



BULLETIN

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Financing the Juncker Investment Vehicle: Better Safe than Sorry

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Jean-Claude Juncker's idea of boosting investment is a good solution to the problems arising from the prolonged stagnation in the EU. There are, however, controversies over the financing of the investment vehicle with the EU budget as collateral. It is not beneficial to Poland, because it poses a risk of limiting the inflow of the financial resources within the framework of common funds.

The plan to create a European Fund for Strategic Investment (EFSI), is intended to mobilise a substantial investment in 2015–2017 and thus to boost the EU economy (mostly the southern eurozone). It is necessary, as the level of investment dropped from 21% of GDP in 2008 to 18% of GDP in 2012, which contributed to lower economic growth. The plan however is not free of controversies, one of which is the financing.

The investment vehicle would function as a fund, and it would have an AAA rating, which enables capital to be obtained at low interest, for lending to investors. The estimated value of the loans generated by the mechanism would reach €315 billion, out of which €65 billion would be lent to small and medium-size firms. Collateral for these loans (€5 billion) would come from the European Investment Bank (EIB) and the EU budget (€16 billion). The Member States may voluntarily contribute to the mechanism, but this is unlikely to happen as they would be discouraged by the fact that they cannot decide how these resources would be used. Juncker's proposal has significant advantages, but it also poses the risk of limiting the inflow of financial resources within the framework of common funds.

A European Innovation Vehicle. Among the advantages of this financing method is the leverage effect. In principle, the loans generated through such a mechanism would be worth 15 times more than the value of the collateral. Currently, it is impossible to mobilise such an amount of capital within the EU budget, as the size of the Multiannual Financial Framework (MFF) cannot be increased until 2020. However, experts have expressed doubts on the planned value of the loans, saying it would be too difficult to achieve such a level. To compare, the European Stability Mechanism (ESM), operating partly on a similar basis, did not reach the assumed level of private financing.

The introduction of this lending vehicle secured by collateral is a continuation of the tendency to decrease the role of grants (in most cases on a basis of co-financing schemes) to the advantage of the revolving instruments that enable the same money to be used several times. EC representatives admit that such a solution is more effective than a grant, which would be financed in a different way than by money from the market. This would, in particular, be most advantageous to small and medium firms which, without such support, would pay high interest rates, making their entire business activity unprofitable.

A considerable advantage of this method of financing is direct relief for the Member States from the necessity to contribute financially to this vehicle. Because the collateral comes from the EIB and the EU budget, individual states contribute only indirectly, and only if there are non-performing loans. This solution is advantageous, because the Member States are obliged to keep their fiscal deficits low due to EU law on coordinating the fiscal policy (i.e., the Six-pack or the Two-pack). These limitations would be a constraint on Member States' ability to mobilise funds to pay to the EFSI (although in the case of the ESM, the eurozone countries managed to gather the required capital).

Moreover, the risk of using the collateral is moderate, yet not totally eliminated. The mechanism does not generate an immediate necessity to contribute financially to the investment vehicle. Movement of such resources would take place when the investors delayed or declined to make repayments, and only then EFSI would need to repay it with

collateral. The mechanism would gain a margin, with which it might cover all the losses arising from the non-performing loans. Thus, the usage of the collateral relies on the share of bad loans and on the profit margin set by the EFSI.

A Threat to the Common Budget. The innovative nature of the fund and its advantages do not compensate for the flaws. Firstly, using the EU budget as collateral for the loans taken by the EFSI is a method that poses a risk that negatively influences the common EU funds. If it materialises, it would be necessary to introduce a new spending component in the EU budget to transfer it to the EFSI, which repays debts to the creditors. The possible introduction of such a new spending item (one not considered during the MFF negotiations or during the work on the annual budgets) would shrink the resources available in other parts of the common expenses. Taking into account the pressure to freeze the size of common expenses, and the tensions linked with agreements on the annual EU budgets, which result in excessive cuts (for example to the ERASMUS programme), many budget areas would not meet their goals because of too limited means.

Secondly, the inclusion of the funds ring-fenced for collateral for the EFSI loans within the EU budget poses a risk of lengthening the process of shaping the annual EU budgets. The Member States would find it harder to reach a compromise at the end of each financial year, thus leading to a provisional budget, rather than a finalised one, being launched within the first months of the new financial year.

The other important risk factor is the threat of delays in payments from the common budget. However, a precedent almost took place, as in 2014 the European Commission has not been able to settle some invoices within the Cohesion Policy, and will instead do this in the next year. If the EFSI notes a financial loss because of the bad loans, burdening the EU budget with collateral would increase the magnitude of this phenomenon. Afterwards, it will limit the expenses of the particular budget areas (such as Horizon 2020 or the Connecting Europe Facility) because of the necessity to repay the overdue bills.

A factor which determines the necessity and scale of the payments of the EU budget to the EFSI is a share of non-performing loans granted to the investors. Werner Hoyer, EIB's CEO warns that bad loans would appear, especially as the crisis has not yet ended and the economic forecasts are bleak. If the rate of the non-performing loans in the banking sector is currently at the level 8% in the EU, the respective rate within the EFSI would probably be similar or lower (5–8%). This means that €315 billion borrowed from the market would, in the worst scenario, require repayments of bad loans at the level of €15–25 billion, minus the margin gained by the vehicle.

Correction Proposals. Juncker's investment mechanism creates the risk of a negative impact on the structure of the EU budget and the procedures designing its shape. This is important to Poland, which is the biggest net beneficiary of EU funds (around €70 billion net in 2014–2020).

Firstly, there is a risk, that the budget areas (Horizon 2020 or the Connecting Europe Facility). This in turn—in the worst case—would limit the level of national investment financed by these parts of the budget.

Secondly, the introduction of the new, unplanned element within the common funds arising from the EFSI losses would imply a conflict during the negotiations of the next financial perspective. In the worst scenario there would be a conflict among the supporters of the big budget, which would weaken their cooperation and result in a smaller budget and a worse net position for Poland and other such countries.

For these reasons, a more advantageous scenario would be an alternative solution on financing the mechanism. The most politically feasible solution would be the introduction of collateral based entirely on EIB capital, which would eliminate the risk of using EU budget resources to repay the bad loans. The main advantage of this solution is that the Member States would still not need to mobilise their funds to contribute to the EFSI. Thus they may be eager to accept such a proposal. Additionally, the EIB would take control of the EFSI, so it seems natural that this institution would finance it entirely. A weakness of this solution is the value of the EIB (around €250 billion). If the collateral were worth around €20 billion, then the financial stability and thus the rating of this institution would be reassessed downwards.

If the Member States are not interested in this solution, a compromise, albeit one that only partly solves the problem, would be an assurance that the EIB's collateral would be used prior to that from the EU budget. Thus the EU funds would be safe in the case of EFSI losses on bad loans not exceeding €5 billion.