SPEECH

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The road to the EU savings and investment union – do's and don'ts

I would like to thank SEB for this invitation and the opportunity to share my thoughts on what is needed for a functioning savings and investment union within the EU, based on experiences from Sweden and the Nordic-Baltic region.

It will come as no surprise to anyone in this room that financing needs in Europe are substantial. Mario Draghi assesses the need for extra investments in the EU to be almost 5 per cent of GDP per year, for the next 5 years. Both public and private investments will have to increase to satisfy this requirement. A large part of the financing for these investments will need to come through debt and equity capital markets. Unfortunately, it is an equally well-known fact that European capital markets are not yet up to this task. Compared to the US, they are dwarfed, especially our equity markets. For instance, US market capitalisation makes up 60 per cent of global market capitalisation, roughly three times more than the EU. US capital markets are not only bigger, but they are more liquid and vibrant with far more IPOs, both in number and in value.

This is not only problematic for private companies and other actors demanding capital for investment purposes, with all the negative effects on growth and productivity that come with a lack of capital expenditure. It also means that European households are deprived of financial investment opportunities and thus receive a lower long-term return on their savings. This makes them relatively less wealthy than, for instance, their US counterparts, who invest in equities to a much greater extent.

Remedying this situation is therefore of the utmost importance. The Commission should therefore be commended for injecting new energy into this process, now in the form of a strategy towards a Savings and Investments Union, SIU.

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However, in moving towards a true Savings and Investments Union, we need to acknowledge that the poor European figures hide a lot of heterogeneity. The Nordic-Baltic region, and especially Sweden, stands out as an exception, in some ways matching the capital markets of the US, at least in relative terms. As an illustration, although markets are much bigger in the US, market capitalisation as a share of GDP is comparable in Sweden with the US. And if we look at how much of household wealth is invested in equity markets, Sweden, with 36 per cent, is very close to the US with 39 per cent. In terms of venture capital, Sweden is number four in Europe – in absolute terms! Relative to the population, we are number one in Europe. This is also reflected in company dynamics. The number of unicorns per capita is among the top five in the world and number one in the EU.[1] This dynamism is not limited to Sweden – if we look at the Nordic region we have 17 per cent of all unicorns in the EU, with only five per cent of the population. So there are certainly examples of success in parts of the Union.

Is there anything for the rest of EU to learn from this? Yes - I think there is.

If you'll allow me, I would therefore like to elaborate a little on what I think is important to keep in mind, when moving towards a Savings and Investments Union. These will be my personal reflections, based on my experience from both the private and public sector, domestically and internationally. My intention is not to try to impose Swedish solutions on everybody else, but rather to identify some issues that I think will make our common path towards SIU easier and quicker. I basically want to make four points:

1. Look at what works and develop this, instead of trying to design grand pan-European solutions to start with.
2. Don't politicise and micro-manage instruments – good returns for savers require openness and broad investment opportunities.
3. There is no silver bullet – creating vibrant capital markets takes time, as it often involves changing both culture and institutions.
4. Turbulent geopolitical times can provide opportunities for Europe.

Now, moving to my first point – we need to move from a top-down to a more bottom-up approach, looking at the components of the capital markets that actually work in certain places, and use these as building blocks for our European edifice. This goes back to the comparison with the US, and the depth, width and scale of their markets. It might be tempting to try to achieve that kind of integration and scale by trying to force actors into a one-size-fits-all solution.

[1] A unicorn is a start-up company valued at over US$1 billion which is privately owned and not listed on an equity market.

However, our experience with grand ideas of such a top-down character is poor and I don´t think that is due only to weak execution.

It is now 10 years since the Juncker Commission presented its plans for a Capital Markets Union, CMU, and although some reforms were achieved, progress has been anything but impressive. To take one example of the kind of top-down initiatives that have failed, we can look at the efforts to establish a Pan-European Personal Pension Product (PEPP). According to the European Court of Audit, the take-up of the PEPP after three years of existence is still negligible (about 0.002 percent compared to what the Commission envisaged up to 2030).

There seems to be numerous reasons for this failure, such as weak incentives for pension companies to offer the product, limited knowledge among households and structural obstacles, for instance different tax systems among member states. This illustrates the difficulties involved in launching broad initiatives before having properly identified the obstacles, the preparedness of the prospective buyers and sellers, and so on. Without making sure the proper “plumbing” is in place, the chances are that these initiatives fail. Instead of going for such one-size-fits-all solutions, we should look at the experience from individual countries and regions and see what really works.

We need to dial down our national prestige and be open to import models and ideas from our neighbours. And it must not be restricted to neighbours. It is a fact that the relative success of Swedish capital markets, at least partly, reflects a strong influence from financial markets in the US and the Anglo-Saxon world in general.

This Anglo-Saxon influence, which has been a feature for several decades, has led to less emphasis on bank lending in corporate finance, compared to continental Europe, and a stronger focus on equities, shareholder value and retail market participation. As a small, export-oriented economy, we needed to look at what worked best in other countries; and in financial markets, that was the US and the UK. But the process was probably also helped by a cultural affection for the Anglo-Saxon world – people say Monty Python was more popular in Sweden than in the UK for instance. But we should also be humble and realise the importance of the huge financial crisis we had in the early 1990s – this made the need for change in the direction of more market-based solutions very clear to every Swede. It also paved the way for many important reforms, such as the reform of the pension system which gave further impetus to the proliferation of an equity culture.

This focus on leveraging what works in practice in different countries or regions also means we should not aim for one all-encompassing financial centre, or even one European stock exchange. Indeed, I think there are other ways to increase cross-border investment flows within Europe, one of which is increased interoperability of exchanges. This would enable us to gain from allowing regional centres to develop, maybe specialising in certain sectors or instruments. As an example, the clearing of commodities in the Nordic-Baltic region is almost exclusively performed in Oslo. With its fish- and oil-based economy, Norway has a comparative advantage in this field.

Regional specialisation can create the critical mass that makes the emergence of clusters of competence possible in such ancillary fields as investment management, legal services, accounting and more. Such cluster effects can benefit European markets at large.

This kind of regional specialisation in capital markets is not only dependent on what we do in terms of reforming the financial system. It is also very much dependent on how well integrated our markets for non-financial goods are. If you see the possibility of expanding your activities in other countries, or better still, the whole of EU, you will be more inclined to try to raise funds outside your home country, for example by listing your company on a stock exchange that is not located in your own country. This illustrates the close interdependencies between financial markets and markets for goods and non-financial services – progress in one field is correlated to progress in the others as well. It is all about creating virtuous circles, as I will come back to in a moment.

When speaking of regional specialisation, it is perhaps appropriate to bring up the topic of how to organise supervision. It is clear that we cannot afford to have 27 different national interpretations of key EU regulation such as the Market Abuse Regulation, MAR, if we want to have a single capital market. But personally, I have not been entirely convinced of the benefits of moving to fully centralised supervision in Europe. Based on my own experience, local knowledge and expertise at the level of national supervisory authorities can be very valuable in many cases. However, when most or nearly all activities in a certain field are mainly concentrated in one or two centres – fund management in EU is a case in point - there may be situations where some more formal centralisation could be useful. In such situations, it might be preferable with centralised supervision, providing some transparency and influence for all member states. Otherwise, you have a quasi-decentralised system, with supervision left to one or two national supervisors.

You could describe my proposed way forward as ensuring that the things that work are taken up and allowed to grow <u>organically</u>. So how should we achieve this in practice? The basic prerequisite is that there is political will and pragmatism, free from prestige, to enable market participants to adopt state of the art methods of doing business – either by innovation, or by importing methods from other places. This would be what I call “institutional competition”, where policy-makers feel the need to adopt policies that are best for their constituencies.

An interesting initiative to try to achieve something along these lines is the Spanish proposal for European competitiveness laboratories, where a more limited number of likeminded countries could come together and try out a common solution among themselves. Importantly, it would be voluntary, and all member states would be welcome to join the initiative. After a certain time, the Commission would assess the feasibility and usefulness of the solution, that is, if it works in reality. The Commission would then decide whether to drop the idea or present a proposal for introduction in the union.

As you may know, this method has been tried, only last month, with a number of countries agreeing on the requirements for a European savings product. I am not sure I agree with all the details of the proposed label, but I think the fact that the initiative has been taken is interesting and welcome – we need a more exploratory mind-set among policy-makers in the union.

There is certainly a role for federal initiatives, but these should mainly be focused on removing obstacles for organic, market-led development. One area that seems to be particularly problematic, often standing in the way of further integration, is the deeply entrenched fragmentation of insolvency legislation among member states. Harmonising this field has been somewhat of a Holy Grail in the struggle for a true capital markets union, proving extremely difficult in practice. There are two issues here. One is that fragmentation creates uncertainty as to what actually happens when a company in another country is distressed. This is bad for cross-border investment. The other issue is that many of the existing national insolvency regimes are quite cumbersome and take time. The recent failure of Northvolt, the Swedish battery producer, provides us with an interesting example. In its struggle to survive, Northvolt went for the US based Chapter 11 protection rather than using the Swedish system for restructuring. The reason? Chapter 11 provides quicker protection, enables new financing and allows management to retain control of the company. In the case of Northvolt, bankruptcy could not be avoided in the end, but the Chapter 11 protection did buy the company some time. Without being an expert in the field, I wonder if the concept of a 28th regime in the EU might be useful to try here, maybe with strong Chapter 11 traits. Member states would then negotiate a common insolvency regime - one that is in parallel to existing national ones, leaving companies with the choice to use this legislation instead of national law. This should be a little bit like “having their cake and eating it” for policy-makers and greatly facilitate cross-border activities.

The need and resolve to remove obstacles to integration is obvious in the Commission’s recent consultation on identifying barriers linked to trading and post-trading, asset management and supervision. This is a very commendable and welcome initiative.

Moving on to my second point, I would like to underline the importance of refraining from politicising different kinds of savings- and investment instruments, and of avoiding micro-managing markets and market participants´ behaviour. As I said before, politicians should focus on removing obstacles to markets finding efficient solutions, not try to dictate what the market should look like. My feeling is that EU policy-making has tended to be a bit heavy-handed in this respect, but that this is starting to change. If you listen to the Commission, this is at least what they say, and I very much welcome this.

One thing I want to highlight in this context is the suggestion that savings- and investment instruments should contribute to fulfilling European policy goals. This may sound reasonable, but I do not think it is the best way of creating vibrant capital markets. If we want people to take the step from savings accounts to the stock market, we need to make sure that we maximise their chances of success, that is, to earn a better return on their savings. If we limit the investment universe, sectorally or geographically, this will unavoidably affect long-term returns. And if we force people to invest in certain sectors or jurisdictions, we assume a certain responsibility for the outcome. This can easily reduce their willingness to invest their savings in the capital market.

In the Swedish case, we have a very popular savings scheme called ISK, "investments savings account". This is a form of savings in which you can invest in equity, mutual funds or other kinds of securities. Presently around 40 per cent of all Swedes have such an account. Why has it become so popular? The main reason, as I see it, is simplicity, as the administrative procedure for paying capital income tax is very simplified. Instead of having to calculate the actual capital gains, you just pay tax on an imputed income, based on the value of your investments and a "standard" rate of return[2]. This rate of return is set at the long-term government bond rate, plus 1 percentage point. In individual years, you can thus benefit or lose compared to regular taxation of the actual capital gains achieved when you sell an investment. It is only this year that a more explicit tax subsidy has been introduced, as the income on the first 15 000 euros of investments (approximately) are tax exempt[3]. The second reason for the popularity of the ISK investment savings account is the returns people have experienced. And here, the fact that there are no geographical limitations on which assets you can invest in has played a role. Swedes have partly invested in foreign markets and enjoyed high returns and sometimes also made currency

[2] The imputed income is calculated as the average market value over a year multiplied by a "standard" rate of return. The standard rate of return is defined as the long-term government loan rate plus one percentage point. In other terms, imputed income = average annual market value × (long-term government bond rate + 1 percentage point). The imputed income is taxed at the statutory rate of 30 percent. Actual cash flows from the asset holdings, i.e., dividends, coupons or realised capital gains, trigger no additional taxation. Losses are not tax deductible.

[3] This threshold will be doubled next year.

gains. This openness to investments in foreign assets is not considered problematic – not least as the home bias in investments is quite strong anyway, at around 40 percent of total investments.

My third point is a sobering one – well-functioning capital markets are nothing you create just like that. It takes time. There is no silver bullet. You need to change the culture and mind-set of people, which inevitably takes time. Individuals, companies, institutions and authorities alike have to make this adjustment. You also need, eventually, to have a complete eco-system of instruments and different kinds of financial firms with complementary offerings. This growth process also takes time.

You need a financial ecosystem where companies of different type, size and stage of development are able to finance and develop their business. You could see it as a “financing chain”, from FFF (Family, Friends and Fools), venture capital and public support for certain high-risk projects, via private equity, to public listings (IPOs) and the ability to raise new equity in public markets - each link must be strong. And the links are mutually supportive. The stronger the links late in the chain are, the higher the likelihood of money flowing into the earlier links. Or to be more concrete – if there is a thriving market for listed equity, where investors can exit an investment and make a profit, they are more inclined to make risky investments in the earlier stages of a company’s development, e.g. through private equity. Here Sweden excels – the number of IPOs in Sweden in the last 10 years is higher than in Germany, France, the Netherlands and Spain combined. And the fact that the median size of Swedish IPOs is only one quarter of the median IPO size in the EU, illustrates the strong activity in the growth segment of the markets in Sweden. Strong links late in the financing chain are extremely important to ensure the continuous growth of successful start-ups. In fact, many companies experience an even greater financing need in the crucial scale-up phase. Often, it is easier to raise that capital in the public markets, provided the company has opted for a public listing at a relatively early stage.

How come Sweden has been able to develop such vibrant capital markets? I think it very much comes down to mind-set and culture. I have already touched upon the Swedish openness to Anglos-Saxon influence, which has led to the willing adoption of market-based solutions. But another important aspect is how people perceive the concept of risk and return. There are two aspects I think are important here. The first is the widespread understanding in Swedish society that higher expected returns require higher risk-taking and that volatility in returns is unavoidable. This widely held view has made it politically possible to design systems that encourage people to enter the stock market. The investment savings accounts I mentioned earlier are actually not a recent invention. We have had similar equity savings schemes in place for the last 40 years. As more and more people have tried equity investment in these schemes with very good returns over the last several decades, more schemes and platforms have been launched. It is another example of a virtuous circle.

It has also made it possible to design the pension system so that it is in effect a vital part of our capital markets. With the major reform of the pension system, some 30 years ago, we moved from a regular pay-as-you-go, defined benefit system to a partly funded, defined contribution system. This means that 2.5 per cent of peoples´ salaries is allocated to and invested in mutual pension funds, according to the individual´s own choice[4]. This scheme is compulsory, in effect making every working citizen invested in the stock market. Today, 25 years after its introduction, these fund assets equal 43 per cent of GDP[5]. In addition, we have a relatively high share of the workforce covered by occupational pensions, where pension contributions paid by employers are also invested in equities by pension managers or funds individually chosen by each employee. The situation is similar in Denmark and the Netherlands.

These factors are important as organized pension savings can add significant investment volume to the individual savings of people and propel investment market growth. Swedish and Danish households have more financial assets, compared to GDP, than any other EU country[6]. These assets consist to a large degree of equity holdings, either directly or indirectly through pension savings.[7]

But this readiness to invest people's pension savings in the stock market is not universal. In many countries, people and authorities seem to think that, since pension savings are so important for old age security, they should be invested with very low risk. In Sweden, people see it the other way around based on a positive personal experience of the long-term returns achieved on previous equity investments. The increased longevity of people underlines the need to start saving towards your pension early and include a meaningful share of equities in your portfolio.

The other aspect of risk and return is the need to understand and accept that, while beneficial in the longer run, equity investments are not risk-free in the short run. Swedish households have embraced this. From my time as CEO of the Stockholm stock exchange, I know that people tend to treat their equity holdings for what they are – long-term investments. They don't panic when markets fall, or even crash, as we have seen examples of lately. If people are to engage in

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4 Corresponding to 14 per cent of people's contributions to the public pension system.

5 We also have the so-called buffer funds in the public pension system. These are not linked to individuals but still contribute to the capital market by investing in a wide range of assets, including equities. Their total assets amount to ca 30 per cent of GDP.

6 Denmark 1.7 times the EU-average; Sweden 1.5 times the EU average

7 Both countries: 85 per cent equity – EU average: 60 per cent.

investments with higher long-term returns, like the stock market, they need to experience that short-term volatility in prices and returns is in effect unavoidable, if you want to reap the long term benefits of owning equities.

All this boils down to what could be described as financial literacy – in theory and in practice. We need to create a virtuous circle whereby people, by experiencing good returns and "surviving" market downturns, are willing to gradually engage more in equity investments. But to get there, we need to work broadly. In a recent study of the Swedish capital markets, the OECD notes that this culture is the result of a set of interconnected policy initiatives and choices that for decades have served to promote the use of equity markets. This has become self-sustaining, creating a virtuous circle where broad-based public interest drives market success and investment returns, which in turn increases interest further.

The last point I want to make is that, although these are turbulent, and in many respects worrying, times, there are also opportunities for Europe. We have taken for granted that everyone accepts what David Ricardo explained more than 200 years ago, namely that international trade is not a zero-sum-game and that all participating countries gain. Over the last few months, we have found ourselves in a scenario where this is no longer universally accepted. Trade barriers are being erected with negative consequences for both trade volumes and financial flows, consequences that are as yet impossible to determine.

However, when it comes to things like capital flows and relative attractiveness as a reserve currency, the situation is a bit different. It is obvious that market actors' confidence in US policies, and the US currency, has taken a hit from what is perceived as a lack of predictability, trade-distorting policies and fiscal irresponsibility. This has led to the beginning of a redirection of capital and flows. An illustration of this is the weakening of the dollar, something that has been very obvious for me as Governor of the Riksbank, as the krona has appreciated by 14 per cent against the dollar since the beginning of the year. And this should come as no surprise. The European Union has often been accused of being slow and bureaucratic, but in times when political predictability and stability are scarcer than ever, this painstaking focus on the rule-of-law can actually become a great asset. We were reminded of this by last year´s Nobel prize-winners in economic sciences – Daron Acemoglu, Simon Johnson and James Robinson – who have demonstrated the importance of societal institutions for a country's prosperity. Societies with a poor rule of law and weak institutions that exploit the population do not generate growth or change for the better.

So, as President Lagarde recently mentioned, there is now a window of opportunity to enhance the status of the euro as a reserve currency. But to make the most of this, we need to have capital markets that function so well that they mobilise European savings and also attract investments from third countries. This is a further reason why we should do our utmost to make the Savings and Investments Union a reality.

Let me finally reiterate what I think is important for the success of the SIU:

1. We should focus more on what has proven to work and develop this in an organic way – allowing for multiple regional centers.
2. We should refrain from micromanagement and politicising instruments. Limiting where people can invest risks leading to lower long term returns.
3. We must have a broad scope and work long term, because it takes time to change cultural habits, and build functioning eco-systems.

And lastly – we should make the best possible use of this window of opportunity to make Europe an attractive place to invest, for people both inside and outside of EU. If we really make an effort the benefits should be great.

Thank you.