Avoiding a Brexit will be crucial for the success of Europe’s Capital Markets Union

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An EU Capital Markets Union has been proposed with the aim of providing a boost to Europe’s economy by creating funding channels between providers of loanable funds and the firms best placed to use them. **Umberto Marengo** *writes on the potential benefits from the system and some of the key issues that could undermine its implementation. He argues that Britain’s secession from the EU would have negative consequences for capital flows, and would not only spell the end for the Capital Markets Union, but could also close the door to British financial industry in Europe at a time when its services would be much needed.*

The financial and sovereign debt crises had a lasting negative effect on private and public investments in Europe. In 2015 in the Eurozone, gross fixed investments were still 15 per cent lower the in 2007. The Juncker Commission launched three flagship initiatives to boost investments (the Juncker Plan, the Capital Markets Union and the banking union). Yet, little has been achieved because the countries that would need investments the most have used all their political capital to ask more “fiscal flexibility” from Brussels. Important as this may be, this is hardly enough and not a long-term solution to current the lack of investments in Europe.

The EU financial sector is predominately bank-centered and European banks are, arguably, in a pretty bad shape. Only 25 per cent of all debt instruments in Europe are financed by non-banking institutions compared to 80 per cent in the US; over 80 per cent of European SMEs rely on the banking sector compared to 50 per cent in the US; and total market capitalisation in the US is 116 per cent of GDP compared to only 69 per cent in Europe (average 2008-14). Furthermore, equity markets for European SMEs are essentially national, and this limits significantly companies’ access to finance. Clearly, there are significant differences between the EU and the US that will not change overnight, to begin with the role of the US dollar as a global reserve currency.

A trade panel at the stock exchange. Credits: Rafael Matsunaga / Flickr.

Yet, much can be done. In September 2015, the European Commission laid out a detailed action plan to harmonise regulation and foster transnational funding. The objective is not to reduce overall banking funding per se, but rather to increase access to other sources of funding. The Capital Markets Union, steered by EU Commissioner Jonathan Hill, presented an extensive agenda of initiatives. These included, notably, new rules on securitisation to help financial institutions to transfer securities to third parties and free up additional lending without creating systemic risks, and new rules creating a designated asset category (under Solvency II) for infrastructure financing.

A consultation also opened on how best to harmonise venture capital, private placement regulation, profit accounting for taxation purposes, and covered bonds' treatment. Although the Commission did open up many fronts, the level of ambition of its initiatives is unclear. Furthermore, some of the most sensitive issues such as the harmonisation of bankruptcy laws or accounting standards for SMEs have not been addressed. The harmonisation of bankruptcy laws, for example, would dramatically reduce investment costs and uncertainty across Europe. Yet, different countries have different practices and preferences (for example of debtors' protection) that they are keen to protect.

The second prong is the Juncker investment plan designed to produce over 315 billion euros in the next three years, channelling the ECB's quantitative easing into the real economy. The third prong is the Banking Union. The Banking Union walks on much stronger political support, but it faces harder resistance. In contrast to the Capital Markets Union, which is essentially an issue of regulatory harmonisation, the Banking Union involves significant mutualisation of risks and resources. It aims at breaking the link between banks and governments.

From 2016, investors will have to take the hit in case of bank default before governments can step in to foot the bill. Two of the Banking Union pillars are now operational: a single EU supervisor and a single authority for the recovery and resolution of distressed banks. The third pillar, the creation of a common deposit guarantee scheme is set to become gradually operational in the coming years. The economics underpinning these initiatives is clear, but many political hurdles loom ahead. Most EU countries support harmonisation in principle, but it is all but certain how and to what extent risks, responsibilities and costs ought to be shared.

In the aftermath Greek bailout deal last September, the German government took a strong stand against any further risk sharing. Germany made it clear no liabilities should fall on the EU before banks reform and reduce their level of sovereign debt risk. In particular, Germany wants to make sure that senior creditors will take the hit before taxpayers (the so called "bail in") without provoking litigation. It wants banks to have more buffers, and it wants to close a loophole in capital rules that allow banks to consider sovereign debt as risk free.

The key factor for the success of the Capital Markets Union is the United Kingdom. As the undisputed financial centre in Europe, the UK is set to gain disproportionally from deeper capital markets integration – if it remains in the EU. Harmonised accounting standards, new securitisation and venture capital practices would open up new opportunities for the City of London. Yet, the British Government opposes any move towards a common EU regulator, for example on auditing firms. More centralisation of EU power may not go down well with the Tories, but it is in the best interests of the UK's financial industry. In a highly regulated market, such as financial services, the lesson of the past few years is that it is virtually impossible to harmonise regulations without centralising regulatory powers.

In a nutshell, three factors will shape the EU's financial agenda in 2016. First, the UK referendum on EU membership. Britain's secession from the EU would have negative consequences on economic growth and capital flows. This would not just see the end of the Capital Markets Union, championed by the UK commissioner Hill, but could also close the door to British financial industry in Europe at a time when its services would be much needed. Second, the pace of consolidation in the banking sector. Stronger ECB supervision and a swift implementation of new banking regulation across Europe would provide a forceful argument to overcome Germany's reluctance on the EU deposit guarantee.

Finally, EU governments should focus on the long view rather than on short-term goals. Italy and France forcefully requested more budget flexibility to boost investments. Capital market integration ranked much lower on their political agenda. This is a mistake. In the medium-to-long term, the integration of capital markets will channel more investments to the real economy than a few decimal points of extra public deficit. Deep transformations of the industrial and financial system are called for to get back on a path to growth. Governments can and should lead the way in investing own resources, but eventually the largest share of the pie will have to come from private capitals.

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Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor *of the London School of Economics.*

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