A holistic approach to ECB Asset Purchases, the Investment Plan and CMU

Guest Speech

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Euro50 conference “Fostering Investment in the European Union”
Hotel Amigo – Rue de l’Amigo 1 – 1000 Brussels

Presentation

- Overview of the main « circumstances » that matter
(investment needs, policies, trade-offs)

- Structural factors specific to Europe
(multipliers, investment complementarities, financial structure)

- Aligning policy priorities

Source (1)

No7 – April 2015

Policy Brief

CEPII

A holistic approach to ECB asset purchases, the Investment Plan and CMU

Natacha Valla, Jesper Berg, Laurent Clerc, Olivier Garnier & Erik Nielsen

Summary

To stimulate and finance investment in Europe the three "policy stars" of Europe need to be aligned: the Capital Markets Union initiative, the €315bn Investment Plan, and the ECB's €1,100bn asset purchase scheme. They jointly face a unique set of issues. First, the resilience and the cyclical performance of the European bank based system needs to be improved. Second, the "right" markets need to be developed for banks to outsource risks without jeopardising financial stability. Third, cross-border risk-sharing urgently needs to be rebalanced, because it has become, in the wake of the Great Recession, overly reliant on debt instruments as opposed to equity. We argue that to achieve alignment between initiatives, an overall strategic vision could:

- Set an explicit, holistic strategy, ensuring that the instruments in the Investment Plan receive appropriate regulatory treatment within the CMU, and are eligible to the ECB's purchase programme and collateral.
- Set a strategic objective for the euro area financial structure. It could be a "spare wheel" model where (i) banks would remain predominant (with capital markets as a countercyclical "spare wheel"), and (ii) banks would outsource risk through covered bonds (with untranched securitisation acting as the "spare wheel").
- Proactively promote equity instruments in all three policy initiatives for more sustainable cross border risk sharing.
- Promote a new business model for "credit assessment" with a value chain featuring the credit information collected by commercial and central banks.
- Re-orientate the ECB's purchases away from sovereign debt instruments towards the instruments that will finance the Investment Plan, those of the so-called "agencies", and private sector assets.
- Formally involve NPBs in the Investment Plan, preferably in the equity of the EFSI Fund.
- Improve the governance of public investment ex ante via independent, supra-national investment committees, and ex post via strict disciplinary measures.
- Be pragmatic but tangible in the objectives set for the Capital Markets Union (focus on cross-border insolvencies and improve national business environments).

RESEARCH AND EXPERTISE ON THE WORLD ECONOMY

CEPII Policy Brief n°7

Jesper Berg (Nykredit)

Laurent Clerc (BdF)

Olivier Garnier (Soc. Gen.)

Erik Nielsen (UniCredit)

Natacha Valla (CEPII)

Source (2)

Policy Brief

No 4 – July 2014

A New Architecture for Public Investment in Europe: The Eurosystem of Investment Banks and the Fede Fund

Natacha Valla, Thomas Brand & Sébastien Doisy

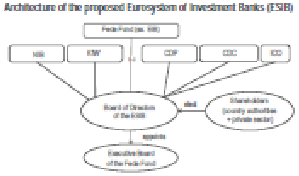
Summary

Some five years after the severe recession of 2009, private sector investment in Europe is still dangerously sluggish. And public sector investment has been cut, reinforcing the downward trend seen over the past thirty years.

In this paper, we discuss the complementarity between private and public sector investment. Evidence suggests that in the medium term, public investment does not hinder, but fosters, the quantity and efficiency of private investment. Moreover, our fiscal multiplier for public investment (at 1.4, considerably above 'breakeven') is significantly stronger then those for other fiscal instruments. Taken together, these two findings suggest that the public sphere would 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 we propose establishing, by treaty, a Eurosystem of Investment Banks (ESIB), around a pan-European financial capacity that would coordinate the actions of the national public investment banks of Euro area member states and add to their funding capacity. The ESIB would channel the Euro area's excess savings towards investment in the right places throughout the continent. To do so in an economically sustainable and financially profitable way, funding would be conditional on firm commitments to growth-enhancing structural reforms and economic policies.

Architecture of the proposed Eurosystem of Investment Banks (ESIB)



Our proposed Eurosystem of Investment Banks (ESIB) would be structured around a federal centre and national entities. The central node, the Fede Fund, would be created by restructuring the European Investment Bank into a truly federal entity. The Fede Fund would orchestrate the joint work of national investment and development banks with a clear European map in mind.

The mandate of the ESIB, enshrined in the Treaty, would be to promote long-term growth, well-being and employment in Europe. The mandate would, by definition, reflect a political consensus emanating democratically from the people of the Euro area member states.

The 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. We propose a structure with both public and private Fede shareholders, who would collectively elect the ESIB Board of Directors. The Fede Fund would also issue debt to finance investment at an economically relevant scale (10% of Euro area GDP, so around €1tn).

RESEARCH AND EXPERTISE ON THE WORLD ECONOMY

CEPII Policy Brief n°4

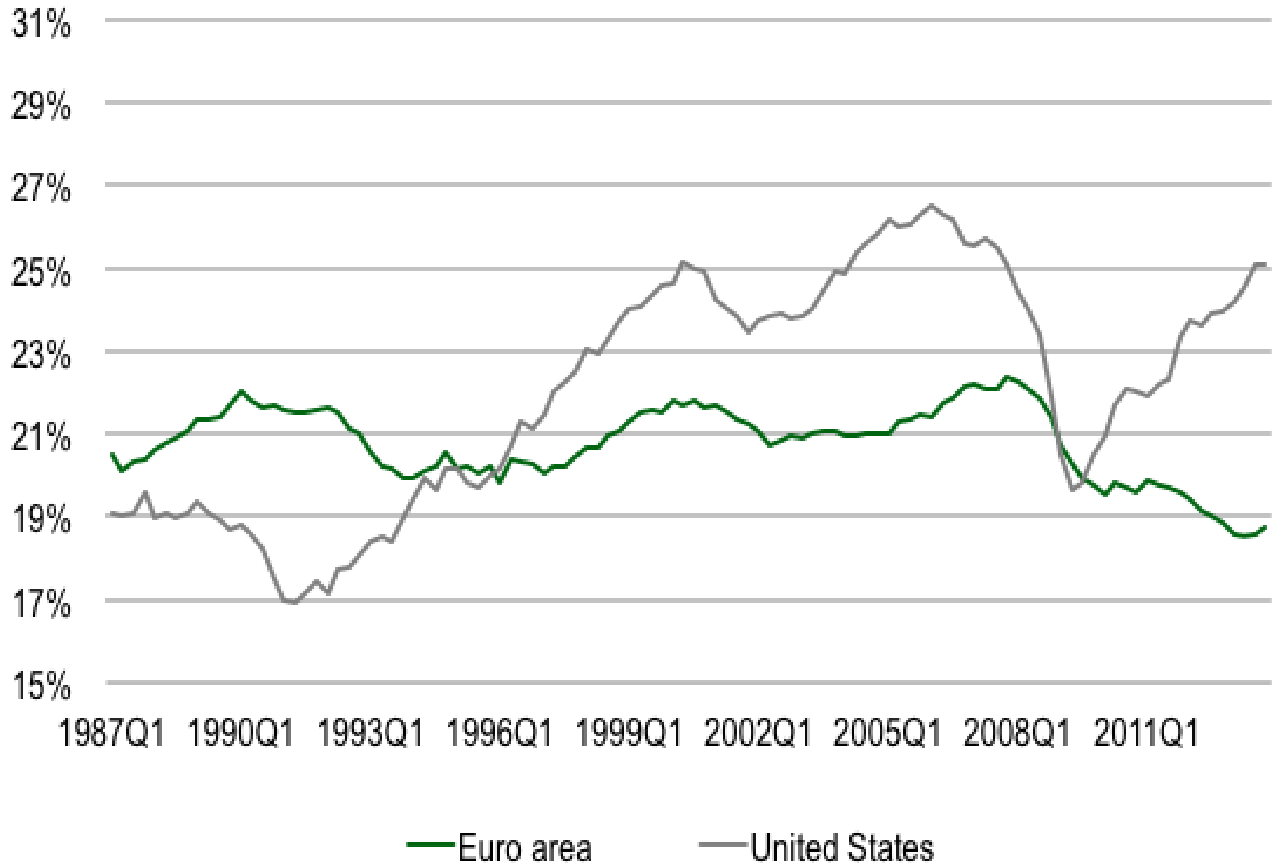
Thomas Brand (CEPREMAP)

Sébatien Doisy (FRR)

Natacha Valla (CEPII)

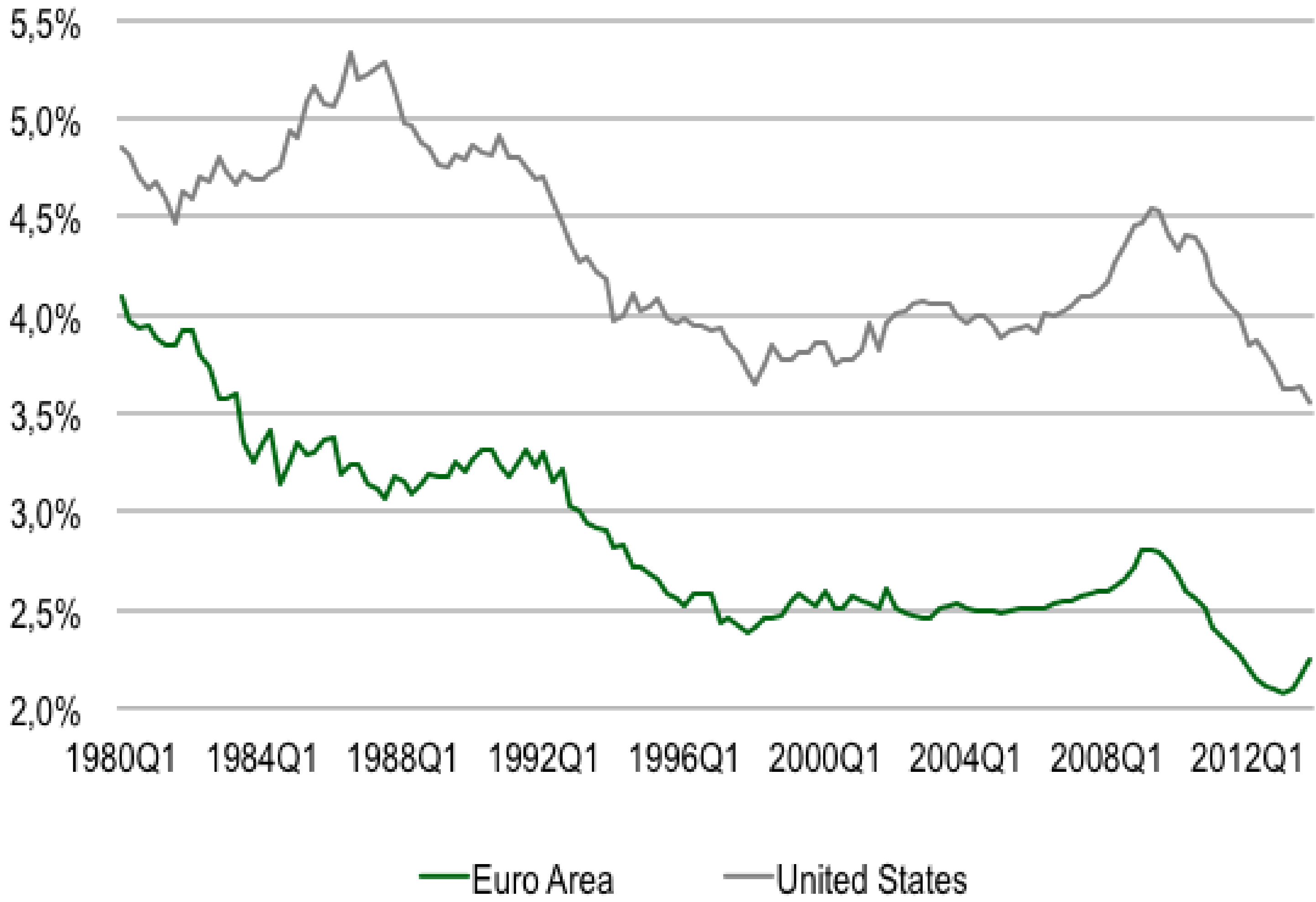
Circumstance #1
Europe (still) needs investment

Share of private sector investment in GDP



Source: Eurostat, Giannone et al. (2012)

Euro area public sector investment halved to 2% of GDP in 35 years (% GDP)

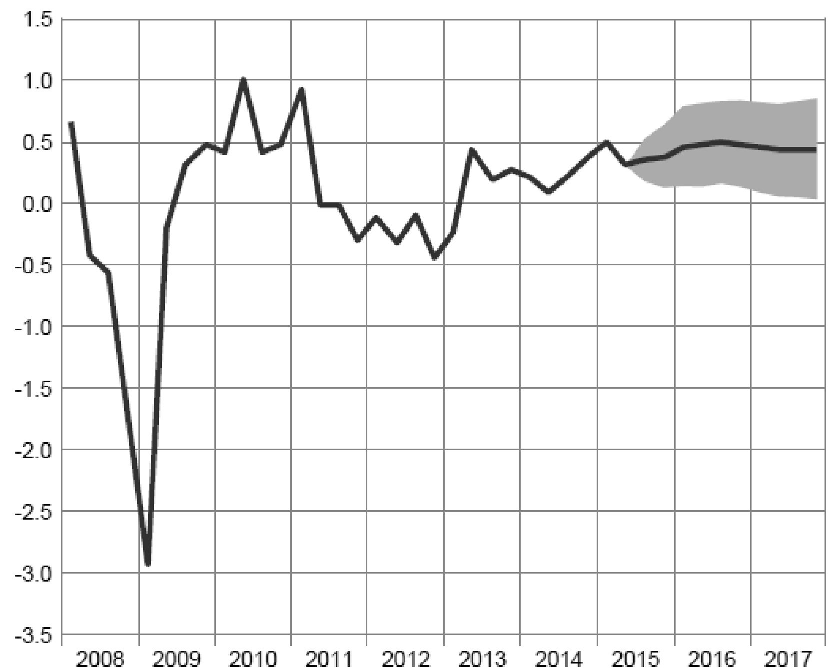


Source: Fred, Eurostat, Paredes et al. (2009), Giannone et al. (2012). Last data: Q4:2013.

Circumstance #2
EMU needs loose monetary policy

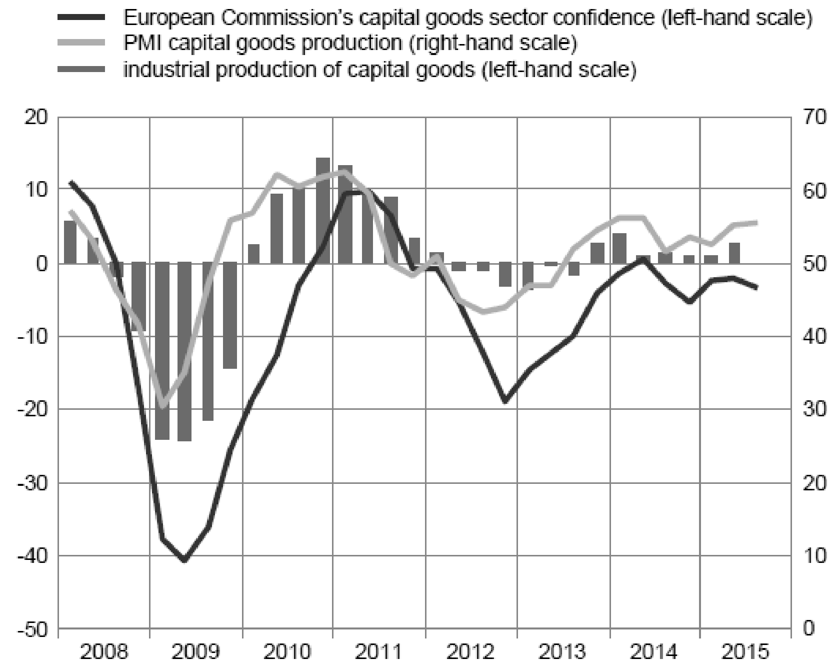
Euro area real GDP (including projections)

(quarter-on-quarter percentage changes)



Euro area capital goods production and investment confidence

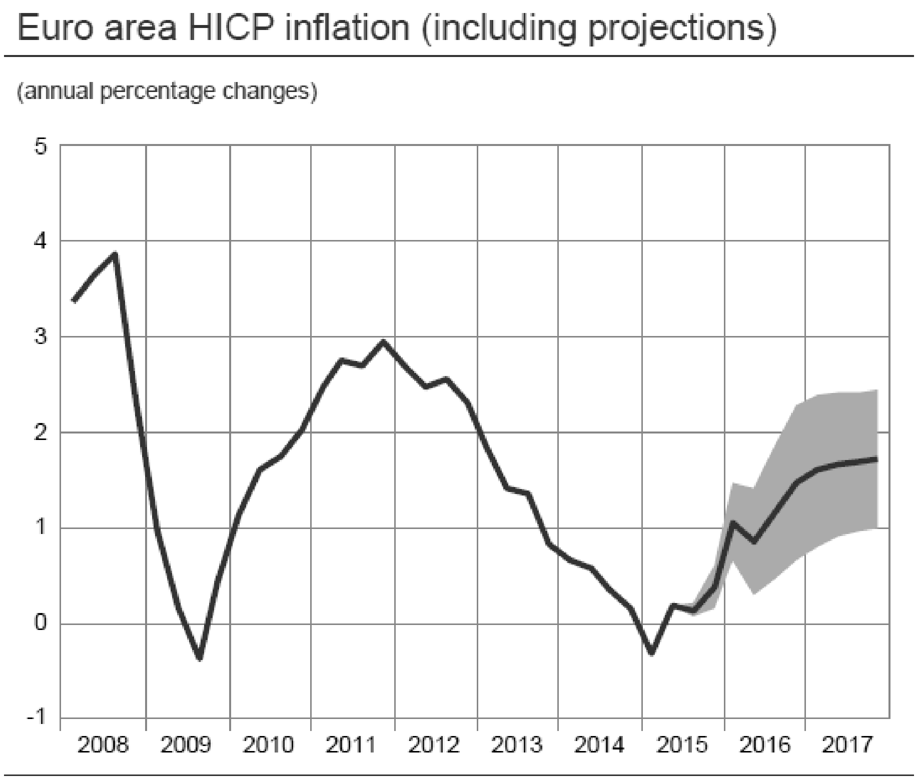
(year-on-year percentage changes; net percentage balance; index)

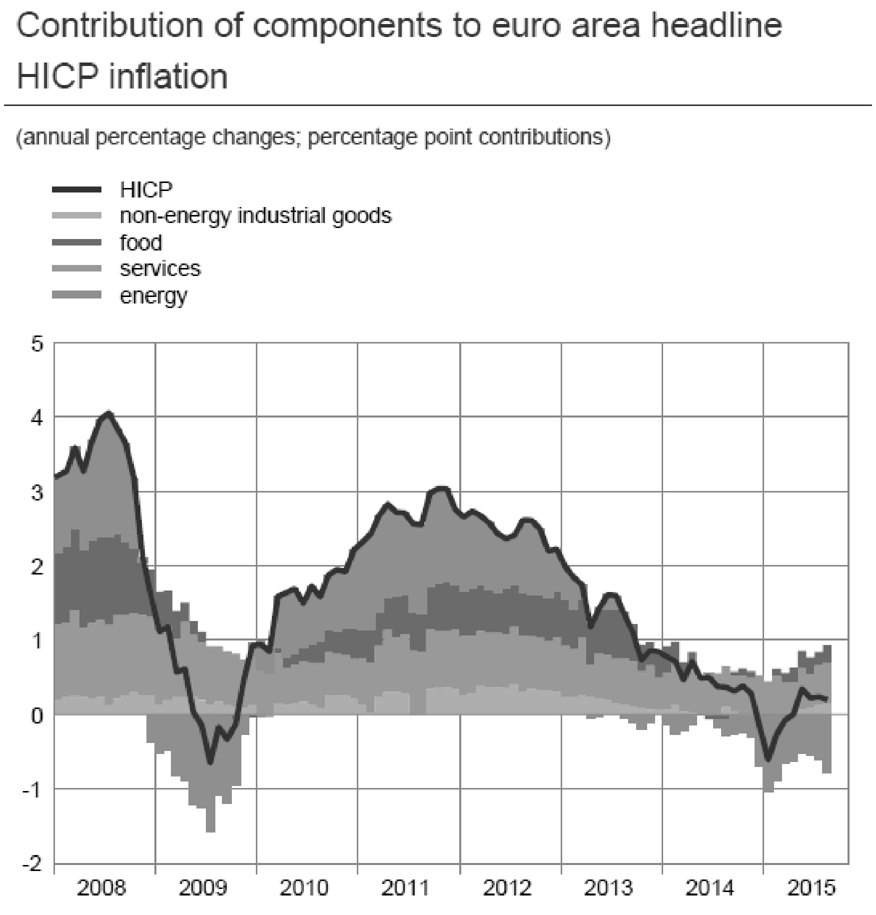


Source: ECB's September 2015 Projections.

(and this may mean many things)

Circumstance #2
EMU needs loose monetary policy





Source: ECB's September 2015 Projections.

(and this may mean many things)

- Circumstance #3

Cross border equity is badly needed

- Circumstance #3 (bis)

Capital markets are still fragmented

Circumstance #3: Policies and Diagnosis

- Investment Plan on the table…
  - 3 pronged strategy (a fund, a list, an environment)
  - EFSI now up and running
  - Parallel initiatives (RELTIF, etc)
  - €315bn
- …CMU in the making…
- …and Banking Union is on (although still missing key bits)
  - Single Resolution Fund
  - Deposit Insurance Scheme

Circumstance #3: Policies and Diagnosis

- …significant ECB purchases underway
  - €1100bn
  - Monthly purchases sped up
  - Some scope for « Interntional » and « Agencies »
  - Scope enlarged in a second step (good!)
  - But still massively focused on sovereign debt
  - No private corporate (yet)
  - No equity (yet)
  - CB and ABS modest
- R5P out, now road-showing
  - Some ideas on « bridge finance »
  - Some ideas on « single » capital market regulator
  - Nothing on the ECB
  - Not much on BU

Structural factor #1: Investment complementarity

- Literature: Old & New – Aschauer (1989), Gramlich (1994) → (…) → Summers (2013)

- Framework: ECB’s New Area Wide Model (2008) (neo-Keynesian model with real + nominal rigidities) & « public capital » as explicit input

- High fiscal multiplier on public investment. Persistent effects

(Positive effect on long-term growth)

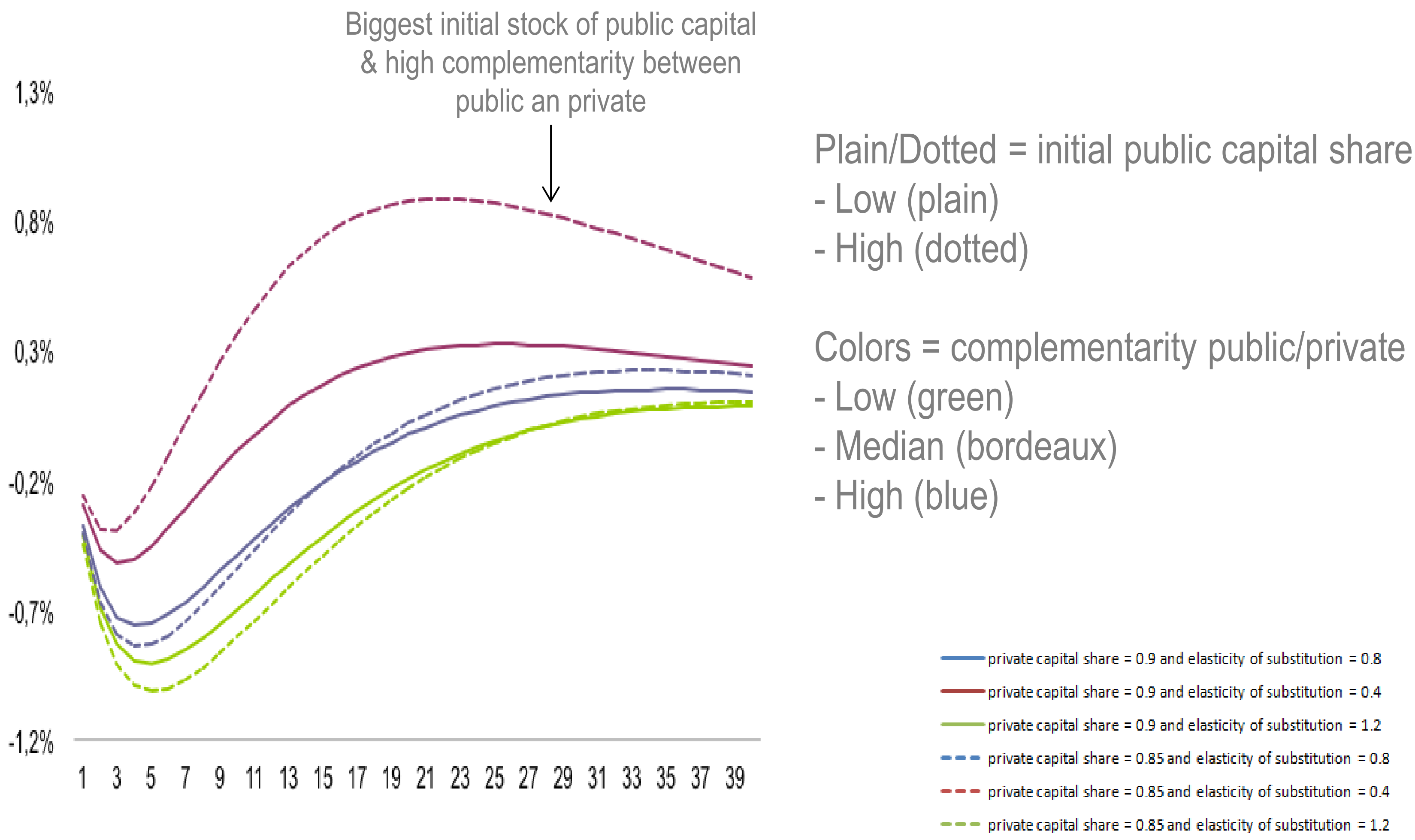
- Strong multiplier compounded by *complementarity* public/private (in the long run, public investment crowds-*in*, and not –*out*, private investment)

Fiscal multipliers by specific instrument for the Euro area

	Immediate	One year later	Two years later	Five years later
Government investment	1.42	1.53	1.57	1.46
Government consumption	1.38	1.4	1.41	1.38
Targeted social transfers	0.92	1	1.03	0.89
Taxes on consumption	0.55	0.8	0.87	0.71
Social contributions of employees	0.37	0.45	0.46	0.25

Source: Authors' calculations.
Note: The numbers shown in the table represent cumulative, net present value multipliers, ie, the sum of output variations up to the indicated year, divided by the sum of fiscal variations up to the indicated year, both discounted at the risk-free short-term interest rate.

Public and private investments are complements, not substitutes, in the long term

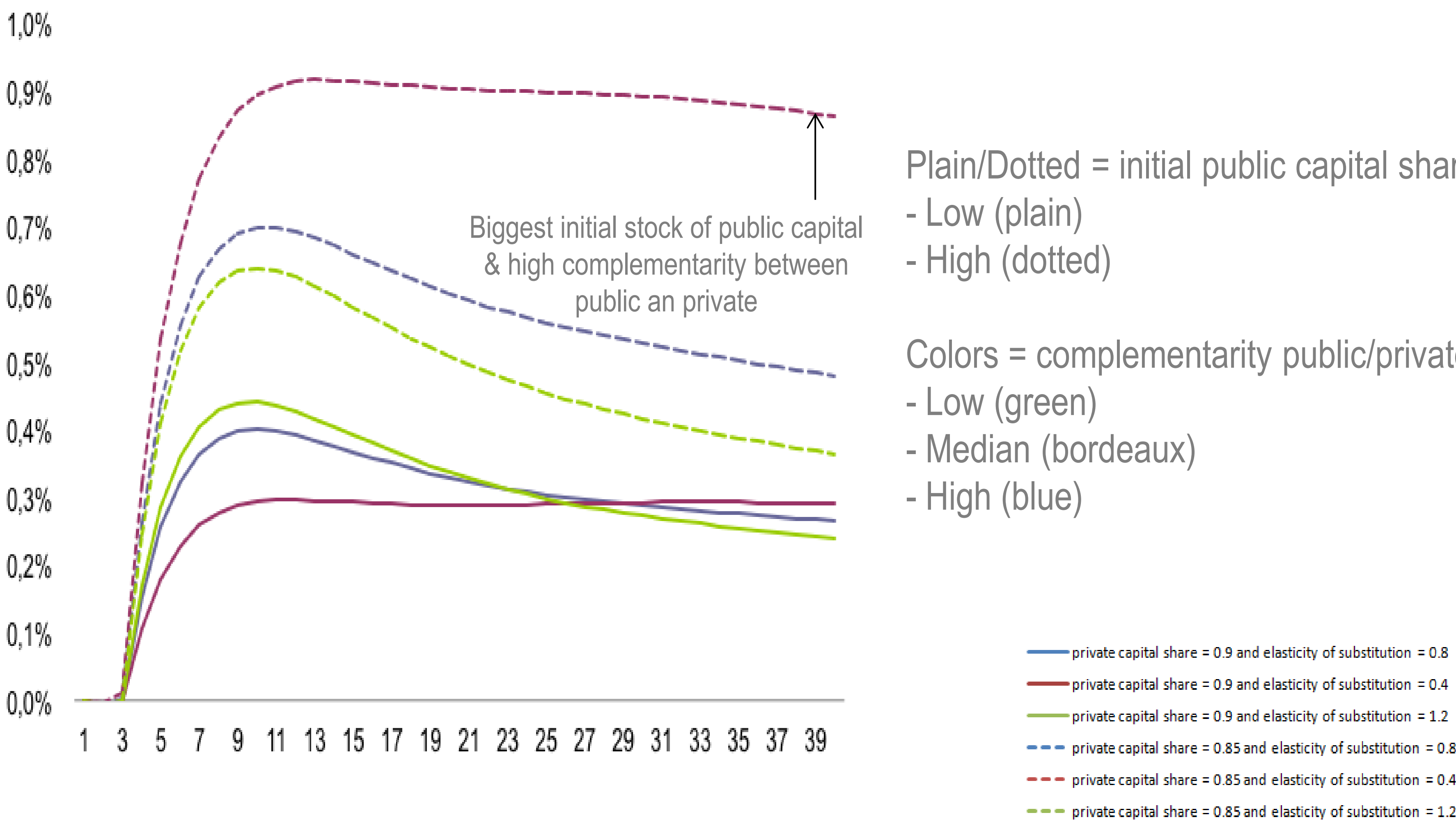


Plain/Dotted = initial public capital share
- Low (plain)
- High (dotted)

Colors = complementarity public/private
- Low (green)
- Median (bordeaux)
- High (blue)

Source: Valla, Brand and Doisy (2014)

An increase in public investment always yields higher capital stock levels



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Source: Authors' calculations.

Structural factor #2: Financial structure

#1: European Financial Structure Bank-centric more than debt-centric (more than equity centric)

Chart 1.a – **Euro area nonfinancial corporates still biased towards loan financing...**

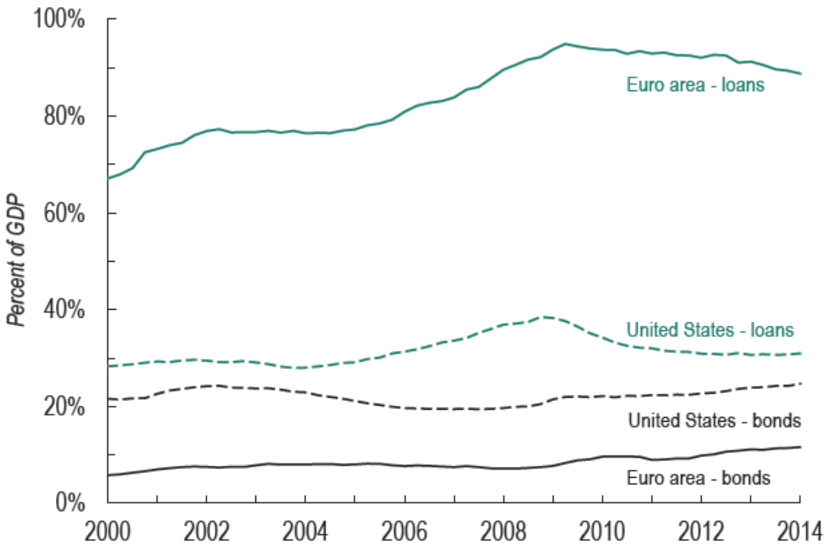
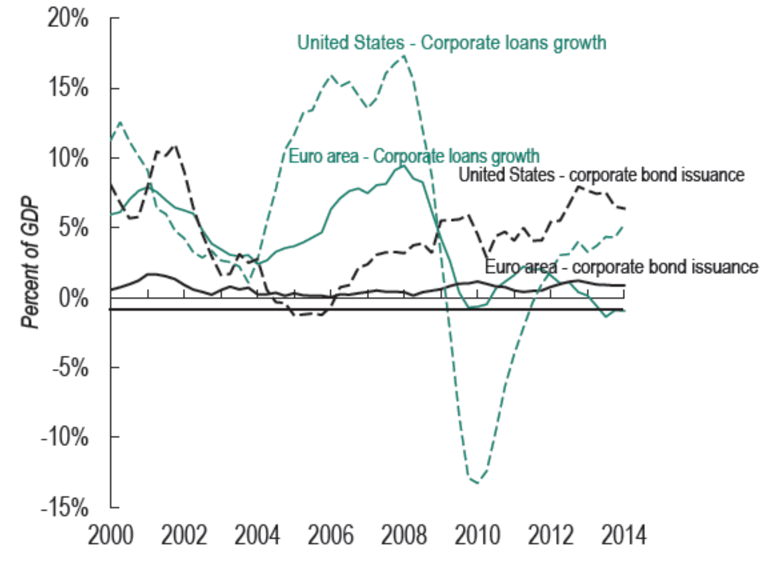


Chart 1.b – **...and differences between the US and the euro area set to persist**

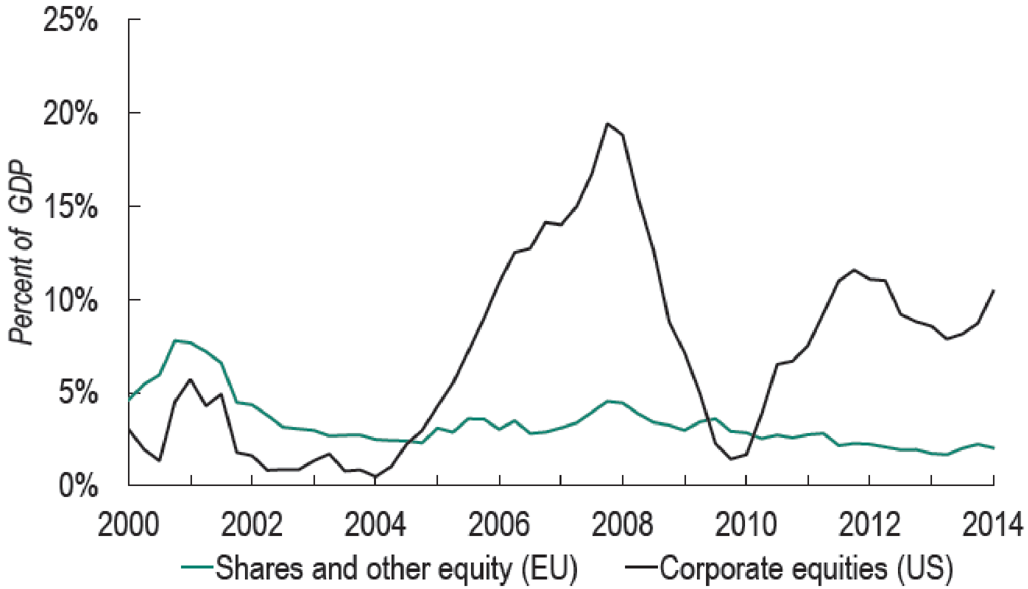


Source: ECB, Fed.

Structural factor #2 : Financial structure

…and equity issuance is still tiny

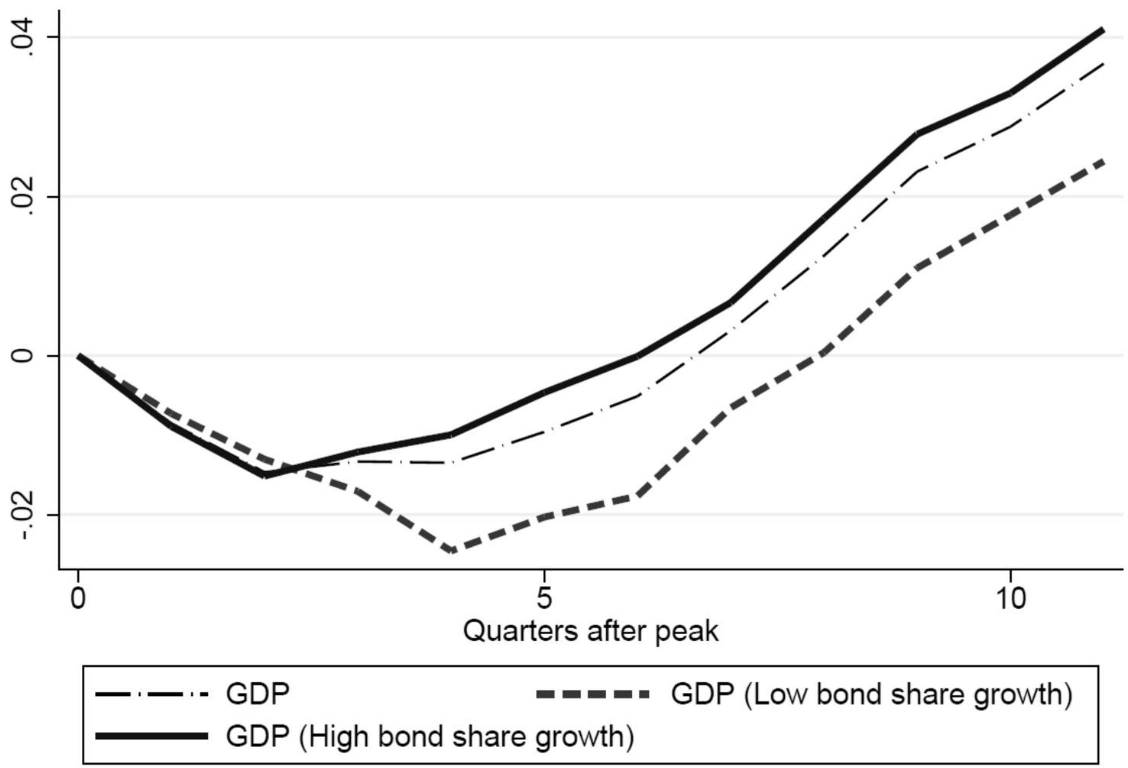
Chart 3 – Equity issuance of nonfinancial corporations in the euro area small compared to the US



Source: .European Central Bank (ECB) and Federal Reserve.

Structural factor #2 : Financial structure

…while market-based economies tend to be more dynamic in upturns



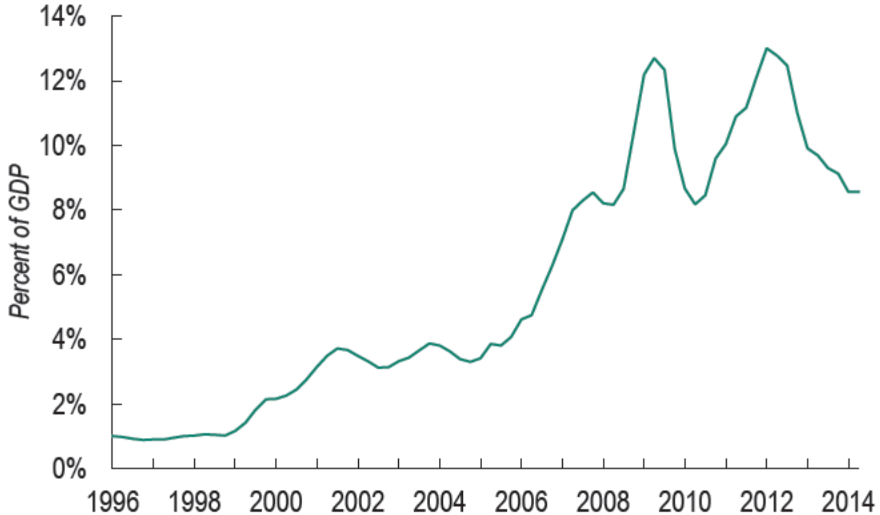
Average variations with respect to GDP peak. Growth with respect to the peak period.

Source: Grjebine et al., CEPII (2015)

Structural factor #2 : Financial structure

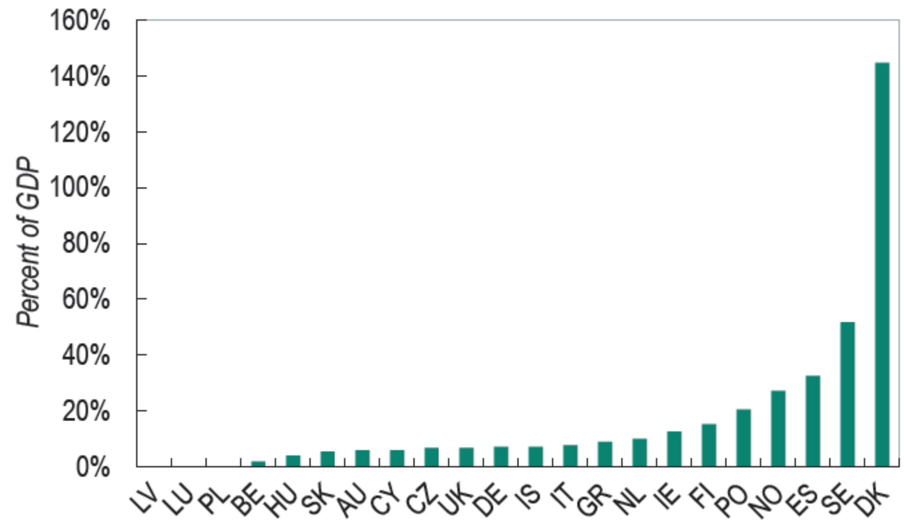
#2: Outsourcing risk: securitisation and untranched securities still underdeveloped…while covered bonds are more contrasted

Chart 4 – Securitisation has remained muted in the euro area



Source: . European Central Bank (ECB).The series presented here is the issuance of securities by euro area financial institutions other than MFIs. It encompasses securitisation and is shown here as a rough upper bound for securitisation in the euro area.

Chart 5 – Covered bond markets are heterogenously developed (outsanding amounts)



Source: European Central Bank (ECB) and Federal Reserve.

Aligning Policy Priorities

- Formulate a holistic strategy CMU / Investment Plan / ECB

- A strategic goal for the European financial structure: « spare wheel » model
  - markets as spare wheel of banks
  - securitisation as spare wheel of covered bonds

- A new value chain for the assessment of credit worthiness
  - commercial banks
  - central banks
  - big data (cf IFC)

Aligning Policy Priorities

- ECB's asset purchases: less sovereign debt but more macroeconomic risk on the balance sheet

- Repair investment
  - Formally network all providers of public funds around the EFSI
  - Allow the EIB model to evolve
  - Improve the governance of public investment (esp. at local level, but also higher up)

- Assign realistic and tangible objectives to the CMU

Key takeaways

- The policy approach should be holistic (ECB/EIB/CMU) and ambitions realistic (CMU)

- A « spare wheel » model for the financial structure
  - capital markets a « spare wheel » of banks
  - securitisation a « spare wheel » of covered bonds

- A new business model for the « credit assessment » value chain

- Re-orientate ECB's purchases away from sovereign debt!