EUROPEAN RECOVERY PROJECT

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Overview

Since late 2008, the developed world has experienced its worst economic growth performance since the first half of the 20th century. The outbreak of the euro crisis in 2010 exacerbated the effects across Europe, with some peripheral economies suffering particularly severely. A fragile recovery has taken hold across most of the EU, but it remains weak and output levels in the euro zone remained below pre-crisis peaks as of the third quarter of 2015. Nor do longer term developments augur well for more rapid recovery. Growth rates have been decelerating in productivity, output and income per capita in many developed economies, and these trends long predate the upheavals of 2008.

The slowing down of growth over recent decades has happened despite a range of developments and policy decisions which might have been expected to cause stronger rather than weaker growth. These include the continuous pushing out of the technology frontier, a steady increase in the quality of the stock of human capital, urbanisation, a policy trend towards market liberalisation in most developed countries and rising levels of cross-border trade and investment, both regionally and globally.

It is imperative that stronger rates of sustainable growth are achieved. Without stronger growth, it is difficult to see how the challenges facing the EU - short, medium and long term - can be addressed without political and social disruption. These challenges include: generating more employment (and youth employment in particular); reducing dangerously high levels of public and private indebtedness which threaten financial stability via further sovereign defaults and bank collapses; and maintaining cohesion among EU member states at a time of deep fissures, particularly between north and south. Put plainly, the societal, political and financial risks for Europe require action more proportionate to the magnitude of those risks.

The policy options set out here are drawn on ideas from across the political spectrum. Although there is very considerable uncertainty about the growth impact of specific reforms, more reforms implemented simultaneously in as many member-states as possible offers the best chance of pushing Europe onto a higher economic growth trajectory. As such, a "grand bargain" of multiple measures is proposed here. It would include more activist use of fiscal and monetary policy levers, greater market integration, most notably in the services sector, and the speedy completion of a true "capital markets union".

Executive Summary

The challenge facing European policy-makers in drawing up a package of pro-growth measures is formidable. There is very considerable uncertainty among economists about the mix of policies that might push economic growth onto a higher trajectory. Nor is there any strategy than can guarantee success. That said, there are reasons for optimism. Europe has a solid foundation owing to its many strengths. Democracy, political stability and the rule of law provide an enviably secure institutional framework for economic agents. According to measures of global competitiveness by a number of organisations[1], many of its national economies are among the most competitive in the world. At corporate level, many European companies are world leaders, while the continent's businesses are more internationalised than those of any other region[2] . With the largest single market in the world and high quality human and physical capital there is considerable untapped potential in the European economy.

Despite the lack of certitude around an optimal macroeconomic policy mix, the clearly superior performance of the US, Switzerland, and more recently the UK, tips the evidence base towards more aggressive policy efforts to support aggregate demand. This, combined with the risks on inaction which could result in continued very low nominal output growth, further strengthen the case for a more accommodative stance. With levels and growth rates of private investment, private consumption, and public investment well below historical trend rates, a range of monetary and fiscal tools as yet unused or underused could be deployed in Europe.

This report is structured as follows. Chapter 1 discusses the largely negative trends in economic growth over the short, medium and long term in advanced economies. These trends provide an essential backdrop in understanding the scale of the challenges facing policy-makers. Chapter 2 sets out measures which could boost aggregate demand, while chapter 3 puts forward a menu of supply-side reform. The measures in chapters 2 and 3 are summarized here.

— Public infrastructure investment: The boosting of investment in infrastructure has been a favoured option since the beginning of the crisis among those advocating stronger fiscal stimulus. Advocates of increased infrastructure spending have seen their position strengthened recently both by a widening infrastructure gap in many economies and the historically low interest rates at which most European governments are currently able borrow. The European Fund for Strategic Investments, finalised in June 2015, aims to disburse €315 billion over three years. While welcome, this amounts to an annual spend of less than 1% of GDP. A package at least twice the size is warranted, not least given the uncertainties around private sector involvement in the EFSI. The issuance of medium-dated Eurobonds is a possible means of financing this investment.

1 Including the Economist Intelligence Unit, the Word Bank and World Economic Forum

2 UNCTAD, annual Word Investment Reports, various

- Corporate investment: Private investment dwarves public investment in all advanced economies. But it has been in trend decline over an extended period, and the acceleration of that trend in recent years has contributed to the dampening of aggregate demand. Efforts by the European Central Bank to revive bank lending to non-financial corporations (NFCs) have had limited success to date. Providing loans directly to NFCs or via state investment banks are among a dwindling number of options available to channel credit to businesses. Such measures would certainly be radical, but they are not without precedent. Given the risks associated with continued stagnation, they do not appear disproportionate.
- Private consumption and monetary stimulus: Private consumption is, by a considerable distance, the largest component of domestic demand in all advanced economies. It has been profoundly weak in most European economies and continues to contract in many. With fiscal policy so constrained, a last resort may be for the ECB to by-pass the financial system if the quantitative easing programmes which began in early 2015 does not succeed. Such a move would be truly radical, but it looks increasingly proportionate.
- Boosting the single market in services: approximately two thirds of EU economic output is now accounted for by services, yet it is in the tertiary sector that the single market is least advanced. A renewed push to unleash the potential for efficiency gains will involve careful design, not least to prevent social dumping, but offers the prospect of a considerable growth dividend. Adopting the "country of origin" principle included in the early drafts of the EU's services directive by a group of member states, using the enhanced co-operation procedure, could be one means of moving towards greater market integration. The early conclusion of the Transatlantic Trade and Investment Partnership (TTIP) would have dynamising effects for services trade both within the EU and with its largest trading partner.
- Capital Markets Union: the weaknesses in the Single Market for financial services have been particularly evident since the outbreak of the sovereign debt crisis. The creation of a partial Banking Union has moved some way to correct the deficiencies, but fragmentation of the financial system has increased in recent years. The creation of a framework in which EU and Eurozone retail banking can emerge and non-bank finance can grow is needed both to support economic growth and reduce the risks associated with banking crises. Focus on greater equity financing and corporate bond issuance would appear to offer the best prospect of boosting investment.

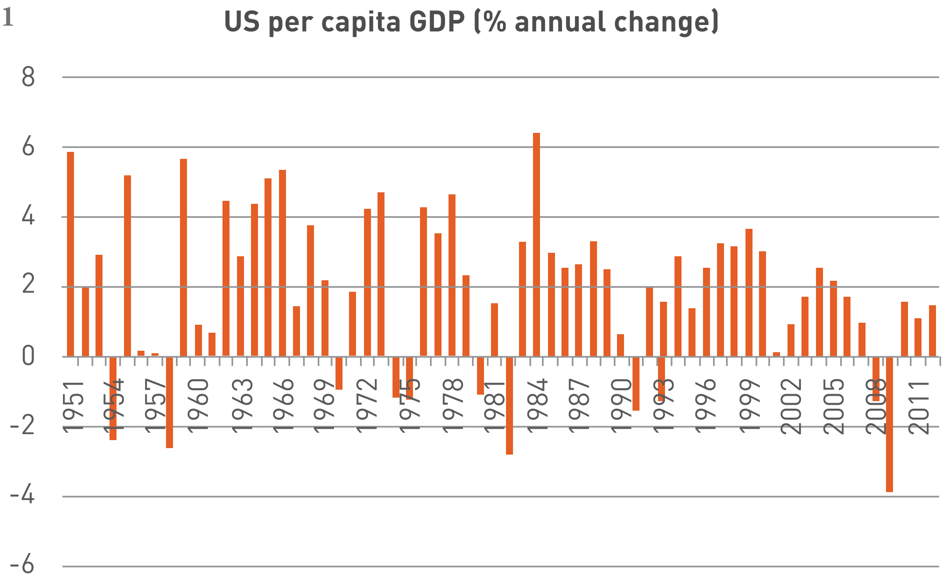
Chapter 1. The slowing rate of growth in advanced economies

Over the past seven years, the developed world has experienced its worst economic growth performance since the first half of the 20th century. The outbreak of the euro crisis in 2010 exacerbated the effects across Europe. While this recent period of crisis has its origins in a financial market failure (large and widespread mis-pricing of risk and resultant capital misallocation), longer term trends which long predate the upheavals of 2008 point to a deceleration in the underlying rate of economic growth. Thus, Europe is facing not just the growth-depressing effects from the current (protracted) period of crisis, but must also confront a deeper problem of a long-run deceleration in growth which appears to have afflicted all of the advanced economies to a greater or lesser extent. And this is case regardless of the measure used: per capita gross domestic product, per capita gross national income or almost any measure of productivity growth.

The deceleration in growth trends over recent decades has happened despite a range of developments and trends that might been expected to cause stronger rather than slower growth. These factors include the continuous pushing out of the technology frontier, a large and on-going increase in the quality of the stock of human capital (as measured by EU workforce participants' rising average number of years in education), a policy trend towards market liberalisation in most developed countries and rising levels of cross-border trade and investment regionally and globally. It seems clear, however, that these technological and supply-side developments are either having a more limited effect than theory might suggest and/or are being offset by other factors. Thus, while structural reforms are vital, particularly in those countries in which reforms have been limited, they are not a magic bullet.

Growth theorists have traditionally looked to the most advanced economy as a baseline for assessing the impact of the process of technological change and other supply side developments on economic growth. For a century and more the US has been at the frontier, with the highest levels of output per capita. But it seems clear that despite very considerable advances, particularly in the information technology sphere, that the growth rate of output per person in the US is decelerating (see Figure 1). While the second half of the 1990s seemed to offer hope of some break with the trend in evidence since the middle of the 20th century, the apparent pay-off from greater information technology use in the 1990s dissipated in the 21st century.

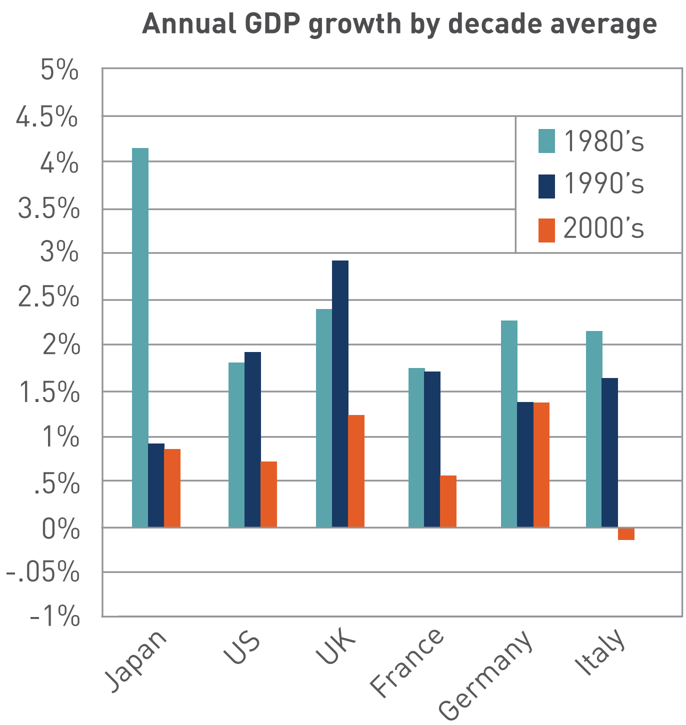
Figure 1



Source: The Conference Board

As illustrated in Figure 2, the sharp decline in growth per head since 2000 has occurred in all major developed economies (Germany is a partial exception). The decline in growth in Japan, until recently the second largest national economy in the world, preceded the inflection point (the turn of the century) reached in most developed economies. The case of Japan and its continued low growth is cause for particular concern given that it remains among the most innovative economies in the world (as measured by annual patenting per person), national expenditure on research and development is among the highest, and repeated attempts to "kick start" growth by boosting aggregate demand using macroeconomic policy tools have not borne fruit.

Figure 2



Source : IMF

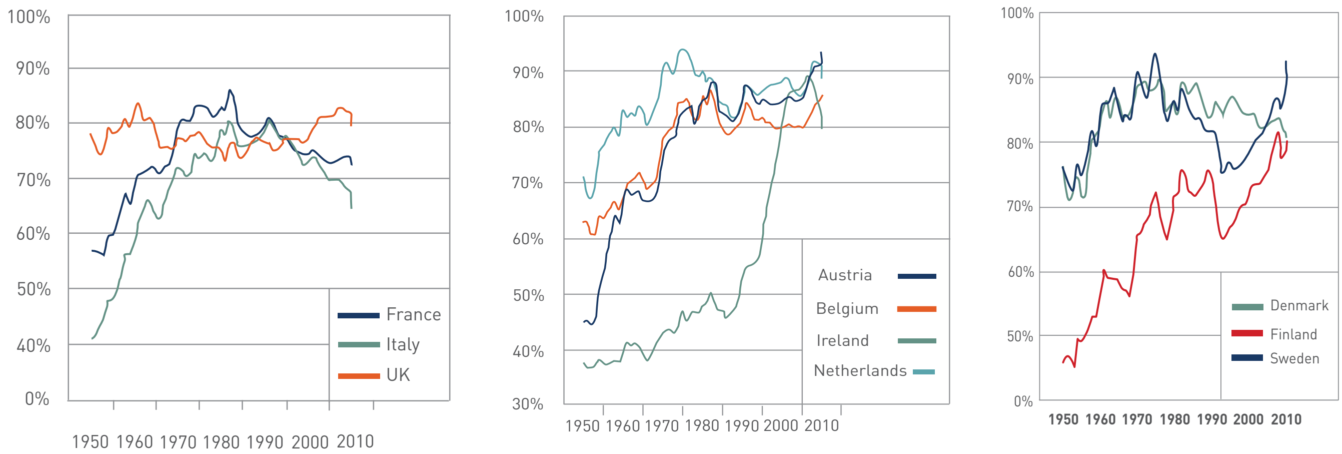
Figure 3

Source: Eurostat

Developments in Western Europe since the middle of the last century have been starker than those in the US (see Figure 3). Although the very high rates of growth in the post-war decades, which exceeded those of the US, owe much to a rebound following the second world war and were thus never likely to be maintained. Thus, by the 1970s, the "glorious thirty years" of post war growth, which had followed the previous thirty years of war and depression, had run out of steam. Thereafter, the peak growth rates in each economic cycle were progressively lower. Unlike the US, only a small number (of smaller) western European economies earned a growth dividend from the information technology revolution in the 1990s.

A more detailed look at the national economies of the most developed economies in Europe compared to the frontier economy (the US) illustrate that even as the US itself slowed, the process of catch-up ended by the 1980s for most western European economies. Even among the limited number of economies that have bucked the trend, none has managed convergence (with the exception of Luxembourg within the EU). Of those economies, per capita output in Austria, Germany the Netherlands, Sweden stands at 90% of US levels, while in Finland, Ireland and the UK it stands at 80%. Denmark, France, Italy have slipped back significantly over the past three decades, while Greece, Portugal and Spain remain well below US levels of per capita output (see Figure 4).

Figure 4 **Per capita GDP relative to US**



Source : The Conference Board

A widening cause for concern

The problem of low and/or decelerating growth has been highlighted by a number of prominent economists from different perspectives. Robert J Gordon, a leading scholar of economic growth, has suggested[1] that technological advances that have driven growth in the past are no longer driving growth and more recent advances are not having a significant impact on productivity. He was written starkly that "the process of innovation may be battering its head against the wall of diminishing returns".

Larry Summers, a former US Treasury Secretary, has described a "new secular stagnation hypothesis[2]" whereby achieving rates of economic growth enjoyed in the past, full employment and financial stability may no longer be possible using conventional monetary policy. Summers suggests that structural changes in economies could mean that the "full employment real interest rate" has fallen to a point whereby full employment is fundamentally more difficult to achieve.

Richard Koo's longer standing thesis on "balance sheet recessions[3]" is less structural in nature and more specific to conditions prevalent in Japan since the 1980s and Europe and the US over the past decade. Yet it also describes the policy challenges of boosting aggregate demand when private sector debt is high and agents cannot be induced to invest and consume at any interest rate owing to their focus on rebuilding their balances sheet via debt paydown.

But whether one or more of these theses is correct, there is little doubt that the rich world has been getting richer at a slower pace for decades, that the trend long pre-dates the financial crisis of 2008, and that in the period since 2008 all developed economies have decelerated further. It is against this backdrop that European policy makers seek to frame an effective set of growth enhancing policies for the second half of the 21st century's second decade.

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1 "Is U.S. Economic Growth Over? Faltering Innovation Confronts the Six Headwinds" http://www.nber.org/papers/w18315, 2012

2 "U.S. Economic Prospects: Secular Stagnation, Hysteresis, and the Zero Lower Bound" Business Economics Vol. 49, No. 2 2014 http://larrysummers.com/wp-content/uploads/2014/06/NABE-speech-Lawrence-H.-Summers1.pdf

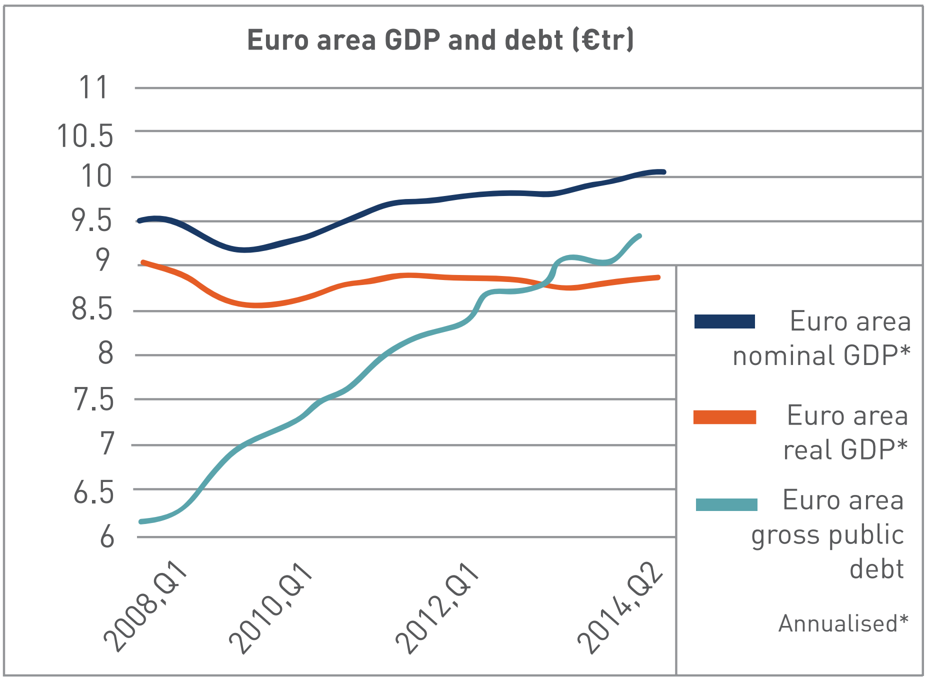
3 "The world in balance sheet recession: causes, cure, and politics" Real World economics review, issue no. 58 2011 http://www.paecon.net/PAERe view/issue58/Koo58.pdf

Chapter 2. Macroeconomic policy

If long run economic growth trends in Europe are a cause for concern, developments since 2008 are cause for alarm. The deepest recession in living memory in 2008-09 took place in the aftermath of the international financial crisis. This was followed by a second dip into recession in 2011-12 as a result of the European sovereign debt crisis. A third dip into recession was narrowly avoided in 2014 and, at time of writing in late 2015, a modest recovery remains underway.

Chronically weak output growth, whether measured as in real or nominal terms (see Figure 5), has characterised the European economy since 2008. Growth has been particularly weak in the subset of economies using the euro. Even now, seven years on from the outbreak of crisis, real output in the single currency area remains below the level recorded in the first quarter of 2008. This is unprecedented in the post second world war era. Very low inflation, which risks turning to deflation, has depressed nominal GDP, making already dangerous debt dynamics in some countries even more threatening. As Figure 5 illustrates, the rate of growth of nominal public debt has far exceeded that of nominal GDP in the Eurozone since 2008. This trend is unsustainable even in the medium term. While a slowdown in the rate of debt accumulation forms part of the answer, the unsustainable trend will not be arrested without a solid and sustained increase in the rate of nominal GDP growth.

Figure 5



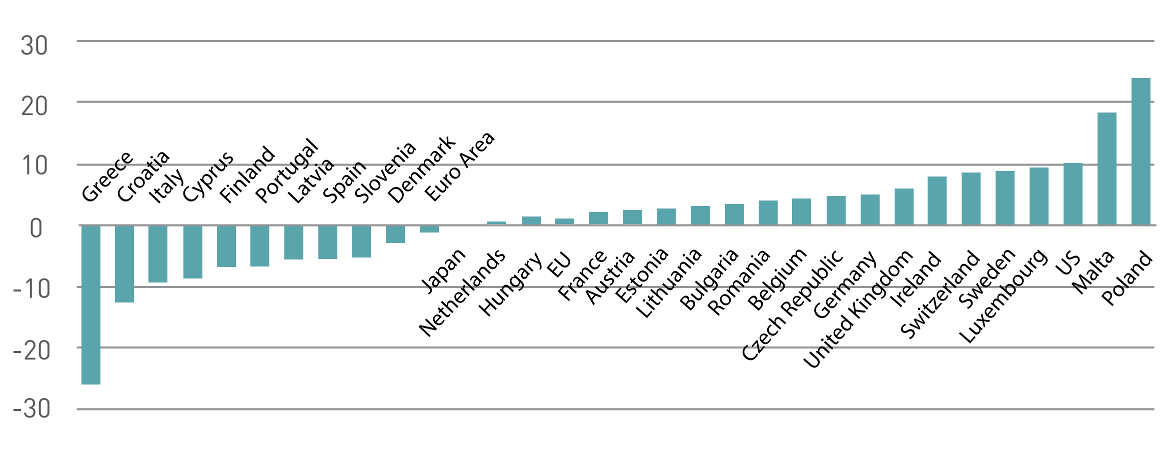
***Annualised**
Source: Eurostat

Across the 19 member currency zone, economic performance since 2008 has varied considerably. But even the best performers have grown anaemically compared to their own performances before the crisis, few of which were notable (see chapter 1). Over that period among the 19 economies of the currency union only one – Malta - has outpaced the US recovery, which itself has been the slowest rebound from any downturn on record. The gap in performance between economies often lauded as Europe's strongest, such as Germany, compared to the US over the period has been considerable (see Figure 6). While the German output, as of mid-2014, was less than 5% larger than it was at the beginning of 2008, US output was almost 8% higher.

If the stronger European economies have lagged the US by a distance, the weaker economies have suffered contractions in output and employment of a kind not experienced in peacetime since the Great Depression of the 1930s. The largest declines have occurred in the southern European economies. While some stabilisation in output seems at hand, growth prospects and competitiveness remain poor in Greece and Italy in particular.

But chronic weakness is not confined to the economies usually described as the "periphery". As of mid-2015 output and employment in Finland and Denmark remained well below pre-crisis levels, mirroring developments in the Eurozone periphery since 2008. While GDP in the Netherlands has recently surpassed its pre-crisis peak, employment remains well below 2008 levels. These three economies have performed poorly despite being at the forefront of implementing structural reforms and despite their high levels of competitiveness by most measures. Denmark's current account surplus stood at over 6% of GDP in 2014, while that of the Netherlands was over 10%, both among the highest among OECD economies. While Finland has recently begun running a small deficit, after many years of running large surpluses, it was ranked 4th most competitive economy in the 2014 World Economic Forum Global Competitiveness Index (Denmark and the Netherlands are ranked 13th and 8th respectively). The recent records of these economies suggest that while structural reform and competitiveness are important, they are not the whole story (discussed in greater detail below).

Figure 6 **% change in GDP from 2008 Q1 to 2015 Q2**



Source: Eurostat; OECD (Ireland, Japan and US)

The policy response

Debate about the conduct of fiscal and monetary policy has been intense since 2008. Nowhere has it been more intense, or divisive than in the Eurozone. This reflects both differences within the economics profession and different national political orientations and histories. And the debate has continued for so long in part because the evidence base – on fiscal expansion versus consolidation, and on the role of unconventional monetary instruments, to take two of the most contentious policy issues – remains less than conclusive.

On fiscal adjustment, theory and even the basic arithmetic of national accounting suggest that if, during a period of private sector deleveraging, fiscal policy tightens too, then recession is guaranteed. It is on this basis that those Eurozone governments with the fiscal headroom to postpone consolidation have been urged to do so. Opponents of this approach are many, arguing that there is no certainty fiscal stimulus works and if it were to be tried but then failed, those governments engaging in it would be left even greater consolidation challenges. Furthermore, it is argued, that however difficult austerity may be, it returns livings standards to sustainable levels (ie levels not artificially boosted by unsustainable capital inflows) and restores competitiveness. The sharp reduction in external imbalances among the peripheral economies since the crisis is pointed to as evidence of the success of the adjustment path.

Those in favour of front-loaded consolidation can also point to the Baltics and, more recently, to the Irish and Iberian economies, as proof that growth can return even while austerity takes place. By contrast, those advocating the use of all available fiscal headroom have specific point to the slower pace of recovery in the Eurozone compared to the UK and US economies.

If evidence on the role of fiscal policy is mixed, giving ample scope for different interpretations, the very limited evidence base on the effects of unorthodox monetary policy make firm conclusions even more difficult to arrive at. Cases of the use of unconventional monetary policies in developed economies in recent years have been confined to Japan before 2008 and a handful of economies thereafter. Given the small number of cases and the very large number of variables that can affect outcomes in all cases, disentangling the precise effects of unconventional monetary policies presents enormous challenges.

Although it can be said at this juncture that these measures have not caused consumer price instability, as was feared by some opponents and sceptics, the effect on asset prices, and particularly many classes of financial assets, is likely to have been considerable, as noted by the Bank for International Settlements[1] . Nor is it indisputably clear that the use of unconventional methods has boosted economic growth as intended. The purchase by central banks of financial assets and other measures has led to no discernible recovery in private spending on investment (fixed capital formation) according to available statistical data.

In Japan after the introduction of quantitative easing (QE) in the early 2000s, growth in fixed capital formation remained below 1% annually in the 2003-06 period and bank lending continued to contract until 2005 despite a near doubling of the monetary base over the period. In 2015, it remained well down on the peak of a quarter of a century ago. In the UK and the US after six years of unconventional measures

1 Annual Report 2014, Chapter 2 http://www.bis.org/publ/arpdf/ar2014e.htm

investment fixed capital formation only recovered to pre-crisis peaks in 2015. Switzerland is the only economy in which QE has been tried and in which fixed capital formation returned to pre-crisis levels in a more normal post-recessionary timeframe. In the case of the Eurozone, the rolling out of a large scale QE programme in early 2015 means that it is too soon to attempt any serious evaluation, although with the ECB signalling at time of writing (late 2015) that the programme would be expanded and weak real economy data, the programme has not (yet) been a success.

In sum, the evidence on QE is mixed with regards its impact on output and employment and the most that can be claimed for it is that it prevented an even deeper recession in the economies in which it has been attempted.

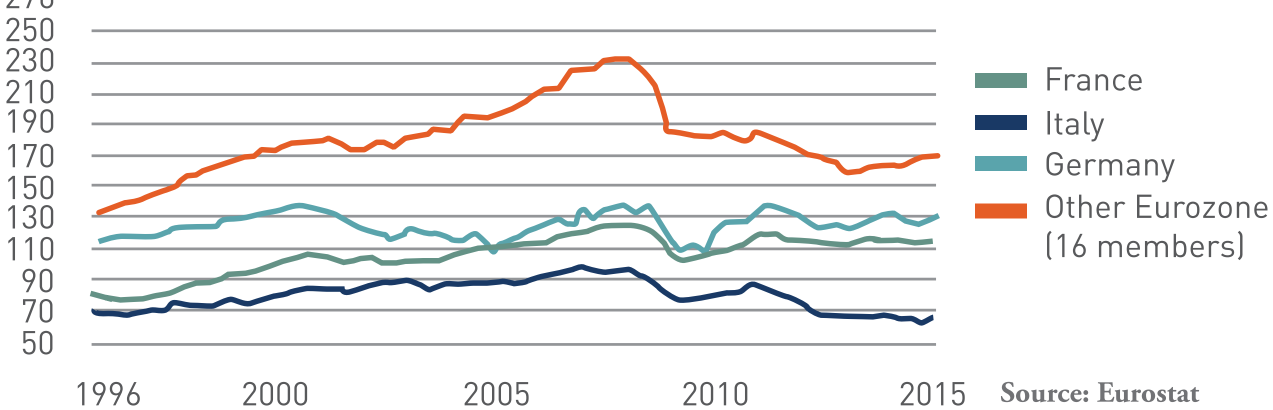
Despite the lack of certitude around an optimal macroeconomic policy mix, the clearly superior performance of the US and Switzerland, and the UK more recently, tips the evidence base towards more aggressive policy efforts to support aggregate demand. This, combined with the risks on inaction which could result in continued very low nominal output growth, further strengthen the case for a more accommodative stance. With levels and growth rates of private investment, private consumption, and public investment well below historical trend rates, a range of monetary and fiscal tools as yet unused or underused could be deployed in Europe.

MENU OF STIMULUS OPTIONS

Corporate investment

Private investment dwarves public investment in all advanced economies. But its trend decline over an extended period, and the acceleration of that trend in recent years, has dampened aggregate demand. Although there is no proven causal link, the decline in corporate investment spending may account for the long run slowdown in economic growth in advanced economies. The fragmentation of the euro zone banking system since the crisis has made matters much worse, in the periphery in particular where fresh bank lending has plummeted and credit, where it is available, remains expensive. Interest rates differentials offered to non-financial corporations (NFCs) have narrowed in 2015, but spreads between peripheral economies and the core remain elevated.

Figure 7 **Investment spending (€billions)**
Fixed capital formation in 2010 prices



Source: Eurostat

There is limited evidence to date that unconventional "credit easing" measures introduced by the ECB since the crisis have increased bank lending to NFCs. Nor is there strong evidence to point to purchases of sovereign paper by central banks elsewhere having an impact on NFC lending. The ECB's decision in early 2015 to purchase government bonds and private securities, including asset backed securities, as part of its QE programme allows financial institutions to exchange illiquid assets for cash, which in turn can be used for new lending. Considerable uncertainty remains over whether it will succeed in reviving lending to NFCs, without which it is difficult to see a wider recovery taking hold. If it fails to boost business lending, the case for the ECB to by-pass the banking system will strengthen. Providing loans directly to NFCs or via state investment banks is among a dwindling number of options available to channel credit to businesses. Such measures have not been an unalloyed success elsewhere (eg the UK "funding for lending" scheme), but given the risks associated with continued low growth, such measures do not appear disproportionate.

Infrastructure investment

The new European Commission is committed to an EU-wide public infrastructure investment programme amounting to €315 billion public investment plan in 2015-2017. This amounts to much less than 1% of annual EU GDP. Nor is all of the €315 billion "fresh" money. Some of the funds included in the package of measures had previously been allocated under different spending lines. As a demand stimulus package it is too small to be significant. If a fiscal stimulus is to be undertaken, and current low interest rates make it very likely to prove value for money, it would need to be very significantly larger than the current EU-wide plan to have a significant impact on aggregate demand. A Eurozone package of €750 billion in newly raised funds over three years would appear to be close to a minimum amount needed if any significant short term effects were to be felt. Raising the funds could come from a mix of public and private sources.

Eurobonds

The joint issuance of debt has been rejected repeatedly by a number of euro area member states. The implications of so doing are considerable and would potentially amount to the first step along a road towards fiscal union. Yet the issuance of €500 billion in Eurobonds, amounting to just over 5% of Eurozone GDP, would be a low risk experiment and doing so would not lead to any sort of inexorable process towards fiscal union. Eurozone members could agree to an upper limit of issuance and on a maximum maturity – 3-5 year bonds would allow time for the funds to be invested but would allow the unwinding of the measure by 2020 if members states deemed it ineffective or unpalatable. The issuance of Eurobonds could become a confidence-building and trust-enhancing mechanism for Europe if the funds raised are used solely for the investment projects and the allocation of funding is done along transparent and evaluative lines. In order to achieve that an independent EU-level body to conduct cost/benefit evaluations on projects is needed.

Efforts to stimulate to growth by infrastructure spending have in some cases led to wasteful spending. The case of Japan in the 1990s is pertinent in this regard. Given the politically fraught nature of increasing EU and/or Eurozone collective spending commitments, it is imperative that there every effort is made, and is seen to be made, to ensure that 1) value for money is achieved 2) a clear case that the spending will yield a return greater than the cost of funding 3) and that priority is given to the projects that are the most growth enhancing. In order to achieve this, extensive and impartial cost benefit calculations would be needed on a long-list of projects. Such evaluation would be required both before funds are committed to any project and after it has been completed. The taskforce involving both the European Commission and the European Investment Bank which is currently assessing projects for the proposed €300 billion public investment plan in 2015-2017 could be tasked with such an evaluation as an interim step, but over the longer term a more permanent agency would be require in order to do so.

Project bonds

Still in a pilot phase under the European Investment Bank, the EU 2020 Project Bond Initiative[1], provides an existing model to channel private capital into public investment. The project should be fast-tracked and ramped up. With the stock of private wealth continuing to rise and a demand for longer maturity instruments by some of the largest allocators of wealth, such as pension and insurance funds, one third of the €750 billion Eurozone infrastructure package could be funded from this source.

Private consumption

Private consumption is, by a considerable distance, the largest component of domestic demand in all advanced economies. It has been profoundly weak in most European economies and continues to contract in many. There are a number of reasons for this. In economies where employment is contracting, the decline in aggregate household income as a result of falling employment is compounded by stagnant wage growth and high/rising savings rates. In economies where household debt levels are high, deleveraging is dampening private consumption. Very low inflation and the risk of outright deflation are making the rebuilding of household balance sheets more difficult.

Although boosting private and public investment are priorities, without a recovery in private consumption, it may prove impossible to break out of the vicious circle in which the weaker euro zone national economies appear to be locked. In this regard, radical and controversial proposals[2] to break such a cycle may have to be considered. With fiscal policy so constrained, a last resort may be for the ECB to by-pass the financial system and make cash payments to households via newly created money. This could be used by households either for consumption purposes or to accelerate the rebuilding of their balance sheets via further deleveraging.

Choosing such a policy would be very much a last resort and has serious risks, in terms of the danger of undermining confidence in the ECB, the precedent it would set and the complications of distributing money fairly. And it is clear that the political climate in the euro zone is very far from being prepared for such a radical experiment. Yet the dangers of under consumption could become greater and more immediate if the Eurozone economy fails to return to growth. If the choice ultimately becomes one of allowing the euro to collapse or taking such a radical step as gifting euro zone households ECB-created money, then the case for it would be strong.

1 http://ec.europa.eu/economy_finance/financial_operations/investment/europe_2020/index_en.htm

2 "Print Less but transfer more: Why Central Banks should give money directly to the people" Foreign Affairs, September/October 2014 Blythe, Mark and Lonergon.https://www.foreignaffairs.com/articles/united-states/2014-08-11/print-less-transfer-more

Chapter 3. Microeconomic reform

Efficient markets are central to generating economic growth. Opening markets to more participants allows economies of scale to be exploited and generates dynamic effects via increased competition. The EU's decades-long drive to improve market efficiency via liberalisation and regulatory improvement has brought real prosperity gains . But many obstacles remain before product and services markets in Europe are truly integrated. Although some barriers are unlikely to be overcome even in the longer term, owing to language and traditional/historical preferences for instance, many of the barriers which exist are more amenable to being lowered and/or removed, as the European Commission highlighted in October 2015 . While there remain many areas of the European economy that might benefit from further EU-level liberalisation/integration, two appear to offer particular benefits for economic growth: the expansion of non-bank financing options for firms and increased cross-border trade in services. These are worth prioritising at EU level as they offer the prospect of unlocking significant growth potential.

The funding of corporate investment

The funding for corporate investment in Europe remains overwhelming sourced from the banking system to a degree that is unusual when compared to other developed economies, and the US in particular. This is likely to explain, in part at least, the deeper and more protracted recession suffered by Europe compared to the US. As has been made clear in recent years of European banking sector crisis, lack of diversification in the sources of corporate funding comes with costs and considerable risks. Increasing the range of financing options for companies would likely reduce the risks associated with Europe's very large banking sector and allow for increased corporate investment, which in turn offers the prospect of more rapid economic growth. Although there are advantages to bank-based financing of corporate funding needs, Europe appears excessively dependent on this source and diversification of financing sources offers both the prospect of higher investment spending and lower concentration of risk in the banking sector.

Trade in services

Despite accounting for well over two thirds of EU output, intra-EU cross border trade in services stood at just €700bn in 2013, or less than 4% of GDP. Growth in trade in services within the Union has not been strong and overall values remain a fraction of merchandise goods trade. The services directive, fully in force since the end of 2009 does not appear to have added to growth in services trade in any significant way (although the low levels of GDP growth since the directive came into force may account to much of the sluggishness). Removing barriers to the purchase of services provided in other member states offers the prospect of considerable efficiency gains.

Capital Markets Union

Financial systems are a critical system for all economies beyond those of the simplest agrarian societies. The channelling of savings from those who chose to store their wealth at any given time to those who need to invest it is central to the economic development, renewal and advancement process. In Europe, banks have traditionally been the intermediation point between savers and investors, and that has remained the case to a degree which is unusual in advanced economies. While corporate lending by banks is an efficient mechanism to channel savings into fixed capital formation (among other uses), and can have advantages over other forms of financing, it also has weaknesses, particularly during times of banking crises. Among these disadvantages are the risks associated with have such a heavy dependence on a single source of financing. Europe's banking system (as measured by assets relative to GDP) is more than twice as large as its closest peer economy, the US. The financial crisis in Europe since 2008 triggered a longer and deeper recession in Europe and this is likely to be in part because the challenge of repairing a much bigger banking system was much greater.

The benefits of diversifying sources of finance for companies has long been recognised. And the protracted problems of the European economy in recent years has pushed the issue up the policy agenda. The European Commission's February 2015 Green Paper on "Capital Markets Union[1]" sets out a range of issues, questions and proposals on how greater funding diversification might be achieved. Many of the issues it highlights are laudable and are discussed in greater detail below. But one of the objectives – boosting the level of loan securitisation by banks – may not be worth prioritising. The focus on securitisation as a means of freeing up bank funding for more fresh lending is questionable. In theory, the packaging of banks loans (both those to households and businesses) into interest bearing securities which are sold on to investors has advantages, including the spreading of risk. And while it is true that losses on securitised bank loans originating in the EU were far lower than those issued in the US before 2008, there is scant evidence that securitisation in the past has led to increased bank lending to companies for the purposes of fixed capital formation. There are, by contrast, numerous historical examples of the bouts of securitisation ending badly[2]. Given the questions over securitisation, other aspects of capital markets union may be worth prioritising and this paper suggests that it does not warrant being included on a menu of EU-level policy options designed to boost growth.

1) Increased access to equity financing

Access to equity markets is important in many respects. Although there may be an increased short term focus for managers (owing to pressure to maintain the share price), the funding of fixed capital formation using equity instead of debt has the benefit of lowering leverage and, as highlighted in the CMU Green Paper, acting as an economic shock absorber in times of crisis, and particularly in times of banking system crisis.

1 http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=COM:2015:63:FIN&from=EN

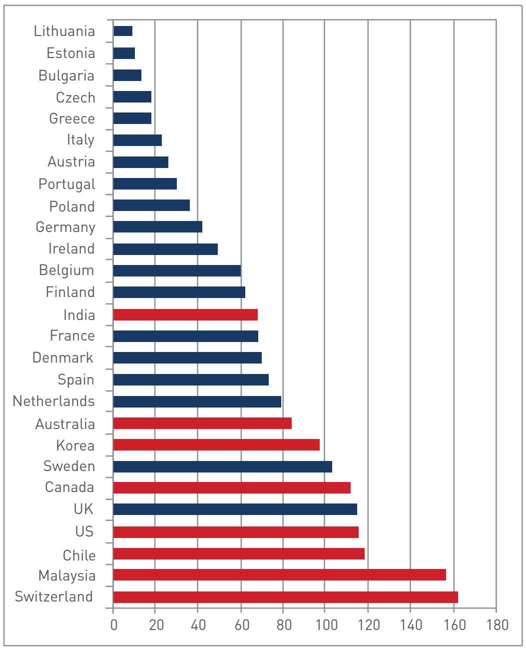
2 Developing an effective securitization model is not easy--according to one economic historian, mortgage securitization schemes were tried and abandoned at least six times between 1870 and 1940

See Kenneth Snowden (1995), "Mortgage Securitization in the United States: Twentieth Century Developments in Historical Perspective," in Michael D. Bordo and Richard Sylla, eds., Anglo-American Financial Systems: Institutions and Markets in the Twentieth Century (New York: McGraw-Hill).

Despite Europe's historical lead in the creation of stock markets, today equity financing tends to be less common than in non-European economies, including some economies whose level of development is much lower than that of Europe. As illustrated in Figure 8, stock market capitalisation as a percentage of GDP tends to be lower in Europe than peer economies, such as Canada, the Republic of Korea and the US. Italy is a particularly notable case. Despite being one of the G7 large industrialised economies, its stock market capitalisation as a percentage of GDP – less than 25% - is lower than many much smaller and less developed economies.

One factor explaining Europe's underdeveloped equity markets is the large number of small economies. Because smaller economies tend to have fewer big firms, and firm size is an important determinant in the decision to go public, there tends to be a coorelation between economy size and equity market size. But even accounting for this factor, European equity markets are comparatively under-developed. This is all the more surprising giving the decades-long existence of free movement of capital in the EU and the absence of currency risk within the Eurozone for more than a decade and a half.

Figure 8 **Stock market capitalisation as a % of GDP (2012)**



Source: World Bank

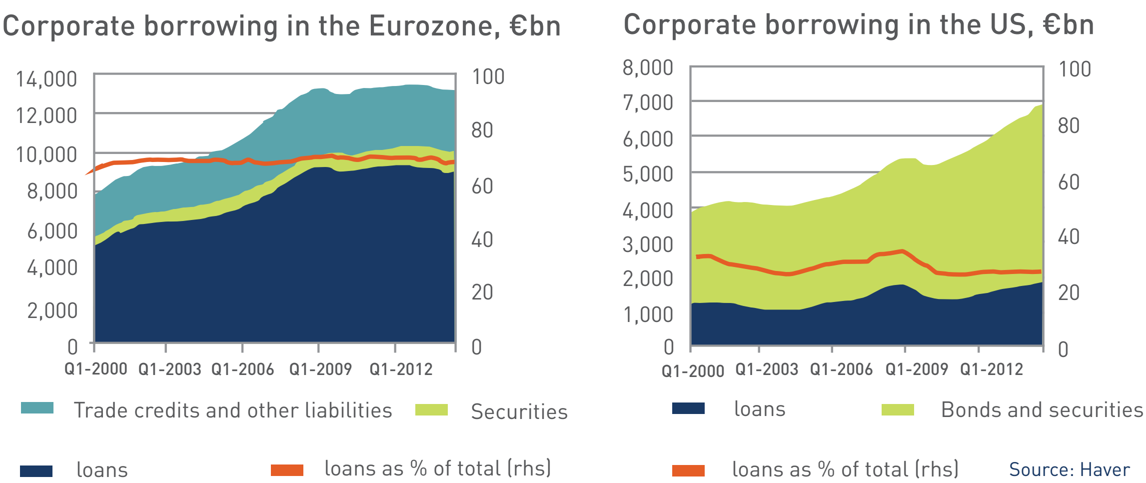
2) A larger and more liquid bond market for non-financial corporations

The second unusual aspect of Europe's corporate financing system is the lower prevalence of bond issuance by non-financial companies. In headline terms, Europe has a very large corporate bond market, but this is dominated by bank bonds and is very different from the US corporate bond market which allows medium and small non-financial companies unintermediated access to capital markets[1]. The existence of the large

1 European banks issue bonds which are sold to institutional investors. The funds raised are used to lend to companies (and individuals), with credit risk remaining with the banks. In the US, by contrast, institutional investors lend directly to companies via the bond market, thus cutting out the intermediation function of banks and lessening the concentration of credit risk in the banking system.

and liquid market for non-financial corporation bonds in the US has resulted in a very different funding model for American businesses, with only approximately 25% of their non-equity funding needs being sourced via banks. In Europe, by contrast, the profile is reversed, with almost 70% of funding coming via the banking system, as illustrated in Figure 9. As it is larger companies which usually tap the corporate bond market directly, smaller economies (which tend to have fewer larger companies) are even more reliant on banks to fund corporations. The creation of a deeper and more liquid bond market in Europe would likely reduce the cost of capital, and would appear to be achievable in the euro zone in particular owing to the absence of currency risk.

Figure 9 **Non-Financial corporate funding in the Eurozone and the US**



Source: Haver; http://qed.eu/files/CMU_-_Judith_Hardt_PPT.pdf

Menu of policy options to improve access to equity financing and increase corporate bond issuance

Prospectuses: There has been a recognition for some time that the drawing up of prospectuses in preparation for a stock market listing is a disincentive for firms when considering funding options owing to the cost in time and financial resources. The existing prospectus regime is being reviewed and a public consultation is underway by the European Commission. Reducing the amount of information included in prospectuses and making the approval process less onerous may be warranted in reducing the barriers to firms tapping capital markets. In some instances, particularly for smaller companies, there may be a case for companies not to be obliged to draw up prospectuses as they seek access to capital markets.

Taxation: Currently the treatment of debt over equity in the tax systems of many member states is more favourable towards the former. Changes to ensure, at the very least, that equity is not more expensive than debt would level the playing field and eliminate a fiscal bias towards higher corporate indebtedness.

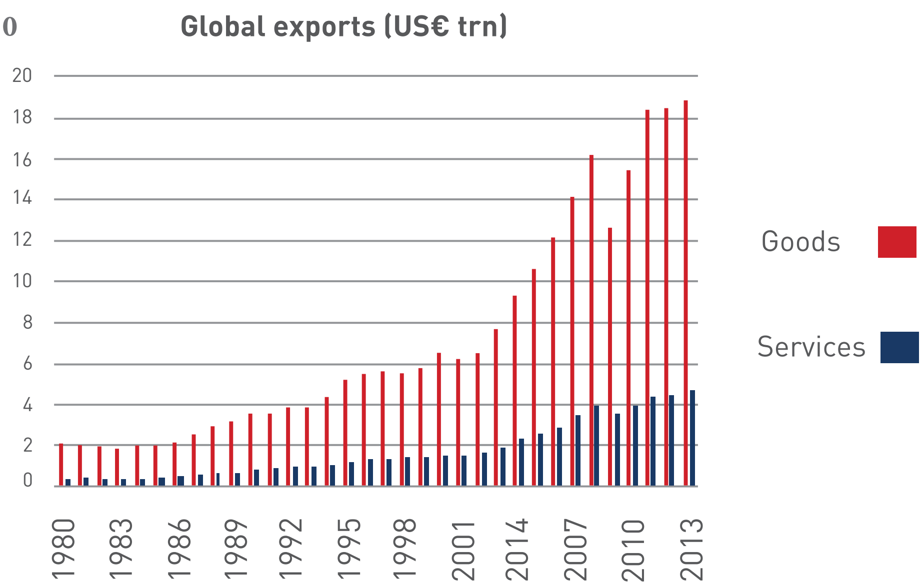
SME credit scoring: While larger corporates will frequently be rated by credit rating agencies, information on the creditworthiness of smaller companies is usually more opaque. In large part this owes to the cost of providing the information and it is unlikely that an intermediary, such as a credit rating agency, will be able to provide such information profitably. There may be a case for EU or national level public intervention to make up for the non-provision of the market of this function. Credit scoring data on smaller companies would be beneficial not only to investors considering taking ownership stakes or purchasing bonds, but for all kinds of potential funders, including banks, private placements and others. Consideration of public investment to remedy this possible market failure would require a detailed and comprehensive cost/benefit analysis.

Services: deepening the single market

As economies develop the demand for an ever greater range of services means that both agriculture and industry come to be dwarfed in economic output by the provision of services. While large differences still exist between the richest and poorest countries, today services dominate almost everywhere. In the EU services account for two thirds of output, reaching over 80% in some member states. The importance of services in employment is almost a great, and in terms of generating jobs growth it is even greater. In 1993, 148 million people were employed in the EU-15. Two decades later the number was 24 million higher, with all of the net employment gains over that time coming in the services sector. Despite the need to ensure strong manufacturing and agriculture sectors, economic growth and employment growth in particular will be driven by services in the future.

The rise to dominance of services in economic activity saw growth rates in global services exports exceed those of goods exports in the 1980s, but since then growth rates of services and goods exports have been remarkably similar. That has resulted in a very stable ratio between the two, with the latter remaining dominant (see Figure 10) despite the former coming to dominate global economic output.

Figure 10



Source: WTO

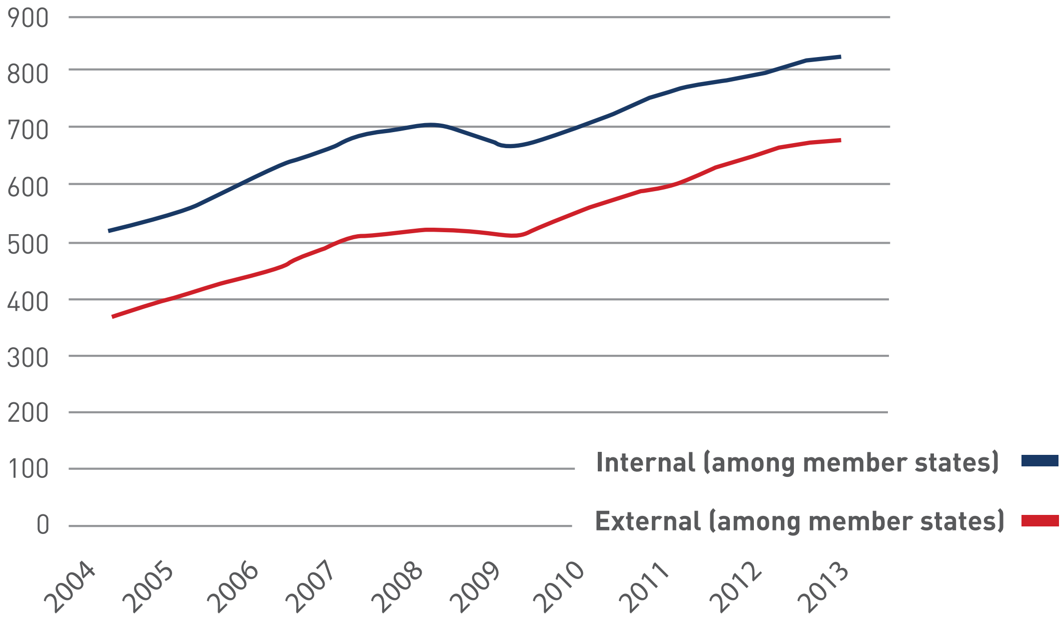
The relatively low rate of growth in international cross border services trade reflects in part the inherent problems of providing some services over distance. Many services require face to face contact and/or are consumed at the point of provision, making their provision over distance difficult or impossible. But "the death of distance" owing to improved communications, and advancements in internet technologies in particular, means that more services in more industries are becoming tradeable – consider as an example MOOCs, or "massive open online courses" that education services professionals provide in growing numbers. Yet despite this, the internet revolution has yet to show up in the services export growth numbers, either globally or in Europe.

Nor has liberalisation driven up growth rates in services exports in most countries. Globally the inclusion of a widening range of services industries in the multilateral framework of the WTO in recent decades was expected to spur growth in services trade, but appears to have had little or no effect. The absence of a liberalisation effect has been even more surprising in the EU. The opportunity of improving Europe's single market for services was recognised a decade ago when the European Commission put forward a directive designed to lower barriers to cross border provision of services. The Services Directive was designed to remove discriminatory, disproportionate and, ultimately unjustified national requirements on service providers. It was also intended to clarify issues around the freedom of services companies from one member state conducting business in other member states. In addition, under the directive all member states have been obliged to creates "Points of Single Contact" in order to lessen the cost and time in dealing with administrative requirement.

But almost six years after coming into effect, the directive appears to have had little impact as growth in cross border services within the EU registered no shift onto a higher growth trajectory (see Figure 11). Indeed, services exports to non-EU countries have grown more rapidly than cross-border services trade within the EU over the past decade (the former rose by 87pc and the latter by 62pc). Nor is there evidence to suggest that services providers are more likely to establish in non-home member states. The very limited impact of the services directive raises very serious questions about the adequacy of the initiative in removing the obstacles to a real single market in services.

The limited impact of the directive has increased attention on barriers to cross border services trade that still exist or which were not included in the services. Of the latter there are sectors that are covered by other, sector specific legislation, such as telecommunications and energy, public procurement is among the most sensitive issues.

Figure 11 EU 27 services exports (€bn)



Source: Eurostat

Conclusion

The European economy has many strengths, but its weaknesses are greater in number. The balance between the two has been tilting away from the former and towards the later over decades. In the 21st century, few national economies have enjoyed even modest economic growth and, of those which have, in most cases unsustainable increases in debt were the main reason. Since 2008, demand across the continent has been particularly anaemic. Periods of recovery have been weak by historical standards. Many fragilities remain, most notably in the financial system and the public finances of member states.

There is no panacea for Europe's low growth problem. There is, moreover, considerable uncertainty around the various policy options that have been advocated in the post crisis era, both in terms of their efficacy and their risks. But the multiple downsides of failing to return to stronger rates of expansion, particularly in those countries which have experienced the weakest growth, are much greater.

Public debt levels are at dangerously high levels in some member countries. A renewed bout of even mild recession could very easily raise afresh the prospect of sovereign default. Given weaknesses in the European banking system, even the prospect of a default on sovereign debt could trigger a renewed bout of the crisis which caused recession in the early years of the current decade. Within countries, political tensions and a rise in support for populist and extreme elements are at least partially the result of economic weaknesses. Among the members of the EU tensions have arisen as performance diverges. This poses a risk to the EU and euro constructs.

Given the risks between action and inaction, the case for a grand bargain of macroeconomic and microeconomic reform measures is strong. More aggressive fiscal and monetary measures would spur demand and boost employment. This would not only generate confidence effects, it would also help to offset dislocation effects of microeconomic reforms. The liberalisation of the EU services market, for instance, offers hope of considerably boosting European economic growth, but it is also likely to lead to some job losses as increased competition impacts inefficient producers. Co-ordinated, EU level agreement and action offers the best chance of pushing the continent's economy onto a higher growth trajectory. Without stronger growth, Europe's challenges will mount and, sooner or later, risk reaching a point of rupture.

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