ORGALIME

Orgalime's views on investment

Executive summary

Orgalime is the prime voice of the EU engineering industry as whole. This is a growing industry both in terms of jobs and turnover. The industry employs nearly 11 million people in the EU and in 2016 accounted for some €2000 billion of output. Most of the growth in our industry arises from the innovative products, processes and systems which our companies develop in the EU and then market worldwide. Our sector is at the heart of the transformation currently taking place in industry, which centres on the merging of manufacturing and data technologies. It is at the core of strategic European value chains and of crucial challenges like sustainability and energy. Orgalime's Industry is an enabler of growth and productivity in other sectors. **With more investment, we can contribute to a higher competitiveness for the whole economy. Manufacturing has a proven track record in generating growth and jobs – not only in our own sector but throughout the economy. If policymakers can help us build on this, it is Europe's citizens who will reap the rewards.**

European engineering companies in many market segments are still maintaining and even developing their market shares. However, competition from Asia and America is fierce. The high level of investment in these continents puts European engineering and manufacturing industries under high pressure.

The EU needs to be a top destination for manufacturing investment, leading to an increase of manufacturing in Europe. We want our industry to still be able to do business and create growth and jobs in a decade. This paper expresses our rationale to make it happen.

The financial crisis in 2008/2009 showed us clearly that there is no alternative for Europe than to promote our industry and keep it in Europe to create sustainable employment and demand for other sectors of the economy.

We face structural problems that demand structural action in Europe. Once we stray away from the economic growth path it gets very difficult to catch up again. Europe is clearly falling behind compared to the US in terms of investment in tangible and intangible assets.

Europe is about to enter a more favourable phase of the business cycle. When that happens, the state of our economy needs to be ready to make investments and the capital stock grow again. There are several ways forward and measures that can be taken.

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Among the most crucial ones is a focus on digitisation that can be promoted by giving incentives to invest in intangible goods. **Higher productivity is the key to competitiveness and jobs in the future, so there is no time to lose on prioritising the modernisation of our industry**.

To attract more foreign investment and keep our factories in Europe we need to improve our competitiveness also by supporting national fiscal initiatives with regards to investments and corporate taxation.

The European Commission established the European Investment Plan. This initiative is potentially helpful but needs milestones and further elaboration to channel the money into the right projects that have the potential to lead to increasing productivity in the future.

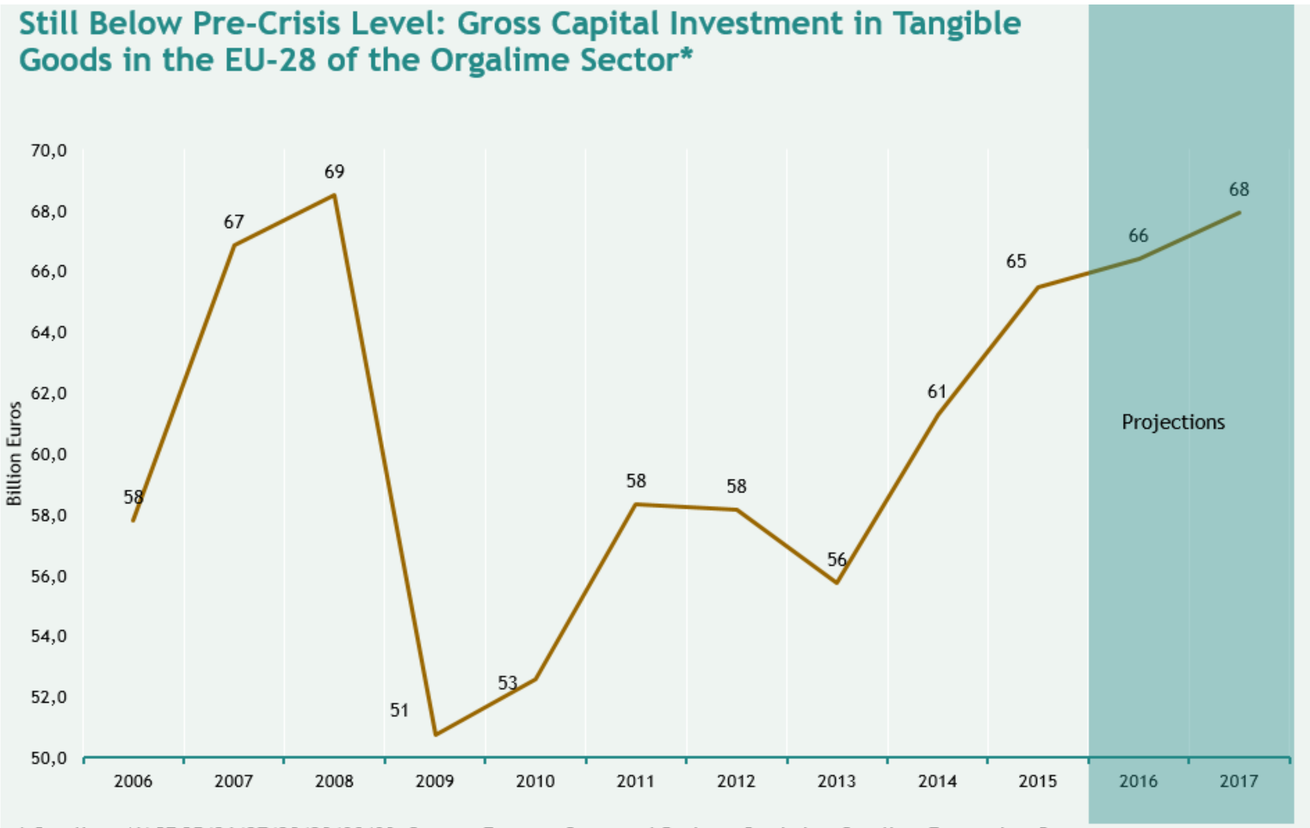
The European Commission put several very important initiatives on its agenda, including the Digital Single Market, the Banking Union, the Capital Market Union and the continuous improvement of the EU Single Market. This should lead to a level playing field for all potential investors and a more sound and predictable investment environment.

We present our detailed arguments hereafter

Foreword: poor investment endangers technological progress and future growth

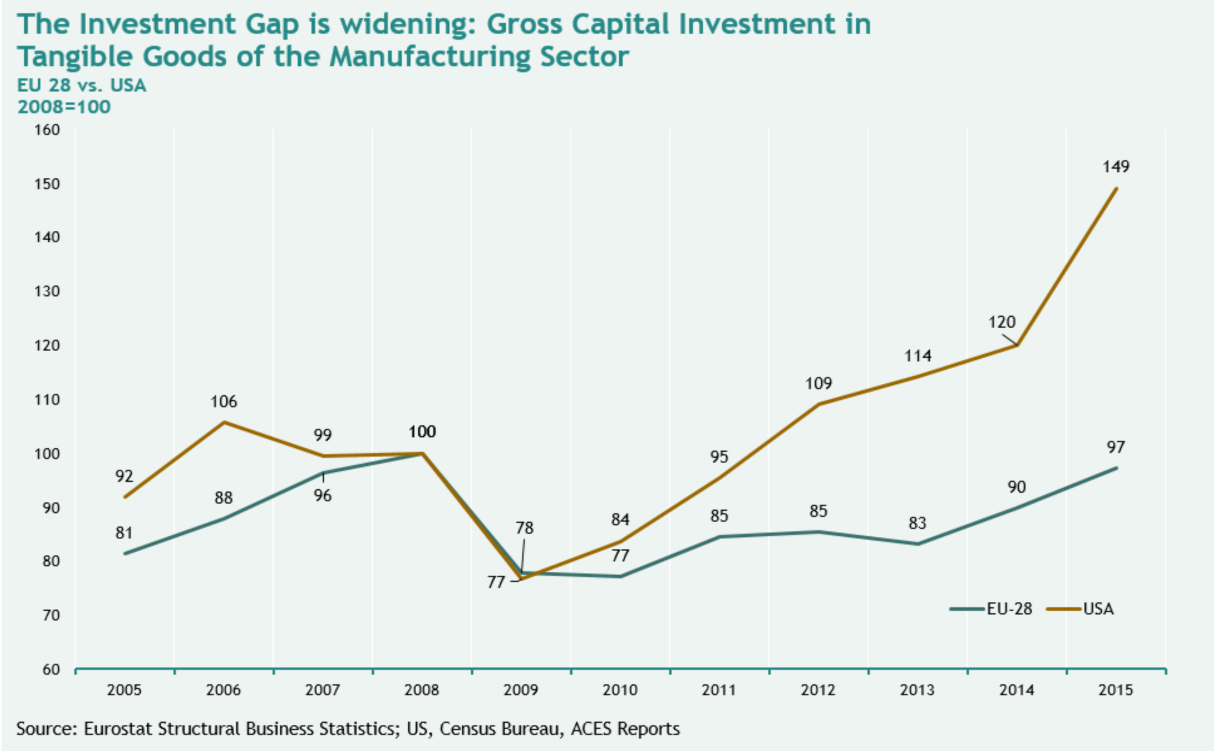
Orgalime believes that Europe – and our sector in particular – has the resources to contribute to a European industrial renaissance. However, we note that poor investment could be a major hurdle if we want companies to be able to invest in Europe in the coming years. Indeed, the European Commission has acknowledged that **lack of investment is one of the biggest threats to economic recovery and restricts future growth potential.**

The engineering industry has continued to invest in Europe (EU 28) at an average of almost 61 billion Euros a year throughout the past decade.



* Orgalime: NACE 25/26/27/28/29/30/33 Source: Eurostat Structural Business Statistics; Orgalime Economists Group

In the USA, however, investments in the manufacturing sector have exceeded the level of the pre-crisis years by nearly 50% whereas in **Europe we were still below that benchmark in 2015**. It is an undeniable fact that **Europe is clearly falling behind**. Falling investment rates have a huge impact on future growth perspectives. A falling capital stock over a long period removes the basis for technological progress.

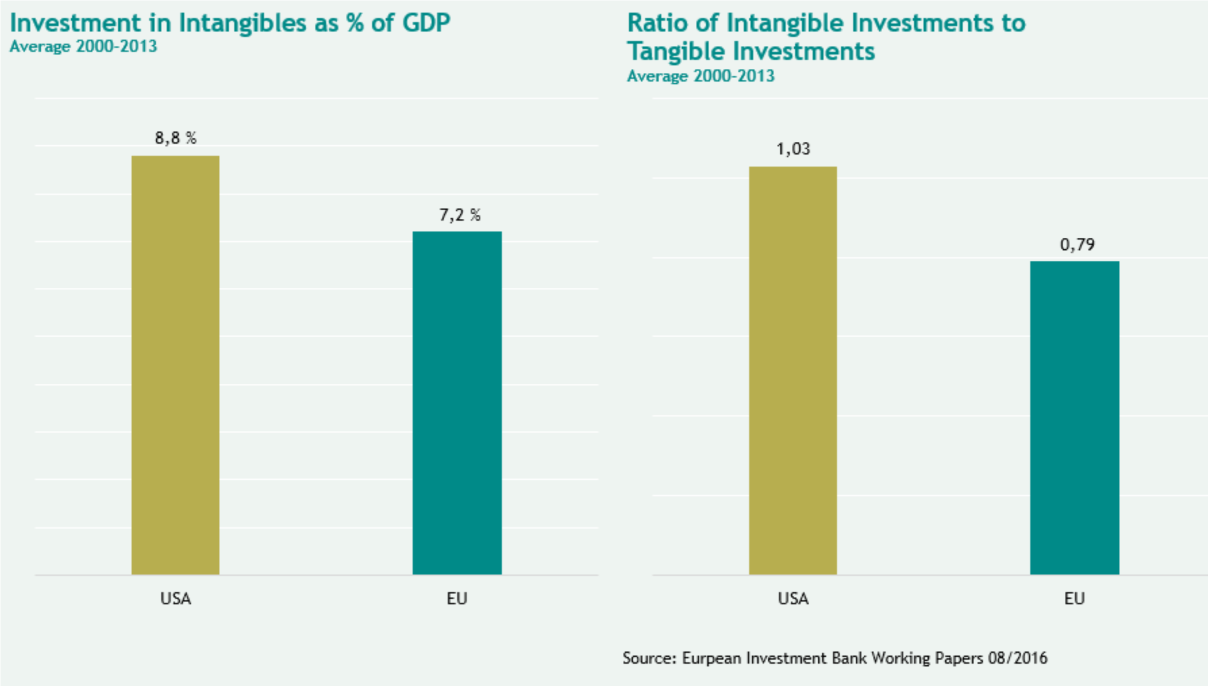


Similarly, **the situation is worrying for intangible assets**. The Council of the European Union underlined[1] that *"the stock of intangibles is still relatively low. The EU as a whole is still lagging behind the USA in this type of investments, without any sign of catching-up. Intangible assets are critical elements of a knowledge-based economy {…} Investment in intangibles are a driver of productivity and economic growth."*

This was also noted in the OECD Science, Technology and Innovation Outlook 2016 *"intangible assets investments have been very dynamic during the crisis, including in recent years, in Korea, Israel and Australia. Such investments have also recovered markedly in the United States since 2010, but have grown only slowly in Japan and the euro area. Noticeable cross-country differences in investment profiles exist even within Europe, signalling a growing threat to the continent's future economic cohesion"*.

According to the European Investment Bank[2], overall the countries that were more intangible intensive before the crisis (2000-2007) were less affected by the crisis or experienced a faster recovery.

[1] http://data.consilium.europa.eu/doc/document/ST-5252-2017-INIT/en/pdf
[2] http://www.eib.org/infocentre/publications/all/economics-working-paper-2016-08.htm



Additionally, **net investment rates are falling much faster than the gross investment rates**. We want to draw attention to the fact that publication of gross investment rates is misleading and masks a very unpleasant truth behind the figures.

Given that the difference between those figures is depreciation, the evolution of low investment figures (that are always in gross terms) is even worse if depreciations are subtracted. Gross investment has risen until 2008; an increasing capital stock leads to higher depreciation in the following years.

Consequently, with average depreciation rates rising afterwards, gross investment would need to be higher than historical benchmarks in order to avoid that net investment should become negative and the capital stock fall.

Estimates of real net investment for business and government combined, derived from new OECD estimates of the real productive capital stock, suggest that they are much lower than prior to the crisis.

According to OECD figures, the net investment is down by 69 % in 2014 compared to 2008. This is an important contributory factor behind the post-crisis weakness in potential output growth. **The major part of current investment is therefore in replacements and not new investment in innovative technology.**

There is an ongoing **structural change that might become irreversible** if action is not taken now. The current lack of investments cannot be explained by weak economic growth and the sluggish business cycle. There is structural change taking place that endangers the future of the core manufacturing industry in Europe.

The future competitiveness of our industry strongly depends on the ability to adapt to the new concepts of digitisation. A highly developed and high salary region like Europe has to be an innovation leader in order to compete with the rest of the world. That is why Europe risks falling behind if we lose the momentum in this critical phase of new rising digital concepts.

A. Reasons for weak investment

Orgalime believes that the following elements play an important role in the poor (?)investment climate.

- **Weak growth rates in the last years including the 2008/2009 recession are among the main factors for weak investment.** There is a significant correlation between economic growth rates (output growth) and investment according to the IMF. Broad trends of investment can be explained by output dynamics.

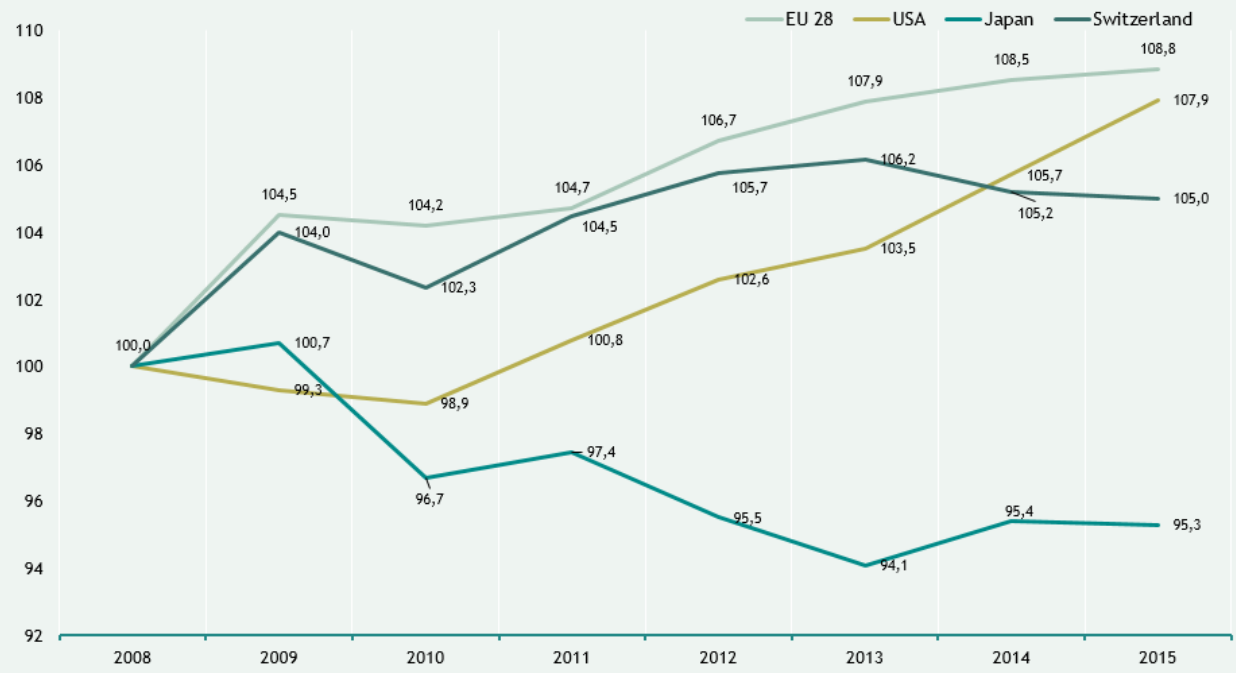
- There was a **high degree of uncertainty and instability**. A sound economic environment and especially solid long term expectations are important factors for investment. This implies a good business climate with optimistic long term expectations. Unfortunately, this has not been the case in the last years. With too little investor confidence in the long term economic development potential, investment will fall or will shift outside the EU.

- Companies that are willing to invest in the **EU need a certain trust that the process of market integration in the EU will not be reversed but driven forward**. There is danger that the process of European market integration not only stops but also leads to tendencies towards disintegration. Discussions about the European Monetary Union and countries leaving the EU must be countered by concepts of deeper market integration in the EU.

- **Secular stagnation is a main issue and linked to a systematic slow-down in productivity**. As Larry Summers, former chief economist of the World Bank, stated, "*there is increasing concern that we may be in an era of secular stagnation in which there is insufficient investment demand to absorb all the financial savings done by households and corporations, even with interest rates so low as to risk financial bubbles*." Furthermore, excessive public deficits that have been triggered also through high money supply caused a crowding out effect: public credit demand crowds out private credit demand and therefore the ability to invest.

- **Competitiveness in Europe is diminishing compared to the rest of the world**. This means that with rising relative unit labour costs, Europe loses ground relating to competitiveness and therefore attracts less investments. This is true for Europe as a whole and even more for countries that could not increase their productivity after the crisis and maintained high labour costs at the same time. Unit labour costs in Europe increased by 8.8 % from 2008 to 2015, compared to 7.9 % in the US, 5 % for Switzerland and even negative figures for Japan (-4.7 %) in the same period**. Europe has lost ground in terms of unit labour costs** in the past and that cannot easily be revised.

Unit Labour Costs
Index 2008=100



Source: EU Commission 02-2017

- **Overinvestment took place in the pre-crisis years.** High investment rates, coupled with the assumption of rising demand, led to a growing capital stock in absolute values. With shrinking demand in 2008/2009, the capacity utilisation rate fell together with profitability. Unused capacities reduce the need for new investment.

- **Lower profitability**, or in other words, lower return on capital reduced private investments **in the aftermath of the crisis.** A high capital stock (that has been established in the years prior to 2008/2009) is expensive to maintain and therefore new investments have a low return on investment.

- Despite low interest rates, **companies are frequently complaining about unfavourable credit conditions**. The European Bank Lending Survey shows a severe tightening during and after the crisis of 2008/2009 and only a very cautious and slight easing of credit conditions since then. A major share of the available bank money is used for financing public deficits instead of supplying the private sector with investment capital. This crowding out effect by public credit demand on private credit demand makes financing conditions for private companies in some countries hard, even if the cost of capital is low.

- **The availability of cheap input materials has reduced the pressure on companies to invest in new technology to stay competitive.** In fact, the prices of raw materials and energy have been low in recent years. One example is the energy efficiency technologies that lost momentum due to the relatively low energy prices.

- **In some economies, the capital labour ratio declines despite low capital costs** owing to a large number of unemployed people in some EU Member States. Moreover, a large share of them are unskilled. This increases the labour input relative to capital input and can also explain the reluctance to invest even in a low cost of capital environment.

The caveat we can add is that **customers of our industry increasingly lease equipment** instead of purchasing it. Thus, engineering companies themselves are changing their own business models from selling products to selling services. Therefore, leasing will be accounted for as an operating expense and not as a capital expense and service providers are accounted in statistics as service companies and not as a manufacturing companies.

B. EU initiatives

We acknowledge the work done by the EU in recent years to reverse the trend of low investment in Europe. We certainly welcome the following EU initiatives.

- **The European Investment Plan** (“Juncker Plan”) potentially triggers investment. We think that this initiative potentially boosts investment under the right framework conditions.
  - The challenge is to channel the money into the right projects. This means projects that would not have taken place without the support of the fund and projects that are creating long term benefits in terms of productivity increase or technological progress.
  - There must be a suitable communication strategy towards companies and involvement of private SMEs in order to make the European Investment Plan efficient.
  - European initiatives such as the European Investment Plan need to focus more on specific projects that have the potential to increase productivity through modernisation and digitisation.
- Capital cost is currently extremely low in nominal and in real terms. Consequently**, access to funds cannot be the only solution.** The European Investment Plan can potentially be helpful but needs accompanying measures. As previously mentioned, there are structural problems and the European Investment Plan is not enough.

- **The EU Banking Union** that has been agreed on in 2014 to achieve a deeper integrated and better supervised banking sector became necessary after the crisis in 2008/2009. Capital markets will be more efficient and more transparent with a single rulebook that is monitored and implemented centrally. A more efficient capital market will improve the private sector´s access to finance.

- Capital markets are still fragmented even though the free movement of capital is one of the four freedoms of the EU single market. The discussions about the **Capital Market Union (CMU)** have started in 2015 and could help bring back investment to Europe. The Capital Market Union removes barriers for cross border investments and can lead to a harmonisation of insolvency laws. The perspective of the largest EU capital market leaving the EU (UK´s exit of the EU) makes CMU even more urgent. It increases the transparency and liability of capital markets and will therefore have a positive effect on investment.

C. Possible ways forward

Despite the generally low level of investment in the past years, our industry grew. Growth in the engineering branch is all the more encouraging as the digitisation of industry has a pervasive effect across the entire value chain. Nevertheless, as noted in the two preceding chapters, the future of industry is particularly worrying. Yet we believe that some things could be changed to drive investment up in addition to the EU initiatives mentioned in Chapter B.

- Europe needs a **predictable investment environment** to give potential investors enough incentives to make use of the existing investment funds.
  - In a macroeconomic sense that means:
    - **sound fiscal policies among the EU Member States,**
    - **predictable pro-industrial taxation policies,**
    - **a more efficient law-making process that is better coordinated with business players and therefore more predictable and applicable for companies,**
    - **a stable regulatory environment,**
    - **less administrative costs of doing business in the EU.**

The European internal market is still heterogeneous and has to be reinforced. Industry needs an **equal level playing field** like for example in the environmental area. Moreover, the European Commission has put the **implementation of a Digital Single Market** (DSM) on its top priority list. We agree that it is a key issue and believe that a DSM needs to be established as soon as possible. Moreover, the Commission needs to ensure that the internal market rules are effectively applied which increasingly we see is not the case. Moreover this appears to be happening without the Commission seeking the legal remedies.

- To attract investment, it is necessary to **make Europe more competitive as a business location** by:
  - **holding back labour costs and increasing labour market flexibility**
  - **investing in R&D**
  - **taking measures that improve the regulatory framework**
  - **having a comprehensive single market for goods and services**

- **National fiscal incentives can trigger investment**. National schemes that subsidise investment, or taxation policies that trigger investment, have a positive impact not only on investment but on the whole economy. Following the economic crisis of 2008/2009 several countries have undertaken major efforts to boost investments in a difficult economic environment. For some countries, those initiatives have been important steps towards economic recovery and might also play a role in a European wide recovery of investment.

- **All tax incentives that trigger investments in R&D or the replacement of outdated machinery and equipment have positive spill over effects for the productivity of the Orgalime Industries.**

  According to r the IMF, every Euro that is spent in R&D in the private sector has a positive spill over effect of 50%.

  Moreover, declining balance depreciation rules are among national incentives that have a positive impact on investments with manageable fiscal consequences. Primarily in the first years of an investment, the decrease in value of an investment is particularly high, before it slowly decreases over the time of use. The 25% declining balance depreciation represents this value better than a purely linear depreciation. Hence, commercial law expressly permits declining -balance depreciation. It should therefore be a permissible method of depreciation for tax purposes as well.

The faster rate of depreciation frees funds which can be used for additional investments and thus lead to more growth and employment. The declining balance depreciation method should be used not only as a crisis instrument to stabilize the economy, but also because it has a delayed impact.

- **Growth of productivity needs digitisation.** Investing in digitisation is one of the key answers to attract investment if labour and capital productivity is high enough and at a competitive level.

Conclusion: a structural change demands structural action

In an era of low interest rates and high Central Bank money supply, the cost of capital should be low enough to attract sufficient investment. This mechanism has not worked for the last 10 years and monetary policy has not proven to be the sole solution in the current economic phase. Despite historically low interest rates, investment has kept on falling or is on a low level.

The investment behaviour of companies is undergoing a structural shift. There is a risk that investment will not automatically pick up when we enter a more favourable phase of the business cycle.

Orgalime thinks that boosting investment is one of the key measures to support an industrial renaissance in Europe as the 20 % target of industry's share in Europe's GDP by 2020 seems difficult to reach. This holds true for both the sector of tangible and intangible investments.

If we want to keep the engineering industry in Europe, we need structural answers to the investment issues that have been raised in this paper.

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Annexe: references:

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