although positive is still very low by historical standard).

Chart 4: Projected 5-year interest rate-growth differentials in EU countries, 2011-2019



Note: the chart shows the projected differential over the following five years, per each point in time. This means, for instance, that the May 2011 values refer to the projected differential from 2011 to 2016, and the values for April 2019 refer to the differential until 2024.

Source: own elaborations on several vintages of the IMF Fiscal Monitor database.

This trend is quite clear; it started in 2012 after the ECB announced its decided intervention to counter the sovereign debt crisis and to play a more active role in supporting the monetary union. The speed of the steady reduction in the interest rate-growth differential is in fact more pronounced in the euro area, but the crucial fact that for almost all countries the differential is now projected to be negative is common to the entire EU. Regardless of whether this scenario is due to subdued aggregate demand – according to the so-called "secular stagnation" hypothesis (Summers, 2015) – or to international transmission of saving-investment disequilibria – according to the so-called "global savings glut" hypothesis (Bernanke, 2005) – it is to be considered as a "new normal" to which macroeconomic policies have to adapt.

The case for public investment

In this context of historically low real interest rates, all data point towards the existence of a larger fiscal space than previously assumed. At the same time, we have documented the unprecedented fall in the level of public investment in the EU. The case for large programmes of public investment seems therefore compelling, for several reasons.

- First, with real interest rates close to zero, or even below that level, any investment which yields minimum returns basically pays for itself (IMF, 2014). All the more so if there is a considerable investment gap and if investment can be directed towards project of common interest, with positive spillovers across the EU.

- Second, there is increasing evidence that, when monetary policy is constrained by the zero lower bound (ZLB) on interest rates, fiscal multipliers are higher than one (Canzoneri et al, 2016; Jordá and Taylor, 2016), this implies that any deficit-financed public investment will also reduce the debt-to-GDP ratio, over the medium term.

- Third, there is evidence that prolonged cyclical events, like demand shortfalls, can have permanent, structural and long-term effects on potential output. In other words, a prolonged period of subdued aggregate demand has not only shot-term implications on the depth of the recession, but also and most importantly it reduces permanently the productive capacity (Banchard and Summers, 1986). It counteracts and neutralises improvements that structural reforms can bring on the supply side.

- Fourth, the consequent observation that costs of public debt are lower than previously assumed (Blanchard, 2019) implies that using fiscal space to reduce levels of public debt may not be more welfare-enhancing than devoting it to additional productive investment, and that instead the net value of a debt-financed investment programme would be higher.

- Fifth, with monetary policy close to the zero lower bound, the usual sharp reduction in interest rates[2] will probably not be available as a policy option for central banks in the event of a next recession, so fiscal policies will have to bear the burden and responsibility to counter it.

The combination of all these facts suggests that there is a strong economic rationale for additional, debt-financed public investment across the EU. The country-specific conditions should be taken into account and the overall fiscal effort in support of public investment could be made in a differentiated way. However, the data show that today twenty countries of the EU, accounting for

more than 81% of the EU's GDP, have at the same time a clear investment gap and an expected negative interest rate-growth differential. In these cases the case for additional debt-financed public investment seems therefore especially compelling.

If projects of common interest for the entire Union can be identified, such as providing European public goods (Lamy and Von Weizsäcker, 2019), the overall return on such investment can be even amplified through positive spillover effects and economies of scale.

Footnotes

[1] The ECB Report on the results of the Survey on the Access to Finance of Enterprises in the euro area says: "Euro area SMEs considered access to finance to be the least important problem that they faced (11% of respondents, unchanged from the previous round), although results differ across countries. Instead, finding customers remains their main concern (25% of respondents, down from 26% in the previous round)."

[2] Data suggest that to counter a recession central banks usually cut interest rates by 400 to 500 basis points.

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