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Juncker's Investment Package: essential background reading

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Squaring the circle – A European Investment Guarantee Scheme (EIGS)

Fabian Zuleeg

This week's EU summit is, once again, returning to the question of how best to balance the need for fiscal consolidation with growth and employment. This is a welcome and necessary focus: Europe is facing a severe economic and social crisis, with unacceptable levels of (youth) unemployment. But how can this circle between the need to save and the need to invest be squared?

Public finances are tight across the EU and there is little appetite for (additional) transfers from the better-performing countries to those in need. Long overdue structural reforms in the crisis countries – if they go beyond simply cutting expenditure or raising taxes – will ultimately help to deliver growth, but this will take years. Some of the measures in the Compact for Growth and Jobs and in the Multi-Annual Financial Framework agreement – when fully operational – will help, but their effects are likely to be rather limited in scale as well as time-delayed.

Progress on expanding the EU's internal and external markets is positive, but will not particularly help countries most in trouble. The devaluation of wages in the EU's periphery is having some effect, boosting exports and limiting imports, but this is only starting to close some of the huge gaps between crisis and better-performing member states. And the positive effect of internal devaluation is somewhat limited as it also depresses domestic consumption, which is already being hit by cuts in public expenditure.

So, with consumption and government spending depressed and the impact of external trade limited, what remains? The way out of the crisis will, at the end of the day, require higher levels of investment, both domestic and from abroad. Investment would not only have a positive overall long-term effect – boosting a country's productive capacity – it would also create employment in the short term, for example in the construction sector in the case of physical infrastructure investments.

But with public investment severely cut back in the crisis, can private investment fill the gap to boost lagging economies? There is certainly scope to increase private-sector investment in public infrastructure through the development of EU project bonds, the Connecting Europe Facility and the further development of Public Private Partnerships. But this is not enough and there are limits to the capacity of a country in crisis to use such instruments.

Nevertheless, there are still significant funds available which are seeking attractive investment opportunities. Companies in northern Europe with access to cheap capital and often significant cash assets, wealthy private investors, some emerging economies, and big institutional investors such as pension funds are looking for interesting opportunities, but high levels of uncertainty prevent them from investing their money in Europe's periphery.

Risks and a lack of confidence undermine readiness to invest in the countries hit worst by the crisis. The majority of investors are not convinced that the crisis countries will be able to generate the economic growth necessary to provide a solid return on their investment. In addition, there are numerous risks associated with investing in countries in Europe's periphery, including political risks (possible changes in policy direction, for example concerning taxation), the risk of social unrest (including strikes) and financial risks (like the potential inability of public and private customers to pay their bills). There is also the more fundamental fear of a country dropping out of the euro, which would risk destroying the overall value of any investment. While this uncertainty has been somewhat reduced since last summer, any residual long-term ambiguity – easily reignited by political events, as seen in Italy – reduces readiness to invest.

So what can be done to address these barriers? The EU should create a **European Investment Guarantee Scheme (EIGS)** to provide a form of insurance for excessive risks incurred when investing in crisis countries. To be credible, such a scheme would require some financial underpinnings, but it would only pay out should the downside risks

materialise. The EIGS would create investment opportunities and help to boost sustainable growth and employment in Europe's periphery, addressing the direct consequences of the crisis. It would resemble a tried and tested method of supporting trade and investment: countries such as Germany use similar instruments to provide export credit guarantees for companies dealing with developing economies.

A number of strong arguments speak in favour of establishing a European Investment Guarantee Scheme:

- It would demonstrate confidence in the long-term future of the crisis economies;
- it would be fairly cheap unless the worst-case scenario is realised;
- any potential pay-out would benefit companies in the countries shouldering most of the financial 'burden' underpinning the scheme, making it politically easier to accept;
- it could help to save viable companies in the crisis countries which might otherwise go bust, despite the positive effects of internal devaluation and structural reforms, for example in the labour market;
- it would provide a safe investment route for institutional investors, freeing up the available capital and increasing returns on savings in the economically stronger countries;
- investment by pension funds in countries affected by the crisis would help to address the challenges arising from ageing by directing the savings from the 'baby boomer' generation into helping Europe grow, ensuring that younger people can get jobs;
- it could help reduce capital flight from crisis countries, and;
- it would not provide an incentive for governments in the crisis countries to overspend ('moral hazard') as no direct support would go to national executives.

Investment in crisis countries would help to realise a key (potential) benefit of a common currency zone – the efficient allocation of resources. Private investment into productive capacity, aiming at long-term and profitable returns – rather than using taxpayers' money to finance sovereign debt and rescue banks – would be a win-win situation for both the crisis and better-performing countries.

The key question for governments (and parliaments) is whether they are willing to 'put their money where their mouth is': how strongly do they believe in the future of the euro zone? If they do, the EIGS would be an effective, cheap and innovative way of providing some much-needed support, which is crucial to make any crisis response economically and politically viable in the long term.

Of course, the EU summit cannot decide to start the EIGS tomorrow. The details of such a scheme would have to be carefully investigated and developed, together with private-sector insurers and investors. But the European Council could, for example, decide to establish a Task Force to work out the details of such a scheme, how it could best be financed and administered, and what excessive risk should be covered. The EIGS Task Force could report in time to allow implementation as early as 2014, potentially backed by EIB (European Investment Bank) assets and/or financing from the (yet to be established) new fiscal capacity ('solidarity mechanism').

The EIGS would help to cure Europe's economy and fight (youth) unemployment from which all countries – in the euro zone and beyond – would benefit. A decision by EU leaders to move the idea forward would send a strong signal of trust in the future of Europe's economy and common currency.

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Disclaimer: The views expressed in this Commentary are the sole responsibility of the author.

The bank credit crisis and its impact on growth

Fabian Zuleeg

The financial sector, and in particular the banks, has been at the heart of the economic crisis ever since Lehman Brothers went bankrupt five years ago. The global financial crisis was, at least in part, to blame on banks taking unsustainable risk, driven by a race for higher and higher returns with greed epitomised for many by the size of bankers' bonuses. The subsequent bail-outs and recapitalisations of banks in many countries – necessary to preserve global financial stability – added insult to injury, especially when banks, despite public bail-outs, seemed to return to some of the behaviours witnessed before the crisis.

At the European level, the result has been a flurry of activity: from legislation to curb bankers' bonuses and stipulate capital requirements to attempts to introduce a Financial Transaction Tax by a group of eleven willing EU countries, including France and Germany, showing the momentum, as well as the difficulties, in trying to regulate the financial sector more tightly. At the heart of these actions is the desire to prevent unnecessary and non-transparent risk-taking and ensuring that private debt does not become public debt again.

The largest and most prominent action at EU level is the Banking Union. A full Banking Union – comprising three key elements: common supervision of banks, a bank restructuring and resolution mechanism and a common deposit guarantee scheme – would help to achieve the abovementioned goals.

However, many question marks still remain, driven by uncertainty over the political will behind creating such an ambitious European approach. While the first element (a common supervisor, in the form of the ECB) is likely to be in place in 2014, an agreement on the coverage of the common resolution mechanism is still outstanding and will likely exclude a number of smaller (but potentially risky) banks. As for the common deposit guarantee scheme, this looks likely to be permanently off the table.

But even when the (incomplete) Banking Union is in place and working effectively (which will take some time yet), it is unlikely to have an impact on a serious current crisis faced by businesses, especially in the crisis countries: the availability and cost of investment capital, which is crucial in Europe, as much private investment activity in SMEs is financed through bank loans (as opposed to raising capital by issuing equity, i.e. shares).

Paradoxically, the requirements of banks to lend more prudently and to have a sound asset base (as part of the so-called Basel requirements) also make banks more reluctant to provide this kind of capital to SMEs. But at the heart of this reluctance to lend is the risk profile of the crisis countries. The political and economic situation in the crisis countries adds risks to any lending activity, which is counterbalanced by higher interest payments, making investments more costly in the crisis countries.

So, despite record low interest rates and money being pumped into the banking sector to encourage lending, the banks are not providing the capital needed. Such a shortfall in investment capital will erode the competitiveness and productive capacity of firms, leading to preventable bankruptcies and, over time, reducing growth and thus eroding these countries' recovery and long-term economic health.

What can be done?

The (full) Banking Union, if successfully implemented, is a step in the right direction but it will not produce the results in the short term which are needed to help the economic recovery of the crisis countries. Europe needs to do more. There is a need to remove barriers to cross-border investment, for example in terms of rules governing

pension fund investments. Building on the, so far limited, activities of the European Investment Bank, we should have an ambitious provision of low-interest public capital where clear market failures can be identified.

But to make a big difference, we have to address the heart of the matter: the additional political and economic risk. While a real long-term solution of the Euro crisis remains a key building block, in the short term, a European Investment Guarantee Scheme¹ could provide the insurance needed to invest and would be beneficial for the entire Eurozone. Such a scheme would provide a form of public insurance (potentially backed by EIB assets) to cover excessive risks for private investors or lenders when investing or providing finance in the crisis countries.

But, to address this fundamental problem at the heart of the Euro crisis, political will is needed. Politicians need to not only focus on the Banking Union but also on ways of addressing excessive risk in the crisis countries to boost investment and to get credit flowing again to viable firms.

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This Commentary is based on an [article](#) published in Polish on the Civic Institute's website on 26 September 2013.

¹ For further details, please see http://www.epc.eu/pub_details.php?cat_id=4&pub_id=3400

A New Deal for growth and jobs in the Eurozone revisited

Fabian Zuleeg

At the EPC breakfast on 28 January, IMF Managing Director Christine Lagarde will launch a book on *Jobs and Growth: Supporting the European Recovery*², containing detailed policy analysis and recommendations. The book is a further sign that there is now wide-spread recognition that it is high time for Europe to take more action to deliver jobs and growth.

The need to focus on growth and jobs

With the immediate 'euro crisis' subdued by the substantially reduced danger of a country exiting the euro area, the actions of the European Central Bank (ECB) and a range of policy actions, including progress on the Banking Union, the EU and its members need to think more about the real economy. While there are undoubtedly flaws in the European Monetary Union's (EMU) new governance structure and further steps are still needed (with complacency a real danger), the risk/threat of immediate and catastrophic collapse is off the table. This creates the much needed space to deal with Europe's dual growth crisis: low aggregate growth and a divergent economic performance of some countries, which are falling further and further behind.

The need to focus on the real economy is a political and economic imperative if the EU wants to avoid getting trapped in a low growth/high debt scenario with deflationary tendencies, which would also imply, at best, a stagnating labour market. Not only would this be a loss of economic potential and a human tragedy for those trapped in unemployment but it would also favour political forces that will undermine European integration – as will be demonstrated by the populist anti-EU/euro vote for the European Parliament.

The current crisis recipe

What can be done? So far, there has been a strong emphasis on fiscal consolidation and structural reform, with an asymmetric adjustment mostly carried out by the countries in crisis. This is not to say that there has been no support: the European Financial Stability Facility / European Stability Mechanism, the IMF and indirectly the ECB have provided plenty of support. However, the focus has been ensuring that countries can continue to meet their debt obligations and to ensure the stability of the financial system, rather than boosting economic growth. Of course, many have rightly argued that a stable macro-economic and fiscal environment with deficits under control creates conditions for growth and that reform of the financial sector is an essential step towards restoring bank lending which is crucial for investment. But while these actions are clearly necessary, they are not sufficient to restore growth.

Ideally, structural reform should boost growth in the longer term. By removing product and labour market imperfections there will be a greater incentive to invest and employ. However, this does not necessarily happen: many structural reforms are, in reality, merely public spending cuts without a long term growth-enhancing effect. But even if these reforms are effective in raising the level of growth, they usually take a long time to work, especially with respect to employment. And if there is an absence of labour demand in the economy or a lack of available and affordable credit for private investment, even painful reforms might not bring the desired effect.

What remains? Monetary policy is another key factor, with the ECB continuing its low interest rates, as well as signalling that monetary policy will remain loose for some time to come. While the ECB is considering a more active stance, such as buying up packages of bank loans, it is difficult to imagine much more being done, given the institutional limitations

² www.imf.org/external/np/seminars/eng/2014/EURbook/index.htm

of the ECB and the current political debate, especially in Germany. Tolerating higher inflation and European-style quantitative easing are likely to be a political step too far.

Improving export performance could help, and to some extent is already happening, with countries in crisis improving their external economic balance, albeit in some cases through import compression rather than better export performance. But becoming more balanced alone will not provide a positive growth impulse, especially if there is no adjustment towards a greater focus on domestic demand in the strong export-surplus countries, which is unlikely given their strong political resistance.

EU actions: effective and sufficient?

In the long term EU actions can help. But, even if effectively implemented, most growth-enhancing actions often mentioned at EU level, be it trade deals, such as the Transatlantic Trade and Investment Partnership (TTIP) with the US, regional funds, industrial policy, further development of the Single Market or the digital agenda, will take time to implement and even longer to impact on growth. In addition, they are also likely to benefit mostly the strongest economies, which have the economic structures to maximise returns from more open and developed markets and can also access support more effectively.

The 2013 Compact for Growth and Jobs is supporting the recovery through, for example, the expansion of lending activities for the European Investment Bank (EIB) but the reality is that implementation is too slow and there is little in terms of new growth impulses. There is no convincing answer to the problem of high unemployment, particularly youth unemployment, risking the credibility and long-term stability of EMU. The Youth Guarantee has too little funding underpinning it and there are serious doubts about its practical implementation, especially in countries in crisis. In the end, only a recovery in growth can boost employment levels.

A New Deal for the Euro

It is time to revisit the idea of an EU-wide plan to boost growth: as the EPC has termed it, a New Deal for the Euro³. This could include a dedicated investment fund – a new Stability and Growth Fund (SGF) of around 0.5% of EU GDP, aiming specifically to deliver investment for growth in countries unable to make the necessary investments themselves. Funds from the SGF would not be a bail-out but long-term investment – not a transfer union, but an ‘investment union’. Such an ambitious public investment programme should go beyond current plans for frontloading European Structural and Investment Funds, project bonds and the Connecting Europe Facility. More public investments financed by euro-infrastructure bonds and new financial instruments should be complemented by boosting private investment, including through a European Investment Guarantee Scheme (EIGS)⁴ to provide a form of insurance for excessive risks incurred when investing in crisis countries. The EIGS would create investment opportunities and help to boost sustainable growth and employment in Europe’s periphery, addressing the direct consequences of the crisis.

Of course such a New Deal would not come for free and additional money would need to be found. This will not be easy, especially since it will be difficult to reallocate any part of the EU budget now that the overall framework has been agreed. But the ongoing discussions around the fiscal capacity for the Eurozone could be an opening, if the willingness exists to see this funding as a means of investment rather than an instrument to incentivise structural reform.

A new confident beginning

Such a New Deal based on investment would help all of Europe. While targeted especially at crisis countries, it would also create opportunities for companies across the EU and attract global and European investments from pension

³ Janis A. Emmanouilidis and Fabian Zuleeg, ‘A New Deal to help save the euro’, 10 May 2011; www.epc.eu/prog_details.php?cat_id=4&pub_id=1277&prog_id=2

⁴ Fabian Zuleeg, ‘Squaring the circle - A European Investment Guarantee Scheme (EIGS)’, 14 March 2013, www.epc.eu/pub_details.php?pub_id=3400&cat_id=4

funds, helping them to reallocate their investments more profitably, from companies which have amassed significant unused funds, and from globally mobile capital, which is looking for safe returns.

Most importantly, such a plan could create confidence in the EU's longer-term future, triggering investment and consumption and thus truly setting Europe on a path of sustainable recovery. An ambitious New Deal could be Europe's 'Befreiungsschlag' – a decisive move to create a new economic trajectory. However, to do this, a New Deal must go beyond small-scale action and repackaging of existing initiatives. Despite the positive long-term impacts structural reforms and policy initiatives may have, without such decisive short term action Europe's recovery might never get off the ground, with economic, social and political consequences which would undermine the European integration project and peace and prosperity in Europe for years to come.

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DISCUSSION PAPER

Policy recommendations for the new European Commission: priorities for stabilising EMU

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Executive Summary

The euro area crisis exposed substantial structural flaws in the currency area's architecture. Improvements in the euro zone's economic governance, the introduction of a (limited) banking union, the European Central Bank's (ECB) unconventional support, and consequently, the substantially reduced fear of a country exiting the common currency have all contributed to overcoming the immediate risk of the euro area's collapse. But a number of fundamental issues still need to be addressed.

In the short term, an appropriate balance within the new governance system between sustainable public finance consolidation and Member States' public/social investment needs has to be found, but such flexibility should not lead to a repatriation of fiscal powers to the national level. The new European Commission should develop a new framework to assess the real returns to growth of public and social investment, which could open the path for more flexibility on deficits in future.

In close coordination with the European Parliament (EP), the Commission should also review the way the Country Specific Recommendations (CSRs) are drawn up. The CSRs specifically need a stronger focus on a smaller number of key priorities for each country, clearly focused on growth and going beyond mere expenditure cuts. There is also a need to foster political commitment by all of the Eurogroup to adhere to the new governance and to politically support it in public.

The absence of mechanisms to provide effective ex ante fiscal risk sharing in the euro zone needs to be addressed. This could be done through the establishment of a fiscal capacity. Euro area governments and EU institutions (including the EP) should intensify their efforts to set out the conditions, roadmap and outline features of such a fiscal capacity in the very near future. The Commission should make the construction of a fiscal capacity a priority in the new political cycle.

In addition to institutional/governance issues, the attention now needs to be directed even more strongly towards encouraging growth and thus, ultimately, jobs. To boost growth, there is a need to encourage private, public and social investment, at EU and at Member State level. The crucial step needed now is an ambitious European Investment Programme (EIP). The Commission should expedite the creation of such a Programme and ensure that the implementation of an EIP is compatible with the long term goals of a fiscal capacity, and that the possibility for a consolidation of the two measures in the future is given.

In the medium term, these actions are necessary but not sufficient. There continues to be a need to systemically address the flaws and gaps in the current governance framework, including the questionable effectiveness of EU policy in influencing national policies, the need to further deepen the banking union, a need to strengthen the social dimension of Economic and Monetary Union (EMU) and the creation of a fully-fledged fiscal union, including addressing the incomplete political legitimacy and accountability framework, and creating a better framework for the limited mutualisation of some public debt.

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