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Policy brief

The European Savings and Investment Union

Risks and Opportunities for Workers

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Part I: Overview of the policy discussion

The recently launched initiative of a European Savings and Investment Union builds on the Capital Markets Union, launched in 2015 and renewed by the European Commission in 2020.

Both projects aim to provide a response to the need to invest an additional 750 to 800 billion euro each year in order to address the mega challenges of decarbonisation, technological transition and geopolitical security that Europe is confronting. While the Capital Markets Union focuses on creating a single and integrated marketplace that enables finance to flow across Europe without encountering national barriers, the Savings and Investment Union is meant to enhance the capability of the financial system to translate savings into productive investment.

Both projects contain a wide range of specific, often rather technical measures: including a financial literary strategy, the development of a supplementary pensions sector, promoting equity investment and venture capital, aligning company insolvency laws, addressing the more preferential tax treatment of debt over equity, a joint supervision of capital markets, and repatriating clearing platforms from outside the EU.

Going beyond a listing of individual measures, several **key ideas** stand out:

- **Levelling the playing field:** Firms with comparable characteristics should have comparable financing conditions, instead of the cost of capital depending on the location of their business. To do so and decouple financial pricing from national sovereign bonds, a **European safe and highly liquid asset** is to be created whose interest rate provides the reference for other financial products.

- **Redeploy European savings for European investment.** Each year 300 billion euro of European savings are diverted abroad, primarily to the US economy. Keeping internal savings

in Europe **and** attracting additional savings from the rest of the world would require an integrated financial marketplace, but also, again, a **European safe asset** where savings surpluses, including those from the rest of the world, could find a secure haven.

- **Business has to lead the way:** Given the precarious state of public finances, private money and initiatives need to step up to finance the massive investment that is necessary to address the megachallenges mentioned above.

- **Capital markets, not banks, are key.** The European financing system of business investment is currently based on banking lending, while capital markets play a more limited role. In Europe, companies are externally funded through bank loans (75%), with capital markets funding the rest (25%) In the US, this is the other way around.

European overreliance on bank lending is frustrating the financing and development of innovative companies and SMEs. Banks do not tend to lend money to projects that are uncertain and highly risky and thus unable to guarantee regular debt payments. When looking for more capital to grow their business, startups and other innovative firms reportedly relocate to the US where risk capital is more easily available and prospects for higher market valuations implying substantial capital gains are stronger.

- **Bringing back financial securitisation.** More generally, banks' lending is limited by capital standards requirements, whereas market finance isn't. Reviving the European securitisation market would therefore allow banks to bundle loans, sell these on the capital market, thus liberating bank capital for new loans.

- **More risk-taking.** The US stock market is more than double the size of the EU in terms of GDP, and growing rapidly (from 137% of GDP in 2015 to 227% in 2021, compared to 61% in the EU in 2015 and 81% in 2021). To redirect European household savings from bank deposits and savings accounts to equity investment, as well as to allow European asset management to reach critical mass and achieve economies of scale, a European single savings product of private pensions sold in all EU member states and benefitting from preferential tax treatment is being proposed.

- **Making European Finance Great Again.** European financial markets are in the process of being dominated by non-EU financial actors. US ones especially have a double competitive advantage over European financial actors. Backed up by the large US domestic market, they are already in a stronger position. Moreover, they can locate headquarters within any of the 27 European jurisdictions, reaping regulatory and tax advantages in that process. US-based institutions thus acquire a key place in the design and financing of strategic decisions (mergers) and sectors (infrastructure investment) in Europe.

Part II: Risks and Pitfalls for workers

The preceding overview of main ideas and arguments illustrates that the debate on a European Savings and Investment Union (ESIU) is wide and complex. It is also ambiguous, implying that workers and trade unions especially need to be on their guard.

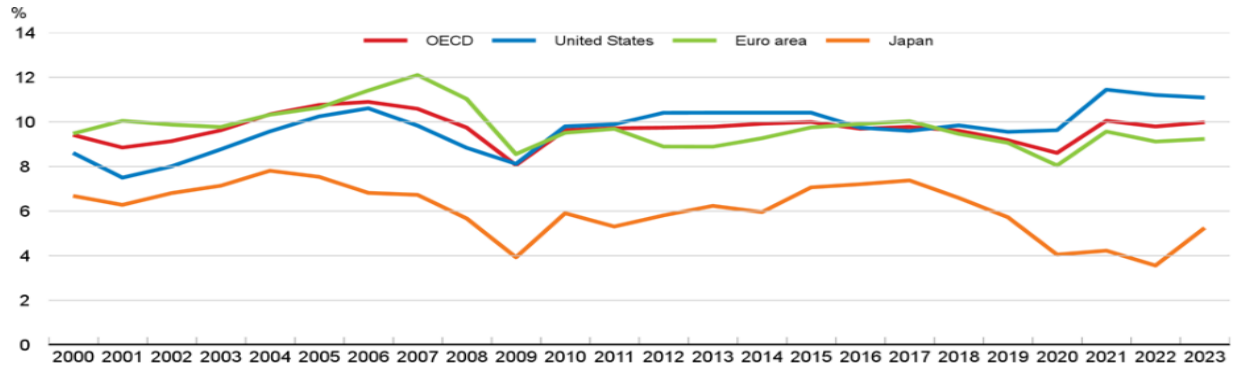
Keeping savings in Europe should not become an excuse to demand higher business profitability

The discussion immediately takes a regrettable twist when arguing that the 300 billion euro of the European savings surplus are invested in the rest of the world, and mainly in the US, because returns on equity are claimed to be comparatively lower in Europe.

However, the supposedly European disadvantage in profitability disappears when considering the rate of return on corporate capital assets (*see graph from the OECD*). Over the last two decades since 2000, business returns in the euro area have been higher, or at least equal, or in line with those of the US. Hence, lower profitability of investment can hardly be seen as a major cause of capital leaving Europe to the advantage of the US.

Figure 2.15. The rate of return on corporate capital assets remains high

Rate of return on corporate fixed assets



Note: The return on capital is calculated as the corporate gross operating surplus less consumption of fixed capital relative to net fixed assets where available. Euro area refers to the weighted average of 13 euro area countries. OECD refers to the weighted average of 23 countries.

Source: OECD National Accounts database; and OECD calculations.

Coming back with a vengeance: Economic and financial instability

The following *quote* eloquently captures a key theme of the debate and CMU and ESIU: "Public funds will not be sufficient (to finance the huge investments required), given the dire state of public finances. Bank financing is limited by banks' capital requirements and profitability. Market financing is therefore essential".

But when it comes to financial markets, things are not that simple. Markets are not always functioning in a rational way, focussing only on so-called economic fundamentals. Markets are also driven by irrational factors, such as fear, greed and 'herd behaviour'. In particular, the competitive race to obtain short-term returns higher than the next investment firm results in a focus, not on the intrinsic long-term value of the assets, but on how other investors are expected to value that asset in the short term. This usually results in 'herd behaviour', making financial markets prone to "overshooting" but also to "sudden stops" whereby access to funding is shut down, especially in a time of crisis. In other words, markets are able to set self-fulfilling prophecies in motion. This is exactly what happened during the euro crisis, when financial markets got themselves caught in a bad equilibrium. By fearing defaults on member states' sovereign debt, markets hiked the cost of financing that debt, thereby making default the inescapable outcome.

In other words, market finance is pro-cyclical[1], offering plenty of funding when times are good and thus feeding an economic bubble to incredible heights. But when the bubble bursts, markets restrict the access to funding for business and households, hence amplifying the bad times. In this respect, re-introducing a leading role for securitisation, with credit risks being shifted from the banking sector to the shadow banking system (non-bank financial institutions) risks repeating the mistakes of the past. Experience from the Great Financial Crisis shows that securitisation does not make systemic risks disappear, and that the problems with toxic assets in the shadow banking sector spilled right over and back into the banking system itself, thereby triggering a deep crisis in the real economy as credit flows and related investment and spending was frozen.

More instability in financial systems and economies has negative consequences for workers. Indeed, with each crash, especially deep and prolonged ones, comes the opportunity for businesses to warn of a competitiveness crisis, urgently requiring fewer workers' rights, weaker collective bargaining institutions, disciplining of trade unions and cuts in social security.

Innovation or making jobs more insecure?

Pro-cyclical financial markets and the "sudden stops" they involve are also used to claim the existence of a trade-off between innovation and job security. On the one hand, capital market finance is considered to be necessary to promote innovation as it enables better access to finance for investing in startups and innovation. On the other hand, the possibility of these "sudden stops" implies that businesses relying on financial markets need to be able to quickly lower their cost base when economies and financial markets hit crisis mode, in particular by easily engaging in mass redundancies. In this line of thinking, job protection and innovation seemingly contradict each other, thus opening up the way for a renewed employer offensive to deregulate employment protection and increase job insecurity in Europe (*see table below*). This trade-off would be even more acute for startups. Startupsit is argued, face more uncertainty about the likelihood and stability of future demand. They would therefore be reluctant to invest, scale up and expand employment if firing previously hired workers is onerous or expensive.

Strictness of job protection (scale 0-6)

	Germany	France	Italy	Spain	US
Individual and	2.3	2.7	2.9	2.4	1.3

[1]Bank lending also tends to work in pro-cyclical ways as banks become overly cautious about extending new credit in times of crisis. However, when funds are obtained through anonymous financial markets instead of banking credit, pro-cyclicity is worse. In the absence of any relationship with the business that is borrowing, and with capital markets typically showing 'herd behaviour' (as explained previously), capital markets may shut down and block access to funding in times of crisis and uncertainty.

collective dismissals					
Temporary contracts	1.7	2.6	2.8	2.5	0.3

Source: OECD

However, the claim that an innovative economy can only be obtained on the basis of insecure and unstable work practices is far from being credible. In fact, the OECD, in its 2018 Jobs Strategy, also stresses the fact that employment protection systems provide a level of job stability which fosters learning in the workplace and innovation, investment in worker skills, staff motivation and loyal workers.

Moreover, as shown by IMF research, another disadvantage of the lack of robust job protection measures is that the lack of job security weakens a worker's bargaining position, resulting in wages lagging behind productivity developments and depressing the income share of labour (*see next point below*).

In the end, smart economic policy is not about simply managing trade-offs, it is about going beyond these trade-offs and trying to achieve the best of both worlds by a robust design of labour market institutions. In the case of innovation and employment protection, this can be done by ensuring (1) a gradual build-up of job protection (so that startups can employ new workers in the knowledge that adjustment, if necessary, is feasible in the early years); (2) protecting jobs by putting an important focus on advance notification (thus providing an early warning signal and time to prepare for those dismissed workers) and, last but not least, (3) short-time work systems providing business with the flexibility to adjust labour input without incurring all the costs of firing and then rehiring workers, while protecting workers through generous unemployment benefits during their temporary inactivity.

Financial speculation, superstars and labour market power

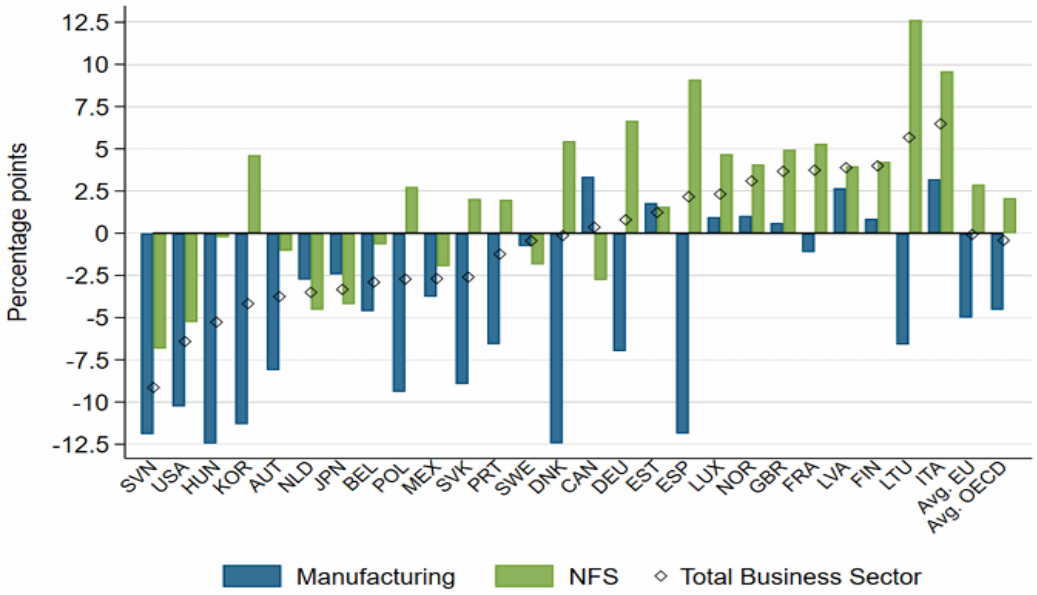
The potential of financial markets to stage self-fulfilling prophecies is not limited to situations of economic downturns. The power of financial speculation can also lead to the making of “superstar” firms able to profit from "winner-takes-all" dynamics and related network effects by dominating the market for their services or products. Vivid examples of such a process at work can be seen from the stock market for tech services in the US. Massive speculation on future, excessive profits raises the stock prices of new and young promising tech firms to a multiple of the company's earnings, providing the company with gigantic financial power. That power is then used to buy up possible competitors, thereby building a monopolistic position which, in turn, justifies the initial valuation of the equity. The result is a huge concentration of profits, with the corresponding political power, in the hands of a relatively small number of firms. In the US, the top 0.1% - or just one in a thousand firms - capture 99% of the total of after-tax profits.

Monopolistic firms are bad for consumers, but they are bad for workers as well if they also succeed in dominating labour markets. In the latter case, such firms will try to limit the number of workers being hired in order to pay lower wages and maximise profits, resulting in fewer jobs and wages below worker productivity.

Recent OECD research on the role of high-productivity firms, so-called "superstars", in depressing labour shares of the business sector points in this direction. Besides concluding that the US has experienced one of the largest declines in the business sector labour share (-6.41pp) over the 1995-2017 period, it also reveals that within the group of high-productivity firms, there is an expanding subgroup of firms where

average wages are more than 40% lower compared to the average wage of all high productivity firms. In other words, the pass-through of high productivity to wages is broken in this group of well performing firms, implying that policies that strengthen the productivity/wage link, such as collective bargaining, are required.

Figure 3.2. Changes in business sector labour shares by country-industry, 1995-2017



Note: The graph shows the cumulative percentage point change of sector-level nominal labour shares from the first three to last three years in the data. Total business sector is the average of manufacturing and non-financial market services (NFS) using sector-level VA as weight. 'EU' is an average of all EU countries included in the figure. 'OECD' is the unweighted average of all the individual countries shown.
Source: Authors' calculations based on the OECD STAN database.

Pension savings: Blackrock and Private Equity calling

European households are considered to be timid investors, holding the majority of their savings as bank deposits instead of making these directly available for productive use by investing in corporate equity. To partially offset the perceived lack of finance for risk investment, the policy discussion quickly turns to pension savings. With occupational pension funds managing 4 trillion euro of assets, and insurance companies 9 trillion euro of reserves, a loosening of investment regulation for these particular industries is expected to foster EU corporate investment, or so the argument goes.

This involves several risks:

- Unleashing a flood of retirement capital to buy equity will boost the stock exchange and the price of shares in general. Given the fact that ownership of equity is highly unequal, the top wealthiest households stand to gain significantly, thus increasing wealth inequality further. And when the flooding of financial markets with pension savings occurs at a time when economic crisis and a stock meltdown are looming, a scenario of established shareholders dumping risk on the new entrants is not far off.

- When it comes to stock markets and equity, the factor of speculation is never far away, with returns depending on the next wave of buyers willing to pay an even higher price to acquire shares. However, building a pensions policy on a system that has the characteristics of a

typical Ponzi scheme is not a good idea: With the population ageing, the number of young people in the next generation will be declining, thereby limiting the inflow of new money that is necessary to allow the actual pay-out of pensions based on high share prices.

- Investing pension savings in stocks boils down to shifting risk to individual savers. This involves a further demise of 'defined benefit' pension systems to the benefit of 'defined contributions' systems. And if risks indeed materialise and future pensions collapse because of a stock market crash, the collective public sector will again be forced to pick up the bill.

- Substituting "more patient" finance provided by bank loans for capital focussed on the next quarter of earnings risks triggering a negative feedback loop for workers. Market pressure for quick wins and excessively high returns ends up in management squeezing jobs and wages to cut costs as much as possible. Ironically, this may also involve reducing worker access to pension entitlements, for example by resorting to precarious and unstable forms of labour contracts and by redefining retirement compensation as a 'defined contribution' instead of a 'defined benefit'.

- Moreover, there is the role of the asset management industry. As the US experience shows, gigantic asset management firms have succeeded in becoming the gateway for institutional investors to stock markets, thereby mobilising trillions of savings from pension funds and university endowments. Just three firms (Blackrock, Vanguard and State Street) collectively control 20% of every publicly listed company. This degree of financial concentration worsens the negative feedback loop for workers. With the asset management industry as main shareholders, imposing similar maximum profitability requirements on entire industries and economies, the bargaining position of workers is weakened. Whichever firms workers turn to in order to change jobs and get better pay, these firms will be facing the same pressure for maximum profitability and minimal wage costs.

To summarise, while the argument of better returns for future retirees is indeed tempting, maximum care needs to be taken when exposing workers' capital to the excesses of the financial markets. To prevent importing the "shareholder revolution" to Europe, robust social dialogue and worker participation in the organisation and management of workers' capital, together with strong financial market regulation, are key conditions.

Part III: A trade union narrative

Channelling savings into European investment, as is the intention stated by the CMU and the EU Savings and Investment Union, is certainly a laudable and necessary objective. At the same time, a trade union narrative to ensure that the implementation of these initiatives is indeed focused on this objective, rather than venturing into ambiguous policies that trigger a significantly negative fall-out on workers (as described in Part II), is necessary.

The Savings and Investment Union as a "red herring"

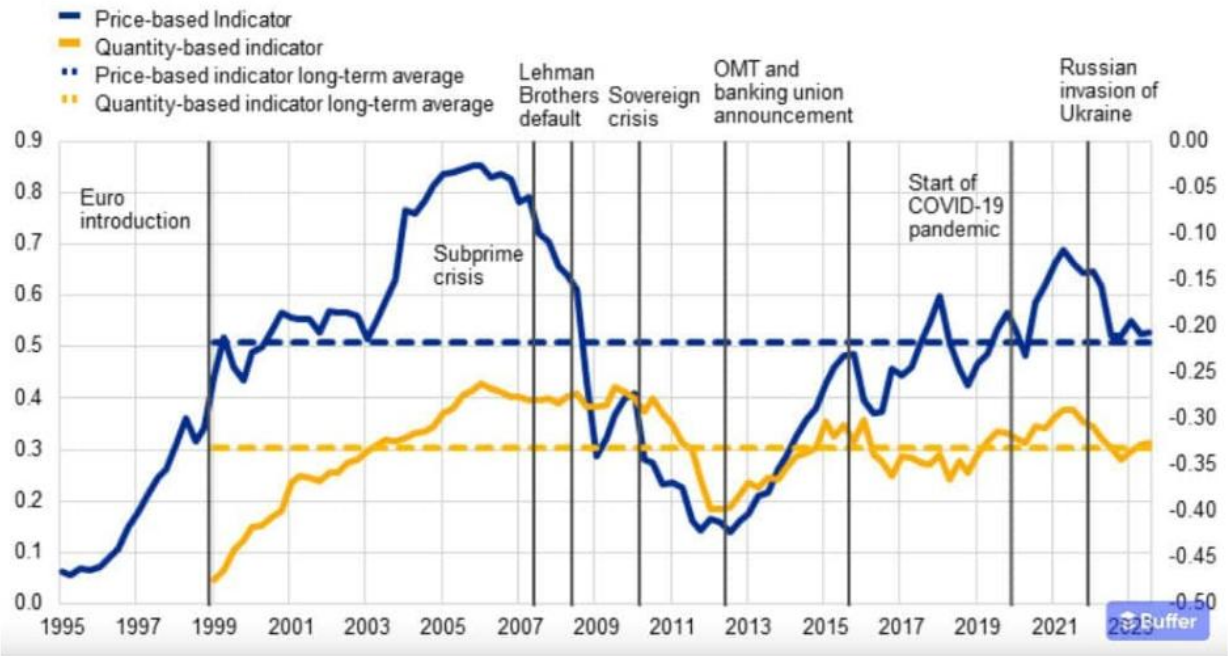
Making it easier for capital to flow freely across Europe may trigger some business investment that might otherwise have remained constrained by the lack of local savings. However, whether this will fully mobilise the European savings glut, currently estimated at 300 billion euro, from being invested abroad, is rather doubtful.

Recent OECD work, for example, finds that, when excluding the role of aggregate demand, the cumulated gap in real business investment since the 2008 financial crisis is as large in the US as it is in Germany or the UK, or the OECD average (*see graph*). In other words, the fact that capital in the US is free to roam the different states in search of business opportunities, or is eager to engage in potentially highly profitable but also high-risk adventures, does not appear to make much of a difference.

This finding should not come as a surprise. ECB indicators on financial integration point to the fact that since July 1990, when restrictions on moving capital around European were removed, remaining obstacles should not be exaggerated. In fact, the ECB's price-based indicator (which measures the dispersion across member states of the returns to different types of assets), shows that Europe actually reached almost perfect financial integration (a value of one in the graph below) from the mid-'90s to 2006.

What also played a role during this latter period was the success story of European monetary union (EMU). By replacing national currencies with a single European currency, risk premiums on national sovereign debt bonds almost disappeared as the risk of a devaluation of the national currency was no longer relevant. Unfortunately, this success story ended with the subprime financial crisis, when the ECB allowed financial market speculation on sovereign debt defaults to take hold.

Figure 1: price- and quantity-based composite indicators of financial integration



Source: ECB

The ECB's quantity-based indicator, showing the extent to which different types of assets are held across borders, is not making a convincing case for the substantial lack of a European capital markets union either. As could be expected after ensuring the freedom of capital to move, and after introducing the single currency, this indicator has improved substantially since the end of the nineties. Importantly, there is no correlation whatsoever with the European savings glut that started to appear around 2010, and the ECB's quantity-based financial integration indicator as the latter remained mostly stable over the last two

decades.

A much more likely candidate to explain diverging investment performance between the US and Europe is the role of demand management. While profitability is one of the factors driving corporate investment, it is not the only one, and not even the most important one. Investing is about committing to high capital expenditure now, expecting future sales and revenue and flows to recover the sunk cost of the investment. This requires relatively stable and sufficiently dynamic demand prospects, in the absence of which businesses will be reluctant to invest.

When it comes to managing domestic demand, the difference between the US and Europe is staggering Before the financial crisis, domestic demand dynamics in the euro area were somewhat, but not so much, lagging behind domestic demand growth in the US, with the expansion of internal demand 1.4 times stronger in the latter. After the financial crisis however, the gap between domestic demand strength in the US compared to Europe accelerated, with demand expanding 2.2 times faster in the US. One important driver of this was the stance of fiscal policy: While structural deficits in the euro area averaged just 0.3% over the 2007–2019 period, they amounted to 3.9% in the US. As a result, the US injected 14 times more funds into its internal demand dynamics, or 7.8 trillion euro compared to 560 billion euro in the euro area. With an overall demand management that is so active and outspoken in the US, it does not come as a surprise that business investment soared over there in that process, attracting surplus savings from Europe.

A trade union narrative therefore needs to start by addressing the 'elephant' in the room. The fact that hundreds of billions of European savings fail to be mobilised for European investment is not a coincidence, but an intrinsic feature of the economic model that Europe has chosen to pursue; a model that systematically underplays the importance of a robust management of the domestic demand side of the economy.

In this model, aggregate demand is locked into a straitjacket. Fiscal policy is restrained by the continuous drive for austerity, monetary policy is fighting inflation even when inflationary dynamics have receded, and wages and collective bargaining are disciplined in the name of cost competitiveness.

As a result of this model, domestic demand as a share of GDP in the euro area has now fallen to the bottom range of advanced economies. In the absence of sufficiently dynamic domestic demand, business has little other option but to count on exports to the rest of the world as the aggregate demand driver of 'last resort',keeping the economy and its growth performance somewhat afloat. In this way, Europe has gradually built up large and structural current account surpluses. The European current account turned from a mild deficit of -0.5% to -1% of GDP in the mid-1990s to 2008 into a structural surplus of 2% to 3% of GDP from the mid 2010s on. These external surpluses are then exported as capital to the rest of the world, in particular to those regions where aggregate demand dynamics - in contrast to Europe - are robust and offer the opportunity of putting capital and savings to work.

In summary, transforming Europe into a 'savings and investment' union requires policymakers to turn to a new economic model: a model that ensures domestic demand is dynamic enough to launch robust business investment. This requires a very different fiscal policy framework, a central bank that takes the risks of undershooting growth and missing full employment as serious as the danger of overshooting inflation and, last but not least, strong collective bargaining practice to avoid wages lagging behind productivity.

Stabilisation policy and innovation

A better management of the demand side in Europe will also have an impact on innovation by fostering business investment in R&D, an area where European business significantly lags behind US business, with the former spending 1.5% of GDP while the latter has now boosted such spending to over 2.5% of GDP.

Demand side policy and business investment in R&D and innovation are connected because such investment requires stable business income flows in order to continue research over time. Recessions however put pressure on current business, implying that long slumps see business expenditure on R&D plummet. Moreover, increased economic volatility resulting from the failure of demand stabilisation policy will inject a structural bias against business R&D spending. Even when the economy eventually takes off again, firms will have learned that macroeconomic policy cannot be counted on to limit and quickly reverse the downturn, implying that investing in R&D may not pay off as the continuation of this research is likely to be jeopardised when the next recession strikes.

This pro-cyclicality of R&D is important since one of the alleged promises of the project of a European Savings and Investment Union is to accelerate innovation by improving the access of startups to venture capital. This, however, is not without a cost to society. The perception of potentially large gains somewhere in the future could result in increased inequality (when innovation does pay off and a monopoly rules the market – see Part II above) or in financial instability and crisis (when the pyramid game of selling equity at a higher price to the next investor blows up the equity price bubble and is followed by a financial crisis).

In summary, pursuing a more active demand-side policy presents a broader and less risky route to foster business investment in R&D. Another alternative worth mentioning is the role of public development banks in providing access to finance for research and in assisting startups in opting for an initial public offering. The recent initiative of the European Investment Bank, mobilising 250 billion euro in this respect, provides an interesting example.

Hurdle rates, business pay-outs and corporate cash piles

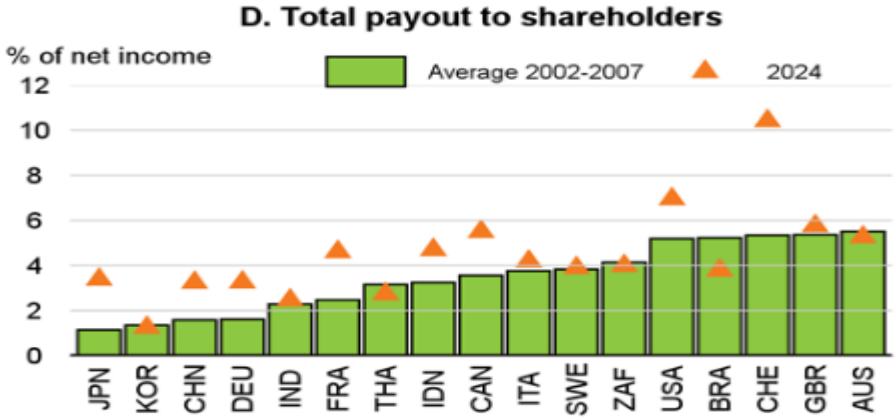
The European savings glut needs to be transformed into European investment spending, but the right type of investment is needed. Experience from what has happened over the first decade after the introduction of the euro is instructive: From the end of the nineties up to 2008, capital was indeed flowing more intensively across Europe from savings surplus to deficit countries. This, however, was on the basis of housing price bubbles that subsequently blew up, resulting in the 2010/2011 euro crisis.

The aftermath of the financial crisis provides another illustration. Driven by wage moderation, stronger profits, lower taxes and lower interest rates, the business sector increased total savings, often significantly, as was the case in Germany (+2% of GDP) and even more so in Italy and Spain (both around 6% of GDP). However, despite increased funding, business investment remained weak compared to past trends. As a result, the business sector shifted from being a net aggregate borrower to the rest of the economy into a net lender.

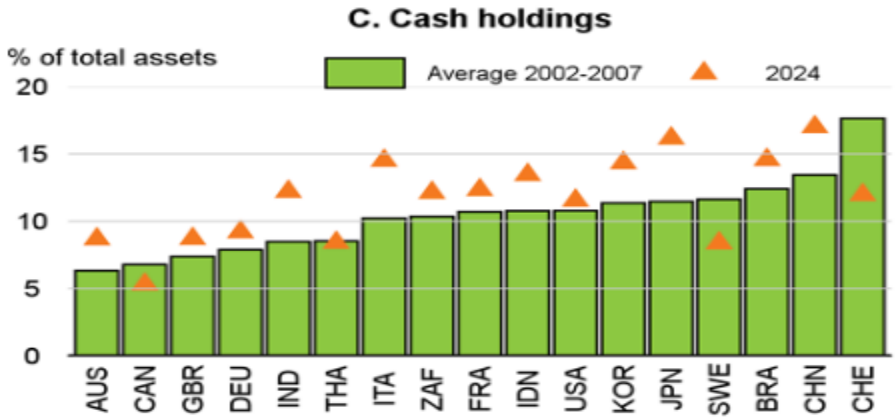
The OECD further documents what use businesses on the whole had for the increased resources they had at their disposal, and the picture is not comforting.

- Instead of investing in fixed assets, savings were increasingly guided to hike dividend pay-outs and share buybacks, with total pay-outs to shareholders doubling in France and Germany and

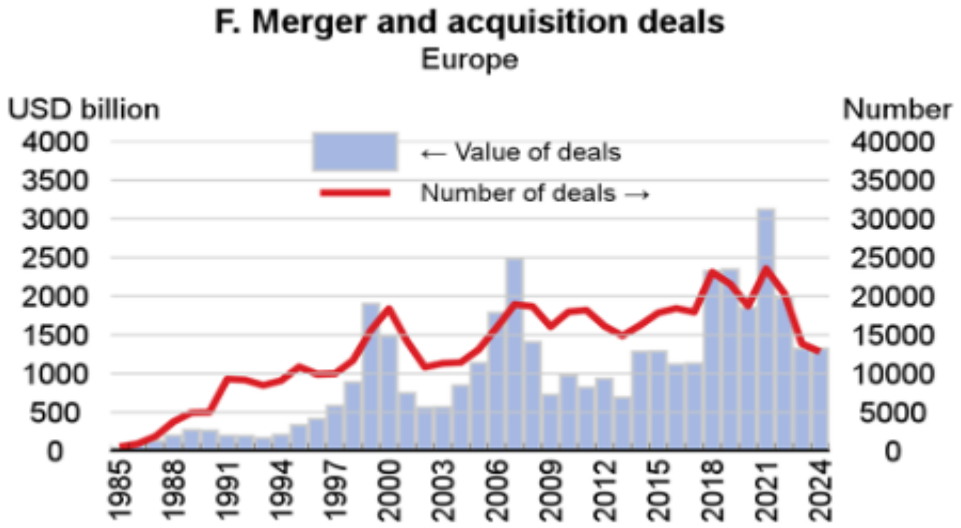
continuing to reach a record high in the UK.



- Firms have also been holding on to much more cash and financial assets, rather than strengthening their balance sheet by paying back debt.

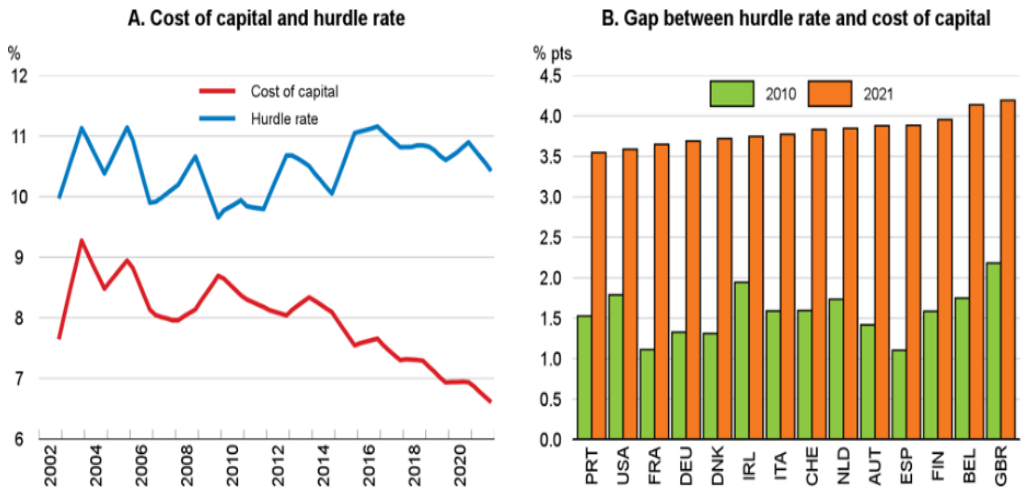


– Business has also used savings to acquire existing financial assets by merging and buying up other companies, instead of expanding the overall capital stock.



– Last, but not least, a key role here is played by so-called 'hurdle rates', or the minimum profitability threshold required by business before considering to invest. That threshold has not only remained stubbornly high, even if the cost of finance has collapsed over the last decade (both because of close to zero interest rates and because of falling corporate tax rates). It has also tended to edge further up, thereby obstructing many still profitable investment projects.

Figure 2.16. The gap between financing costs and hurdle rates has increased



Summary

Policy to ensure that (corporate) savings are effectively used for productive investment, including investment to address the mega challenges, such as energy transition and digitalisation, needs to be part of the package of the European Savings and Investment Union. This includes taxing excessive profits to limit exorbitant hurdle rates, targeted price controls to prevent price gouging and, importantly, worker consultation and participation to provide for a steering of corporate profits into investment, strengthening the company and its employment.