

Towards a deeper Baltic capital market - speech by Rolf Strauch

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Introduction

Good morning, ladies and gentlemen. It is a great pleasure for me to be here in Vilnius. Let me extend my sincere thanks to Lithuania's Ministry of Finance, Central Bank, and Banking Association for their excellent work in preparing this conference.

The European Stability Mechanism was honoured to join the preparations and to contribute to the theme of capital market integration in the Baltics. Achieving deeper integration in your region is both an important goal and a reflection of the broader ambition to advance the EU Savings and Investments Union.

Importance of capital market integration for financial stability

The ESM's mandate is to safeguard financial stability of the euro area and its Member States. And there is a very clear connection between the level of integration of capital markets and economic and financial resilience.

Having well-integrated capital markets increases the effectiveness of private risk-sharing. This translates into better shock absorption through investment and credit flows across countries which help distribute losses and profits across borders.

This, in effect, can smooth out economic cycles and enhance resilience. As a result, financial stability can be supported without putting excessive pressure on public money.

Well-integrated capital markets are also conducive to economic growth, by facilitating efficient resource allocation, attracting foreign investment, and supporting innovation and productivity. Sustained economic growth reinforces financial stability by strengthening the capacity of economies to withstand shocks and maintain robust financial systems.

This does not mean that a European public backstop, and this is essentially the role of the ESM as a crisis resolution mechanism, is obsolete. However, it should alleviate the need for governments to step in and the risk that we will have to support a country.

ESM's reflection on the savings and investments union

Against that background, it is clear why ESM attributes high importance to the savings and investments union project.

We look at it from our perspective as crisis mechanism and market player. We operate globally in financial markets - as a seller of Eurobonds and an investor. The ESM holds €80 billion of paid-in capital to back our high creditworthiness, which we need to invest securely and profitably.

We were happy to accept the invitation of the Lithuanian government to provide a

policy note on the Baltic capital market hub.

The question to ask and to answer then is why it would make sense for Lithuania and its Baltic neighbours to maintain and strengthen regional cooperation in parallel to the savings and investment union and possibly beyond this common European project. Or in other words – what are the benefits of deeper Baltic capital market integration in an environment where the savings and investment union will be rolled out over the coming years?

Our assessment in addressing this question departs from the analytical work we have done on the savings and investments union itself. We fundamentally agree with the European Commission that it is necessary to bring capital markets closer to people and firms to make the savings and investment union a success.

In an analytical study, entitled “Capital markets union redux: Towards a deeper and more equitable Savings and Investment Union”, published as an ESM Discussion Paper in May, we explore how a truly integrated Savings and Investments Union can be achieved using a comparative approach to identify best practices among EU Member States.

One of the authors, Senior Economist Mathias Skrutkowski, has built on the insights from this paper and applied it to the Baltic region. I thank Mathias for his work, which is now also published in the series *ESM Briefs* website under the title “[Capital markets in the Baltic region: A deep dive](#)”.

My speech builds on this analysis. I will explain where we see scope to improve the working of the Baltic capital markets in converting savings into productive investment financing growth. And I will finish my reflections with a set of concrete policy considerations.

The Baltic capital market initiative

Briefly looking back, the pan-Baltic capital market initiative has existed for 8 years. The initiative dates back to the Memorandum of Understanding (MoU) signed by the Baltic states in 2017.

This agreement, supported by the European Bank for Reconstruction and Development (EBRD) and the European Commission established a framework for cooperation aimed at harmonising regulations, reducing investment barriers and

pooling the strengths of the three countries to promote economic growth and investment.

The MoU set ambitious goals including legal convergence, improved market infrastructure the creation of new financial instruments, and enhanced cross-border capital flows.

Let me just mention the harmonised covered bonds regime, and the launch of a Baltic MSCI index and joint Nasdaq listing as concrete achievements.

Strengthening the Baltic capital market hub

This initiative can go further in converting savings into productive investment.

Looking at the profile of household savings in the Baltic countries [[presentation](#) - slide 2] we find that households in these countries overall tend to save less and possess lower wealth levels than the EU average. It is displayed in the left-hand chart, comparing the gross household savings rate and on the right, showing household net worth. This pattern should not come as a big surprise given the relative low levels of income compared to the European average and the fact that the region went through a deep crisis and adjustment period that involved an internal devaluation around the time of the Global Financial Crisis, which led to a period of negative savings on aggregate, as households dissaved to compensate for wage cuts.

[slide 3] Nonetheless, the savings allocation of households is broadly comparable to that of the euro area average, but there is some interesting variation among the Baltic countries, as shown in the chart. Estonian households are notable for holding a significantly lower proportion of their savings in cash and deposits.

One explanation for this variation is financial literacy [slide 4]. Households in Latvia and Lithuania display levels of financial literacy broadly similar to the EU average according to a Eurobarometer survey, while Estonian households score higher than the EU average. The high variation in financial literacy suggests that more can be done in this area to channel more household savings towards productive investments.

At the same time, Baltic households appear to place notably less trust in investment advice compared to the EU average. This is a deterrent to households' capital

market engagement. We believe it may also be related to people's experience with their funded pensions and the advice they received to invest for their old age.

To address the issue, a possible step forward is to strengthen the supervision of entities providing investment advice and potentially harmonise it across the Baltics. The Baltic countries made early progress in expanding funded pension schemes. [slide 5] As a result, Latvia and Estonia have a ratio of retirement savings to GDP that is higher than in France or Spain, for example and in the case of Lithuania, still higher than in Germany or Austria.

However, pension funds in the Baltics have contributed less to the development of local stock markets than in these countries. More visibly, the Baltic countries fall way short of both the level of retirement savings and stock market capitalisation achieved in neighbouring Scandinavian countries and the Netherlands.

Why is it that the Baltic countries rank very low in market capitalisation despite having assets earmarked for retirement?

First, their pension funds allocate a very low share of their investments to domestic firms. [slide 6] Baltic stock markets are seen even by local funds as risky, given their limited scale and liquidity, and also their classification as a "Frontier Market" both by FTSE Russell and MSCI, two global equity index providers. This ranking as "Frontier Markets" deters both local and foreign investors.

The cautious behaviour may actually create a deadlock: the limited involvement of institutional investors constrains the growth and liquidity of local stock markets. This prevents them from reaching the scale needed to attract more capital and improve market conditions. We believe that there is room for pension funds to increase their allocation to Baltic firms without compromising the interests of pension beneficiaries.

Second, operational costs and fees charged by pension funds in the Baltic countries remain high by international standards although they have come already down in recent years. This suggests that there is still insufficient competition in the fund selection process.

Pension funds - best practices in the Netherlands and Sweden

We can learn from examples of best-practice solutions among EU Member States how to address these issues. A notable feature of Scandinavian pension funds is their active contribution to regional investments and firm creation. This is due to investing a substantial share of assets in startups and growth-stage companies.

Crucially, the investment mandates of these pension funds allow investments in unlisted equities and infrastructure projects which, when successful, generate significant value for pension beneficiaries. This also fosters new business formation, job creation, and productivity gains.

Another critical success factor is the high cost-efficiency achieved by Scandinavian pension funds. They maintain some of the lowest operating costs and fee levels in Europe, thanks largely to a competitive fund selection process. This process involves regular tenders where participating funds compete against a low-cost primary pension fund established within each scheme, explicitly to serve as a price leader which puts downward pressure on costs and fees.

Such a model ensures both strong investment performance and cost discipline which together contribute to the success of these pension systems.

Recommendations

I would like to conclude now by outlining some policy recommendations. [slide 7] They are spelled out in more detail in the ESM Brief.

An important incentive to strengthen the Baltic capital market initiative is to gain the necessary scale to become more attractive to investors. This requires pooling investors and directing savings into joint investment fund structures. In our view, changes to the way the funded pension schemes operate is a cornerstone to address these challenges.

Several concrete policy measures can be taken to strengthen the funded pension system. Based on the examples I just mentioned, national authorities in the Baltic countries should consider reforming the Pillar 2 pension system by establishing a primary pension fund that acts as the default choice and price leader within the scheme. This structure could help drive down costs and fees for pension beneficiaries.

The primary pension fund should also be granted an investment mandate that allows for a significant allocation to unlisted equities including companies in the start-up and growth phases, thereby fostering capital market development within the region.

We also see merit in harmonising the tax treatment of national investment savings accounts to enable greater scale and facilitate cross-border investments.

Finally, centralising the supervision of Baltic financial markets under a common authority could promote greater harmonisation of regulatory and supervisory practices.

Initial priorities could include:

- Coordinating initiatives to improve financial literacy education across the region.
- Strengthening harmonised supervision of entities providing investment advice, to enhance investor trust and confidence.

These measures would contribute to shaping a more integrated, efficient, and accessible capital market in the Baltic region which would support the creation of the necessary scale to finance long-term economic growth and significantly improve peoples' well-being.

Other regions face a similar challenge and a parallel regional initiative has been launched by Central Eastern European countries. In these regional initiatives, the expectation is that regional proximity and alignment will allow to go further in the integration of capital markets than in the case of the savings and investments union, which fundamentally relies on national coordination and alignment among countries.

Strengthening this regional integration in our view is not a “nice to have” but a must in order to generate a “quantum leap” for Lithuania and its Baltic neighbours.

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