Flash Economics

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If the return on capital is low in Europe, should we risk investing Europeans' savings in the rest of the world?

Europe is characterised by:

- a high household savings rate and a significant current account surplus;
- low corporate return on capital when compared to the United States, due to insufficient spending on research and development, limited investment in new technologies and automation, and a distribution of income that is considerably more favourable to employees than in the US.

This leaves Europe with two possible strategies:

- The proactive strategy (as outlined in the Draghi report): hold back Europeans' savings within Europe in order to finance investment in digital infrastructure, breakthrough innovation, and the energy transition;
- The strategy of accepting low return on capital in Europe: further invest Europeans' savings abroad in order to benefit from higher capital income, and use that income to help finance social protection systems (such as pensions).

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Two key features of the European economy

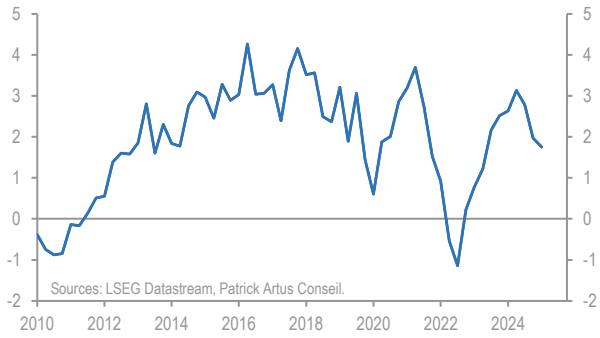
Europe (more precisely, the euro area) has an economy characterised by:

- A high household savings rate (Chart 1), and consequently, a sizeable current account surplus (Chart 2);

Chart 1
Household savings rate (as %)



Chart 2
Euro zone: Current account balance
(as % of nominal GDP)



- by low corporate return on capital when compared to that achieved by US companies (Chart 3), which is due to:
  - The absence of a skew in income distribution away from employees — a key difference between the euro area and the United States (Charts 4A/B);

Chart 3
RoE

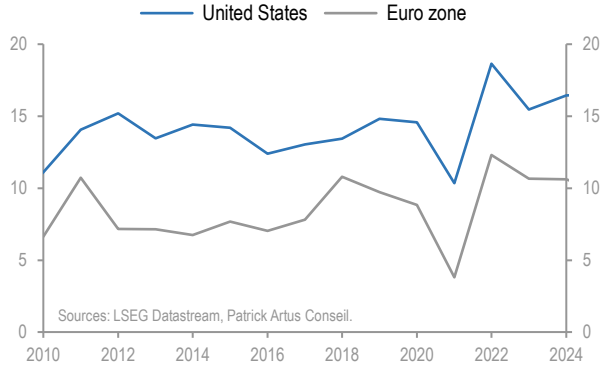


Chart 4A
United States : Real compensation per hour and
productivity per hour (business sector, 2010.Q1 = 100)

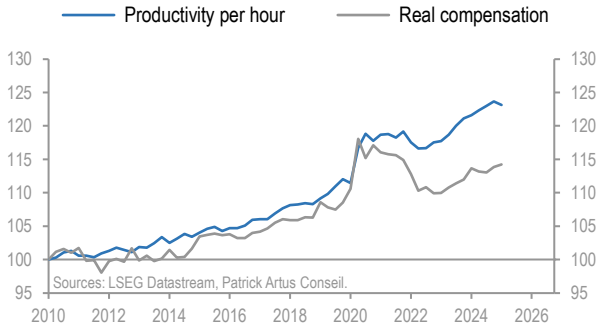
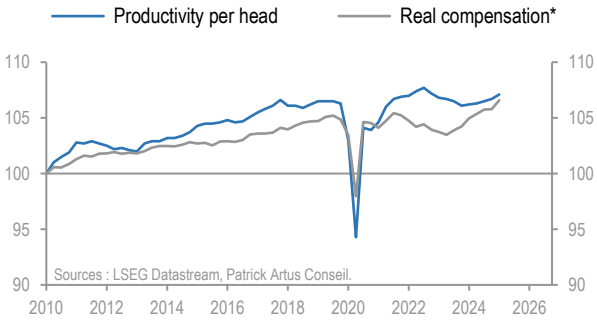


Chart 4B
Euro zone: Real compensation and productivity per head
(2010.Q1 = 100)



* Deflated by GDP deflator

- Limited efforts by European companies in research and development (Chart 5a) and in investment in new technologies (Chart 5b).

Chart 5A
Corporate R&D spending (as % of nominal GDP)

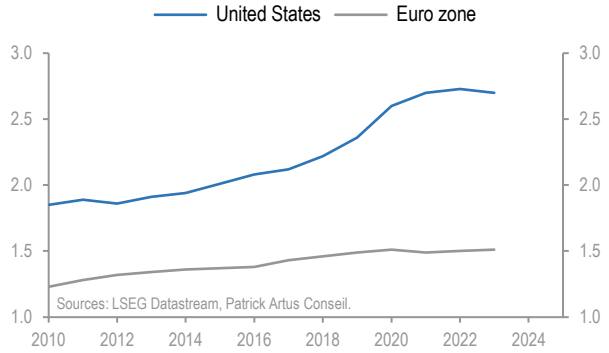
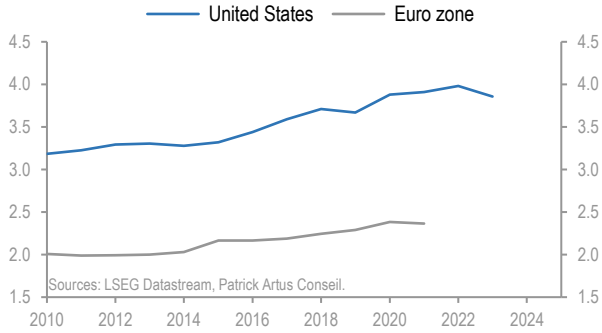


Chart 5B
ICT investment including software
(in value terms, as % of nominal GDP)



Given these two features of the European economy — high savings and a current account surplus, coupled with low business profitability — **two possible strategies for Europe can be identified**.

First Strategy: The proactive approach

This is the strategy put forward in the Draghi report:

- **Significantly increase investment** (both public and private) in the energy transition, digital transformation, and breakthrough innovation. The Draghi report suggests a sustained rise in investment equivalent to 4.5 percentage points of GDP over many years;
- **Retain European savings within Europe** in order to finance these investments. It is estimated that Europeans currently invest around €400 billion per year in the United States — an amount that represents half of the total additional investment needed. One way to achieve this could be by making European financial markets more attractive (through the Savings and Investment Union, formerly called the Capital Markets Union).

However, this proactive strategy faces several challenges:

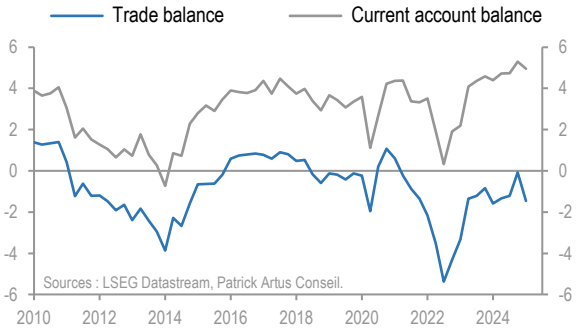
- Europe's return on capital currently lags that of the United States and will only improve gradually as modernisation investments are implemented;
- issues with low workforce skills and the inefficiency of the European education system;
- High labour costs in some European countries (such as Germany and France);
- Complex regulatory frameworks and administrative burdens.

Second Strategy: The resigned approach

This second strategy involves **accepting that return on capital in Europe** is structurally low — for the reasons outlined above — and **continuing to invest a portion of Europeans' savings abroad, particularly in the United States**. This would allow Europeans **to benefit from higher returns on their savings and to use the income generated from foreign investments to finance social protection systems (notably pensions)** via income earned on capital invested abroad.

This approach is the one adopted by Japan, which today runs a large current account surplus, not linked to a trade surplus in goods and services (Chart 6), but rather thanks to income from overseas investments.

Chart 6
Japan: Trade balance in goods and services and Current account balance (as % of nominal GDP)



Summary: which strategy should be preferred?

The first strategy — massive investment and the retention of European savings within Europe — is preferable, as it would lead to an upgrade of the European economy, a technological catch-up, and accelerate the energy transition.

However, this strategy faces major obstacles: the initially low return on investment in Europe compared to the US; the need to save more and consume less; the shortage of skills and the inefficiency of the education system; and the lack of coordination in industrial policies across European countries.

There is a real risk that the second, more resigned strategy may prevail, due to the considerable barriers to implementing the first.

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