PARIS – The European Commission’s new president, Jean-Claude Juncker, has put public investment back on the agenda with his idea of a three-year €300 billion ($378 million) capital spending plan. The European Union’s leaders are expected to discuss his proposal in December. Everyone seems to agree that more investment would help to strengthen a worryingly feeble European economy. But, behind the superficial consensus, many questions remain unanswered.

For starters, this is not the first time that Europe has considered such an initiative. In 1993, the Commission, under Jacques Delors, proposed a capital spending plan in its White Paper on growth, competitiveness and employment. The plan was broadly endorsed, but no action was taken. Likewise, in 2000, as part of its Lisbon Strategy, the EU sought to increase national spending on research and development to 3% of GDP. It failed to reach this target. More recently, in June 2012, EU leaders adopted a Compact for Growth and Jobs that was supposed to mobilize €120 billion. The check is still in the mail.

It is indeed easy to pretend to act without taking effective action. One way is to ask the European Investment Bank (EIB), the EU’s development bank, to lend more. Such calls face two limitations: the EIB itself is careful not to jeopardize its financial rating by taking on too much risk, and its loans easily substitute for private financing. More lending therefore can be pointless if it results in the EIB crowding out private financing of the best available projects. A bridge financed by the EIB may be more affordable than one financed by capital
markets, but it remains the same bridge and has the same economic impact. The size of the EIB’s balance sheet is not a good measure of its effectiveness.

Instead, three investment levers should be used. The first lever is budgetary: Governments that enjoy fiscal space should spend on economically sound projects. Public investment is a complement to private investment; if designed and targeted well, it can trigger more private investment, rather than crowding it out.

For example, adequate transport and broadband infrastructure favors the burgeoning of business initiatives. At a time when markets are willing to lend to solvent governments at historically low rates, there should be little room for hesitation.

Obviously, cheap financing does not justify public investment in projects with dubious social returns, or what development practitioners call “white elephants”: headline-grabbing projects of disputable value but supported by special interests. Investments should be assessed on the basis of their overall economic impact, with proper procedures put in place to prevent public money from being wasted.

The second lever for investment is regulatory in nature. Many large-scale investments that only pay off over the long term – for example, in energy, digital infrastructure, and transport – are concentrated in state-regulated sectors, giving governments the power to influence business decisions.

Predictability regarding the future course of regulation would unlock projects held back by uncertainty. A credible outlook for the price of carbon, for example, would prompt new private-sector investment in cleaner technologies. Similarly, an agreed European framework for projects that connect countries would remove obstacles to cross-border investment.

These conditions are a long way from being met, which means that profitable investments are not being made. Changing that would not cost a single euro; it requires only political resolve.

The third lever is financial. Investment demand has slackened not because interest rates are too high, but because there is not enough risk appetite within the banking system. Financing in continental Europe is traditionally bank-based, unlike in the US, where capital markets reign supreme. But banks are being told by regulators to reduce their leverage and to post higher capital when they embark on risky lending, and their creditors are being told that they should not expect to be bailed out if banks get into trouble.
This is intentional. Governments and citizens in Europe have paid – and are still paying – an astronomically high price for the reckless lending and investment of the 2000s. Understandably, they do not want to repeat the experience.

The consequence, however, is that high-risk, high-return projects are more difficult to finance than they should be. If Europe wants to revive its economy and escape stagnation, it needs entrepreneurs to take more risk to innovate. But its financial system is undergoing a transition from a bank-based to a market-based system that involves risk aversion.

This is where the public side – both national governments and the EU – should step in and share some of the risk with private players. They should temporarily behave more like investors who scrutinize projects, contribute funding, and earn returns. Using the EIB and national development banks to this end would help overcome the current impasse.

Would these three types of initiatives add up to €300 billion? No one knows at this stage. But this route would be the surest way to reach the goal.


© 1995-2014 Project Syndicate