‘The future of savings’ conference – 4 November 2016

Introductory speech by François Villeroy de Galhau,

Governor of the Banque de France

Savings glut, or investment deficit?

First and foremost, I would like to warmly welcome you all here at the Banque de France. I am delighted to open this conference dedicated to the future of savings, with such distinguished speakers and panelists: leading academics, bank and insurance industry experts, as well as regulators. Before leaving the floor to them, I would like to share with you a few thoughts on the role that savings can play in the current challenging macroeconomic context.

Post-crisis growth has been disappointingly weak, both at the global level, with growth standing only marginally above 3% in 2015 and most likely in 2016 as well; and in Europe, where growth is levelling off. So what is the problem? (slide 2) In the mid-2000s, Ben Bernanke famously coined the term **“global savings glut”** to refer to the situation of surplus savings in **emerging market economies**. Savings are still abundant worldwide, but one thing has dramatically changed in recent years: (slide 3) **investment**, which has sharply dropped as a share of GDP in **advanced economies.** This is what I call the **“investment dearth”** or “investment deficit”. This is particularly true in the euro area, where the gap between savings and investment is huge: the current account surplus reached EUR 350 billion on a yearly basis in August 2016,

which is more than 3% of GDP.[i] I believe that the solution to closing the gap is not to diminish savings, but to increase productive investment – and savings can be instrumental in doing so. Let me delve further into this issue by answering three questions: what is the **evidence**? What are the **causes**? What is the **remedy**?

**

First, what evidence do we have?

The **total investment to GDP ratio** offers a first glimpse of the current investment dearth (slide 4). The 2007-08 crisis caused the total investment ratio to fall sharply. In many countries, it has not yet returned to its pre-crisis level. This is particularly the case in the euro area, where the total investment ratio has dropped by around 3 points since the 2007 peak and has only slightly recovered since. By comparison, the pace of the recovery is significantly faster in the United States.

Now, (slide 5) let's dig deeper into the composition of this investment dearth: real estate and public investment have contributed to the post-crisis decline in total investment, but what matters the most for our economy is the contraction in **business investment**. The IMF estimates that it stands 10% to 15% below pre-crisis forecasts in the euro area.[ii] However, to fully understand the situation, we need to take a closer look at the *nature* of business investment. We must distinguish between investment in construction on the one hand – which in itself does not spur innovation – and investment in research and development and industrial machinery on the other, which I call "**productive investment**".[iii] The matter of concern is that productive investment is insufficient: across the economy as a whole, the productive investment rate has long been lower than before 2007 in the euro area and is persistently weaker in France than in Germany.

This brings us to the third important feature of this investment dearth: the **behaviour of businesses** (slide 6). Since mid-2009 it has dramatically changed: given the weakness of business investment, non-financial corporations have turned from net borrowers into net lenders. Thereby they

have fuelled the current account surplus in the euro area. In short, all of these realities converge: the root of the problem today in Europe is the investment deficit more than the savings glut.

2. Now, why has this investment dearth happened?

Let me briefly elaborate on the key levers of investment. The first and most important one is **expected demand** (slide 7). The overall weakness in economic activity acts as a deterrent for most businesses. The latest biannual survey conducted by Bpifrance shows that demand remains the main obstacle to investment for French small business owners[iv]. This diagnosis is confirmed at the macro level by one of our staff's recent working papers, which investigated a panel of 22 advanced economies: expected demand appears as the main determinant of the slowdown in business investment (negative contribution of more than 80%).[v] The second key economic lever of investment is **confidence**, or to put it another way, the level of uncertainty (17%).[vi] If the environment is blurred, complex or unstable – especially as regards rules and norms –, businesses opt for a "wait-and-see" behaviour and postpone their investment decisions. So, the simplification and stabilisation of rules is an often underestimated albeit key trigger of business investment.

Economic levers are of the essence, but financial ones also play a role. Currently, the cost of debt financing is low in the euro area, there is no evidence of credit rationing, and yet business investment is not completely responding. So what's wrong? There are two intertwined features that explain this puzzle. First, as Europe's economy is "at the technological frontier", businesses need to innovate more, which means they need to diversify their sources of financing: to be able to take more risks, they need less internal or debt financing and more equity financing. Yet, (slide 8) and this is the second key feature of today's environment, the cost of equity (CoE) has remained high, despite the sharp fall in interest rates over the last two decades. According to Banque de France calculations, the nominal CoE is still more than 9% for large listed companies in the euro area – compared with a risk-

free rate of around 0%. In other words, the risk premia have increased. The high CoE prompts companies to give priority to dividends and share buybacks over investment. In addition, it often goes hand in hand with a persistently high "hurdle rate"[vii] within companies, which results in an excessively severe selection of investment projects. The United States are a case in point (slide 9): since the early 2010s, share buybacks and dividends have increased sharply to more than 100% of reported earnings, while productive investment has significantly slowed down to an almost zero growth.

3. So what can be done to cure the investment dearth?

First and foremost, we need a **comprehensive therapy** in Europe, both economic and financial. On the economic side, monetary policy is active and efficient; but it cannot remain the only game in town. Growth will be stronger in Europe if we combine structural reforms – including pro-business measures – where they are needed, such as in France, with greater fiscal support to help spur investment in the countries that have room to manoeuvre, such as Germany. But we also need to address the financial side of this investment dearth issue. The United States shows how crucial it can be in the long term. Their model has positive features: (slide 10) equity capital amounts to 121% of GDP in the United States, compared with only 52% in the euro area, which means that in the United States innovation finds appropriate financing more easily. But it also has limitations that we should be mindful of: excessive cost of equity can have harmful effects.

To meet the financial challenge, savings have a central role to play. I will focus on two avenues for steering them into productive investment. First, **savings should be reoriented towards the long-term**, more easily than towards direct risk-taking. French and, more generally, European savers are more risk-averse than American ones – and this is probably not going to change. The first savings motive in the euro area is indeed insurance against unexpected events (mentioned by more than 50% of households).[viii] But at the same time, savers are more and more concerned by the increase in life

expectancies and the need to prepare for retirement: old age provision ranks as the second most important savings motive (nearly 40%).[ix] Therefore it makes sense to offer savers new, complementary forms of savings products, that are less liquid during the first years, but that include some form of long-term capital guarantee. These new products would provide financial intermediaries – in particular life insurers – with liabilities long enough to take pooled risks – in the form of equity investments essentially – and savers with the higher returns offered by equity over the long run. To promote these new products, we also need, at the very least, to avoid any tax distortions that might penalise them more than liquid and risk-free investments.

Second, **savings should better circulate across Europe**, to where investment needs are. A large part of the solution lies at the European level, with the building of what I call a **"Financing and Investment Union"** (FIU), rather than just a "Capital Markets Union" (CMU). This FIU would merge together the initiatives already in place – the CMU of course, but also the Juncker Plan and the Banking Union – in order to magnify their impact through synergies and more ambitious measures. Let me mention two measures for tackling obstacles to cross-border investment. Firstly, the FIU would encourage the development of a pan-European venture capital ecosystem. One of Europe's most obvious limitations is indeed the size of its funds compared with US ones: the size scale varies from at least 1 to 10 given the national borders and the domestic bias in Europe. This unfortunately limits European funds' ability to take on big enough equity stakes, especially in "scale up" companies – successful start-ups at a later stage. The second example concerns the regulatory and legal barriers to equity financing. The FIU would promote further convergence of insolvency regimes, as well as standardised and more detailed financial information on European corporates, including SMEs. In this regard, advantage could be taken of the experience acquired in certain Member States – in France for instance, the central bank's expertise in company rating.

**

To conclude, let me quote Benjamin Franklin who, in his essay entitled *The Way to Wealth*, gave advice that remains highly topical: "vessels large may venture more, but little boats should keep near shore". In the present situation, savings are certainly closer to large vessels than to little boats. And yet, unlike large vessels, they do not take sufficient reasonable risks. Our future will depend on them venturing more to help fill the investment dearth that plagues our economy. I have given you my view on the forms it can take, and I wish you fruitful debates throughout this conference.

---

[i] 12-month cumulated current account for the period ending in August 2016. Source: ECB.
[ii] IMF WEO Chapter 4 'Private Investment: What's the Holdup?', April 2015. The figures express the average percent deviation from spring 2007 forecasts.
[iii] GFCF in machinery and equipment and intellectual property.
[iv] 63% of French small business owners mention demand as an obstacle to investment. Source: Bpifrance, '63rd survey of the economic climate for SMEs', May 2016.
[v] Matthieu Bussière, Laurent Ferrara and Juliana Milovich: 'Explaining the recent slump in investment: the role of expected demand and uncertainty', Banque de France WP No. 571 – September 2015.
[vi] Ibid.
[vii] The hurdle rate is the internal rate of return that must be cleared for a project to be approved by a company.
[viii] 'Savings and investment behaviour in the euro area', ECB occasional paper series No. 167, January 2016. Note: Finland, France and Italy are not included in the panel.
[ix] Ibid.