Attractive European capital markets

In short In this in-depth analysis we show that a strong European capital market union is a necessary precondition for a competitive European economy, but not a guarantee. Currently, a lot of European risk capital is still flowing to the United States, among others. That capital does not benefit European economic activity. We illustrate this using indirect and direct investments of Dutch households. We explain why Dutch pension funds and households choose to invest outside the EU and where the opportunities lie for the European capital markets to compete with the US capital markets.

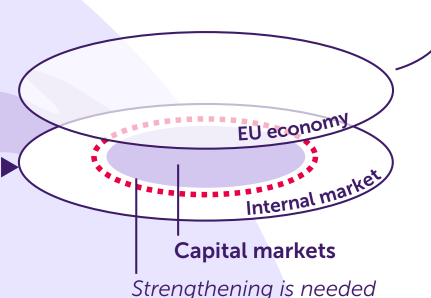
Start **1** Europe faces **major challenges** if it wants to remain a competitive economy:

2 The vast majority of the capital needed will have to come from **private investment**. Part of that money must come from **European capital markets**.

3 However, a lot of capital **flows to** the capital markets in **the US**.

For example: *Dutch pension funds and households choose to invest in the US.*

European capital markets are a crucial part of the European single market, a key pillar of the EU economy. By ***strengthening the European capital markets****, more capital can be attracted to the EU.*



4 Conclusion

A European Capital Markets Union encourages **more supply of risk capital**, but it is not enough to ensure that this capital will support the European economy.

What else is needed?

- Make it **more attractive** to invest in Europe
- Increase the **competitiveness and innovation capacity** of the EU
- Raise **labour productivity** in Europe

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1. Introduction

Strong European capital markets are needed to foster innovation, sustainable growth and the strategic autonomy of the EU. European capital markets are a crucial part of the European single market, a key pillar of the European Union (EU) economy.[1] Capital markets play an important role in supporting the real economy and the financial and economic integration of Europe. In addition, it is expected that European capital markets will have to be further integrated and grow more strongly in the coming years to finance innovation in general and for the sustainability transition in particular. The European Commission's (EC) extensive plans to create a European Capital Markets Union (Capital Markets Union; CMU) aims to strengthen European capital markets by promoting integration, increasing competition and growing capital markets. Deeper and more integrated European capital markets will support economic growth with risk capital and strengthen financial stability. A strong European Capital Markets Union will also strengthen the resilience of the European economy and increase the strategic autonomy of the EU.

To finance these strategic goals of the EU, huge amounts of additional (risk) capital are needed. This is evident from the report written by Mario Draghi on behalf of the EC. It focuses on the competitiveness of the European economy and sets out the challenges facing European industry and businesses in the single market.[2] To finance the sustainability and digital transitions, boost innovation and strengthen defence and security, the EC estimates that €750-800 billion will be needed annually (Table 1). This corresponds to 4.4%-4.7% of EU GDP[3], an unprecedented task in the history of the EU.

Table 1 A lot of additional capital is needed to finance the EU's strategic goals

Investment category	2025-2030
Achieving the energy transition	450
Energy (including the deployment of clean technologies)	*300*
Transport (including charging infrastructure)	*150*
Becoming a leader in digital technologies	150
Strengthening defence and security capabilities	50
Boosting productivity through breakthrough innovation	100-150
Total annual additional investment needs	**750-800**
ECB estimate	771

Source: EC (2024)

1 'EU single market', EC.
2 'EU competitiveness: Looking ahead', EC, september 2024.
3 Relative to the 2023 GDP level.

A strong European Capital Markets Union is a necessary precondition for generating sufficient (risk) capital to make investments in the European economy. In his report, Draghi offers a number of recommendations that can increase investment in the European Union. While fiscal stimulus and direct public spending (public investment) have an important role to play, the vast majority of the capital needed will have to come from private investment. To achieve this, companies need to reduce the costs of raising capital on the European capital markets. A well-functioning European Capital Markets Union will improve the efficiency of capital markets and increase the supply of risk capital so that private financing costs can be reduced.

At an earlier stage, the AFM – together with the Dutch Central Bank (DNB) – made policy recommendations to promote a European Capital Markets Union.[4] For example, barriers to entry to European capital markets should be lowered and accessibility increased. The aim is to deepen European capital markets so that they can support European growth and innovation even more effectively. To achieve this, concrete measures are needed, such as harmonisation of laws and regulations, strengthening the mandate of the European Securities and Markets Authority (ESMA) and promoting fair competition. In addition, the availability of risk capital should be increased by stimulating investment by European households. This can be done either directly or indirectly through (compulsory) pension schemes.

In this in-depth analysis, we show that a strong European Capital Markets Union is a necessary precondition for a competitive European economy, but not a guarantee. Currently, a lot of European risk capital is still flowing to the United States (US), among others. That capital does not benefit European economic activity. In Chapter 2, we illustrate this using the indirect and direct investments of Dutch households. Chapter 3 then discusses the reasons why Dutch pension funds and households choose to invest outside the EU. It also discusses the opportunities for European capital markets to compete with US capital markets. A strong European Capital Markets Union is part of the answer, but more is needed to increase investment in and the competitiveness of the European economy.

4 'Next steps for the European Capital Markets Union (CMU)', AFM, February 2024.

2. Risk capital of households in the EU

In this chapter, we analyse the supply of risk capital from households in the EU and show where this capital ends up. Currently, much of this capital is being transferred from households to the US, among others, with the result that it does not benefit European economic activity.

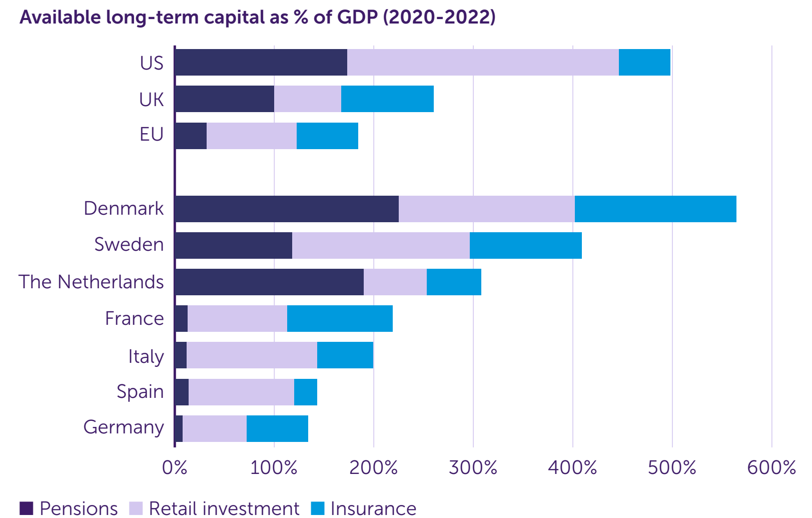
2.1 What does the supply of risk capital from households look like?

European Union

Households in the EU save a relatively large amount and invest relatively little.[5] Compared to US households, EU households have relatively large savings. While Americans save an average of 3.2% of their income, this percentage is 12.7% in the EU. Nevertheless, the net wealth of households in Europe is declining compared to the US, partly because Americans are more likely to use their savings as risk capital for investments, on which they usually achieve higher returns. European households invest less than US households. This is partly due to the relatively high costs for retail investors in Europe[6] and the fact that pension assets are relatively low for many European countries, which means that they are not used as an indirect investment.

Indirect investments by European households through funded pension schemes are scarce. Most Europeans rely for their pension provision on income financed by current taxes and contributions (pay-as-you-go) and not on funded pension schemes such as (compulsory) pension fund membership. This is one of the reasons why average pension assets in the EU are low compared to, for example, the US and the United Kingdom (UK), where households invest more on average for their pension. As an illustration, pension assets invested in relation to gross domestic product (GDP) at the end of 2022 averaged 32% in the EU, compared to 173% in the US and 100% in the UK (Figure 1).[7] The relatively low percentage of indirect investment by households in the EU means, among other things, that there is much to be gained by increasing the contribution of households to the total supply of risk capital by strengthening (compulsory) pension schemes. This will also make pension systems in the EU less susceptible to ageing.

Figure 1 Europeans invest relatively little for their pensions



Source: New Financial

5 See 'EU competitiveness: Looking ahead', EC, September 2024. Figures for 2023.

6 EFAMA, among others, underlines the importance of a European Capital Markets Union in order to reduce current cost differentials between UCITS and US investment funds. See 'EFAMA Market Insights - issue 8', EFAMA, March 2022.

7 Average figures for 2019-2021, 'The future of pensions and retail investment in the EU', New Financial, June 2024.

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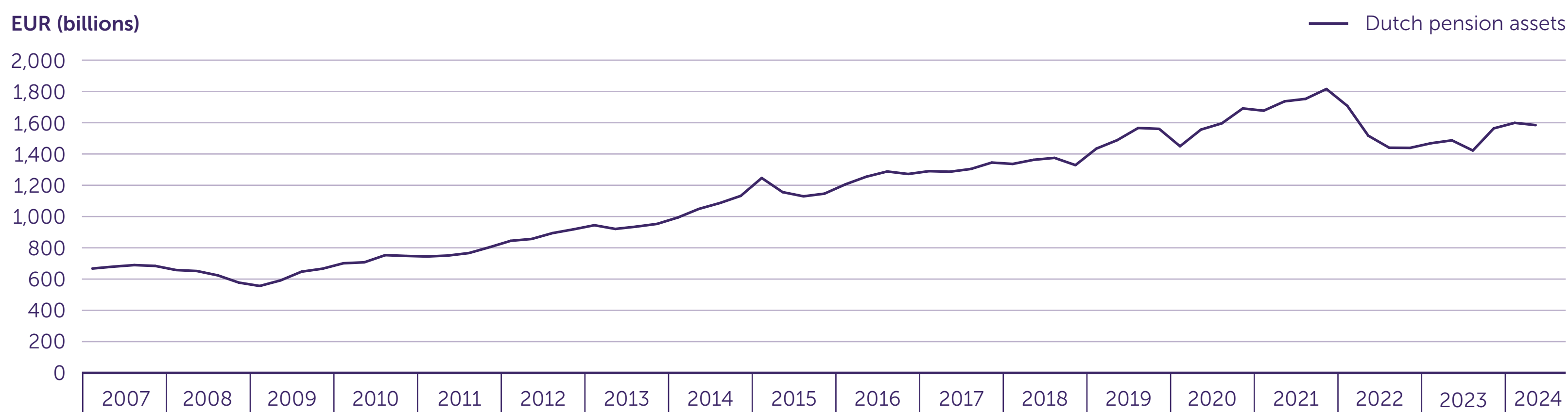
Dutch households invest mainly indirectly through their accrued pension assets. The Dutch pension system is one of the most developed in the world. Dutch households mainly invest indirectly through the compulsory employee pension for their old-age provision.[8] For example, at the end of Q2 2024, investments in the second pillar amounted to approximately €1,584 billion, or around 153% of GDP (Figure 2).[9] In total, approximately 75% of the total savings and invested assets of Dutch households are invested through pensions.[10] The size of the Dutch pension system is therefore relatively large compared to other countries in the EU. Together with the pension funds of Sweden and Denmark, we make up two-thirds of the total pension assets in the EU.

Figure 2 Dutch pension assets continue to grow steadily



Source: DNB

8 The Dutch pension system consists of three pillars: the National Old Age Pensions Act (AOW), supplementary pension accrual through the employer and supplementary, individual pension insurance. Together with the National Survivor Benefits Act (Anw) and the Work and Income (Capacity for Work) Act (WIA), the AOW forms the first pillar of the pension system and is paid from tax revenues of the Dutch government. The second and third pillars comprise compulsory supplementary pension accrual through the employer and voluntary individual supplementary pension accrual through pension insurance.

9 'Financial position of pension funds', DNB. GDP figures at the end of 2023.

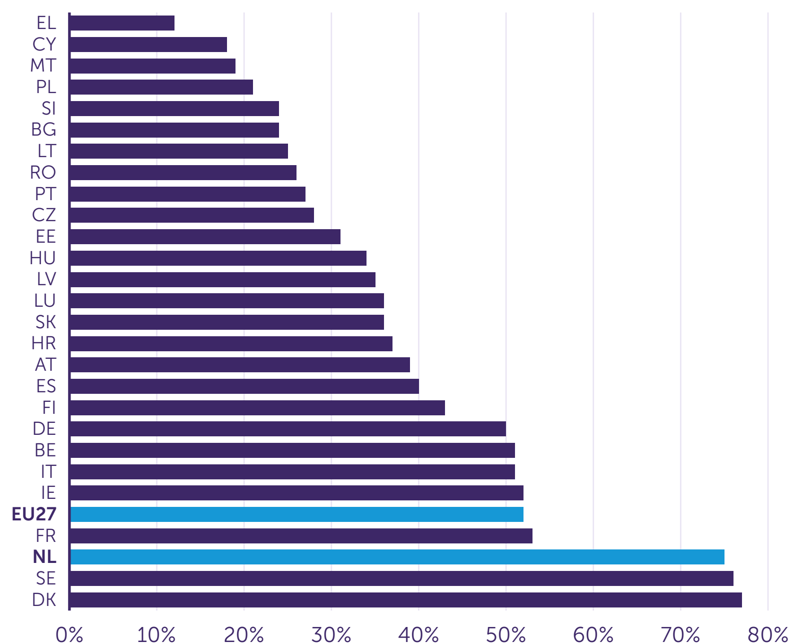
10 'Commission staff working document: Monitoring progress towards a Capital Markets Union: a toolkit of indicators - 2024', EC, July 2024.

Direct investments by Dutch households are relatively low compared to other EU countries, due to investments in partly compulsory pension savings. In the Netherlands, only 7% of households' total savings and invested assets are invested directly, compared to an average of 15% in the EU. According to consumer research by the AFM, approximately 25% of households invest directly.[11] As an illustration, 58% of US households invest directly.[12]

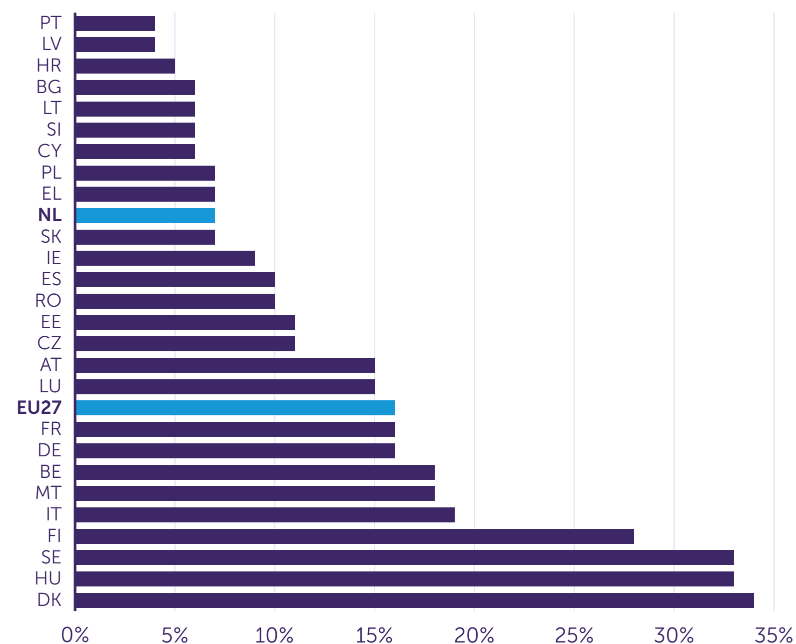
The main explanation for the relatively low percentage of direct investments seems to be that Dutch households already invest much of their assets (compulsorily) through their pensions. Incidentally, indirect and direct investments by Dutch households are still much higher than in other European countries (Figure 3).[13]

Figure 3 Together with Sweden and Denmark, the Netherlands is the European champion in pension investing

Indirect investments (as a percentage of total investments and savings of households)



Direct investments (as a percentage of total investments and savings of households)



Source: EC (2022)

11 'AFM Consumentenmonitor 2023-Q4', AFM, December 2023.

12 'Percentage of Americans who own stocks reaches record high' Axios, October 2023.

13 Excluding invested pension assets.

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2.2 Where does the risk capital supply end up?

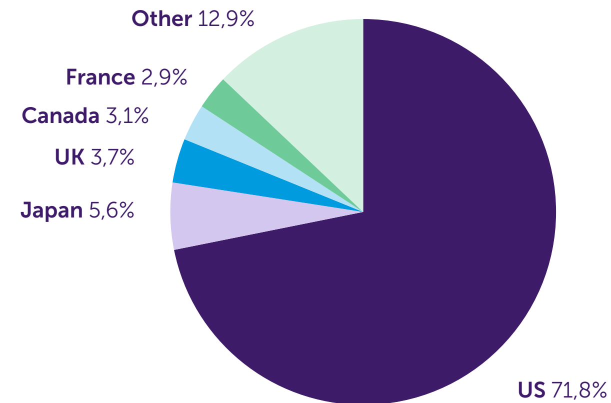
European Union

On balance, (risk) capital flows from the EU to the United States. Historically, the EU has had a deficit on the capital and financial account of its (bilateral) balance of payments with the US.[14] This deficit implies that, on balance, the EU (and the Netherlands) will invest more in the US economy than the other way around, through direct investments in companies (FDI[15]), other investments and US government bonds.[16] This also includes investments by households. European (pension) investors see investing in the US economy as a way to diversify their portfolios and also as an opportunity to benefit from the growth of the US economy. As a result, European companies looking for risk capital are missing out on funds.

The global trend towards more passive investing is reinforcing the increase in direct and indirect retail investment in the US. Worldwide, more assets are now invested passively (in shares) than actively.[17] Passive investing is also on the rise in the EU.[18] One driver is the popularity of Exchange Traded Funds (ETFs).[19] Important reasons for the popularity are the low costs, liquidity and (the perception of) favourable risk-return characteristics of ETFs. Many passive funds, including ETFs, are based on global indices. For passive equity funds, with an allocation of around 60-70%, these indices are mostly made up of US equities (Figure 4). A disadvantage of passive investing is that companies (and therefore countries) with the largest market capitalisation get the largest weighting in the basket on which the ETF is based, and not the companies with the best return expectations, for example. Risk capital in the EU will therefore not be increased if everyone invests passively in global investment funds.

Figure 4 US equities make up the bulk of the MSCI World index

Country weights in the MSCI World index (percentage)



Source: MSCI (2024)

14 'European Union Trade & Investment Summary', USTR.

15 Foreign Direct Investments, see also 'Is the European Union really in surplus vis-à-vis the United States?', Banque de France, February 2019.

16 See, for example, 'Analysis of developments in EU capital flows in the global context', EC, April 2024.

17 'Global passive equity funds' assets eclipsed active in 2023 for first time', Reuters, February 2024.

18 'Are ETFs Taking Over Europe Too? | Morningstar', Morningstar, February 2024.

19 'ETF flows smash record in third quarter', FT, October 2024.

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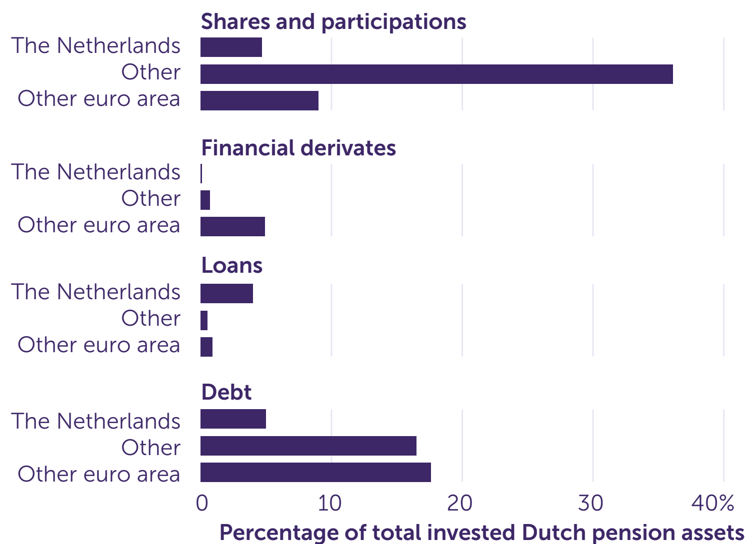
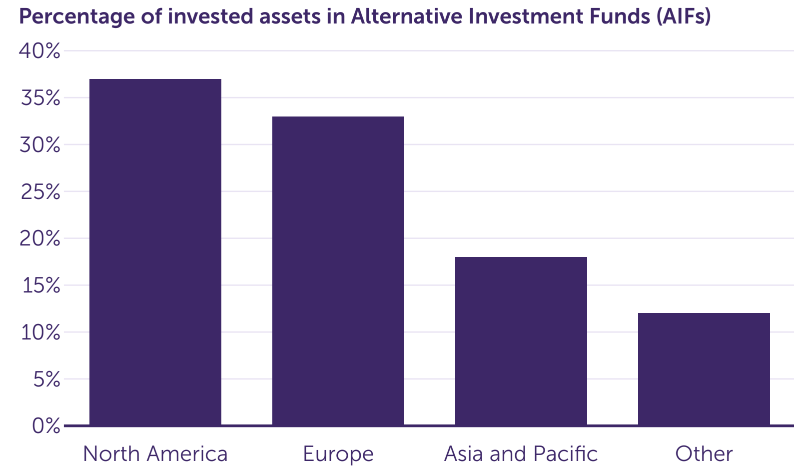
The majority of Dutch households' risk capital is invested outside the EU, mainly in the form of pension assets invested in the US and Asia. The balance sheets of Dutch pension funds mainly include risk assets such as shares and bonds. Around one-third of these assets are invested in non-EU equities, followed by euro area debt (Figure 5).[20] On the basis of the assets managed in (professional) investment funds, it is clear that the majority of Dutch assets are invested outside the EU and particularly in the US and Asia (Figure 6).

Figure 5 Dutch pension assets are mainly invested in shares from outside the EU and debt securities from within the EU



Source: DNB (Q2 2024)

Figure 6 Dutch investment funds also invest mainly outside the EU, and particularly in the US and Asia



Source: AFM (2023)

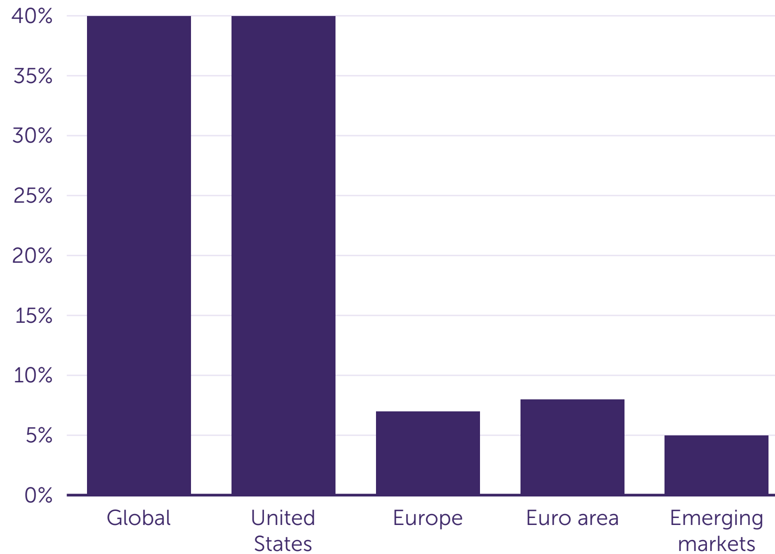
Direct investments by Dutch households largely flow into US capital markets. About a quarter of households indicate that they invest and do so mostly in investment funds, followed by individual shares.[21,22] However, if we look at the geographical distribution of investments, the largest share ends up in the US. As an illustration of this, the top ten equity investment funds in which Dutch households invest the most are based on a US benchmark or a global benchmark consisting mainly of US equities.[23]

20 'Pension funds' balance sheet including a look-through of units in Dutch investment funds', DNB.
21 'Almost 2 million households invest in financial instruments', AFM, December 2021.
22 'Securities holdings of Dutch households', DNB.
23 'The '25 largest' investments by Dutch households in individual investment funds', DNB.

In the Netherlands, ETFs are a popular way to invest, especially ETFs originating from the US. For Dutch investors, the (equities) ETF market is strongly American-oriented. The main players in the Dutch ETF market, such as index providers and issuers of ETFs, are from the US. In addition, ETFs are often based on US indices or on broad (world) indices, in which US equities are dominant (Figure 7). The three ETFs most traded by retail investors on Dutch trading platforms are ETFs on the US S&P 500 or Nasdaq100. Finally, US ETFs are slightly cheaper than, for example, European ETFs (Figure 8).

Figure 7 For Dutch investors, the (equities) ETF market is strongly American-oriented

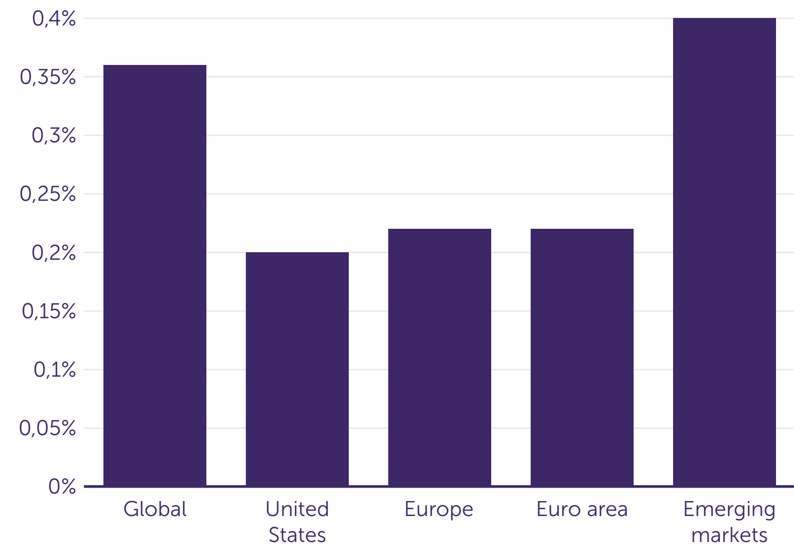
Percentage of invested assets in equity ETFs available for sale in the Netherlands



Source: Morningstar (September 2024)

Figure 8 US ETFs are cheaper than European ETFs

Total expense ratio (annual) as stated in the prospectus of equity ETFs available for sale in the Netherlands



Source: Morningstar (September 2024)

European capital markets are currently less attractive for risk capital, causing capital to flow outside the EU. There is relatively little supply of risk capital from households in most countries. Less developed pension systems in a number of EU countries play a role in this. In countries such as the Netherlands, where there are well-developed pension systems, relatively large (indirect) investments are made compared to other countries in the EU. However, a significant part of the risk capital that is available in this way flows to the US, among others. In the next chapter, we will address the question of why this is the case and why European capital markets are still less able to facilitate the supply of risk capital.

3. Challenges and opportunities for European capital markets

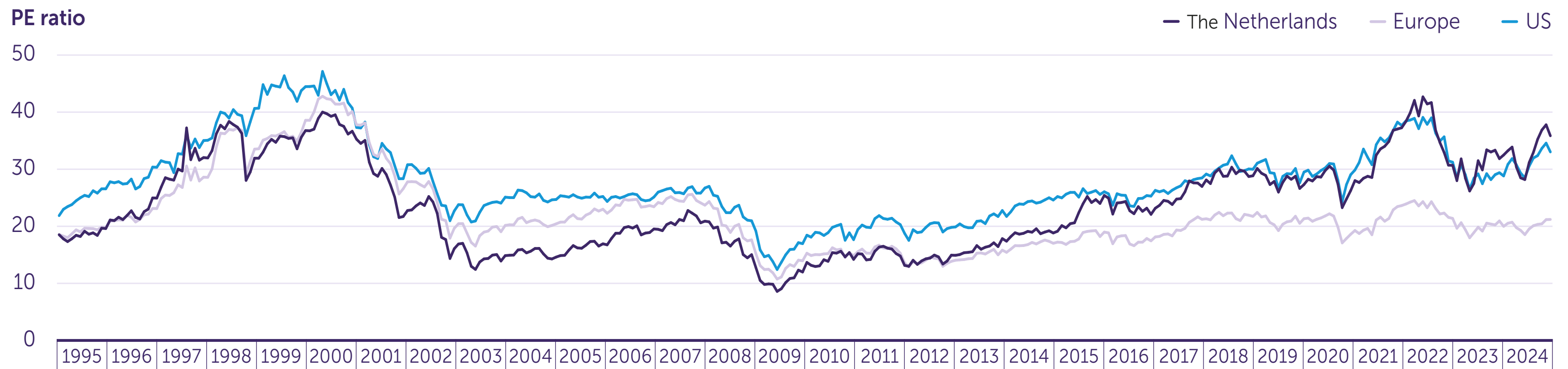
In this chapter, we address the question of what makes (European) capital markets attractive to risk capital providers and what opportunities and challenges there are to make European capital markets attractive. A strong European Capital Markets Union and structural reforms of the European economy can increase the supply of risk capital in support of the European economy.

3.1 What is the appeal of foreign capital markets?

There are good reasons to invest capital outside the EU, including geographical risk diversification, low costs and higher return expectations. Pension funds have the fiduciary duty to invest participants' assets in a responsible manner. This includes a good risk-reward trade-off. Hence, there are good reasons not to invest only within the EU.

First, investing outside the EU offers geographical risk diversification and other diversification opportunities. There are simply more opportunities to invest outside the EU than within the EU. Return expectations also play an important role. Here too, there are more opportunities for investors outside the EU. As an illustration, European equities have structurally lower price-to-earnings (P/E) ratios relative to US equities (Figure 9). Although a high P/E ratio indicates overvaluation in the short term, a structurally lower P/E ratio in a region can be an indication of structurally lower growth and innovation expectations and thus be less attractive to invest in. Incidentally, the Netherlands is faring reasonably well compared to the rest of Europe, possibly due to the high expectations for technology-related stocks, similar to the US. An important demographic driver for structurally lower growth expectations is the ageing population. Europe is ageing (and experiencing dejuvenation) relatively faster than the US.[24,25]

Figure 9 US equities have a structurally higher price-to-earnings ratio than European equities



Source: Bloomberg

24 'Europese vergrijzing in het vizier. Omgaan met pensioen- en begrotingsrisico's', WRR, September 2024.

25 'Old-age dependency ratio', OECD.

Liquidity is an important prerequisite for attractive capital markets. Liquidity can be looked at in two different ways, from a monetary perspective and from a market perspective. Monetary liquidity refers to the availability of money in the economy, while market liquidity refers to the ability to trade assets efficiently in financial markets[26]. For both, there has been divergence between Europe and the US since the 2008 credit crisis. For example, the US central bank (the Federal Reserve, Fed) has generally pursued a more proactive and accommodative stimulus policy, both during and after the financial crisis, than the European Central Bank (ECB). This has led to increased monetary liquidity in the US compared to Europe. The ECB was relatively cautious and less aggressive in its policy. In terms of market liquidity, the situation is similar. Capital markets in the US are more liquid than those in Europe (Figure 10).[27] This is largely due to the scale of the US capital market, but the structure of the market may also be a factor. For example, US capital markets are less fragmented and there is, for example, a single central counterparty (Central Counter Party; CCP) and a single Central Securities Depository (CSD) for all share transactions, which may help explain lower trading costs.

Figure 10 In terms of turnover, European stocks are much less liquid than US stocks

The avarage daily turnover aggregating all the companies included in a specific market capitalisation segment

	Mega-Cap (> €100bn)	Large-Cap (€5bn - €100bn)	Mid-Cap (€1bn - €5bn)	Small-Cap (€250m - €1bn)
United States	€144bn	€116bn	€23bn	€4bn
Europe	€13bn	€44bn	€6bn	€1bn
Ratio (or Liquidity Gap)	x11,1	x2,6	x3,5	x4,2

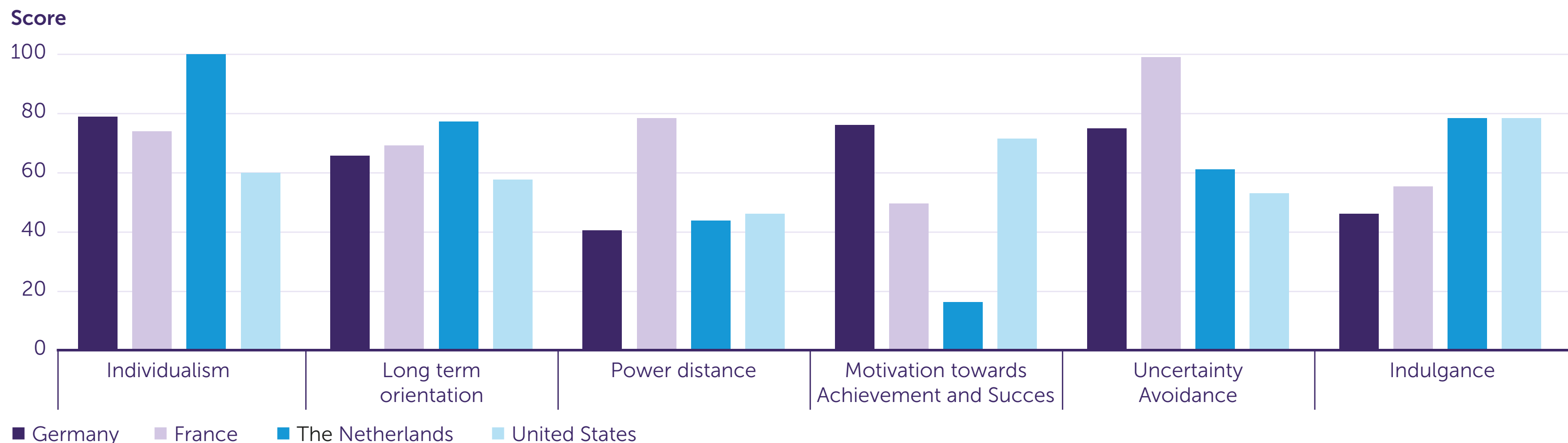
Source: Euronext (2024)

26 Market liquidity is often referred to with the term ‘deep’. The deeper a market, the easier it is to trade assets without affecting the price.
27 See for example: ‘Demystifying the liquidity gap between European and US equities’, Euronext, April 2024.

Network effects and cultural differences also play an important role in the attractiveness of capital markets. Network effects occur when the value of a product, service or market increases as more people or businesses participate in it. In the US, these network effects are stronger because of the larger scale of the market and underlying infrastructure, the presence of more institutional parties and culturally embedded entrepreneurship that facilitates capital inflows. This leads to a self-reinforcing process in which successful companies and markets attract more investors, which in turn stimulates further growth, and so on. In Europe, on the other hand, the functioning of network effects is hampered by the fragmentation of European capital markets, differences in (national) laws and regulations and supervision that is still largely organised at national level. A Capital Markets Union can partly counter this, and European laws and regulations partly ensure harmonisation, but the network effect in the US remains stronger due to the scale of the market.

In addition, higher risk tolerance in the US plays an important role in providing risk capital and accelerating innovations. Currently, European risk tolerance is more limited than in the US (Figure 11). As an illustration, over the past decade EU venture capital investment has averaged only 0.3 percent of gross domestic product, less than a third of the US average (1.1 percent). US venture capital funds raised $800 billion more than their European counterparts during this period.[30]

Figure 11 The 6 cultural dimensions of Geert Hofstede.[28] Cultural differences can lead to differences in risk appetite[29]



Source: The Cultural Factor (2024)

28 'The 6 dimensions model of national culture', Geert Hofstede.

29 See, for example, 'Effects of Culture on Firm Risk-Taking: A Cross-Country and Cross-Industry Analysis' IMF, August 2012.

30 'Europe Can Better Support Venture Capital to Boost Growth and Productivity', IMF, July 2024.

3.2 Opportunities for attractive European capital markets

Progress has been made recently in making European capital markets more attractive. For example, the Single Access Point for Information on EU Companies and Investment Funds (ESAP) has been set up, which helps investors to access and compare financial data. The European Parliament (EP) also approved a revision of the Markets in Financial Instruments Regulation (MiFIR), which allowed for the introduction of a consolidated tape provider (CTP[31]). This will improve access to market data and reduce costs for investors. In addition, a common withholding tax system has been created, which will save investors around €5 billion annually. Finally, the Listing Act has been revised, making it easier for companies to raise capital on the stock exchange.[32]

Earlier this year, the AFM – together with DNB – published additional proposals to accelerate the realisation of a European Capital Markets Union.[33] These proposals include, among other things, adapting ESMA's mandate to increase regulatory clarity and, where desirable and necessary, to centralise supervision. In addition, national initiatives should be supported to set up pension schemes (whether compulsory or otherwise), to increase the involvement of individuals in equity markets and to promote financial education. Finally, creating clear labels for sustainable products and improving the availability of market and supervisory data are also crucial.[34] These combined efforts, as well as initiatives that are still expected in the context of the plans for a new European Commission, can promote the growth and development of European capital markets.

A European Capital Markets Union and an increased supply of risk capital alone are not enough for a competitive European economy. Structural reforms are needed to ensure that European capital markets work optimally for the benefit of the European economy. These reforms aim to make the European economy more future-proof. These reforms are aimed at, among other things, making it more attractive and increasing the opportunities to invest risk capital in Europe, increasing the EU's competitiveness and innovation and increasing labour productivity in Europe.

31 See 'Consolidated Tape Providers', ESMA.
32 'EU competitiveness: Looking ahead', EC, September 2024.
33 'Next steps for the European Capital Markets Union (CMU)', AFM, February 2024.
34 'More effective supervision by centralising financial supervision data in Europe', AFM, March 2024.

4. Conclusion

The European Capital Markets Union is a necessary precondition for a competitive European economy. The European Capital Markets Union aims to strengthen and deepen European capital markets, increasing their efficiency and making them work to support European economic growth and innovation. The EC's policy goals for the Capital Markets Union focus on reducing regulatory fragmentation and increasing liquidity, which is crucial for a more attractive investment environment within the EU.

A European Capital Markets Union combats fragmentation, reduces costs and encourages more supply of risk capital, but it is not enough to ensure that this capital will support the European economy. A lot of European risk capital flows into the US because of deeper and more efficient US capital markets. A European Capital Markets Union will increase the efficiency of European capital markets so that European capital markets can grow and support the European economy. A greater supply of risk capital is important for this growth. To this end, greater retail participation and more and better-developed pension schemes should be encouraged. An illustration based on direct and indirect investments by Dutch households shows that increasing the supply of risk capital is not in itself a guarantee of deepening the European capital market. US markets attract European investors due to their size, accessibility and convenience, lower costs and attractive returns. This is amplified by network effects and cultural preferences. Initiatives for a European Capital Markets Union can only partially counter this. As a result, it remains a challenge to increase the amount of risk capital that actually benefits European economic activity.

A competitive European economy requires comprehensive economic reforms. To address key challenges such as the digital and sustainability transition and the ageing of the population, economic reforms are needed. Without a structural strengthening of the broader European economy, a large part of the capital from the EU will continue to flow to financial centres in the US and Asia. Foreign financial service companies will also further strengthen their dominant position in the market through their continuing attractiveness to European investors and investors looking for good returns. In addition to the need for a strong European Capital Markets Union, also the importance of an attractive European investment environment with higher return expectations, less fragmentation, and more dynamism, as well as innovation and competition in the real economy should be emphasised. Only by realising a strong European Capital Markets Union and structural reforms of the economy can the EU achieve its strategic goals and increase its competitiveness in a world where strategic autonomy is becoming increasingly important.