Flash Economics

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Why investing in Europe will remain unattractive

A significant portion of Europeans' savings is invested in the rest of the world, particularly in the United States. In order to finance the investments needed in Europe (for energy transition, digital technology, education, and military upgrades), Europeans would need to keep their savings in Europe.

But this is difficult given the low return on capital in Europe, and this low return is set to continue for two reasons:

- investment capacity (public and private) is reduced by the burden of social protection, which diverts public resources towards transfer payments at the expense of investment spending, resulting in a high tax burden on businesses that reduces their ability to invest;
- Income distribution in Europe is much more favorable to employees than income distribution in the United States, which explains the higher profitability of American companies.

To bring the profitability of companies in Europe in line with that observed in the United States, Europe would therefore have to abandon its social model and its income distribution model, which is impossible.

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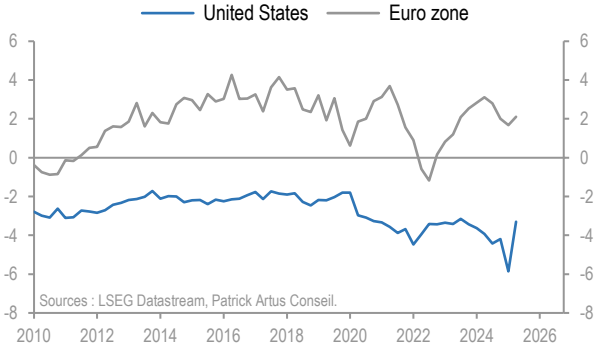
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European savings are heavily invested in the rest of the world

The euro zone has **a structural current account surplus** (**Chart 1**), which means that it is a **capital exporter**; the United States, on the other hand, has a structural current account deficit and is a capital importer.

Chart 1
Current account balance (as % of nominal GDP)



Europeans hold debt securities, equities, and foreign direct investments (**Chart 2**), and among debt securities, they hold a large portfolio of US government securities (**Chart 3**).

Chart 2
Euro zone: International investment position, direct investment and portfolio investment (assets, in EUR bn)

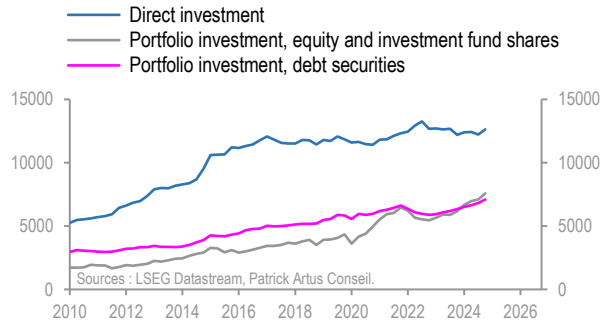
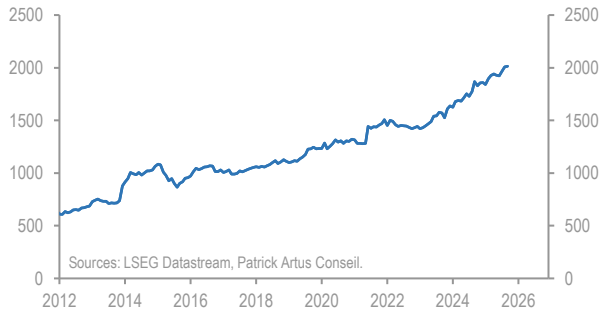


Chart 3
United States: Holdings of Treasuries by European Union (USD bn)



One estimate puts the gross investment flows from the euro zone to the United States at €350 billion per year.

Need for investment, hence the need to keep Europeans' savings in Europe

The additional investment required is very significant in the European Union: investment in energy transition, digital technology, education, and vocational training, to which military spending and investment in companies that manufacture military equipment must be added.

In total, **the Draghi report** estimates that the necessary increase in investment is €800 billion per year (4% of GDP), to which approximately 1 percentage point of GDP must be added in necessary increases in military spending.

In total, **the European Union would therefore need a 3-percent-point increase in public investment** (**Chart 4A**) **and a 2-percent-point increase in business investment** (**Chart 4B**).

Chart 4A
Euro zone: Public Investment (as % of nominal GDP)

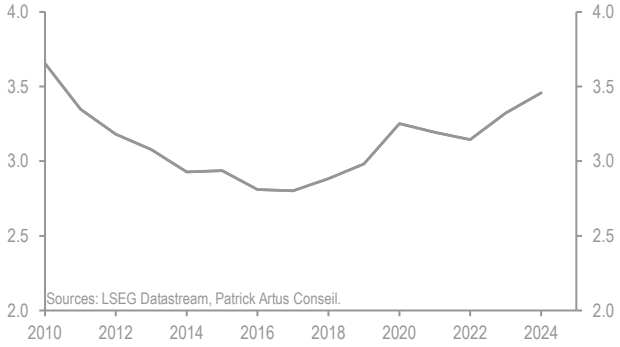


Chart 4B
Euro zone: Investment of corporations
(in value terms, as % of nominal GDP)



Without keeping Europeans' savings in Europe, **it will be necessary, in order to make these investments, to reduce the sum of other investments and public deficits** not related to these investment needs by 5 points of GDP, **or to transform consumption into savings**.

To limit the contraction in investment, excluding strategic investments, public transfer expenditure, and household consumption, **it will therefore be essential for Europeans to keep their savings in Europe, or even repatriate to Europe financial assets that have been invested in the rest of the world, outside Europe**.

But it is highly unlikely that Europeans will keep all their savings in Europe

The main reason why it is unlikely that Europeans will keep all their savings to invest in Europe is the low return on corporate capital and bond investments in Europe compared to that observed in the United States (**Charts 5A/B**).

Chart 5A
RoE

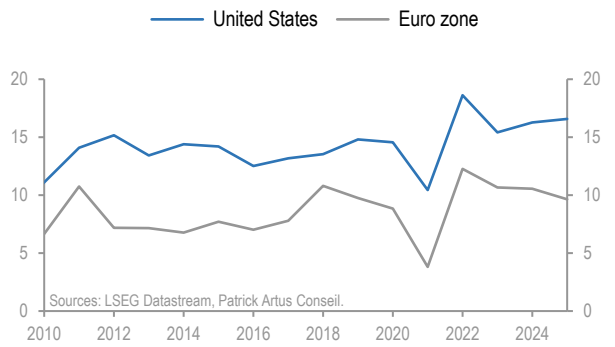
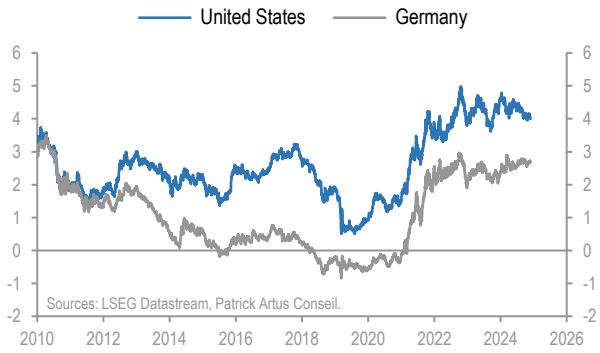


Chart 5B
Interest rate on 10-year government bonds (as %)



As long as investing in the United States is significantly more profitable than investing in Europe, savers will be encouraged to use part of their savings to purchase US financial assets.

We believe that the higher level of return on capital in the United States is **a lasting feature of both economies, for two reasons**.

1. **Investment capacity in Europe is reduced by the burden of social protection**

The burden of social protection diverts public resources toward transfer payments (**Chart 6**), to the detriment of investment, and **results in a high tax burden on businesses** (**Chart 7**), **which reduces their capacity to invest** (Chart 4B, above).

Chart 6
Public expenditure on health and social protection (as % of nominal GDP)

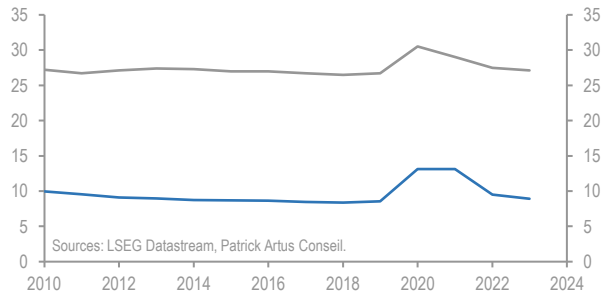
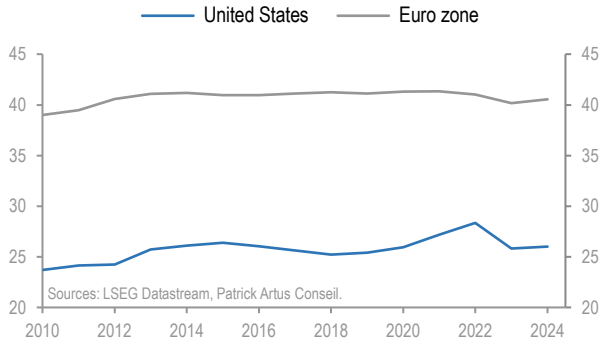


Chart 7
Tax burden (as % of nominal GDP)



Low levels of investment (both public and private) perpetuate low returns on capital.

2. Income distribution is much more favorable to companies in the United States than in the euro zone

While **labor productivity and real wages are increasing at roughly the same rate in Europe, in the United States income distribution is skewed significantly in favor of companies and to the detriment of employees** (**Charts 8A/B**).

Chart 8A
United States : Real compensation per hour and productivity per hour (business sector, 2002.Q1 = 100)

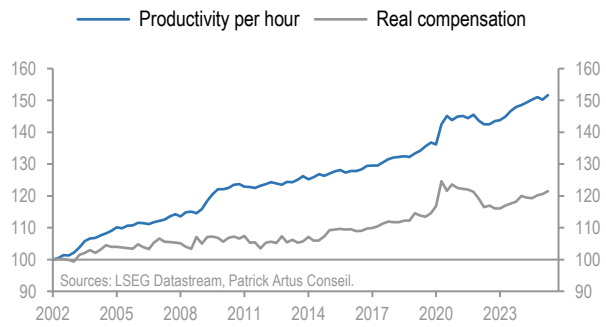
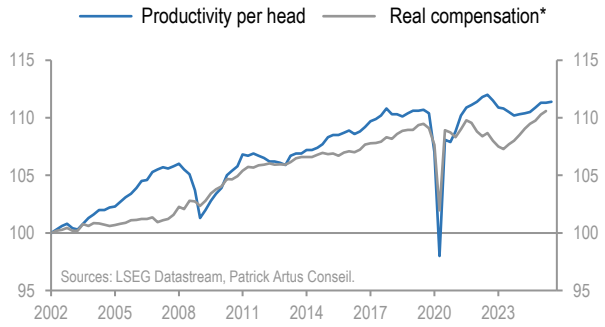


Chart 8B
Euro zone: Real compensation and productivity per head (2002.Q1 = 100)



* Deflated by GDP deflator

This has resulted in a steady increase in corporate profitability in the United States compared to that observed in the euro zone.

Summary: it will be very difficult to keep European savings in Europe

European savings are attracted to the rest of the world, particularly the United States, due to the low return on capital in Europe compared to that observed in the United States.

This attraction of European savings, particularly to the United States, is likely to continue due to:

- Underinvestment in Europe caused by the large size of the social safety net and the high level of taxation;
- The distortion of income distribution in favor of companies in the United States, which is not observed in Europe.

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