Box 4

THE CAPITAL MARKETS UNION: NEW DEVELOPMENTS

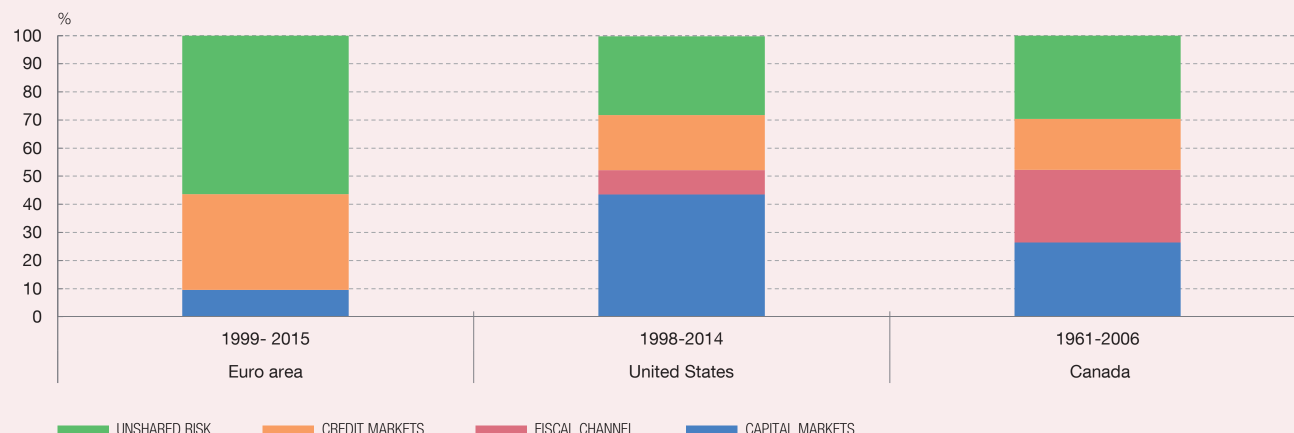
This early-release box was published on 4 September

The Economic and Monetary Union (EMU) project, launched in Europe in the 1990s, did not envisage a fully fledged monetary union from the outset, leaving important aspects to be fleshed out at a later stage. More than two decades later, there are still significant shortcomings in the euro area's institutional arrangements, among them scant headway in the development of sufficiently deep and integrated European capital markets. Given its significance, the European Commission continues to hold the Capital Markets Union (CMU) among its main priorities and has already taken significant steps in this direction. Following completion of the initial action plan launched in 2015, the Commission is working on a second package of measures that will be unveiled this autumn. The smooth functioning of European capital markets is all the more important in light of the withdrawal of the United Kingdom - home to Europe's largest capital market - from the European Union (EU), the situation prompted by the COVID-19 health crisis and the attendant need for economic reconstruction.

The benefits of a fully fledged CMU are significant. In the United States, the presence of deep and integrated capital markets allow shocks affecting one state in the union to be absorbed to a high degree on an aggregate basis.[1] This constitutes a risk-sharing channel and brings stability to the currency area as a whole. By contrast, the fragmentation that is characteristic of the euro area's financial markets means less capacity to share and diversify risks (see Chart 1). In the United States, this capacity stems from the size of the capital markets themselves - far larger in terms of GDP than those of the EU-27 (see Chart 2)[2] - and the high geographical diversification of portfolios, compared to the home bias that predominates in Europe.[3]

Further, the CMU is a necessary complement to the Banking Union within the EMU.[4] More developed capital markets allow the real sector of the economy to achieve greater diversification in its funding sources and support the financing of activities that are important for economic growth, such as sustainable investment and investment in

Chart 1
CAPACITY OF RISK SHARING CHANNELS. AN INTERNATIONAL COMPARISON (a)



SOURCES: Banco de España, "Regional redistribution and stabilization by the center in Canada, France, the UK and the US: A reassessment and new tests", J. Mélitz and F. Zumer, Journal of Public Economics, Vol, 86, November 2002, and "Interstate risk sharing in Germany: 1970–2006", R. Hepp and J. von Hagen, Oxford Economic Papers, Vol, 65, January 2013.

a Estimated using the methodology of "Channels of Interstate Risk Sharing: United States 1963–1990", P. Asdrubali *et al.,* The Quarterly Journal of Economics, vol. 111, 19962, which approximates the percentage of shocks to an economy's GDP transmitted to the income and consumption decisions of that economy's residents.

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1 Specifically, risk sharing refers to the degree to which shocks to the GDP of a country or region affect the consumption of its agents. Risk sharing is considered full where consumption is unaffected by a shock and nil where all shocks are transmitted to consumption unsmoothed.

2 See Balta and Delgado (2008), Home Bias and Market Integration in the EU, CESifo Economic Studies, Vol. 55, 12009, 110–144.

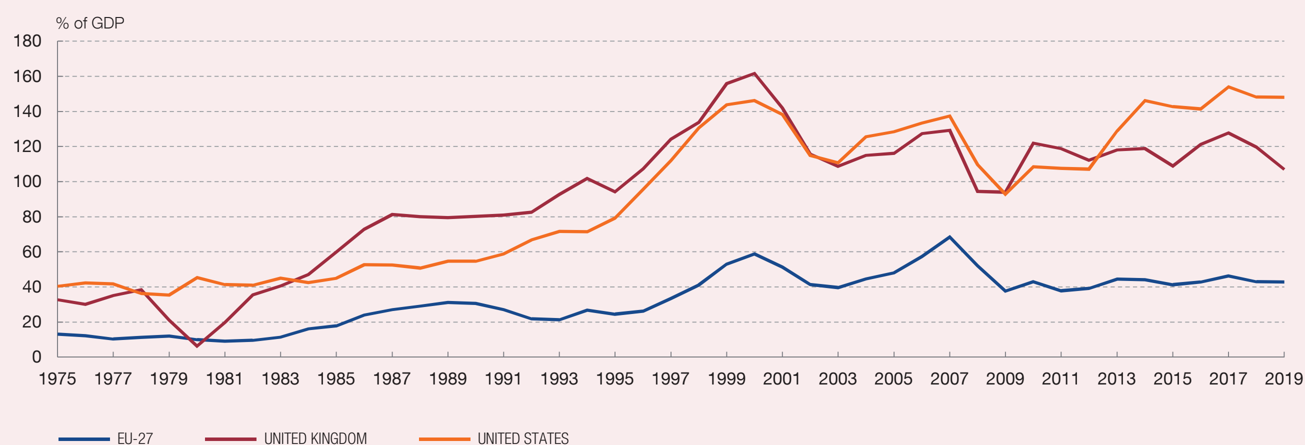
3 See Pablo Hernández de Cos, *Thoughts on global financial stability and the European Capital Markets Union,* Annual Spanish Capital Markets Conference/AFME (Association for Financial Markets in Europe) and AEB (Spanish Banking Association), 13.02.2020.

4 See M. Hoffmann, E. Maslov, B.E. Sørensen and I. Stewen (2019), *Channels of Risk Sharing in the Eurozone - What Can Banking and Capital Market Union Achieve,* University of Houston.

innovation, where raising finance through the bank channel is sometimes difficult.[5] Furthermore, in the context of the Banking Union, there is evidence that the presence of integrated capital markets is necessary to achieve efficient risk sharing when the economy faces supply shocks. Broadly speaking, these shocks have a first-order effect on the market value of assets, which can be better shared through cross-border ownership of private capital.[6]

With a view to achieving fully fledged capital markets in Europe, the European Commission's 2015 action plan was articulated around a series of priorities: supporting the financing of firms, particularly SMEs; fostering investment in sustainable projects and infrastructure; removing barriers to cross-border investment; and creating additional opportunities for savers and attracting capital from outside the EU. Although the measures adopted under the plan represent a step towards building the CMU, this is a long-term objective and a long road lies ahead.[7] The available indicators show that the EU's capital markets remain fragmented at the national level;[8] the European non-financial sector is still considerably dependent on bank funding;[9] and there is no robust upward trend in the proportion of mergers and acquisitions between firms in different EU member states, which remain below the levels seen prior to the financial crisis.[10] In practice, financial integration in the euro area has faced its ups and downs, the latter chiefly being linked to the impact of the global financial crisis and the European sovereign debt crisis, as evidenced by the composite indicators formulated by the European Central Bank (see Chart 3).[11]

Chart 2
STOCK MARKET CAPITALISATION-TO-GDP RATIO



SOURCES: ECB, Eurostat, World Bank and CEIC.

5 The differential aspects of such investment - including highly uncertain expected returns, a very protracted time horizon before projects are completed, and the predominance of intangible assets in the returns of these - mean that debt is often not the most suitable instrument for financing these initiatives and that innovative firms that exhaust their internal sources of financing have to resort to the capital markets to obtain the funds necessary to pursue these projects. For further details on the importance of capital markets in the financing of such projects, see Guindos (2020), *Capital markets union: the role of equity markets and sustainable finance*.

6 See J. Martínez, T. Philippon and M. Sihvonen (2019), *Does a Currency Union Need a Capital Market Union? Risk Sharing Via Banks and Markets,* NBER Working Paper No 26026.

7 See The Next CMU High-Level Group (2019). *Savings and Sustainable Investment Union;* CEPS-ECMI (2019). *Rebranding Capital Markets Union. A market finance action plan;* and New Financial (2019). *A New Sense of Urgency: The Future of Capital Markets Union.*

8 Capital market integration in the EU, measured using the composite cross-border finance indicator, barely improved in 2018. See AFME (2019). *Capital Markets Union – Key Performance Indicators,* second edition.

9 In 2018, 88% of non-financial corporations' new borrowing in the EU was raised from credit institutions and just 12% from capital markets. See AFME (2019).

10 See AFME (2019).

11 See ECB (2020). *Financial Integration and Structure in the Euro Area.*

Against this background, in late 2019 the Commission launched a High Level Forum with the aim of providing an up-to-date diagnosis and defining a set of key proposals to give new impetus to the CMU project. The Forum was composed of a broad group of experts whose recommendations were published in June 2020.[12] The report identifies 17 sets of measures - defined in a specific and granular approach - grouped into four clusters, as detailed in Figure 1: (i) channelling the supply of funds towards the capital markets, fostering saving and the engagement of end savers in the markets; (ii) satisfying demand for financing among firms, particularly SMEs, and facilitating their engagement in capital markets; (iii) developing pan-European market infrastructure; and (iv) driving cross-border integration, which includes some of the more controversial initiatives, such as harmonising withholding tax and insolvency procedures, and shoring up Europe-wide financial market supervision.

The Commission plans to launch a new CMU action plan in the autumn of 2020, drawing largely on the recommendations of the High Level Forum.[13] Some of the levers that can and must drive the CMU project forward are clearly identified in these recommendations:[14] supervisory convergence and the eventual establishment of a single European supervisor; a focus on sustainable finance to cement Europe's global leadership in a segment with strong potential; improving securitisation regulations to boost banks' lending capacity; and supporting SME market-based funding and developing risk capital markets. Further, creating a European safe asset is essential to provide euro-denominated markets with the necessary depth. However, such an instrument, which would likewise be important in other dimensions, remains

Chart 3
INDICATORS OF FINANCIAL INTEGRATION IN THE EURO AREA (a)

SOURCE: ECB.

a The integration indicators formulated by the ECB are composite indicators constructed using various indicators. Their value is limited to between zero (no integration) and one (full integration). For further details see P. Hoffmann, M. Kremer and S. Zaharia (2019), *Financial integration in Europe through the lens of composite indicators,* Working Paper Series, No 2319, ECB, September.
b The quantity-based indicator is formulated using five indicators covering money, bond and equity markets.
c The price-based indicator is formulated using ten indicators for money, bond, equity and retail banking markets.

12 See Final Report of the High Level Forum on the Capital Markets Union (2020). *A new Vision for Europe's capital markets.*

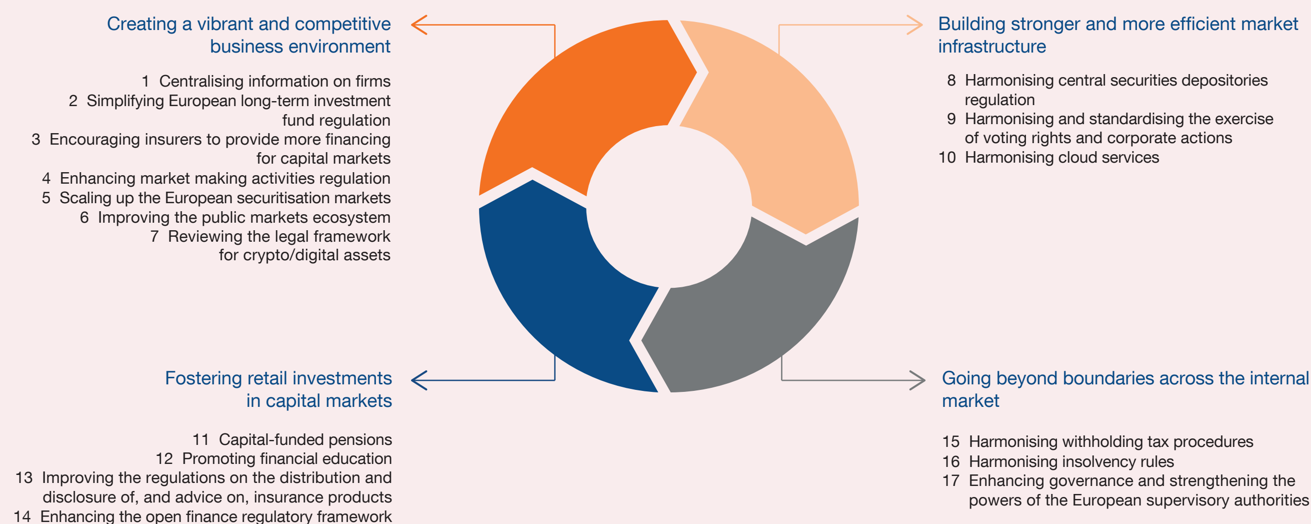
13 In the context of the response to the crisis stemming from the COVID-19 pandemic, in late July the Commission proposed to adopt a package of initiatives geared to facilitating the recapitalisation of firms, channelling investor funds towards the real sector and fostering securitisations by institutions. See *Coronavirus response: How the Capital Markets Union can support Europe's recovery*.

14 See K. Janse and R. Strauch, European Stability Mechanism Blog (22 June 2020). *Momentum builds for Europe's capital markets union.*

beyond the scope of the Commission's project for the time being.[15]

More generally, it is important to note that building the CMU is a complex project that requires the adoption of measures and regulatory amendments in a wide variety of areas, and entails responsibilities not only at the EU level, but also - and critically – for each individual Member State. It is crucial that the various authorities concerned have the political will to implement the required measures, transfer responsibilities and do away with red lines. The plan must also be ambitious enough to tackle the more controversial aspects and ensure that the proposed initiatives are clearly interconnected. In short, to avoid a piecemeal approach and the loss of momentum, the utmost political ambition must be mobilised to overcome the barriers that have blocked the CMU's construction for decades.

Figure 1
SUMMARY OF THE RECOMMENDATIONS OF THE HIGH LEVEL FORUM ON THE CAPITAL MARKETS UNION (a)



SOURCE: Banco de España.

a Based on the final report of the High Level Forum on the Capital Markets Union, *A new vision for Europe's capital markets.*

15 See Pablo Hernández de Cos (2019), *The EMU at 20: from divergence to resilience,* Welcome address, Third Annual Research Conference of the Banco de España.