Investing for a Greener, Competitive and Socially Inclusive Europe*

DEBORA REVOLTELLA AND PATRICIA WRUUCK

Debora Revoltella, European Investment Bank, e-mail: d.revoltella@eib.org
Patricia Wruuck, European Investment Bank, e-mail: p.wruuck@eib.org

Summary: Development banks are there for good times as well as bad times. They promote structural changes in economies, addressing longer-term challenges. They complement financial systems, helping to improve the functioning of banking and financial markets and bolstering economic resilience. They mitigate market failure, but can also help to identify it, contributing to the design of effective policy. Moreover, development banks can help to create and shape markets, such as the green bonds market. In doing so, they catalyse structural economic transformation and spur investment-led growth. For the post-Covid-19 world, Europe needs structural transformation to address the challenges of rapid technological change and stiffer global competition, growing threats to social cohesion and, not least, climate change. In this article, with a focus on the role of the EIB, we discuss three main questions: What is the rationale for development banks? What is the EIB's unique position within the European development banking landscape? And how is the EIB helping to address the key challenges that Europe is currently facing, boosting recovery from the historic Covid-19 shock to create a more competitive, inclusive and greener economy in Europe?

Zusammenfassung: Förderbanken sind in guten und in schlechten Zeiten nützlich. Sie bringen strukturelle Veränderungen in Volkswirtschaften voran und helfen dabei, langfristige Herausforderungen anzugehen. Sie ergänzen Finanzsysteme, unterstützen die Funktionsfähigkeit von Banken- und Finanzmärkten und stärken die Resilienz von Volkswirtschaften. Sie lindern nicht nur Marktversagen, sondern können aber auch einen Beitrag dazu leisten, diese zu identifizieren und so durch Politikmaßnahmen effektiv zu adressieren. Darüber hinaus können Förderbanken helfen, Märkte zu schaffen und zu formen, wie etwa für grüne Anleihen. Auf diese Weise wirken sie als Katalysator für wirtschaftliche Transformationsprozesse und kurbeln Wachstum getrieben durch Investitionen an. Für die Welt, die der Covid-19 Pandemie folgt, braucht Europa strukturelle Veränderungen, um die Herausforderungen durch schnellen technologischen Wandel, verschärften globalen Wettbewerb, wachsende soziale Ungleichheit und nicht zuletzt den Klimawandel erfolgreich anzugehen. In diesem Beitrag, der auf

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die Rolle der EIB eingeht, diskutieren wir drei Kernfragen: Warum gibt es Förderbanken? Welche besondere Position nimmt die EIB im System der europäischen Förderbanken ein? Wie trägt die EIB dazu bei, die gegenwärtig wesentliche Herausforderung einer schnellen wirtschaftlichen Erholung Europas nach dem historischen Covid-19 Schock zu unterstützen und dabei gleichzeitig eine wettbewerbsfähigere, sozial gerechtere und grünere Wirtschaft zu schaffen?

1 Development banks, Europe and Covid-19

Europe has been hit by an almost unprecedented economic shock. Due to the Covid-19 pandemic, the EU economy looks set to contract more strongly in 2020 than during the global financial crisis a decade ago. With the spread of the disease in Europe slowly being brought under control, we now need bold action to support a swift economic recovery. Development banks have an important role to play in this. The European Investment Bank (EIB), in particular, is a keystone of the European Union's joint policy response, supporting the immediate recovery and building the longer-term strength, sustainability and resilience of the EU economy.

Times of crisis always put development banks like the EIB in the spotlight. In the midst of the global financial crisis, they spurred countercyclical investment and acted as a stabiliser. In Europe, in the wake of that crisis, the establishment of the EIB-implemented European Fund for Strategic Investment (EFSI) proved essential for filling persistent investment gaps that were holding back recovery.

But development banks are there for the good times as well as the bad. They form part of the economic policy toolkit to promote structural changes in economies, addressing longer-term challenges. They complement financial systems, help to improve the functioning of banking and financial markets, and bolster economic resilience. The goal of mitigating market failure traditionally underpins development banks' activities. However, they can also help to identify market failures and contribute to the design of effective policy. Moreover, development banks can help to create and shape markets, such as the successful establishment of the green bonds market. In doing so, they can be a catalyst for structural economic transformation and can spur investment-led growth.

The EIB's history is linked inseparably to the development of the European project. In Europe, development banking has evolved as a multi-level system. The EIB, as a multilateral institution, has a unique part in this structure, financing projects of common interest, helping to address common challenges and improving the lives of EU citizens. Promoting cohesion and modernising EU economies – the initial objectives of the bank – continue to guide our work. But we add value wherever scale and coordination are required for results.

As we look ahead to a post-Covid-19 world, we see that, for Europe, structural transformation is urgent. Europe needs to address the challenges of rapid technological change and stiffer global competition, growing threats to social cohesion and, not least, climate change. Scarce public resources will not be enough to fund this process. Private capital needs to be mobilised. EU member states share a common vision of a competitive, inclusive and green Europe, but substantial investment and coordinated action is needed to turn this vision into reality.

This article focuses on the role of the EIB as the multilateral lender for Europe. We ask three main questions. What is the rationale for development banks? What is the EIB's unique position within the European development banking landscape? And how is the EIB helping to address the key challenges that Europe is currently facing, boosting recovery from the historic Covid-19 shock to create a more competitive, inclusive and greener economy in Europe?

2 Development banks make markets work better

Development banks are back in the spotlight because of their stabilising, countercyclical role in mitigating the impact of large-scale economic shocks. This was the case during the financial crisis and its aftermath. Now, with the unprecedented economic shock triggered by the Covid 19 pandemic, development banks are again stepping up efforts to cushion the impact on the real economy and support a forceful recovery.

But there are also less newsworthy reasons why we need development banks. They have a structural role that is no less important. As a part of the economic policy toolkit, they complement financial systems, improve the functioning of banking and financial markets and help to address longer-term challenges and bolster economic resilience. Development banks are public financial institutions with a dedicated promotional mission. They are established by public authorities to provide credit and financial services to market participants that are not served by private financial institutions to a desirable extent.

Development banking is linked with the notion of market failure. While a functioning financial sector is vital for economic development, some financial services are underprovided in a free market setting. The establishment of a dedicated financial institution can be the best strategy to correct this.

A typical market failure is the one driving the under-provision of finance to small and medium sized firms, innovative companies or start-ups. Asymmetric information with high information costs relative to scale can make the evaluation of such businesses' prospects prohibitively costly for financial providers in the market. Yet without adequate finance for such businesses, we have little hope of tackling long-term unemployment or of staying at the forefront of innovation.

Where the broader positive impacts of an investment are not reflected in narrow financial returns, we speak of positive externalities. This means that projects that are valuable for a large group of beneficiaries or for the society as a whole, but where some of the benefits are hard to internalise as revenue, often face funding gaps and are prevented from going ahead. This is for instance the case of projects that help to tackle climate change as a key example, but so are research and development and investment in education.

Market failures can be cyclical, emphasising the need for development banks' intervention in economic downturns (Mazzucatto and Penna, 2016). In a downturn, coordination failures can occur. It may be that everyone would benefit from increased lending, across the economy, to lift it out of recession. For each private bank, however, these benefits are not fully internalised. The risks of going it alone are high. Private banks' appetite to lend in a crisis may therefore be limited. Development banks can help to address such coordination problems, helping to avoid or shorten recessions (Levy-Yeyati et al., 2004). Private banks' risk aversion can even be pro-cyclical, amplifying recessions by cutting lending (Arrow and Lind, 1970). Government actors with greater risk-bearing capacity and a long-term perspective can smooth the economic cycle by countering crisis-driven reduction in lending by private banks and other financial intermediaries.

Mitigating market failure is at the core of what development banks do. Nonetheless, recent scholarship suggests that we can also think beyond this traditional role. Development Banks can also help to identify market failures, thereby helping to inform the design of development policies and help with their implementation (Fernando-Arias et al., 2019). This is because market failures are not directly observable and it takes a learning process to identify them. Through loan-screening and lending activities, development banks can inform governments about issues that exist in different markets. They can play an intelligence gathering role, in other words, while also considering social returns when collecting and producing information. Moreover, development banks can create and shape markets where they do not yet exist or are underdeveloped (Mazzucato and Penna, 2016). In doing so, their activities can be a catalyst for structural transformation of economies and can spur investment-led growth.

Development banks have a long history in Europe. Some of the institutions operating today can trace their roots back to the 19th century when they helped to promote industrialisation and provided banking services that were lacking in the market at the time. Historically, development banks played an important role in fostering large-scale structural transformation processes. They supported the rebuilding of Europe's economies after the Second World War and the transformation that took place in transition economies after 1989. With the financial crisis, their countercyclical role came back into focus, with new development banks being established in countries such as Portugal and Ireland. Countercyclical activity was particularly pronounced in high income countries, helping to compensate for the credit crunch resulting and acting as a stabiliser (Bertray et al., 2015, Luna-Martinez and Vicente, 2012, and Luna-Martinez et. al., 2018).

3 As the EU bank, the position and capabilities of the EIB are unique

In Europe, development banks exist at subnational, national and the European level, in a multi-level system. In addition, European Member States are also shareholders in multilateral development banks (MDBs), such as the World Bank, focusing on the common task of supporting economic and social progress in developing countries through project financing. Rather than operating in isolation, these different levels are linked through cooperation and common projects, both within Europe and beyond.

The EIB has a unique position in this structure. As the EU bank, it is uniquely owned by the Member States of the EU, and solely represents their interests. The EIB works closely with other EU institutions to implement EU policies, providing finance and expertise for sustainable investment projects that contribute to the Union's policy objectives. While the bulk of its activities are in Europe, the EIB is also a global development bank with activities outside Member States to support the EU's external policy objectives.

The EIB finances projects of common interest, helping to address common challenges and improving the lives of EU citizens. In particular, the EIB adds value where scale and coordinated action is required for results. Sometimes, the potential that is there can be easy to miss. When we issued the first green bonds in 2007, people considered us lunatics. Today this market is worth nearly 1 trillion dollars.

The EIB's establishment and operations are deeply intertwined with the history of the EU. Set up under the Rome treaties in 1958 with the aim to modernise the European economy and promote cohesion, the bank has since invested over EUR 1.1 trillion in more than 160 countries, financing almost 12,000 projects. To promote the priorities and objectives of the EU, our activities focus on four key areas: infrastructure to connect Europe's citizens, internal markets and economies; support for small and medium-sized enterprises; innovation and skills; and the transition to a low-carbon, climate-resilient and environmentally friendly economy. At the same time, our lending activity promotes cohesion within the EU and sustainable development around the world.

Whatever the objective, what we care about is impact. One way in which we assess our impact is through an annual macroeconomic assessment based on a large-scale economic model called RHOMOLO-EIB, together with the European Commission's Joint Research Centre.[1] The model is used to assess the impact of investments supported by the EIB Group. The model is geared towards identifying long-term structural effects of operations.

In 2019, the EIB group signed operations in the EU that mobilised total investment of EUR 247 billion. Model estimates indicate that these investments will add about 1% of GDP and 1.1 million jobs by 2022 compared to the baseline scenario. With a view to longer-term effects, these projects will add 0.9% to EU GDP and 720,000 jobs by 2037 in the model scenario (see Figure 1).

To make sure that we deliver the high impact we seek, our projects go through careful screening and a tough process of due diligence. We are a "projects bank". Our statutes require that we can finance only projects that are financially viable and socially and economically sustainable. The EIB uses a dedicated value-added framework to properly assess the results of its projects, as well as the difference that EIB intervention makes. This framework is also in line with the newest thinking about how development banks can play an intelligence gathering role to help inform development policies.

EIB operations and activities have evolved over the last six decades, reflecting the changing nature of the challenges facing the EU and the Union's evolving policy objectives. The promotion of cohesion and the modernisation of EU economies remain core EIB objectives. Nonetheless, the financial crisis and the following EU Sovereign Debt crisis that unfolded between 2007 and 2012 put the EU to the test and had a significant impact on the EIB. Notably, the establishment of EFSI proved instrumental to overcoming investment gaps in the wake of the financial crisis and to ensuring that more money reached the real economy. EFSI, a EUR 26 billion guarantee programme, complemented by a EUR 7.5 billion allocation of the EIB's own capital, mobilised EUR 514 billion in additionsl investment since July 2015 through some 1,400 operations to benefit about 1,400,000 small and medium-sized companies.

Looking to the future, it is certain that addressing climate change will be a key challenge for development banks everywhere. In 2019, at the EIB, we committed to increase the share of climate

1 For further information on the RHOMOLO model see https://ec.europa.eu/jrc/en/rhomolo and EIB/JRC (2018).

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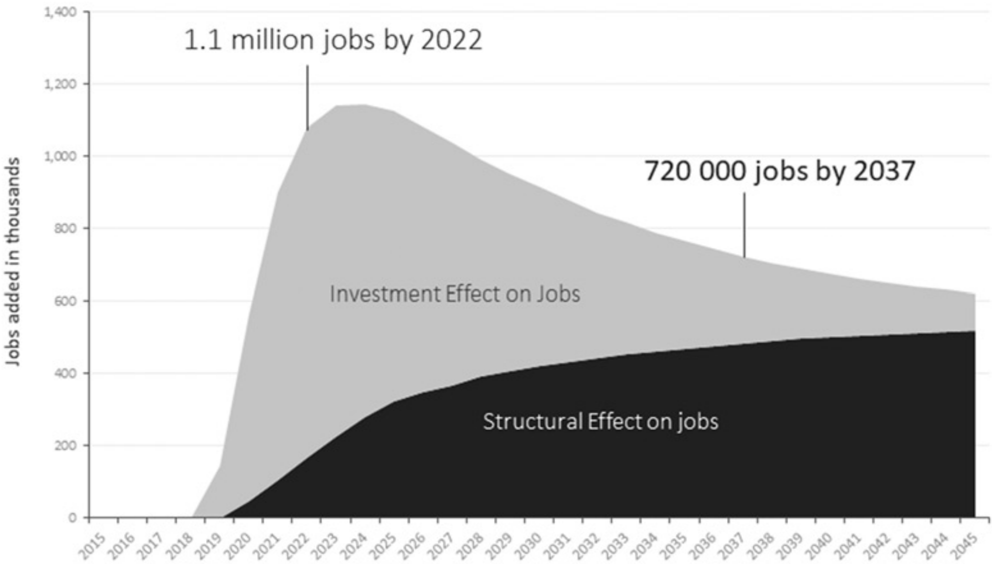
Figure 1

Estimated impact of projects supported by the EIB Group in 2019



Source: EIB/JRC.

projects in our lending to 50 % in the coming years. This way, we plan to mobilise EUR 1 trillion of investments in the critical next decade to 2030.

In addition, through our new Energy Lending Policy, we committed to withdraw from financing unabated fossil fuel technologies. This is not just an important step to combat climate change but also sound banking practice. We are thinking 30 years ahead, about assets that have a 30-year life span. We must not invest in the stranded assets of the future.

Now, like the rest of the world, Europe is currently undergoing a massive economic shock triggered by the covid-19 pandemic. This has put a halt to the economic recovery that had been underway in Europe. The EU economy is contracting sharply and the pre-existing economic challenges it faced – like digitalisation, social cohesion and climate change – will likely be further compounded by this contraction.

4 The EIB has responded decisively to the Covid-19 crisis

The EIB's immediate response to the pandemic focuses on strengthening the capacity of the European health sector to cope with and overcome the immediate threat from Covid-19, as well as measures to ramp up support for EU firms. To shore up health-sector capacity and fight the pandemic, EIB group has EUR 6 billion available for medical infrastructure and to support research or other activities related to improving treatments for the disease. This is part-financing projects, or offering guarantees to help catalyse higher amounts funding for more investment in total. The EIB is also working to make additional support available for healthcare infrastructure outside the EU.

The EIB Group has also acted swiftly to alleviate corporate liquidity constraints through a financing package of bridge loans, credit holidays and other measures to support liquidity and working capital needs of SMEs and midcaps. The latter includes the establishment of a EUR 25 billion Guarantee Fund which will allow us to mobilise up to EUR 200 billion in funding for viable firms affected by the crisis.

The majority of Member States have put forward dedicated guarantee schemes to support firms affected by the pandemic shock, typically administered through national promotional banks and guarantee finance institutions. However, not all countries have the same capacity to pledge financial support and to implement programmes rapidly. The EIB guarantee scheme helps to prevent divergences further opening up across the EU. Moreover, it helps to preserve the single market and to maintain a level playing field for all.

The close economic linkage between EU economies makes the creation of this pan-European guarantee fund imperative. The EIB's own data suggests that 40% of the long-term impact on growth and jobs from the operations we finance comes from cross-border spillovers. Europe's venture capital and innovation ecosystems are transnational by nature – no individual Member State has adequate incentives to fully protect them – calling for a pan-European perspective and policy instrument.

Diversification is also essential in a guarantee product. By pooling credit risk across all of the European Union, the overall average cost of providing guarantees can be reduced, when compared to national schemes.

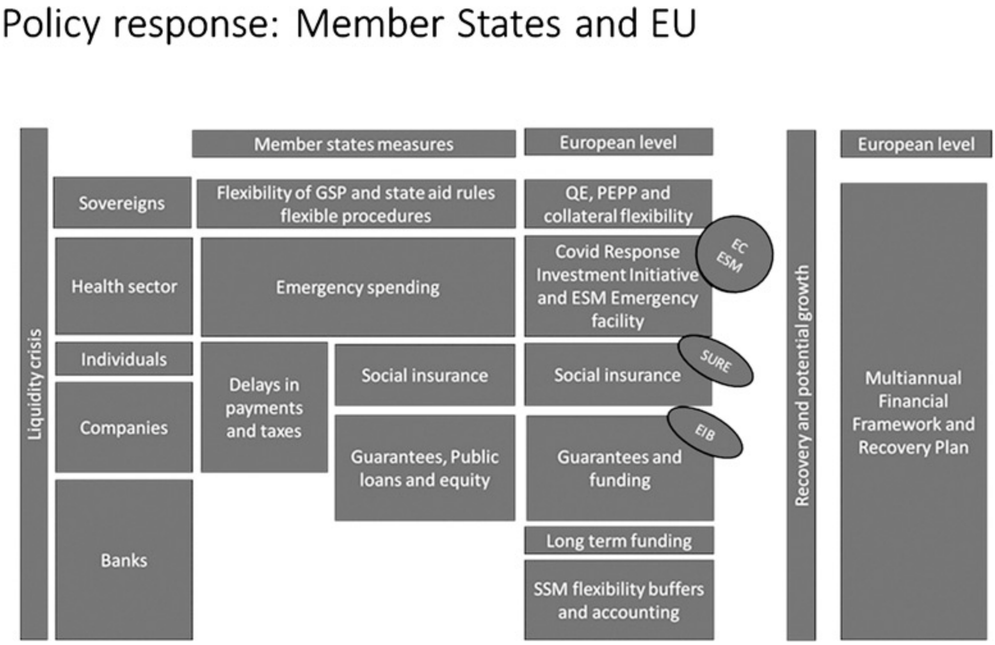
To implement these immediate response measures, the EIB is working together with the European Commission, financial intermediaries in Member States and national promotional banks.

EIB activities to address the Covid-19 shock form part of a comprehensive policy package of measures to address the crisis at European and national levels (see Figure 2). They can be seen as part of countercyclical measures to mitigate the pandemic shock across the EU and paving the way for recovery.

Together with other development banks, the EIB is also contributing to a comprehensive response to the coronavirus pandemic outside the EU, in line with the EU's global role. This includes accelerated financing and targeted financial assistance as part of the Team Europe response package. It means short-term support for health and business investment in Africa, Eastern and Southern Neighbourhood countries, the Western Balkans, Asia and Latin America, as well as increased backing for businesses impacted by the pandemic.

Figure 2

EIB support as part of the European policy response package



Source: EIB Economics Department.

5 Europe needs more than recovery; it needs transformation

In the midst of this pandemic, it would be tempting just to turn the economic clock back to 2019, but that would not be good enough. Europe has long faced unaddressed structural investment needs for innovation and digitalisation, for addressing climate change, and for rebuilding the social inclusion and cohesion that is a foundation of our prosperity (EIB 2019). Strategies for recovery from the Covid-19 crisis must put building a more competitive, sustainable and resilient economy at centre stage. This requires the structural transformation of EU economies, addressing gaps that existed already and have now become even more urgent. EU member states share a common vision of a competitive, inclusive and green Europe, but substantial investment, patient investors and coordinated action will be required to turn the shared vision of a competitive, inclusive and green Europe into reality. We will never achieve our climate goals relying only on public money. But the public sector also has to provide emphatic commitment to indicate the way ahead.

The Covid shock has clearly demonstrated the need to speed up digitalisation in Europe. This will require a new level of investment in digital services and infrastructure. It will also require proactive policies to enhance skills as a complement to the adoption of these new technologies. Moreover, it will require a more supportive financial system that puts Europe's innovators in a position to help drive the economic recovery and restore Europe's competitive edge.

The experience of the financial crisis and the following sovereign debt crisis in Europe showed that the accumulation of persistent investment gaps comes at costs to competitiveness and social cohesion. The investment decisions we take today in Europe will determine success or failure in the decades ahead. Transitioning towards a more digital and less carbon-intensive future offers a way to renew our economy and to restore Europe's competitive position through innovation. At the same time, we must make sure that none of Europe's citizens are left behind.

Development banks in Europe have boosted the structural transformation of economies in the past and they will be needed to support an inclusive structural transformation in the post-Covid-19 era. We have a unique chance to transform the European economy, one we cannot afford to miss. Beyond a focus on physical infrastructure needs, including energy, digital, environmental and transport, investment in social infrastructure and human capital will be key to make this renewal process an inclusive long-term success.

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