HSBC Global Research

EU investment shortfall

Facts and myths about the "*Juncker Plan*"

ECONOMICS
EUROPEAN UNION

- Investment in the EU has lagged the overall recovery and remains some 9% below its pre-crisis peak in real terms
- The *Juncker Plan*, so far has approved almost EUR140bn of investment and proposes EUR630bn by the end of 2022
- But not much of that is additional spend to what would have been invested – more public investment is needed

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Since its inception in mid-2015, there has been much talk of the positive investment implications of the *Juncker Plan* – named after the President of the European Commission (EC) Jean Claude Juncker who initially proposed it.

The plan aims to release EUR315bn in investment over a three-year period, by the end of 2017. It is based on an ambitious leverage mechanism. There is an initial EUR21bn "seed" (capital + guarantees), diverted from EU budget, European Investment Bank (EIB), used as a "first loss" absorption capacity. The EIB leverages this up 3 times to borrow EUR63bn from the market, and private investors provide the rest. The EC recently proposed extending the plan to 2022, with an overall investment target of EUR630bn.

Up to September, the fund approved EUR140bn in investments (1% of EU GDP), 60% of which financed by the private sector. The main beneficiaries have been Italy, Spain, and the UK, with EUR20bn each. The main sectors benefiting are energy, R&D, and SMEs.

In this note, we go beyond these headline figures, trying to assess the real impact of the fund in terms of additional investment. We answer three key questions:

- **How much has been spent so far?** On average, firms have to pay back the loan over 10-15 years, so we assume it could take them 3-5 years to actually undertake the investment. This suggests investment spending of about 0.6% of GDP per year;
- **How much of the investment is additional to what might have happened anyway?** The key idea is to get the EIB to fund riskier projects than normal. But the limited available evidence suggests this has not been the case;
- **What is the real economy impact?** Investment gap to GDP has narrowed recently, but the pick-up in investment started before the *Juncker Plan*, possibly thanks to other factors (eg. recovery, QE). Also, there is no clear relationship between the countries that received more funds, and investment growth.

In conclusion, the fund might have helped in terms of encouraging the private sector to undertake slightly riskier projects, or channelling investments from countries like China to the EU. However, the need to attract private investors makes it less suited to address the investment shortage in areas such as education and large infrastructure projects, which have been a drag on potential growth. For these, a pan-European public investment plan would still be preferable, in our view.

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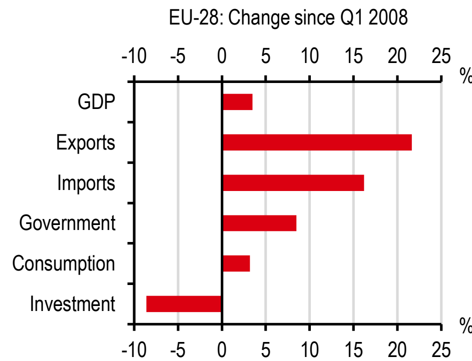
An investment-less recovery

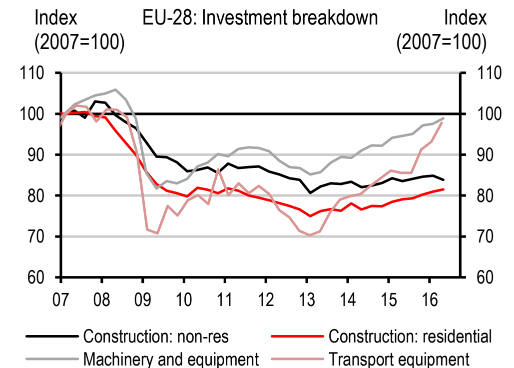
The level of EU GDP (in real terms) is now about 4% above its pre-crisis peak, but investment is still about 9% below its 2008 Q1 level (Chart 1). This is true across all the components of investment, even if it is more evident in the construction sector, which has been affected negatively by the bursting of the construction bubble in countries like Spain, or Ireland (Chart 2). Interestingly, though, non-residential construction is down some 20% in real terms, with a fall in public investment during the recent austerity phase playing an important factor.

1. Investment is still down 9% in real terms since the pre-crisis peak in GDP…



Source: Eurostat

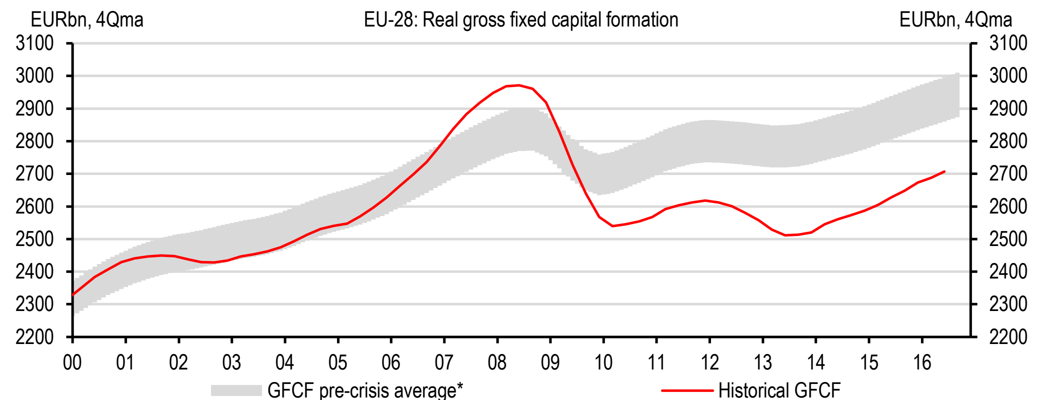
2. …and it's not just because of the bursting of the construction bubble



Source: Eurostat

The recent recovery has been less investment-intense than previous ones. Compared to the historical investment-GDP relationship, GDP growth has outpaced investment opening an 'investment gap' of about EUR200-300bn (1.5-2% of GDP) (Chart 3). Narrowing this gap was the main purpose of the Investment Plan for Europe, which was announced by the European Commission (EC) President Jean-Claude Juncker (hence the nickname *Juncker Plan*) in November 2014. After some initial delays, the fund has effectively been active since mid-2015.

3. There is still an investment gap in GDP, even if it has narrowed slightly recently



Source: European Commission, Eurostat, HSBC *Assumes investment/GDP ratio of 21-22% of GDP

What has the Juncker Plan achieved so far?

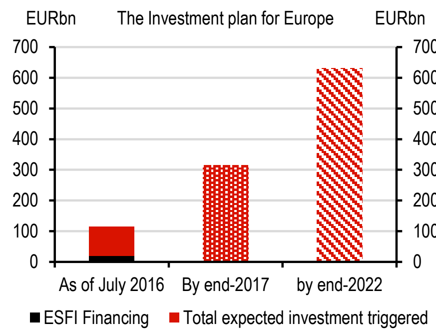
The *Juncker Plan*, initially aimed to mobilise "at least" EUR315bn (2% of EU GDP) in public and private investment by December 2017. Recently the EC has proposed to scale up the fund beyond the initial 3-year period, targeting a total amount of EUR630bn by the end of 2022. The plan is based on a complex leverage system, explained in detail in the ANNEX at the end of the note. In a

nutshell, a "seed" of capital and guarantees, diverted from the EU budget and the EIB, is leveraged up twice: first by the ECB, which borrows money from the market to finance the projects, and second, acting as "first loss" provision, to attract private sector investors to put the additional money. The fund is managed by the European Fund for Strategic Investments (EFSI).

By July 2016, the EFSI had approved 97 infrastructure projects and 192 SME financing agreements, totalling EUR13.6bn and EUR6.8bn respectively. According to EFSI estimates, this will generate EUR115.7bn in additional investment through the leverage effect (Chart 4). By September, the EFSI had reached 324 projects, triggering EUR138.3bn in investment.

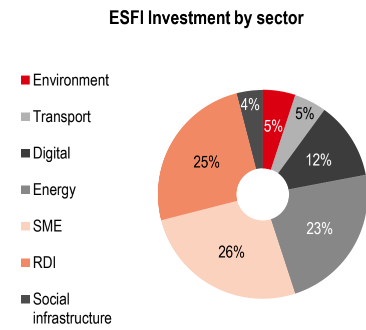
The main target areas are energy and innovation projects (R&D) and SME financing (Chart 5). So far over 60% of the total investment potentially mobilised has come from the private sector. Other players can contribute to the fund, for example domestic promotional banks in Italy, France and Germany have contributed an additional EUR8bn each. China has also expressed its interest to contribute up to EUR10bn through its Silk Road Fund (Euractiv, 18 April).

4. The *Juncker Plan* has an ambitious target of EUR630bn of investments…



Source: EFSI, European Commission

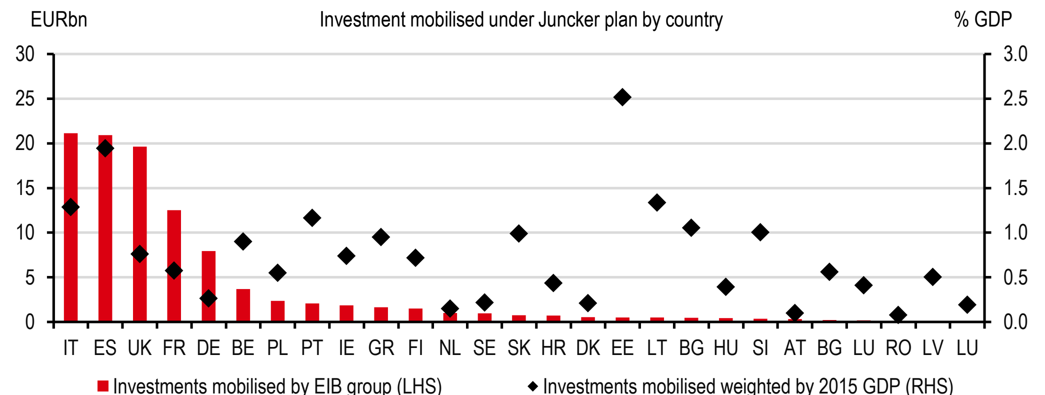
5. …focussing mainly on areas such as SMEs, R&D, and Energy



Source: EFSI

Across countries, the main beneficiaries have been Italy, Spain, and the UK, with total investment triggered in the region of EUR20bn. France follows, with EUR12bn of total investment, whilst Germany is lagging behind, with only about EUR8bn (Chart 6). The potential investment triggered in the UK amounts to c10% of the total annual business investment.

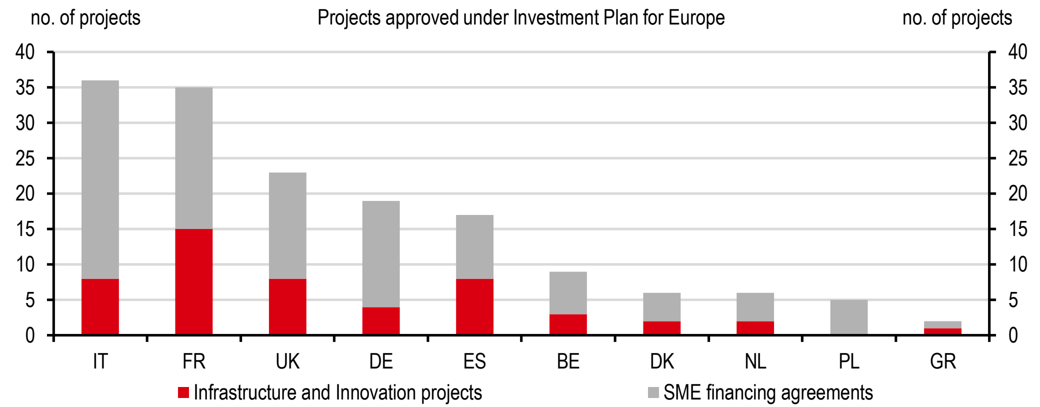
6. Italy, Spain and the UK should see the highest level of investment from the EFSI…



Source: EFSI, HSBC

In terms of number of projects, Italy and France are topping the list, suggesting that France has been focussing more on small-scale projects, whilst Spain on larger-scale ones (Chart 7).

7. …though Italy and France are top of the list in terms of number of projects approved



Source: EFSI, HSBC

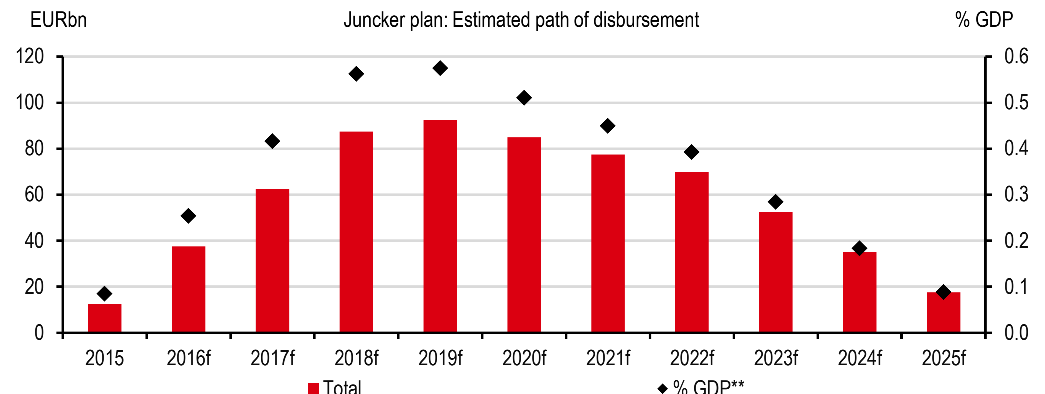
What is the impact on the economy?

There are at least three questions that need to be addressed to understand the real impact of the plan from an economic perspective. The first is how much money has actually been spent. The second is how much of the investment triggered is *additional* compared to what would/might have happened anyway. The third is whether the plan is addressing the needs of the economy. Let's take each question in turn.

1. How much money has been spent?

Clearly, approving a project does not mean that the money has actually been spent. Working out exactly how much cash has been deployed is difficult. EC data can give us a vague indication. According to the EC, the average loan maturity for EFSI projects is approximately 10-15 years for EIB loans, whilst the average repayment period for the EU budget funds is 3-5 years (equity) and 2-3 years (guarantee). So projects financed by the fund should start paying dividends within 10 years (given that, by then, firms should be in a position to start paying back the loan). To estimate how much cash will actually be spent each year under the plan, we therefore assume a spending profile. We think it is reasonable to assume that for a typical *Junker Plan* project, the initial funding is spread over four years. This suggests the actual flow of cash from the fund could peak in 2019 at about EUR90bn, 0.6% of EU GDP (Chart 8).

8. The actual cash out of the door will have a different profile than the amounts approved



Source: HSBC calculations based on EFSI (as of November 2016). **Uses European Commission forecasts of real EU GDP and assumes growth rate forecast between 2017-2018 remains constant between the remaining periods

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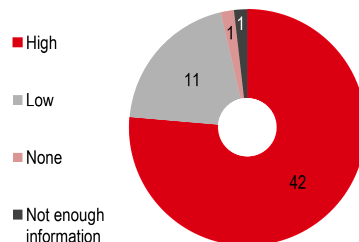
2. The "*additionality*" question

The main idea behind the plan is that the provision of the initial guarantee should allow the EIB to finance projects with a higher risk profile than those that would be able to finance under their normal lending framework. However, a May study by the Brussel-based think tank Bruegel looked at the 55 projects approved by the EFSI, concluding that there was "*only one project for which we could not find any similar EIB projects, even roughly similar: the ECOTITANIUM project, which involves the construction of the first European industrial plant to recycle and re-melt aviation-grade scrap titanium metal*" (Chart 9 and 10). Although this study is based only on a small subset of the total approved projects, those for which they had sufficient information, it suggests limited additional impact of the EFSI compared to traditional EIB lending, and possibly even some crowding out of projects that would have normally been funded by the EIB.

> **Out of the 55 projects approved so far for which we have details, there is only one project for which we could not find any similar EIB projects, even roughly similar**
>
> **Bruegel, *Assessing the Juncker Plan after one year*, 17 May 2016**

9. Only one of the projects approved is different from previous EIB's projects…

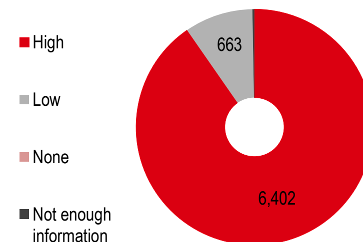
Similarity between ESFI projects and past EIB projects by number of projects (May 2016)



Source: Bruegel, HSBC

10. …and looking in terms of values the difference is even more striking

Similarity between ESFI projects and past EIB projects by ESFI financing, EURmn (May 2016)



Source: Bruegel, HSBC

3. The impact on the economy

To the best of our knowledge there hasn't been any study of the impact of the plan in terms of investment and growth in the EU. The EFSI suggested recently that one useful comparison is the recent increase in EIB capital (EUR10bn between 2013 and 2015) which allowed the EIB to provide a total of EUR372bn in financing. The EIB estimated a positive impact by 2017 of 0.8% of GDP, and an additional 1.1% of GDP by 2030 (so around 2% of GDP in total).

However, of the initial "seed" (capital + guarantees) of the EFSI, funds from the EU budget had already been allocated to transport and R&D, and the EUR5bn from the EIB was also not new paid-in capital. So there was very little - if any - fresh capital behind the *Juncker Plan*. The fund simply enabled the EIB to embark on riskier projects. Moving down the risk spectrum is likely to have a more muted impact on investment than the spending of genuinely additional funds.

Also, after the weakness in 2012-13, and again in the second half of 2014, investment has picked-up across the EU, and is now showing a higher elasticity with respect to GDP growth, (Chart 11). But investment had already started to pick-up in H1 2015, before the *Juncker Plan* had started approving projects, suggesting there might have been other factors at play -- most notably the economic recovery kicking-in also thanks to the boost from lower oil prices, and the QE announcement by the ECB in January 2015 -- that might have led to the investment revival.

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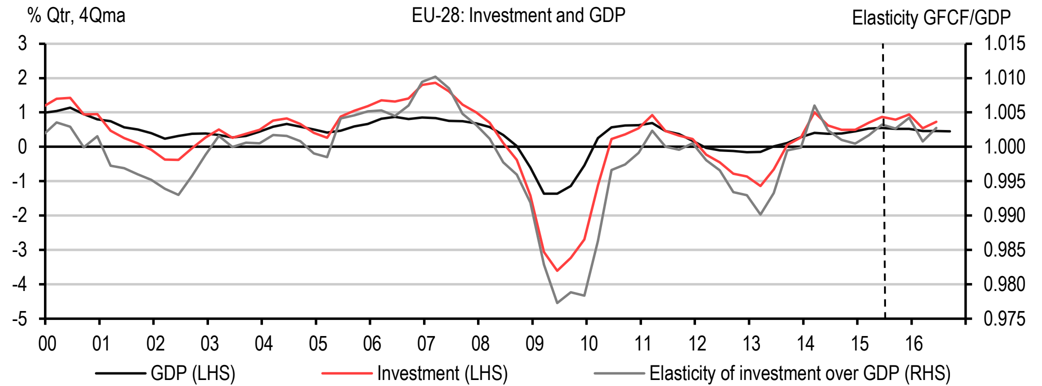
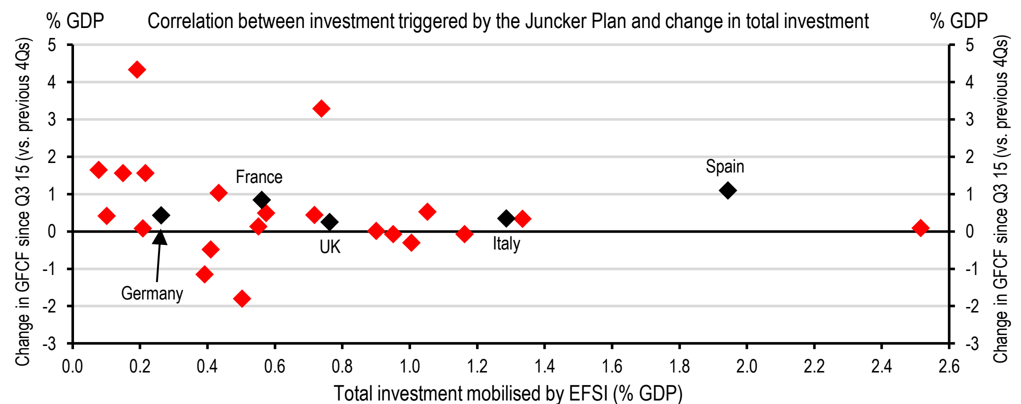
11. Investment has picked-up relative to GDP, but it might not be just thanks to the EFSI



Source: HSBC calculations based on Eurostat

Chart 12 also shows that there is no correlation across EU countries between the investment mobilised under the *Juncker Plan*, and the change in investment between the four quarters immediately before the implementation of the plan, and the four quarters after. This suggests that so far the role of the plan in terms of boosting investment has been limited. Of course, this hypothesis would have to be tested again in the coming months, once the money actually starts to flow in a more sizeable manner, and the impact of the fund might start to be more tangible. It is also possible that the countries that have benefitted more from the funds, might have seen even lower investment growth over the past year had it not been for the Juncker Plan.

12. There is very little correlation between Juncker Plan and increases in investments



Source: HSBC calculations based on EIB, Eurostat

In our latest European quarterly (*Political deadlock, economic gridlock*) we noted the increasing evidence of skills mismatches in the labour market, and yet most countries have been cutting back on education spending since the crisis. Training is also still a very small component of the unemployment benefits system. This increases the risk of lasting damage from recessions – the so-called 'hysteresis' effects - which is when a lack of demand eventually leads to permanent damage to supply as resources lie idle for too long. However, the *Juncker Plan* does not seem to be well geared to target the investment shortfall in areas such as education due to the need to attract private investors, and therefore generate returns within a reasonable timeframe.

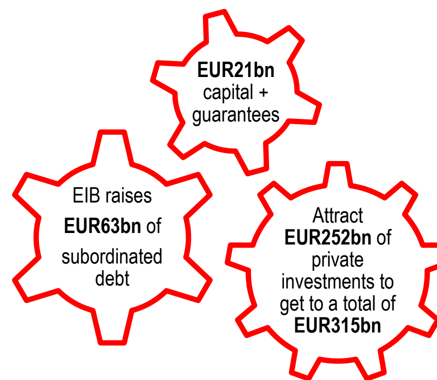
For similar reasons, the fund might not necessarily be well suited to finance large infrastructure projects, which might have limited direct returns. This, however, is increasingly critical to raise potential supply in the medium to long term, and not just in the countries of the eurozone periphery, but also in Germany (*Germany fiscal policy: why so tight*, 12 October 2016).

ANNEX: How does the Juncker plan work?

The Investment Plan for Europe initially aimed to mobilise "at least" EUR315bn (2% of EU GDP) in public and private investment over three years (Jan '15 - Dec '17)[1]. It entails three steps:

- **Step 1**. The EC and European Investment Bank (EIB) have established a new European Fund for Strategic Investments (ESFI), set up within the EIB. The two institutions have then put an initial "seed" of EUR21bn, effectively reallocating existing money – EUR21bn (EUR5bn from the EIB EUR16bn from the EU budget) – into the new fund. Moreover, only EUR8bn is 'real cash-on-hand' from the EU budget, the rest are guarantees.
- **Step 2**. The seed money of EUR21 billion is not directly invested in projects. Instead, the EIB will use this as a buffer to borrow cEUR63 billion from the market through issuing bonds. The EU guarantee allows the EIB to finance projects where the risk for the EIB (defined as "expected losses") is higher than in their normal activities. Therefore, as stated by the EIB, "for every one initial euro of protection by the Fund, EUR3 of financing could be provided to a certain project in the form of subordinated debt".
- **Step 3**. This debt would then act as a 'first loss buffer' for private investors. As a result, private investors are expected to find favour with the senior tranches of that same project. According to the EC's and the EIB's estimates, each euro of subordinated debt tends to generate EUR5 in total investment on average. In sum, the EC hopes that for each euro of protection by the fund, there is a consequent increase of EUR15 of real private investment in the economy. This means a total leverage of from the initial "seed" of 15 times.

13. An ambitious leverage effect



Source: European Commission, HSBC

The process of approving a project is as follows. First, the project promoters present the project directly to the EFSI, which makes an assessment and can decide to approve it, or reject it. If approved, money is disbursed by the EFSI, and there is a monitoring and reporting process until the full amount is paid back by the project promoter.

In terms of the areas, of the total EUR315bn, EUR240bn was expected to go towards long-term strategic investments – broadband, energy, transport, education and research, renewable energy and energy efficiency – targeting projects with a higher risk profile compared to those normally financed by the EIB. Funds are not earmarked for specific sectors nor does the programme make a country-specific allocation. EUR75bn instead are to be dedicated to supporting investment by SMEs and middle-capitalisation companies.

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[1] Recently, the European Commission proposed to scale up the EFSI beyond the initial 3-year period, increasing the seed capital from EUR21bn to EUR33.5bn, and targeting a total amount of up to EUR630bn of investment by 2022.

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