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Economic situation and challenges in the EU

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Presentation based on publications from the EIB Economics Department

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** The views presented do not necessarily reflect those of the EIB*

Overview

- The EU economy is back to pre COVID-19 crisis level but not to pre-crisis trend. Recovery period too short and uneven - not terminated for investment before the start of the war.
- Policies deployed during the COVID-19 crisis supported the investment recovery, especially for investment in digital technologies. While they dampened the rise in corporate vulnerabilities, there are remaining pockets of vulnerabilities…
- Two types of – interconnected - headwinds: Urged by inflation, **monetary policy tightening** will impact financial conditions. And the **war in Ukraine**: uncertainty/confidence, cost push and demand shock.

How policies can accompany firms' investment for the twin transition in these challenging times?

- For those investments, finance is a key impediment and public policy support/financial instrument helps.
- Need for stronger financial integration within the EU. The ongoing work on the **CMU** is key.

Outline

1. From strong and short recovery to fast monetary policy tightening

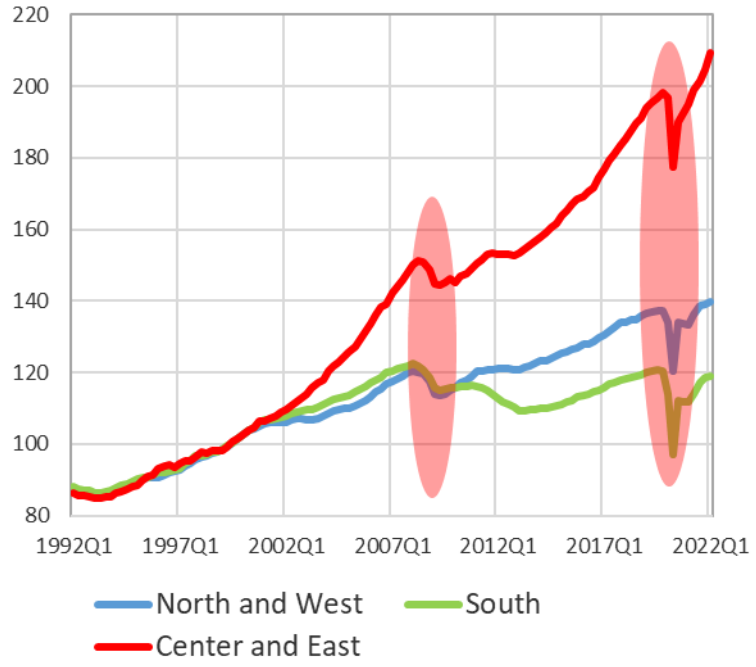
2. Learnings form COVID-19 firm-level policy support

3. War-induced vulnerabilities add to existing ones

4. Twin challenges and the need for stronger financial integration in the EU

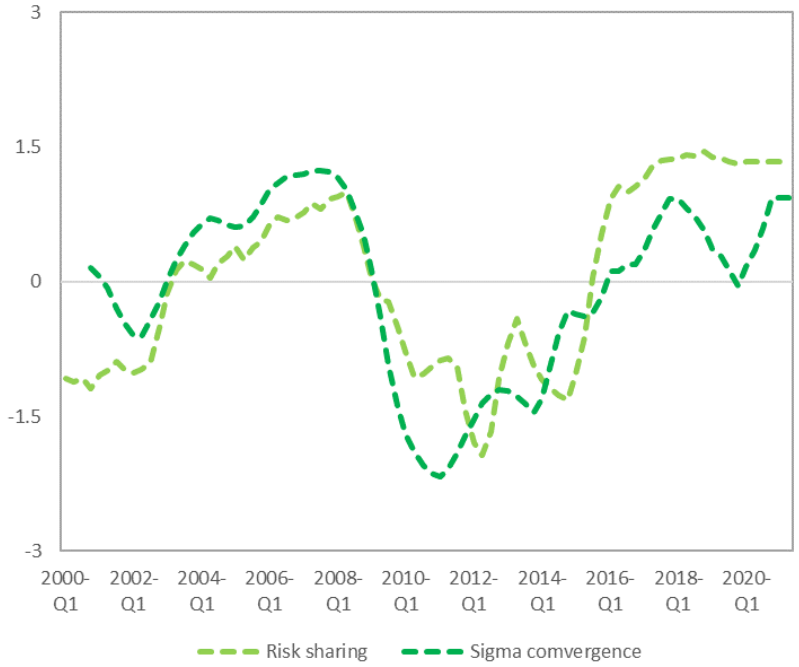
1 – Long-term GDP growth

Real GDP across the EU (*100=1999*)



***Source**: ECON computations based on Eurostat. **Note**: The shaded areas indicate the GFC and the COVID-19 crisis.*

Risk sharing sigma convergence and Beta convergence

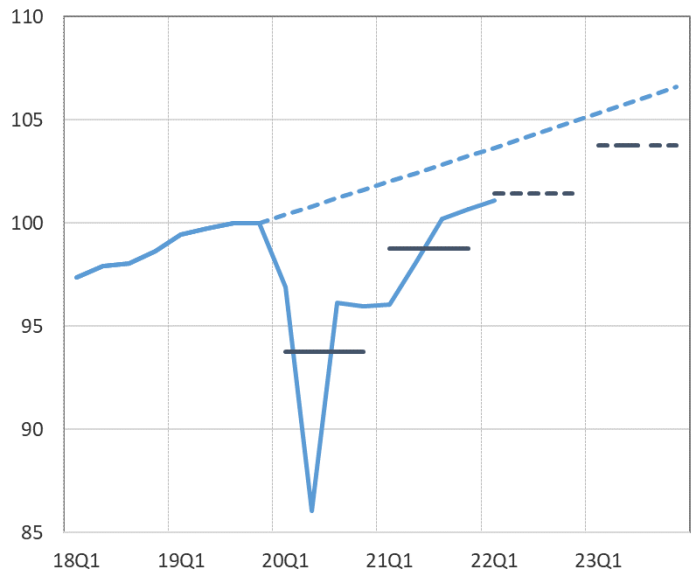


***Source:** ECON computations based on Minnella, Maurin and Lake (2022). **Note:** four-quarter moving average. Last record 2021Q4 partially estimated.*

- ✓ Increased convergence over time – catching up on Central and Eastern economies
- ✓ GFC and COVID-19 as two major crises since mid-nineties (short-lived collapse for COVID-19)
- ✓ Recovery time much shorter after COVID-19 crisis

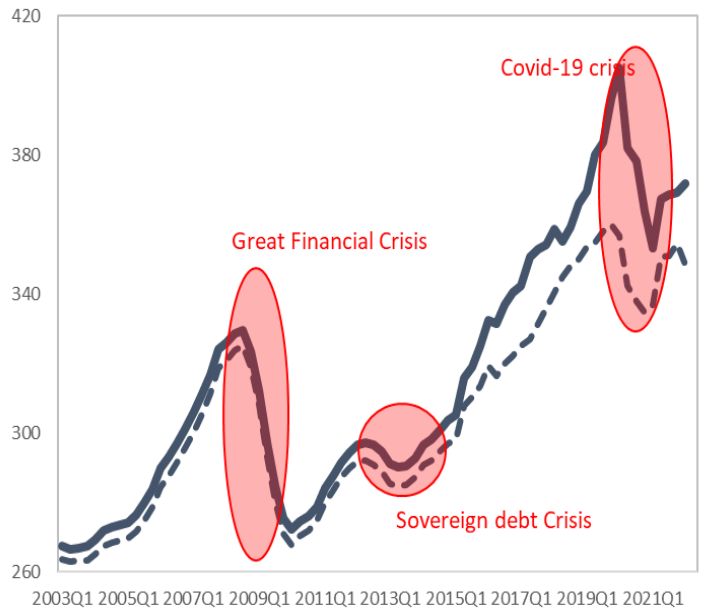
1 – Pre-war, strong economic recovery

EU real GDP *(100=2019Q4)*



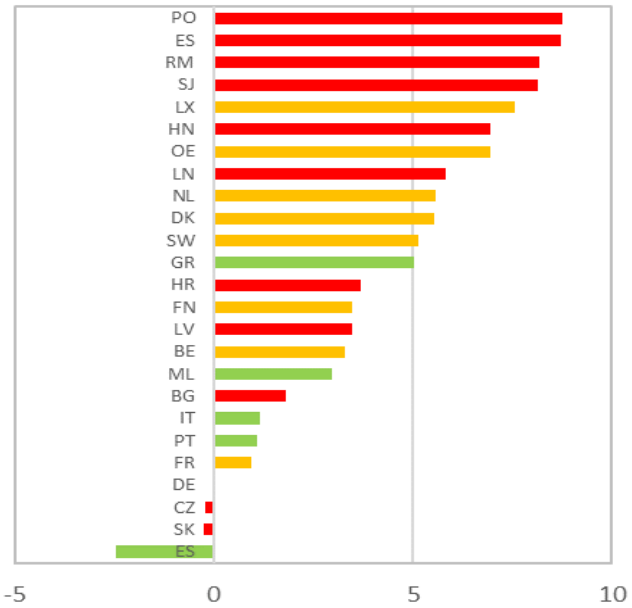
***Source**: ECON computations based on Eurostat. **Note**: The dashed line extrapolate pre-Covid-19 trend. The horizontal bars represent the annual real GDP level. For 2022-23, it is taken from the EC Spring 2022 forecast.*

EU real corporate investment *(real terms in 2005 euros)*



***Source:** ECON computations based on EUROSTAT. **Note:** The most recent record, for the second quarter of 2022, was partially estimated. Four-quarter moving average of non-seasonally adjusted data. The dash line reports the evolution without Ireland.*

Real GDP in 22Q2 compared to 19Q4 *(% deviation)*

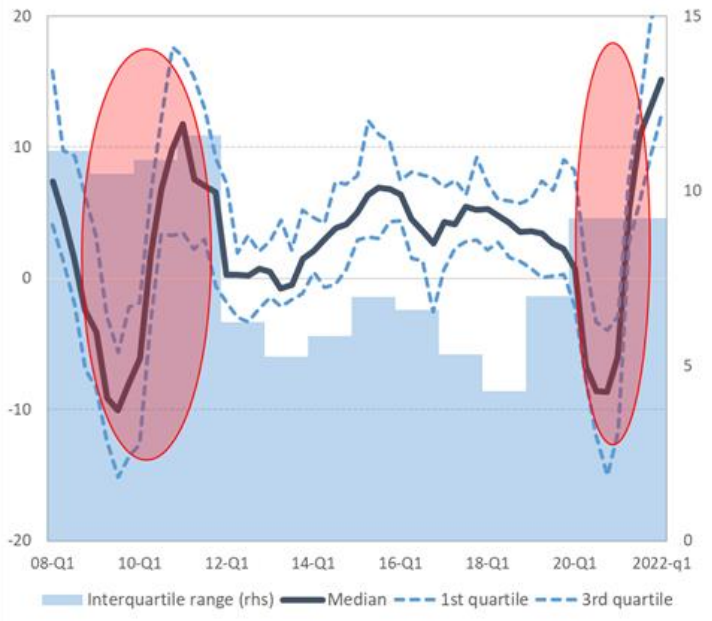


***Source:** ECON computations based on EUROSTAT.*

- ✓ End 2021, real GDP back to pre-crisis. Pre-war, gap to trend was expected to shrink thanks to European policy response and accommodative monetary policy
- ✓ Corporate investment still far from pre-crisis trend. Firms had not fully recover before the start of the war in Ukraine
- ✓ Yet, country divergences

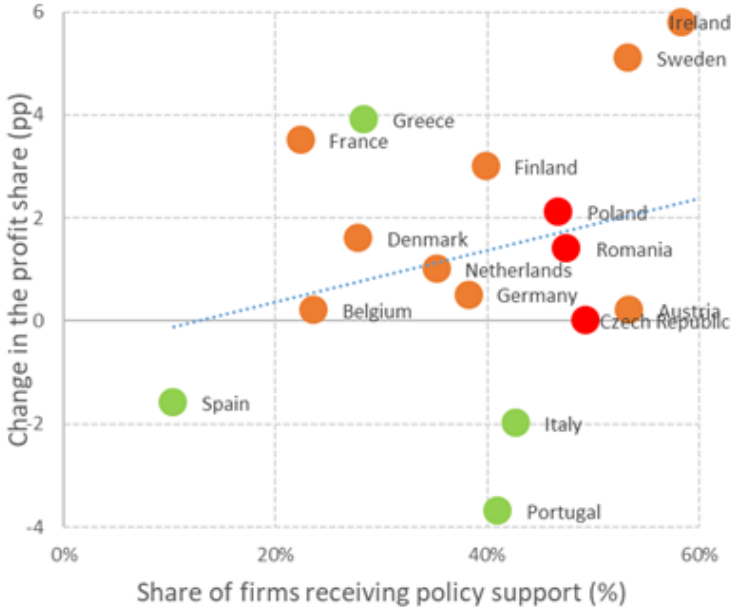
1 – Strong rebound in profits

Growth in entrepreneurial income and dispersion *(annual growth, %)*



***Source**: ECON computations based on Eurostat. **Note**: Based on individual EU countries. Last record in 22Q1.*

Intensity of the policy support and rebound in profits

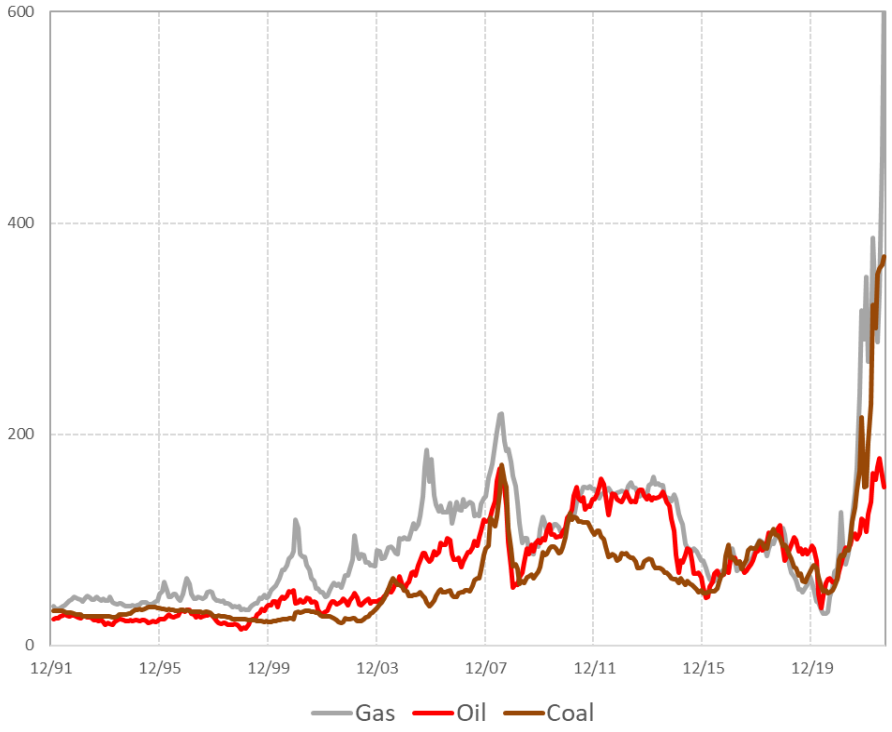


***Source:** ECON estimates based on EUROSTAT and EIBIS.*
***Note:** The change in the profit share relates to 2022Q1 (moving average of four quarter) to 2019. The profit share is obtained as the ratio of entrepreneurial income to the value added of non-financial corporates.*

- ✓ Strong rebound in profits
- ✓ Somewhat correlated with the intensity of the policy support deployed during the COVID-19 crisis

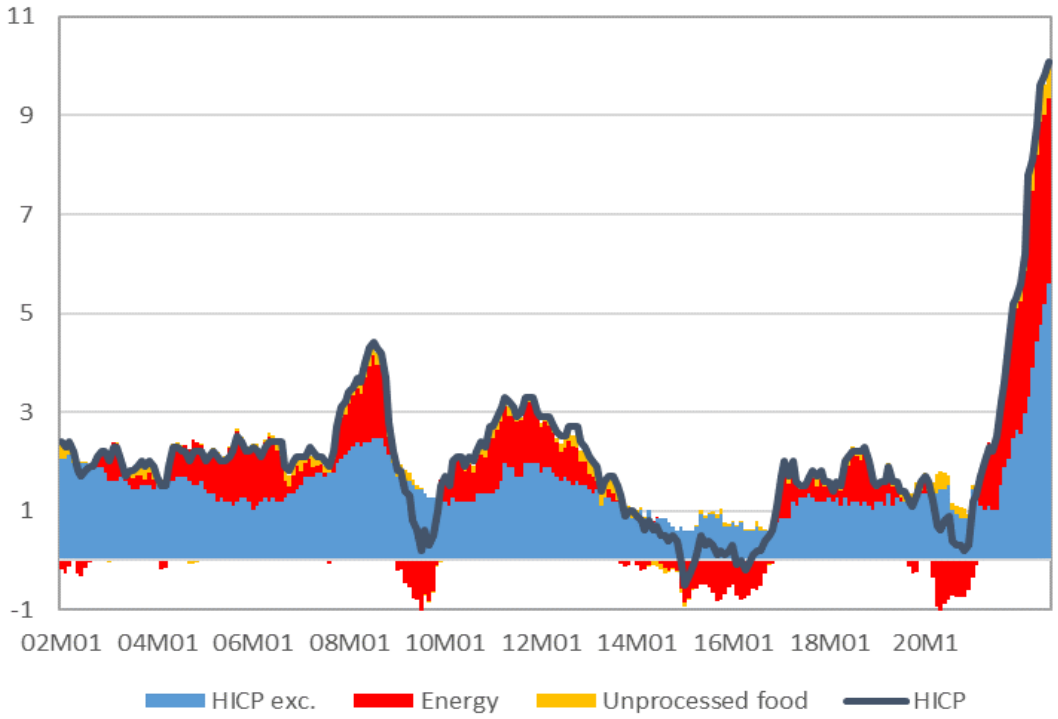
1 – Inflationary energy price pressures propagate

Skyrocketing international fossil fuel energy prices *(100=2018)*



***Source**: ECON computations based on Refinitiv. **Note:** Last record is August 2022*

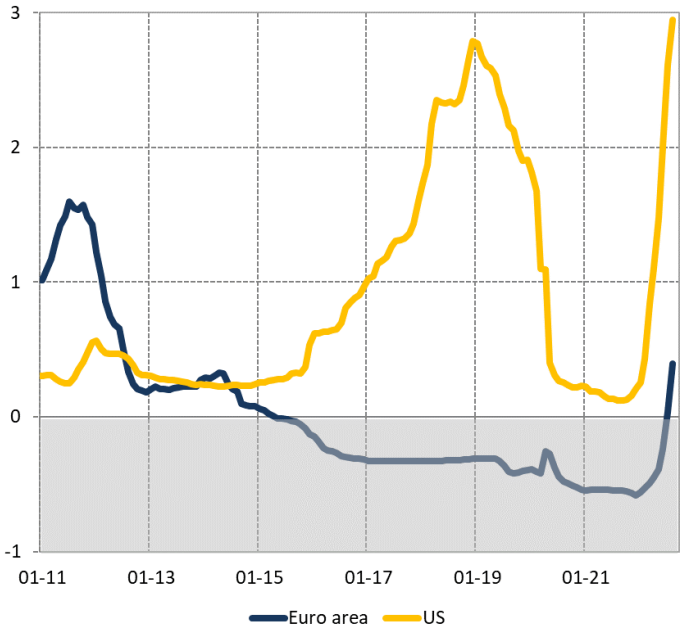
EU HICP and contributions *(Annual change, %, and contributions, pp)*



***Source:** ECON computations based on EUROSTAT. **Note:** Last record is August 2022.*

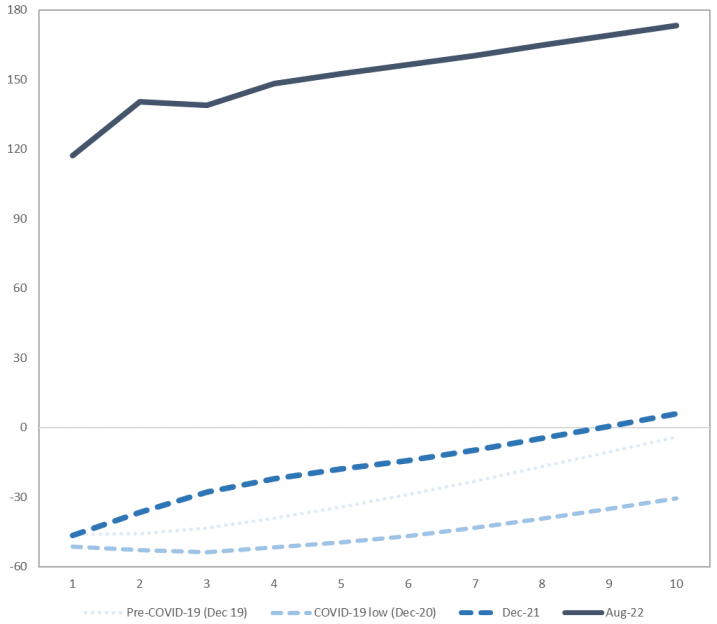
1 – Ongoing very abrupt tightening

Short-term rates *(3-month interbank rate, % per annum)*



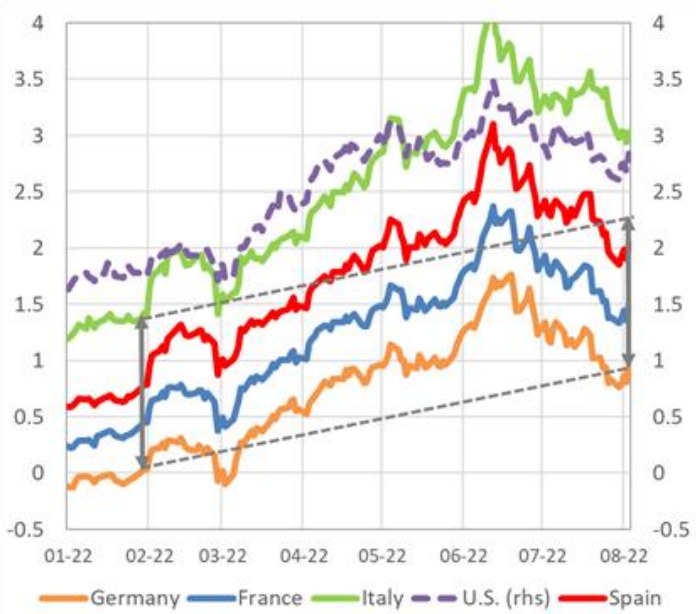
Source: *ECON computations based on Refinitiv.*

Snapshots of the euro area yield curve *(% per annum)*



Source*: EIB computations based on Refinitiv.* ***Note****: The x-axis reports the maturity of the bond.*

10 years government bond yields *(% per annum, euro area firms)*

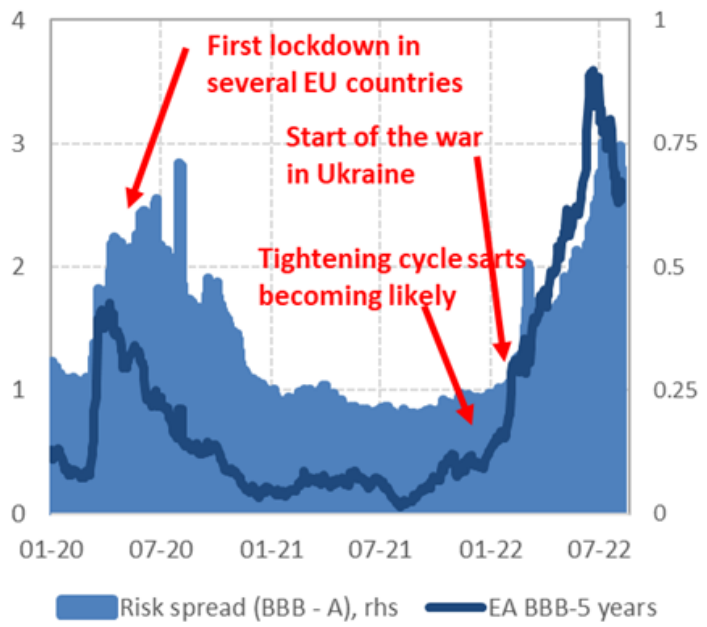


Source: *EIB computations based on Refinitiv.* ***Note:*** *Last record is August 2022. Quanto-CDS*

- ✓ Sharp and swift upward shift of the yield curve. Volatile but driven by monetary policy expectations.
- ✓ Also steepening, partly owing to the end of APP.
- ✓ And some government bond spread reopening.

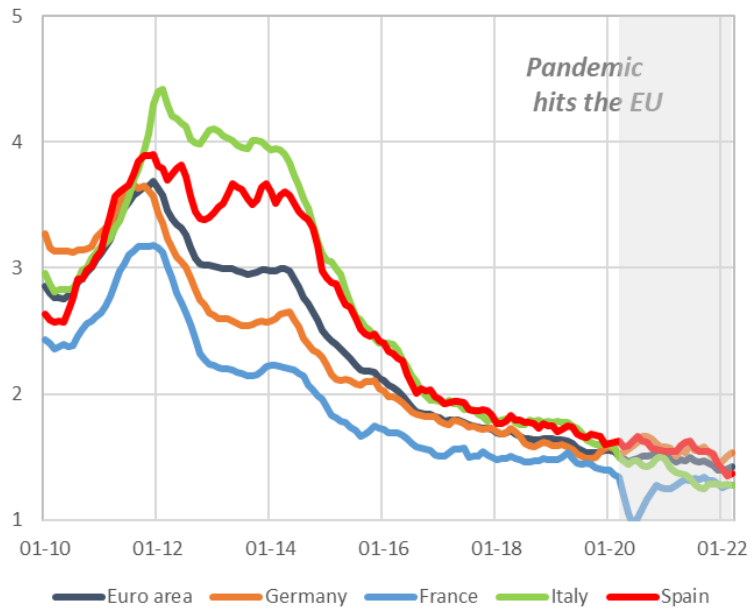
1 – Rising yields pushing-up the cost of external finance for firms

Corporate bond yields *(% per annum, euro area firms)*



***Source**: ECON computations based on Refinitiv. **Note**: The x-axis reports the maturity of the bond.*

Rates on corporate bank loans *(% per annum)*

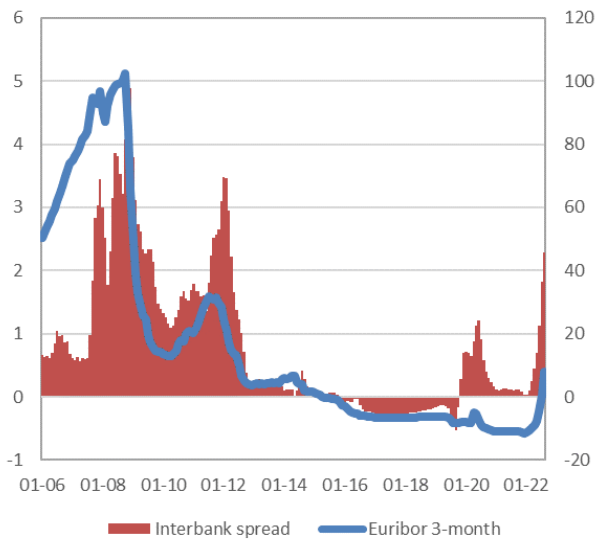


***Source:** ECON computations based on Refinitiv. **Note:** last record is July 2022.*

- ✓ Monetary policy tightening already visible in corporate bond yield up.
- ✓ Corporate bank loans to become more costly. In line with standard pass-through models, the impact will take more time to materialise.

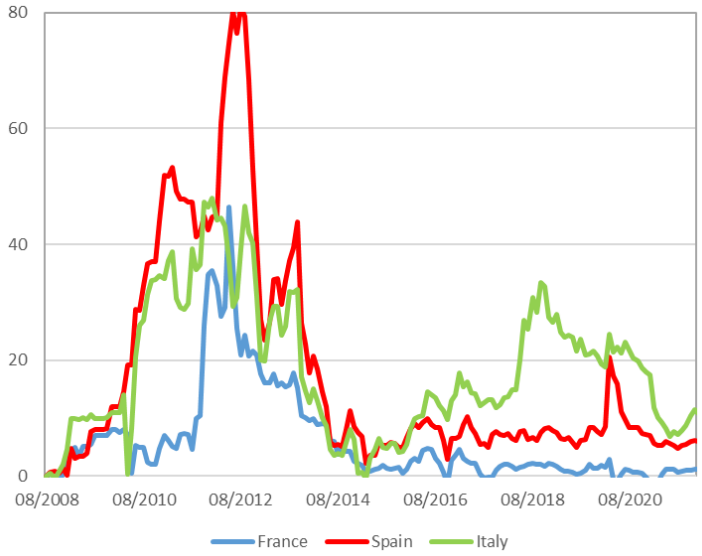
1 – Government bond spread reopening with contained effects so far

Interbank spread *(bps)*



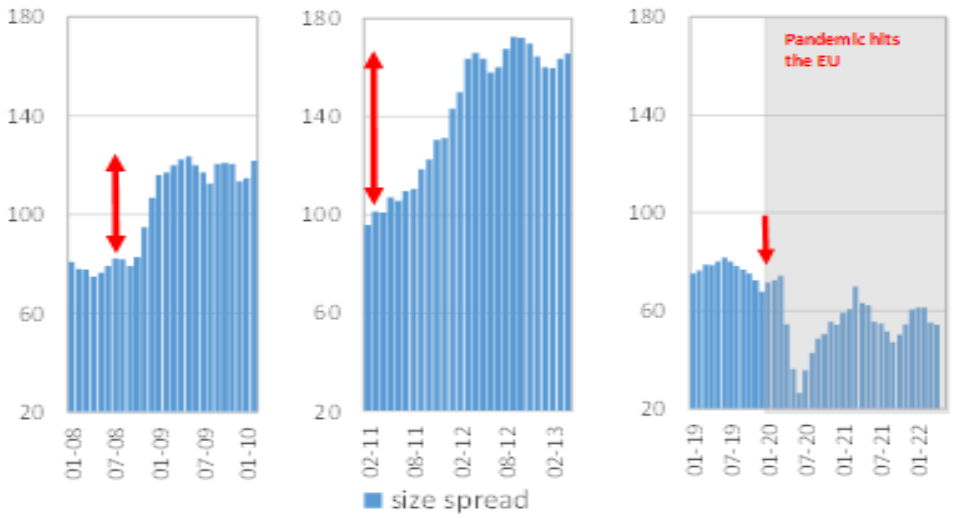
***Source**: ECON computations based on Refinitiv. **Note**: Spread obtained as difference between Euribor 3-months and EuroSTR).*

Redenomination risk within the euro area *(bps)*



***Source**: ECON computations based on Refinitiv. **Note**: Based on quanto-CDS. Last record is August 2022.*

Rate size spreads during economic crises *(From left to right: the global financial crisis, sovereign debt crisis and COVID-19. In basis points.)*



***Source**: EIB estimates based on ECB. **Note:** The difference between the cost of borrowing on small loans (below EUR 250 000) and large loans (above EUR 1 million) is expressed in basis points. New business volumes. The last record is July 2022.*

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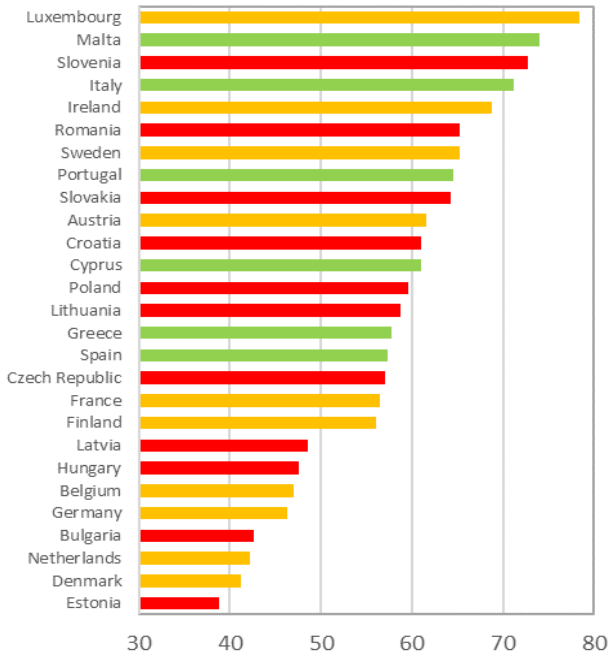
4. Twin challenges and the need for stronger financial integration in the EU

2 - Massive, diverse and effective firm level policy support across EU economies

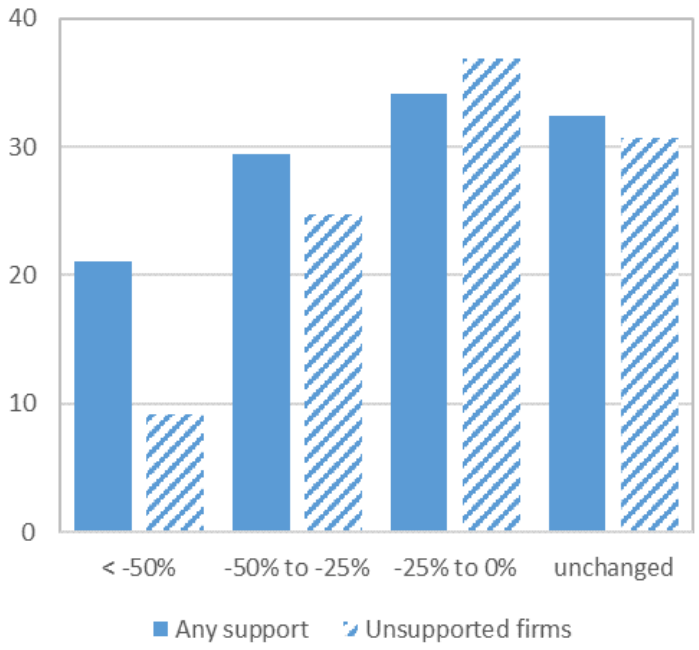
Overall firm level policy support

(% of supported firms)



Source: ECON Calculations based on the EIBIS 2021. ***Note:*** The color reflects the region in which the economy is located: Red indicates Central and Eastern economies, Green indicates Southern economies and Orange indicates Northern and Western economies.

Investment plans conditional on sales losses and policy support *(% firms)*

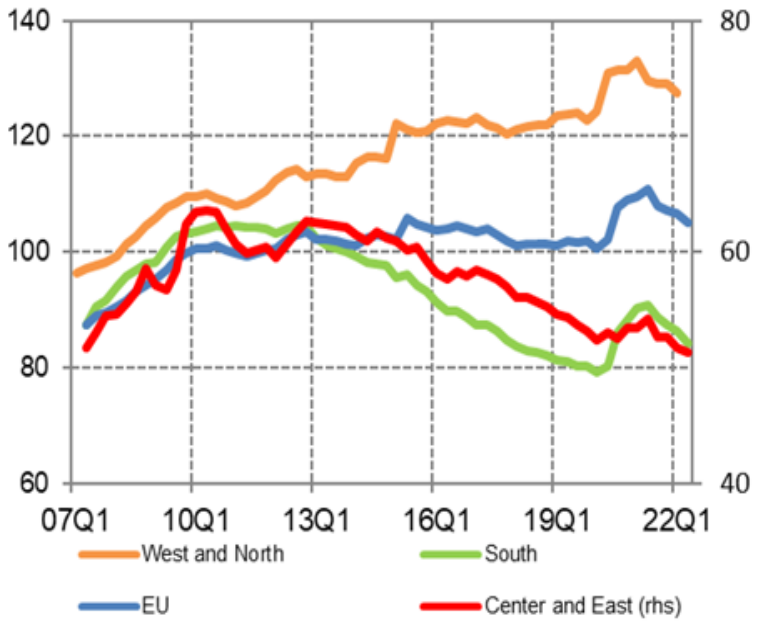


***Source**: ECON computations based on the EIBIS 2021.*
***Note**: the x-axis reflects the sale losses reported by the company. The y-axis reports the percentage of firms surveyed that plan to raise investment in the current financial year.*

- ✓ In Europe, **56% of firms got support via at least one specific policy**.
- ✓ Among types of policy support, **subsidies or temporary support** is the most common, used by 36% of the firms. A similar share of firms, 16-17%, benefitted from the deferral of payments or credit support to be paid back.
- ✓ For the same level of losses, **supported firms plan to raise investment by more**. The difference is especially pronounced for large sales losses.
- ✓ Leverage increased for 17% of firms and supported firms strengthened their equity base by more. Supported firms more likely to recapitalize (7% compared to 4%).

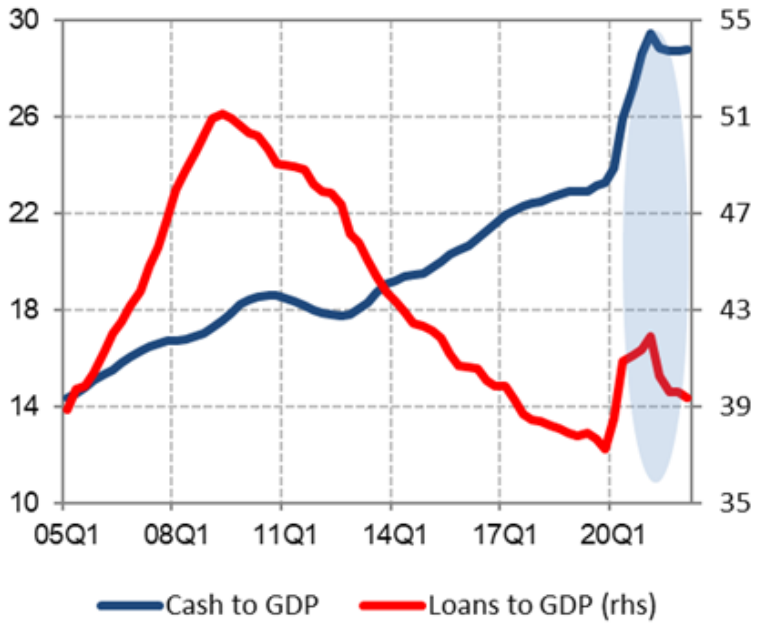
2 – Major rise in firms' indebtedness backed by cash accumulated at the corporate level

Corporate debt *(% GDP)*



Source: *ECON computations based on EUROSTAT.*

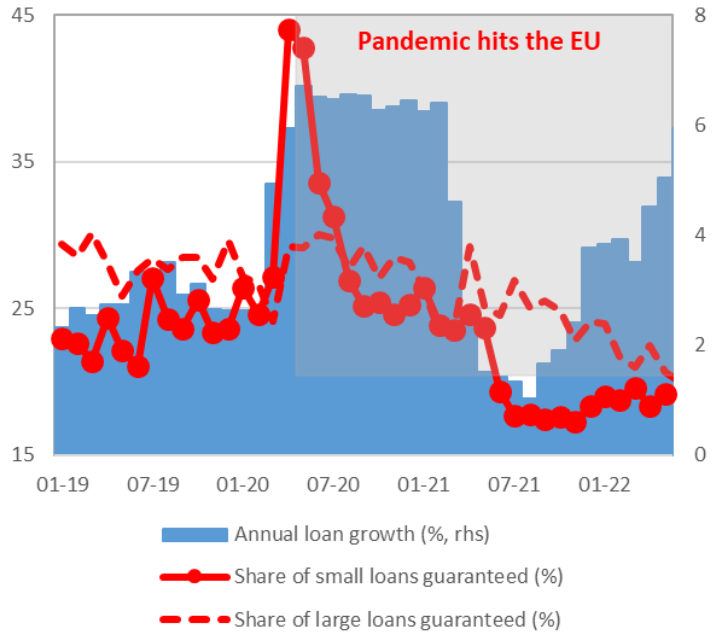
Liquid assets and bank loans *(% GDP)*



Source: *ECON computations based on EUROSTAT.*

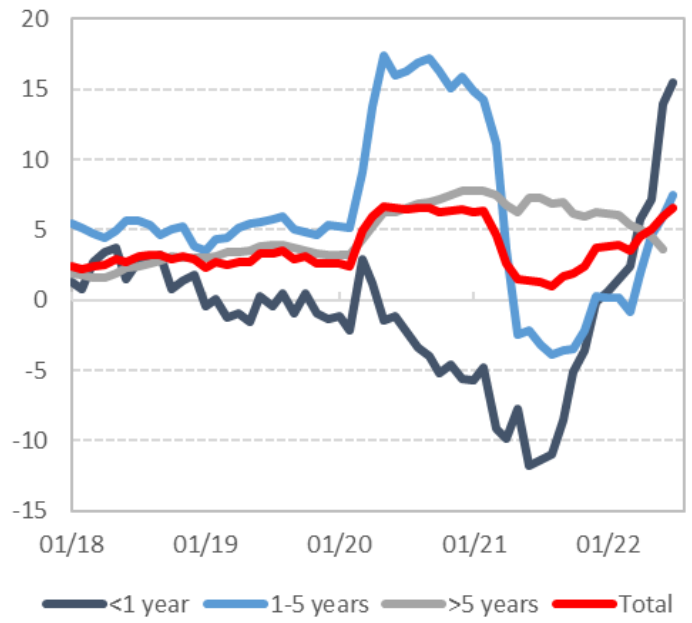
2 – Corporate bank loans started normalising and supporting capex

Corporate bank loans under guarantees *(based on monthly flows)*



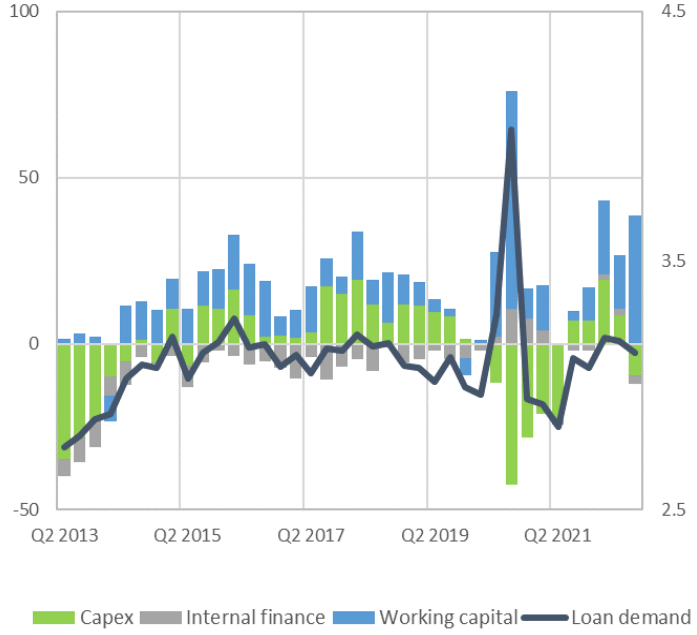
Source: *ECON computations based on ECB.* ***Note:*** *Last record in July 2022.*

Corporate bank loans *(Annual growth rate, %)*



Source: *ECON computations based on ECB.* ***Note:*** *Last record in July 2022.*

Loan demand and component *(Net indices)*



Source: *ECON computations based on ECB Bank Lending Survey.* ***Note:*** *Last record is 2022 Q3.*

- ✓ Impetus provided by support programmes in 2020, undershooting in 2021, start of a normalisation in early 2022.
- ✓ Loans had started to support capex, from end 2021 until recent record.

2 - Policy support cushioning the crisis impact on investment and digitalisation

Estimated impact on the likelihood to raise investment *(in pp)*

Estimated impact on the likelihood to invest more in digitalisation *(in pp)*

***Source**: ECON estimations based on the EIBIS 2021 and ORBIS. **Note**: The bars indicate the impact range estimated through a suite of models. See Harasztosi et al. (2021). The impact of sales losses (of above 25%) is always negative and is reported in absolute terms.*

- ✓ Covid-19 induced sales losses always have a negative impact on investment, which is never fully compensated by the policy support, especially in Southern and Central and Eastern economies.
- ✓ For investment in digitalisation, policy support has been somehow countering the negative effect of sales losses in the overall of the EU and in the North-Western Europe and in the South, but not in Central and Eastern Europe.

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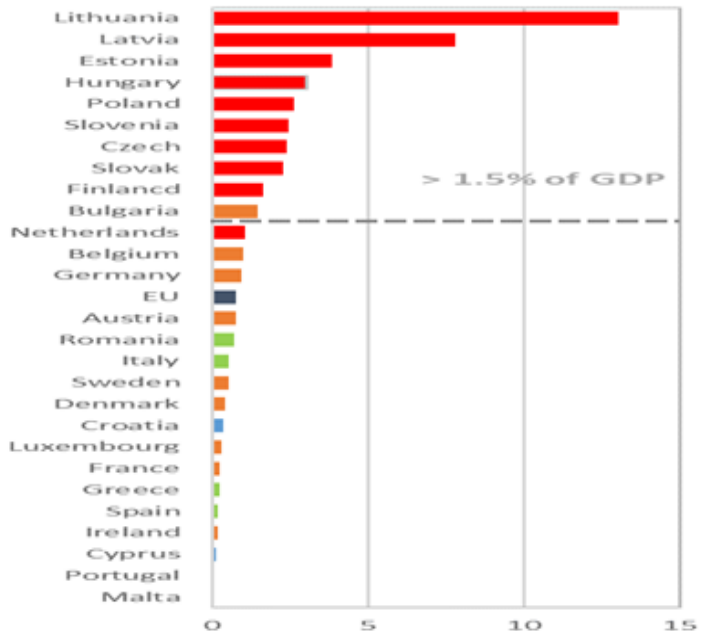
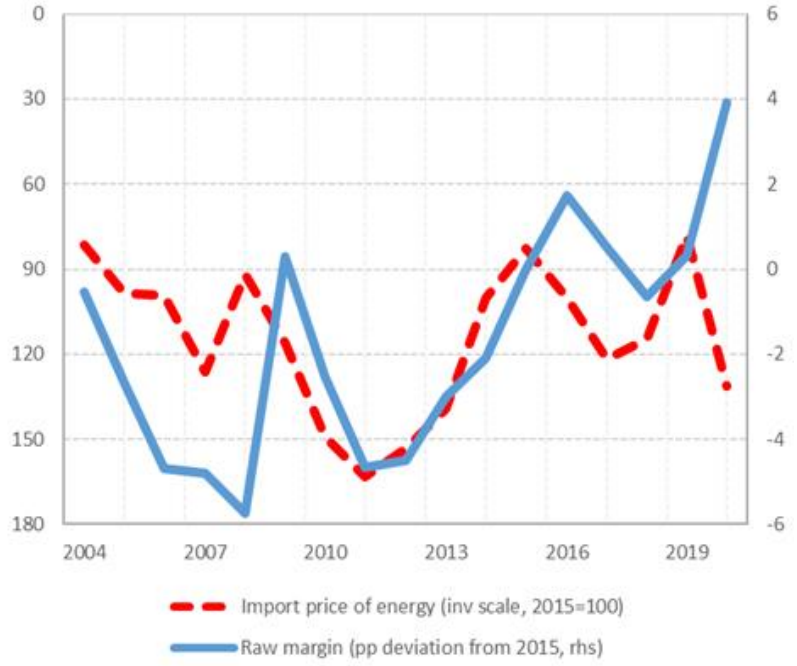
3 – The economic channels of the war in Ukraine

Share of exports to BRU *(2019, % of GDP)*



Source: *ECON calculations based on Eurostat.* ***Note:*** *The colour reflects the region in which the economy is located: Red indicates Central and Eastern economies, Green indicates Southern economies and Orange indicates Northern and Western economies.*

Energy prices and profit margin indicator

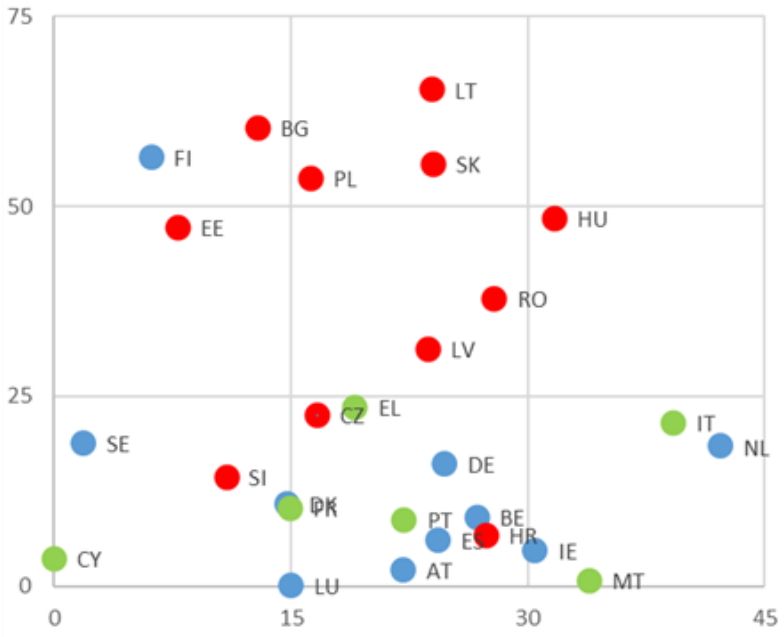


Source*: ECON calculations based on Eurostat****. Note:*** *The raw margin indicator is the ratio between gross value added of the corporate sector and intermediary consumption.*

- ✓ Impact of the war multifaceted: energy costs + export loss + potentially confidence loss/funding stress
- ✓ Differences in the energy mix and export intensity to BRU explain uneven pressures across sectors and countries
- ✓ **Export not the major channel but energy cost yes**

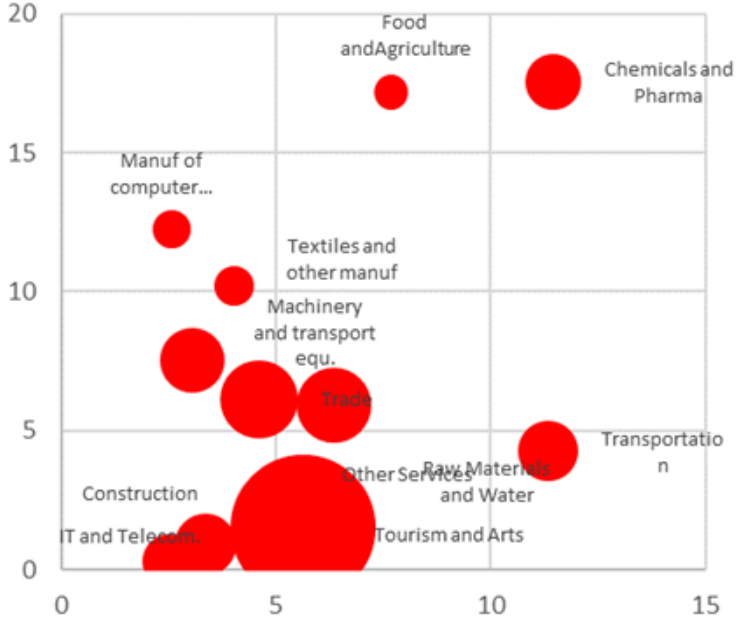
3 – Corporate vulnerabilities triggered by the war in Ukraine

Gas dependency *(x-axis)* and share of energy imported from BRU *(y-axis)*



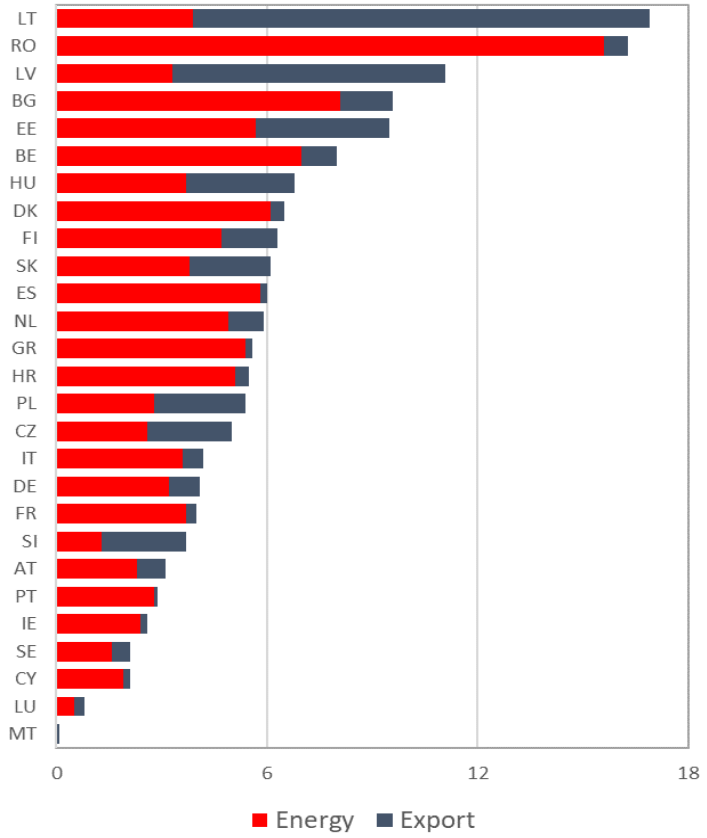
Source: *ECON computations based on EUROSTAT and OECD.* ***Note:*** *data refer to 2019.*

Energy dependence *(x-axis)* and firm vulnerabilities across sectors *(y-axis)*



Source: *ECON estimations.* ***Note:*** *The x-axis depicts the energy dependence in each sector. The y-axis indicates the increase in the vulnerability indicator (mean share of firms with losses, IRC<1 and negative equity). The size of the dot reflects the share of the sector in the EU economy.*

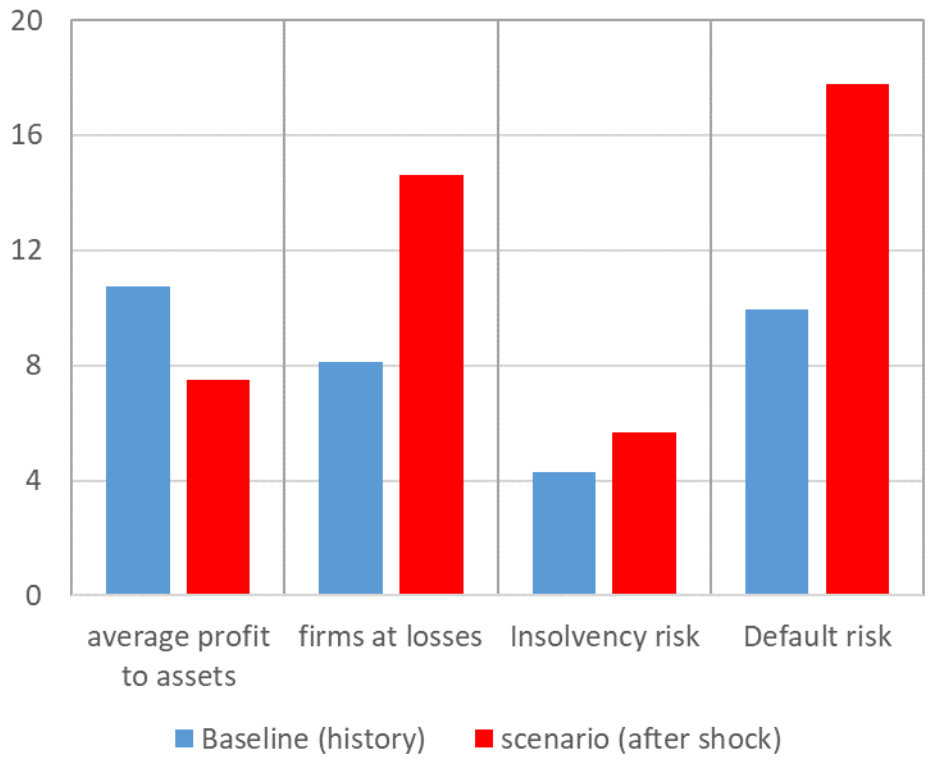
Increase in the share of firms reporting losses *(pp)*



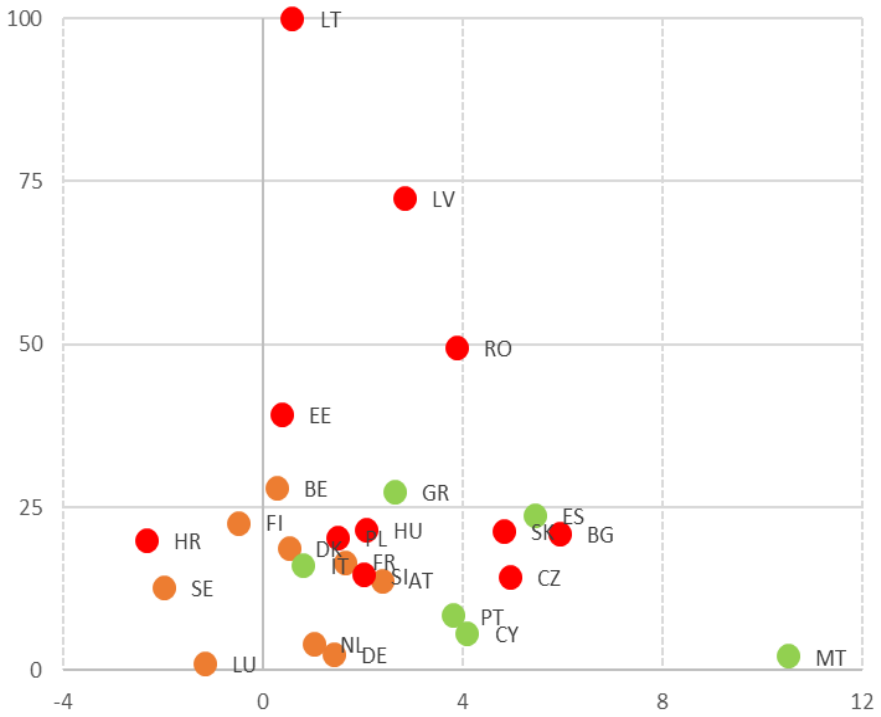
Source: *ECON estimations. See EIB report "How bad in the war in Ukraine for the European economy?", May 2022.* ***Note:*** *Stop of the export to BRU and doubling of the energy bill in each sector/economy.*

3 - War-induced corporate vulnerabilities add to pre-existing ones…

Rising vulnerabilities at the EU level *(%)* – one-year ahead



Gap to pre-covid19 *trend* *(x-axis, real GDP pp. deviation)* and post-war vulnerability indicator *(y-axis, index, 1-100)*



Source: *EIB estimations.* ***Note:*** *Gap between real GDP in 2022 forecast in the EC Winter 22 and Autumn 19 EC projections, pp. deviation*

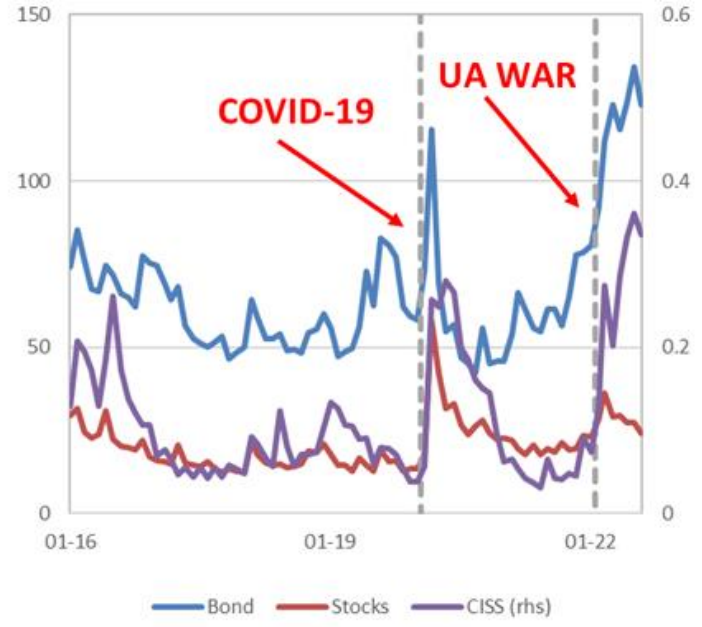
Source: *EIB estimations.*

However, the rise in vulnerabilities is not correlated, across sector and economies

3 – Uncertainty, confidence loss and tightening in financial conditions could add pressures

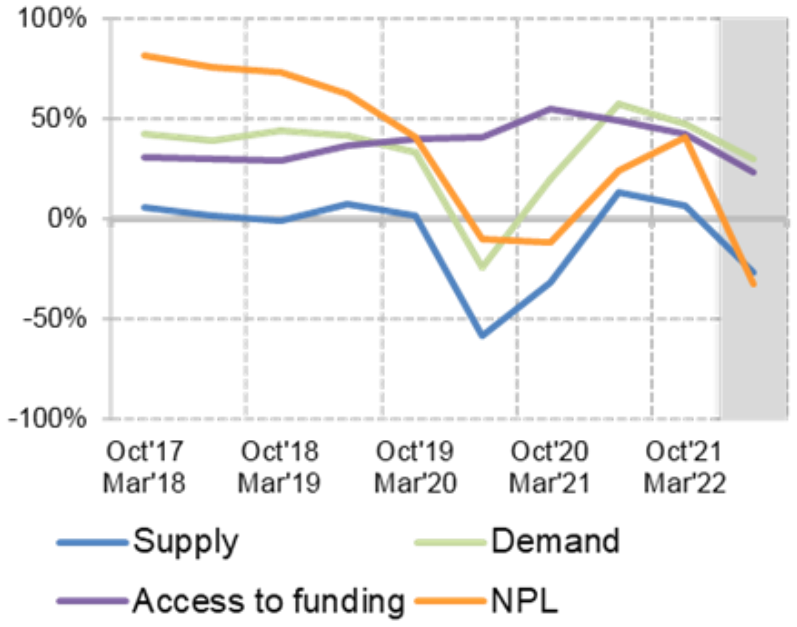
Estimates of volatility and risk

(Implied volatility, and CISS)



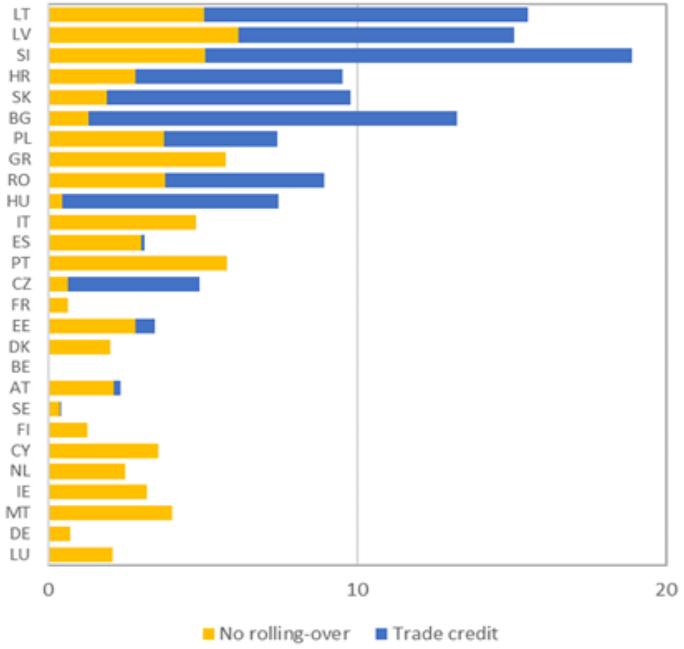
Source: *ECON computations based on ECB and Refinitiv.* ***Note:*** *For the CISS, See Kremer et al. (2012). Last record is August 2022*

CESEE banks expectations *(net balances, %)*



Source: *EIB – CESEE Bank Lending Survey.* ***Note:*** *Supply/Demand: Positive figures refer to increasing (easing) demand (supply). Access to funding: Positive values indicate increased access to funding. NPL: Negative figures indicate increasing NPL ratios.*

Rise in the proportion of firms out of cash due to additional funding stress *(%)*



Source*: ECON estimations. See EIB report "How bad in the war in Ukraine for the European economy?", May 2022* ***Note:*** *in all countries, short-term debt is not any more rolled over for finance constrained firms and that 20% of net trade credits are not anymore financed in CESEE. In the scenario, short-term debt is no longer rolled over for finance constrained firms, and 20% of net trade credits are no longer financed in the CESEE.*

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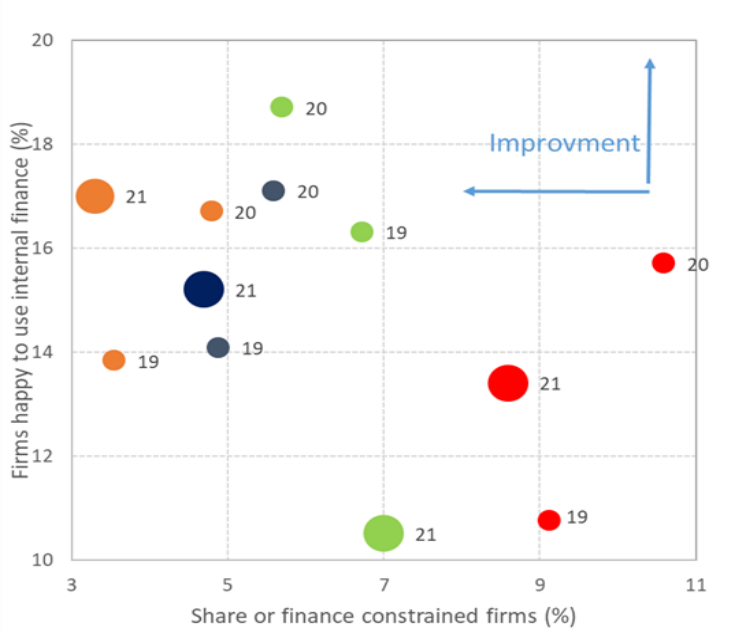
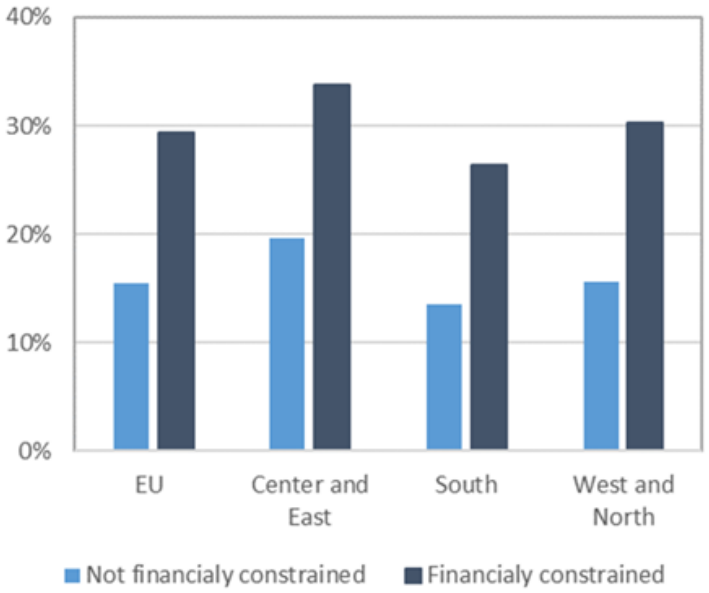
4 – Access to finance, an impediment to investment in some assets/regions

Share of credit constrained firms by country vs. share of firms that could rely on internal financing (%)



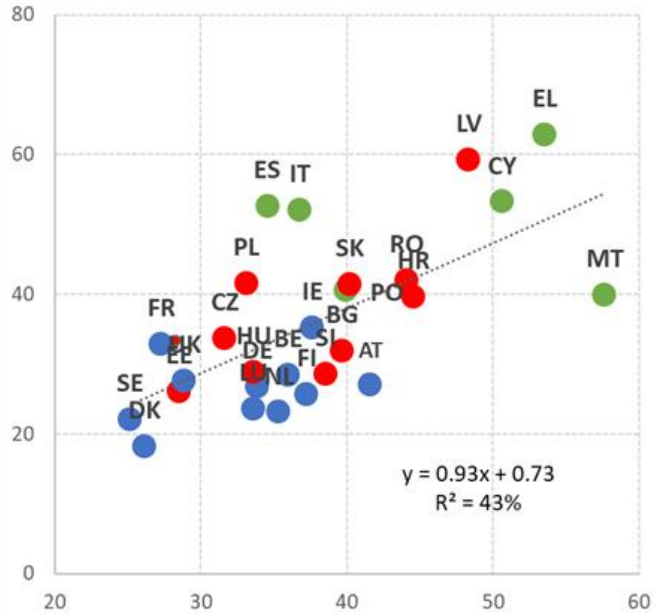
Source: *Source: EIBIS, 2019-2021.* ***Note:*** *The dark blue, orange, green and red dots refer to the European Union, Western and Northern Europe, Southern Europe, and Central and Eastern Europe respectively. The numbers indicate the year.*

Investment gap for firms conditioned on finance constrains



Source: *EIBIS (2016-21).*

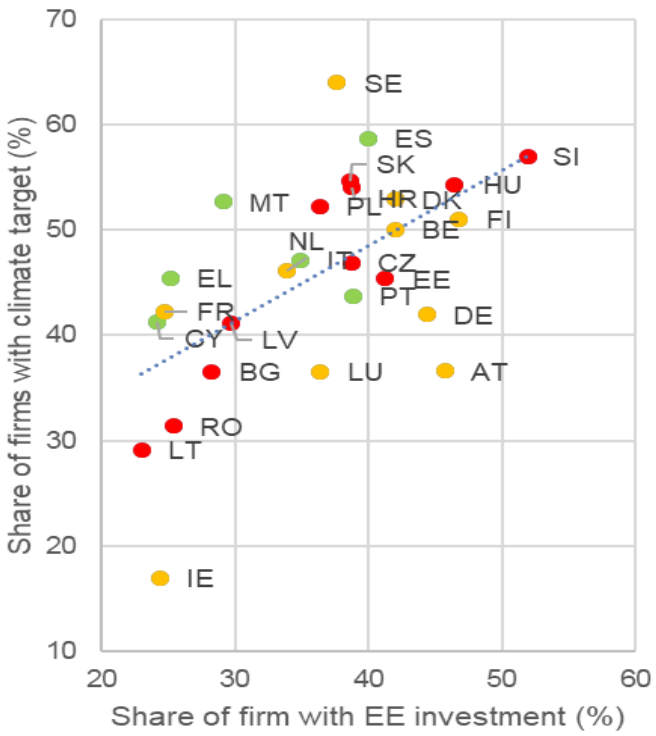
Bank dependence *(x-axis, %)* and finance as an obstacle *(y-axis, %)*



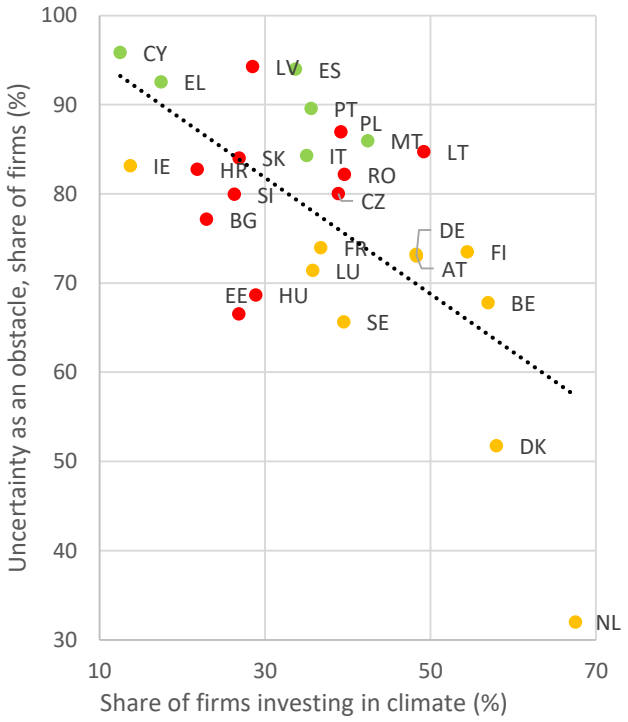
Source: *EIBIS 16, 17, 18 and BIS.*
Note: *x-axis reflects bank dependence, the share of loans over loans, debt and equities from the BIS. The y-axis reports the EIBIS (half minor and major, averaged over 16-19).*

4 - Uncertainty, finance and green management practices affect climate-related investment

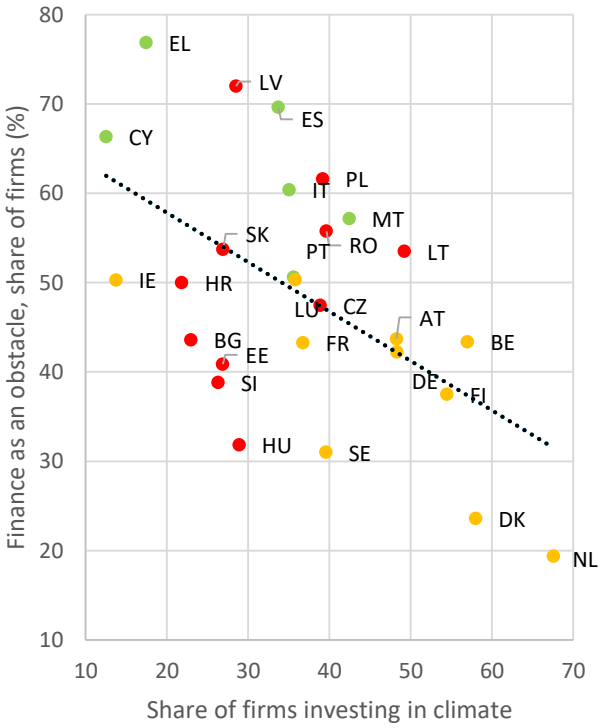
Target setting is accompanied by actions



Uncertainty a drag on investment decision



Finance obstacles hinder climate investment

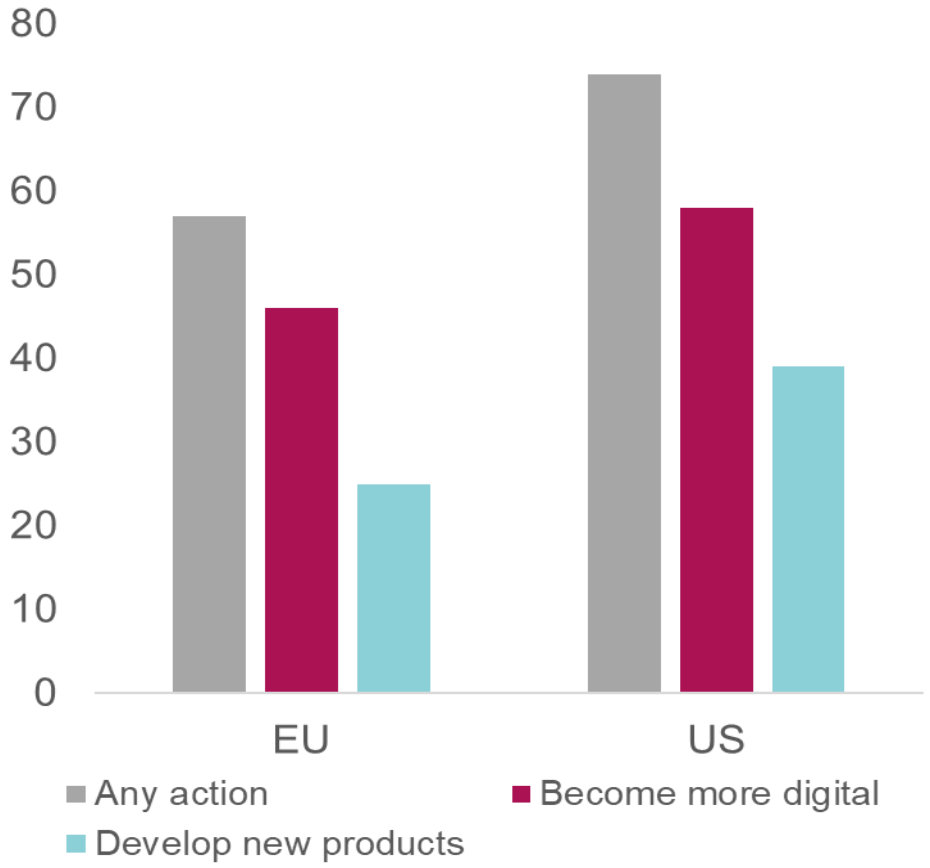


Source: *Climate change report, 2022*

4 - Many firms reacted to the pandemic, starting their "digitalisation journey", but to a lesser extent than in the US – still a long journey

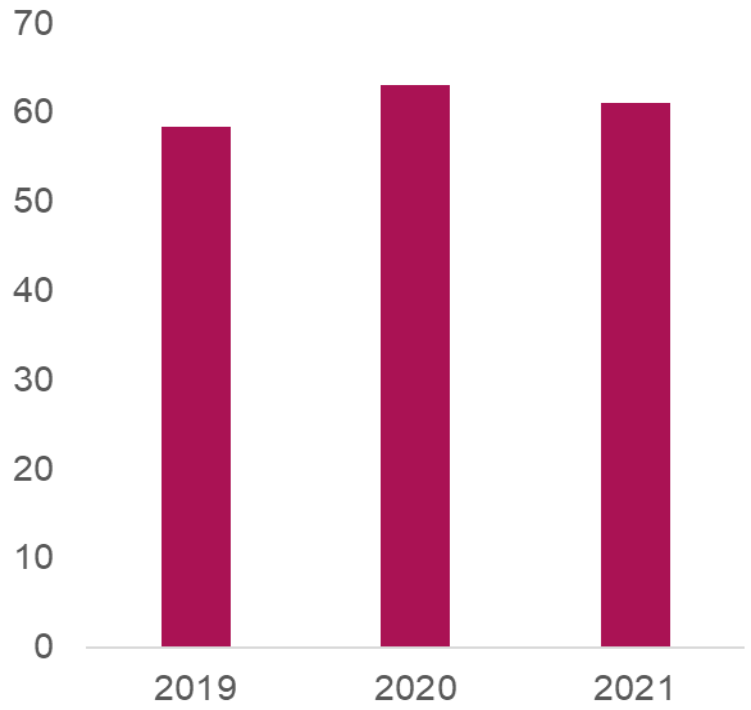
Firms' short term reaction to Covid-19

Share of firms %



EU firms using advanced digital technologies

- Share of firms %

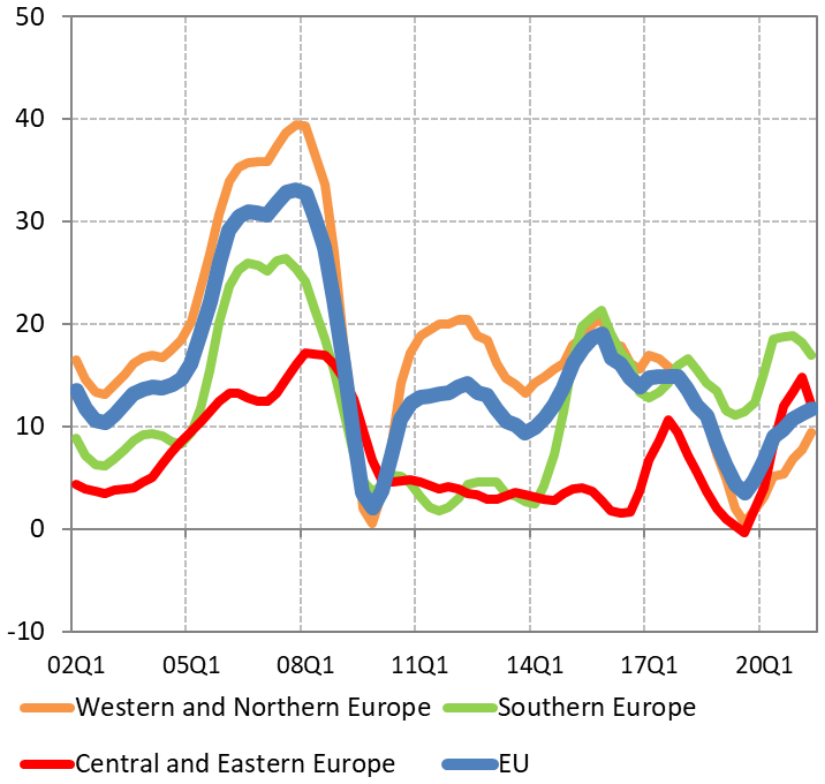


Source: *ECON based on the EIBIS*

4 – Stronger EU cross-border financial integration needed to provide adequate financing

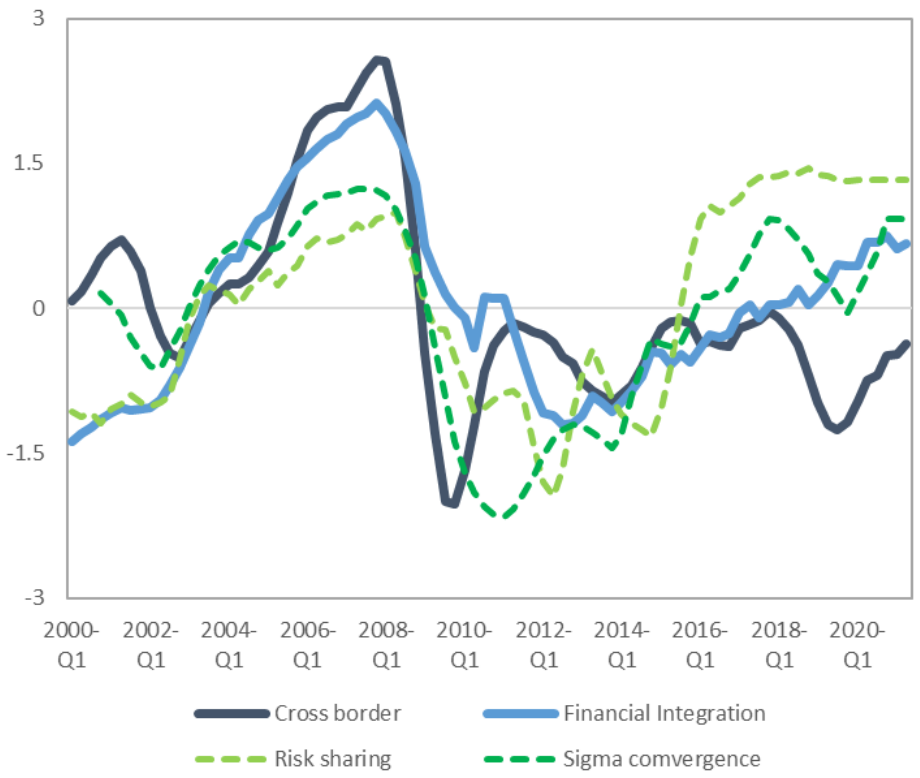
Average gross cross-border financial flows

(% GDP)



Source: *ECON calculations based on IMF.* ***Note:*** *Gross capital flows equal the sum of inflows and outflows of direct, portfolio and other investments. Last record is 2021Q4.*

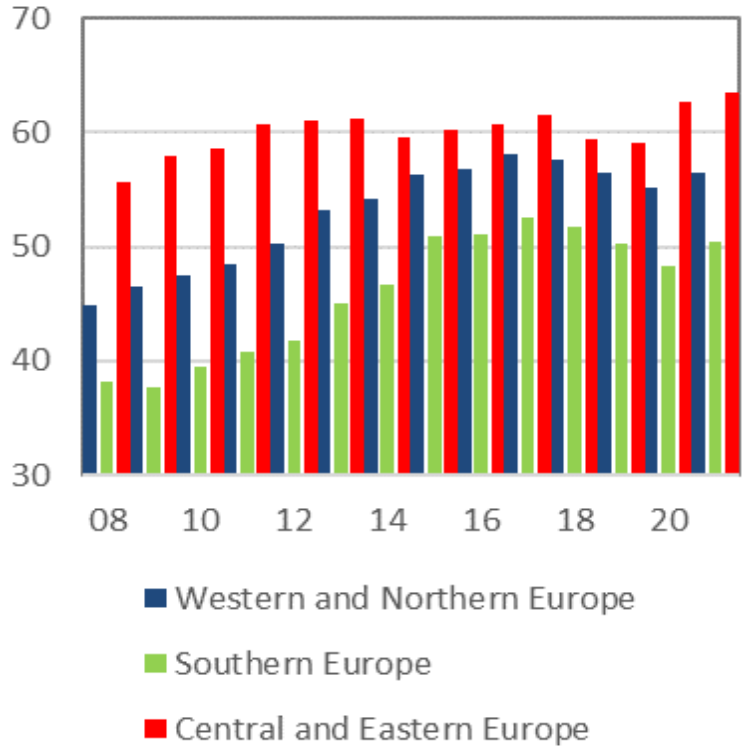
Financial integration indicators *(de-meaned and standardized)*



Source: *ECON calculations based on Lake, Minella and Maurin (2022), IMF and EUROSTAT.* ***Note:*** *Gross capital flows equal the sum of inflows and outflows of direct, portfolio and other investments. Last record is 2021Q4.*

4 – Quality of financial integration and economic benefits

Share of equity in foreign positions *(% of external assets, average over two years)*



Source: *ECON calculations based on IMF.* ***Note:*** *Average share of foreign direct investment and portfolio equity in international position. Last record is 2021Q4.*

Benefits of integration *(response to an integration shock)*

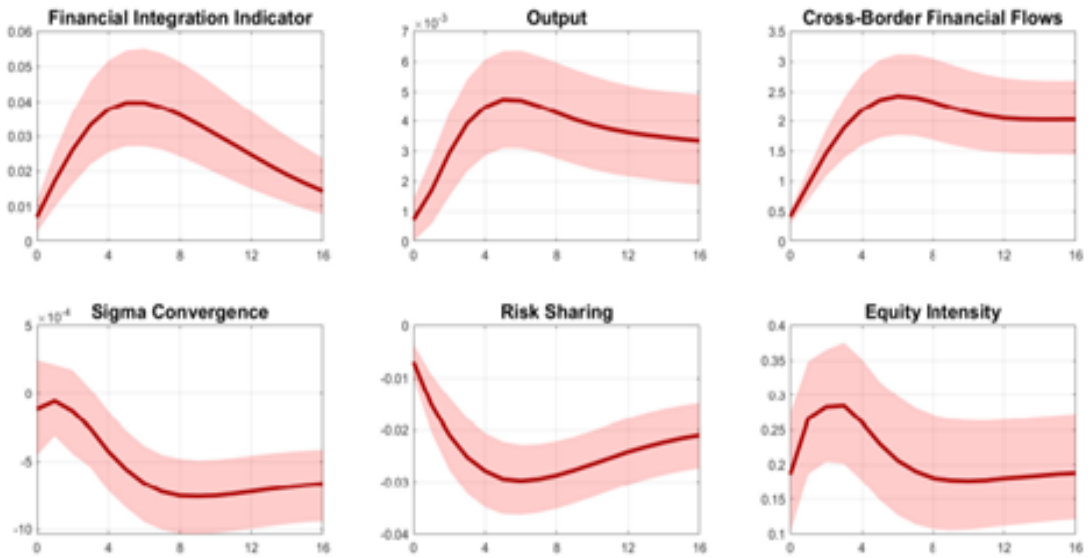


Figure 5: *Impulse Response Functions - True Integration shock*

The solid red line is the posterior median response of each variable to the "True Integration" shock, whereas the red shaded area corresponds to the 20% and 80% posterior percentiles.

Source: *ECON estimations based on Lake, Minnella and Maurin (2022), IMF and EUROSTAT.*

Concluding remarks

- ✓ Energy crisis is a drag on corporate profits, investment and economic activity
- ✓ How long and deep depends on geopolitical development and policy response
- ✓ So far, policy response remain mostly at the national level, with fiscal support. Discussions on EU fiscal rules will reignite later
- ✓ In parallel, monetary policy tightening – so far in an orderly way
- ✓ Challenging time can be breakthrough, incentivize rebooting/change. Indeed, COVID-19 crisis has been supportive to digitalisation
- ✓ How to ensure that, beyond the short-medium run, the energy crisis strengthens and/or fastens the green transition?
- ✓ Public financial instruments help but in parallel, improving the structure of the financial system is key. Hence the CMU 2.0.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