Putting the Capital Markets Union (CMU) in a wider perspective

I thank the CFA Institute for the invitation to join such a distinguished group of panellists in a debate on financial markets in Europe. My thoughts touch upon to a few themes: financial markets in European emerging economies (NMSs); what kind of financial integration should be aimed at in the EU; risk-sharing vs risk-reduction, and, not least, the need to reform the policy arrangements in the euroarea (EA).

Let me start with a few remarks.

The Capital Market Union (CMU) development is a long-term endeavour, as most of us agree. And it is reasonable to assume that the CMU cannot be divorced from the functioning of the Banking Union (BU), of the euroarea in general. Therefore, the CMU can be judged in a narrow sense (on its own) and in broad sense, with the latter considering the functioning of the BU and the EA. Brexit does add an additional dimension to this debate because London is a global financial hub.

The current economic recovery includes a cyclical component and has relied considerably on ECB's non-standard operations; an inevitable economic downturn, when it comes, will be felt quite painfully unless proper policy arrangements are put in place in the EA.

1. Financial (capital) markets in the New Member States (NMSs)

Financial systems in the NMSs are overwhelmingly bank-based, for over 85% of funding is provided via bank credit. Banks are better capitalised in the EU following the reforms of recent years, but big debts afflicts their balance-sheets, especially in the EA. It is noteworthy that the overall debt is significantly lower in NMSs than in the older EU member states.

In the NMS, financial markets are pretty thin; and capital markets play a much lower role in financial intermediation (equity and bond markets) – even when judged against EU benchmarks. One would assume then that there is big scope for the growth of capital markets in NMSs. External funding is prominent in a region where local markets are dominated by European groups; this can help business oft, but it can also be a nuisance when thought is given to SMEs; for the latter are frequently discriminated against.

There is a feature of NMSs that needs to be highlighted; economic growth rates in these countries are considerably higher than the EA average – though much below pre-crisis levels. And catching up is likely to go on assuming that adequate policies operate. This should enhance, arguably, the development of local capital markets. Nonetheless, it pays to notice that substantial financial dis-intermediation has taken place in some NMSs; this phenomenon mirrors fragmentation and retrenchment in the EU as a whole – as an outcome of both the financial and EA crises. This dis-intermediation occurred most dramatically in Hungary and Romania, but external funding should be factored in in assessing the whole picture.

There are rapidly expanding sectors (IT, services), which would benefit from capital markets funding. And I would underline again that local financial (capital) markets are badly needed when it comes to SMEs.

Capital markets in NMSs would be underpinned more strongly by growing pension systems (and here one sees the importance of sustainable economic growth), the development of local financial infrastructure, of encouraging entrepreneurship, the listing of state owned companies, etc.

But it needs to be stressed that *Trust* is a major issue, as it is linked with the overall functioning of financial markets, an ugly side that has come into the open during the financial crisis. Financial markets are not kept in high esteem by people at large owing to undue rents they obtain and an insufficient protection of investors; finance has to serve real economies and people, not viceversa.

The bottom line is that NMSs markets depend enormously on what happens in the EA.

2. What sort of financial integration in the EU – judging the CMU in a broad sense

A critical question should be put forward: can the CMU/BU overcome market fragmentation and economic divergence in the absence of arrangements in the EA that would enable accommodation of asymmetric shocks, foster economic convergence and deal with systemic risks? I say it since the BU and the CMU would enhance connectivity and systemic risks. Consequently, adequate regulation and supervision of financial markets (CMU) and proper risk reduction and risk-sharing arrangements are needed. In my view, two key issues should be highlighted in this regard: financial stability with the related lender of last resort (LoLR) policy issue; and business conduct. When it comes to financial stability one needs to mention that pro-cyclical capital markets are hardly avoidable; this implies that macro-prudential tools need to be imagined and used for capital markets too.

By the way: could “shadow capital markets” become a problem, as shadow-banking has turned out to be? What I have in mind here are unregulated business, rising systemic risks, the impact of fintech, etc.

Dealing with market fragmentation

The non-standard operations of the ECB (including the LoLR operations) have rescued the EA. A big question is what will happen when the ECB normalises its policy. Although the correction of external imbalances (deficits) should not be underestimated, it is sensible to think that the current sovereign bond spreads of the "periphery" over German bunds do not illustrate member states' economic performances accurately – the Italian crisis is a proof of it.

Some member states highlight the need to reduce NPL stocks (a legacy problem) as a risk reduction measure, prior to implementing a risk-sharing scheme – like a collective deposit insurance scheme, which is the key missing link in the BU architecture, though considerably higher resources for the SRF are also needed. But, the flow of non-performing loans hinges, essentially, on economic performance, and not on a particular level of NPLs. In the absence of mechanisms and instruments that foster economic convergence in the EA, NPL stocks at national level would tend to diverge widely again.

One can imagine a diversification of banks' loan portfolio that would diminish the threats posed to their balance-sheets by activities in weaker economies. However, a major decoupling of banks from weaker economies is not welcome; it would cause further fragmentation in the Union/EA, where finance is largely bank-based. Moreover, there are small- and medium-sized banks whose activity remains quasi-local/national. Let me stress such a bad scenario further. If banking groups optimize their government bond portfolios while considerable competitiveness gaps persist among member states, and if sovereign bond ratings were no longer "risk-free", a strong preference for holding safer bonds would ensue. Banks would discriminate among countries, thus harming economic activity in some member states… peripheral economies would become even more fragile once non-zero risk bonds come into being. And the non-existence of proper risk-sharing schemes would only strengthen such perilous dynamics.

3. Risk-reduction vs. risk-sharing

Some argue that a complete BU/CMU would dispense with the need of public risk-sharing. But is it sufficient for a robust EA that risk-sharing applies to finance only? And would private risk-sharing be sufficient to cope with systemic risks? What about the LoLR function? What about this function in financial markets at large? And it is not clear that a collective deposit insurance scheme (EDIS) would involve private money only; some fiscal risk-sharing may be needed in worst case scenarios.

A European "safe asset" and financial integration

The need to reduce the bank-sovereign doom loop as much as possible lies at the root of attempts to come up with a European safe asset. Eurobonds have been mentioned as risk-pooling assets that would make the EA more robust. But, mutualisation of risks is rejected (fear of a "transfer union"). Hence the idea of a synthetic financial asset (sovereign bond-backed securities/SBBS), which is derived from the pooling and slicing of sovereign bonds into three tranches: a senior one (deemed to be equivalent in strength to the German Bunds), a mezzanine (medium-risk) tranche, and a junior (seen as highly risky) tranche, with the latter bearing the brunt of losses in case of default.

But SBBS pose a big problem: the supply of senior tranches depends on the demand for junior tranches, and this demand is likely to fall dramatically during periods of market stress, when some member states' market access may be severely impaired. One can envisage a variation of the composition of SBBSs as a function of member states' market access, but this would make the whole scheme extremely cumbersome to implement.

Fiscal integration is the biggest hurdle to overcome in the EA since it calls for institutional integration and a significant EA own resources (a EA budget); but the latter leads to a huge political conundrum. Here lies a deeply going fragility in the design of the EA, in the spirit of Dani Rodrik's trilemma (there can be no integration in cohabitation with an autonomous economic policy and democratic accountability at national level; something must be given up). But, unless financial integration is accompanied by policy arrangements and mechanisms that combat growing divergence between member states, extremism, populism, Euroscepticism would continue to rise (Italy as an example…but not only). And the "redenomination risk" would continue to reemerge from time to time, in spite of Mario Draghi's famous statement from 2012.

The progress of the EA, of the BU and the CMU, demands a reconciliation between rules and discipline on one hand, and risk sharing (private and public) on the other. But an adequate calibration between rules and risk-sharing, between private and public risk-sharing, is an open question. Unless it will get adequate risk-sharing schemes, the EA will stay fragile. My opinion is that only private risk-sharing schemes, via the CMU, would not make the EA more robust. Financial markets are too fickle and produce systemic risks recurrently.

Concluding remarks

Let me conclude by very succinctly outlining a few policy guidelines of reform in the EA that would help develop the CMU as well. Thus:

- liquidity assistance available during times of market stress;
- schemes to cushion asymmetric shocks, such as an unemployment benefit scheme;
- sovereign debt restructuring should not be triggered automatically (automaticity as a condition for ESM support programmes), for it may cause panic in the markets, more fragmentation in the EA;
- rules for adjusting imbalances should not be pro-cyclical;
- the macroeconomic imbalance procedure (MIP) should operate symmetrically, for both large external deficits and surpluses countries;
- a euro-area-wide macroeconomic policy that should reflect in the fiscal policy stance over the business cycle;
- investment programmes should foster economic convergence;
- no de-reregulation of finance (as it is attempted in the US currently);
- it does make sense to endow ESMA with more prerogatives, as it is happening in the framework of the BU (the SSM, the SRF, eventually a EMF…); ESMA can help avoid regulatory arbitrage and rule enforcement; fintech is to be regulated by all ESAs (not only ESMA)