SPEECH

Follow the money: channelling savings into investment and innovation in Europe

Speech by Christine Lagarde, President of the ECB, at the 34th European Banking Congress: "Out of the Comfort Zone: Europe and the New World Order"

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At last year’s conference, I spoke about Europe’s fragmented capital markets and the urgent need for us to integrate them.

The main thrust of my argument was that Europe was facing transformative changes that came with huge financing needs, and that we would not succeed without mobilising private capital much more effectively.

I called for a “Kantian shift” in how we approach the capital markets union (CMU) project, moving away from bottom-up harmonisation to top-down integration.[1]

But as Martin Luther King said, “we are now faced with the fact that tomorrow is today.” And in that time, the urgency to integrate our capital markets has risen.

Since last year, Europe’s declining innovation position has come more clearly to light. The technology gap between the United States and Europe is now unmistakeable.

The geopolitical environment has also become less favourable, with growing threats to free trade from all corners of the world. As the most open of the major economies, the EU is more exposed to these trends than others.

CMU lies at the centre of all these challenges.

It is key for making our economy more dynamic and technologically advanced. While banks play an essential role in the European economy, we know that integrated capital markets are needed for financing early-stage, breakthrough innovation.

And it is key for becoming more resilient in a fragmenting world economy. Capital markets are the missing link for Europeans to turn their high savings into greater wealth – which will ultimately enable them to spend more and strengthen our internal demand.

However, this growing urgency has not been matched by tangible progress towards CMU, in large part because its implementation remains loosely defined.

Since 2015, there have been more than 55 regulatory proposals and 50 non-legislative initiatives, but breadth has come at the expense of depth. It has allowed CMU to be picked apart by national vested interests that see one or another initiative as a threat.

So if we are to achieve a “Kantian shift”, we need to refocus, exposing the core inefficiencies in the system and identifying a smaller number of initiatives with the highest return.

As I see it, the core problem of CMU is that the “pipeline” from savers to innovators is blocked at three key stages: *entering*, *expanding* and *exiting*.

First, European savings are not *entering* capital markets in sufficient volumes because they are concentrated in low-yielding deposits.

Second, when savings do reach capital markets, they remain trapped in national silos and are not *expanding* throughout the European economy.

Third, once savings have been allocated by capital markets, they are not *exiting* towards innovative companies and sectors owing to an underdeveloped ecosystem for venture capital.

These three blockages require different solutions, but they must be seen as a single problem, because they are self-reinforcing. Fewer high-growth companies means lower equity valuations and liquidity in EU markets and lower returns for savers.

In my remarks this morning, I will outline the key blockages I see in each area and present some actionable policy proposals that can resolve them.

Entering capital markets

Europeans save a high share of their income: around 13%[2] in 2023 compared with around 8% in the United States.

But typically, Europeans favour low-risk, liquid savings products. In Europe, approximately €11.5 trillion is held in cash and deposits. This is one-third of households’ total financial assets. In the United States, the figure is around only one-tenth.

This has two main consequences for our economy.

First, European households are much less wealthy than they could be. Since 2009, US household wealth has grown by around three times more than that of EU households.[3]

Second, the flow of savings into capital markets is much lower than it could be.

According to ECB analysis, if EU households were to align their deposit-to-financial assets ratio with that of US households, a stock of up to €8 trillion could be redirected into long-term, market-based investments – or a flow of around €350 billion annually.

So why are people not diversifying their assets?

A key issue is that retail investment in Europe is fragmented, opaque and expensive.

In many countries, investing is complex and intermediated by financial advisors that people do not always trust. 45% of consumers say that they are not confident that the advice they receive is primarily in their best interests.[4]

And if households do invest, they often do not get the best deal. Retail investors in European mutual funds, for example, pay almost 60% more in fees than their US counterparts.[5]

Many Europeans therefore end up investing in guaranteed savings accounts by default.

But when markets are more competitive, and consumers can choose from a wide range of suitable investment products, behaviour does change. In the Netherlands, Sweden and Denmark, households

manage their assets in a similar way to their US counterparts, holding only 10-20% of their financial assets in liquid forms.

So, if we are to unblock the “entry stage” of the pipeline, we need savers in Europe to have products that are *accessible*, *transparent* and *affordable*. In my view, a “European savings standard” – a standardised, EU-wide set of savings products – is the best way to achieve these goals.

If properly designed and distributed, these products would be *accessible*, i.e. simple to understand, available everywhere and offering a range of investment options. They should be *transparent*, because they would be structured according to clear criteria, such as diversification, fee structure and portfolio composition.

And they should be *affordable*, because financial services providers would be able to offer EU-certified products with less red tape, while standardisation would lead to more comparability and competition. Both effects should bring down fees.

The attractiveness of the European standard should also be enhanced by harmonising tax incentives across countries.

The market would decide where savings are directed, not governments. But depending on the preferences of savers, products could also be offered that would support European priorities, such as financing innovation and the green transition.

Expanding throughout Europe

To truly unlock Europe’s innovative potential, we need finance to flow where the best ideas are. And given the nature of digital technology – which often requires large, upfront investments – we need those flows to be in large volumes.

Yet the second stage of the pipeline – expanding throughout Europe – is also blocked.

Capital in Europe is either trapped within national borders or leaves for the United States. If we look at equities, for example, more than 60% of households’ investment in Europe takes place within their own country. Institutional investors invest much more in US markets than they do in the EU.

There are many reasons for this segmentation of European markets, but a key one is that our financial market infrastructures are extraordinarily fragmented.

In 2023 there were 295 trading venues in the EU[6], as well as 14 central counterparties (CCPs) and 32 central securities depositories (CSDs).[7] In the United States, there are only two securities clearing houses and one CSD.

Many CCPs and CSDs belong to pan-European, cross-border groups. But national exchanges remain largely separate, despite some technical synergies like consolidated orderbooks.

This fragmentation creates high transaction costs for cross-border trading, which according to ECB analysis increases home bias in how investors allocate their funds.[8]

That in turn leads to lower liquidity for investors, issuers and stock exchanges. Compared with their EU counterparts, the average daily trading volume per company is 1.3 times higher for US large-caps and two times higher for US mid-caps.[9]

What is driving this fragmentation?

The main issue is that legal frameworks within the EU are divergent and all meaningful attempts at harmonisation are blocked by vested interests.

We have a patchwork of national corporate, tax and securities law, with different requirements for corporate actions, custody services and reporting.[10]

And national authorities tend to exacerbate rather than reduce this problem. For example, some Member States mandate the use of national CSDs for issuing securities under national law, or for settling primary issuances of sovereign bonds.

This mélange of different regimes and enforcing parties severely limits the ability of exchanges and CSDs to integrate their national platforms, even within cross-border groups.

Some progress is being made. Europe is moving towards a common consolidated tape[11], which will help reduce transaction costs. This tape could reduce trading costs by 40-60% by increasing transparency between dealers and investors.[12]

But it will not address the fundamental problem, which is that our incremental approach, focused on harmonising a multitude of national laws, is simply working way too slowly.

If we look at the United States, legal convergence often does not come about through total harmonisation of state-level laws, but rather through federal law being introduced or one state's law becoming dominant. For example, almost 80% of all US companies that held an initial public offering in 2022 were incorporated in Delaware.[13]

In Europe, we will not be able to make progress by promoting one country's legal system over another. That is why I called for a "European SEC"[14] in my speech at this event last year, which could be organised as a network of offices in the Member States. But alongside this goal, there are other options we can pursue.

One option would be to adopt a two-tier approach, as we have for competition enforcement or banking supervision. Entities that meet certain criteria would automatically fall under EU jurisdiction but within a common, Europe-wide legal framework.

Another option would be to use "28th regimes", which would enable us to carve out a special legal framework in areas where progress has stalled. We would then have a separate EU legal regime that firms can opt into sitting alongside the various national regimes.

In my view, the most realistic approach probably involves a combination.

For example, to bypass the cumbersome process of regulatory harmonisation, we could envisage a 28th regime for issuers of securities. They would benefit from a unified corporate and securities law, facilitating cross-border placement, holding and settlement.

Such a regime would be unlikely to work for supervision, however, as it could lead to inconsistent enforcement and misaligned incentives if entities chose their own supervisor. So, here we could envisage a two-tier approach.

Financial services providers that fulfil a set of criteria – such as size or cross-border activity – would fall under European supervision.[15] National authorities would continue to supervise smaller national players. Close collaboration between the European Securities and Markets Authority and national authorities would be essential for success.

Exiting into innovative sectors

Even if we get capital moving more freely within Europe, we still need to ensure that it exits the financial system into innovative sectors and companies. This is the third stage of the pipeline that is blocked in Europe.

In highly innovative economies, there is typically an ecosystem of investors – angel investors, venture capitalists (VCs) – that channels funds to high-growth startups, mostly through providing equity. But this ecosystem is much less developed in Europe than the United States. VC investment is only around one-third of US levels.[16]

The upshot is that innovative young firms struggle to grow in Europe, especially once they reach the scale-up phase, where larger funding rounds are needed. The median European VC-backed company receives around half as much funding as its US counterpart.[17]

And we are largely reliant on foreign VCs to fund European innovation. More than 50% of late-stage investment in European tech comes from outside the EU.[18]

As an open economy, we welcome investment from all parts of the world. But if EU tech entrepreneurs receive mostly outside funding, it can create a path dependency. These founders may ultimately decide to list and grow their businesses elsewhere, especially in the US market – what I would call an “unintended exit”.

So what can we do to close this financing gap?

Fixing the demand side is key. There are too many barriers and bureaucratic hurdles for entrepreneurs in our Single Market, which means there are fewer high-growth companies that VCs want to finance. The recommendations in the Letta and Draghi reports on completing the Single Market are critical for VC to play a greater role.

But we also need to work on the supply side. And since we are starting from a deficit, we need to use all the flexibility we have within the European financial system to unlock funding for innovation. Three changes could make a tangible difference.

First, given the natural alignment of investment horizons, our regulatory regime should allow long-term investors to contribute more to long-term growth.

For example, EU pension funds allocate just 0.02% of total assets to VC, compared with almost 2% for US pension funds. And this percentage is applied to a much larger asset base: over 140% of GDP in the United States compared with around 30% in the EU.[19]

Second, we should fully harness the potential of our public development banks, especially the European Investment Bank (EIB), to pool risks and crowd in private capital.

Successful initiatives are already afoot. Last year, the EIB and six Member States launched the European Tech Champions Initiative, a fund of funds aimed at channelling late-stage growth capital to promising European innovators.

To date, this fund has mobilised €10 billion in public and private resources and supported 16 tech scale-ups. This is significant, considering that in 2023 European scale-ups received around €30 billion in venture capital.

But more can be done to unlock the EIB's potential and enable us to catch up with our peers faster. In particular, the EIB should be allowed to use its resources more effectively and provide a wider variety of instruments to support breakthrough innovations, especially when it comes to supporting early-stage start-ups.

Third, we should explore how to support innovation not only through equity, but also through debt. While Europe should ultimately aspire to have US levels of VC investment, in the meantime we need to make the most of the bank-based system we have.

Banks can play a role in financing innovation. One interesting development in Europe over the past decade has been the rise of venture debt – loans that provide liquidity to start-ups between equity funding rounds. In 2022 around €24 billion in venture debt was allocated, up from around €1 billion in 2014.[20]

But if banks are to lend more to riskier sectors without compromising on prudential regulation, they need the balance sheet space to do so. Developing securitisation in Europe could support this.

EU banks currently lend more than €600 billion to real estate companies but less than €100 billion to technology companies – even though the contribution of each sector to real value added is around the same.[21] Tools that could facilitate some rebalancing of these exposures could support innovative activity in Europe.

Conclusion

Let me conclude.

Leonardo da Vinci is supposed to have said that, "Knowing is not enough; we must apply. Being willing is not enough; we must do".

Today, European leaders know the problems created by capital market fragmentation and are willing to act. But so far, we have neither been applying nor doing.

Lack of progress comes down, in large part, to the loose definition of CMU and the piecemeal legislative approach this creates. That in turn allows the project to suffer "death by a thousand cuts" as vested interests oppose or dilute each piece of legislation.

Today, I have laid out a framework to refocus our efforts, with the aim of providing the precision and direction we need to break the deadlock.

This is the "Kantian shift" I talked about last year: a change of perspective from taking a large number of small steps to a small number of large steps – and choosing those that we can actually take and that will make the biggest difference.

1.

Lagarde, C. (2023), "A Kantian shift for the capital markets union", speech at the European Banking Congress, 17 November.

2.

Of gross disposable income.

3.

Draghi, M. (2024), *The Future of European Competitiveness*, September.

4.

Eurobarometer (2023), *Monitoring the level of financial literacy in the EU*, July.

5.

Comparing the asset-weighted average product cost of actively managed funds for retail undertakings for collective investment in transferable securities versus US mutual funds in 2020. European Securities and Markets Authority (2023), *Market Report on Costs and Performance of EU Retail Investment Products 2023*, December.

6.

This figure does not include systematic internalisers, which are investment firms that execute client orders by trading on their own account, outside a trading venue.

7.

European Securities and Markets Authority (2024), *Statistics on securities and markets*, May.

8.

European Central Bank (2022), *Financial integration and structure in the euro area*, April.

9.

Euronext (2024), "Demystifying the liquidity gap between European and US equities", *Euronext Equities: Liquidity Analysis,* April.

10.

Different withholding tax procedures also still hinder investors' ability to avoid double taxation on cross-border holdings. The so-called FASTER initiative – which aims to make withholding tax procedures in the EU safer and more efficient for cross-border investors, national tax authorities and financial intermediaries, such as banks or investment platforms – while still pending formal adoption by the Council before entering into force, could be an important step in the right direction.

11.

The EU common consolidated tape is a proposed system to provide consolidated data on prices and volumes of traded securities across the EU, thereby improving overall price transparency across

trading venues.

12.

A study analysed the impact of introducing the trade reporting and compliance engine, or TRACE, in the United States in 2002, which served as a consolidated tape for fixed income securities. The significant reduction in trading costs (40-60%) demonstrates how a consolidated tape can decrease information asymmetries between dealers and investors in less transparent markets, such as the corporate bond market. Bessembinder, H., Maxwell, W. and Venkataraman, K. (2006), “Market transparency, liquidity externalities, and institutional trading costs in corporate bonds”, *Journal of Financial Economics*, Vol. 82, Issue 2.

13.

Delaware Division of Corporations (2023), *2023 Annual Report*.

14.

European Securities and Exchange Commission.

15.

Lagarde (2023), op. cit.

16.

Annual venture capital investment in the EU averaged 0.2% of GDP between 2013 and 2023, compared with a US average of 0.7% of GDP.

17.

European Investment Bank (2024), *The scale-up gap: financial market constraints holding back innovative firms in the European Union*, July.

18.

European Investment Fund (2023), *Scale-up financing gap*, 12 September.

19.

These figures are for 2022.

20.

Houlihan Lokey (2024), *Venture Debt Market Update in Europe as of H1 2024*, August.

21.

Andreeva, D., Botelho, V., Ferrante, A., Górnicka, L. and Lenoci, F. (2024), “Low firm productivity: the role of finance and the implications for financial stability”, *Financial Stability Review*, ECB, November.