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THE POLITICAL ECONOMY OF THE CAPITAL MARKET UNION

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Introduction

The objective of creating a more integrated capital market in Europe is widely shared among academics, commentators and even politicians. The process was launched in 2015, following the submission of the Five Presidents' Report.[1] The urgency has been reiterated recently in the report presented by Enrico Letta to the Heads of State and Government.[2] The French and German Ministers of Finance signed a joint article in the Financial times, calling to "close the EU capital markets gap".[3] ECB President Christine Lagarde also advocated restarting the Capital Market Union agenda.[4]

Last April, the European Council asked the Council and the Commission to work "without delay on all identified measures that are necessary to create truly integrated European capital markets which are accessible to all citizens and businesses across the Union, to the benefit of all Member States."[5]

Over the years, little progress has been achieved. This paper examines the main factors underlying this failure, which are mainly of a political nature. They largely consist in not recognizing openly what are the main obstacles and the main driving forces opposing the realization of an integrated capital market in Europe.

Progress has been disappointing

The economic arguments in favor of creating a deep and integrated capital market in Europe are well known. Without it, Europe cannot provide the financing it needs to address the key challenges it has set for the coming years, such as the climate and digital transition, nor support the development of its companies in the global competition. These objectives cannot be achieved with public money alone. Private funds are essential.

The paradox is that while private savings are widely available, they cannot be leveraged and directed efficiently towards the most productive investment in Europe because the financial system remains fragmented and sub-scale. A large part of European savings thus tends to be channeled outside Europe, directed at financing investments and jobs in other parts of the world.

While the case for a European Capital Markets Union seems to be widely shared, progress has been limited, slow and disappointing.[6]

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[1] Five Presidents' Report on Completing the Economic and Monetary Union, Brussels, 22 June 2015.

[2] E. Letta, *Much more than a Market*, April 2024.

[3] B. Le Maire and C. Lindner, *We must close the EU Capital Markets gap*, Financial times, 23 September 2023.

[4] C. Lagarde, *A Kantian shift for the Capital Markets Union*, Frankfurt am main, 17 November 2023.

[5] European Council, *Conclusions,* 17-18 April, Brussels.

[6] Eurofi, *Capital Markets Union, Progress made and future steps*, April 2023.

The official explanation is that the project is more complicated than any other Europe faced in the past and requires many actions in very different fields. This argument is not very convincing. Achieving a completely integrated capital market is indeed a complex task, but so were the single market in the mid 1980s, the monetary union of the late 1990s and the banking union of the past decade. Furthermore, not everything needs to be implemented from the start to get a critical mass capable of generating a centripetal dynamic, as the experience in other areas shows.

The alternative - more credible - explanation for the lack of progress is the fear that a CMU would produce negative consequences for specific sectors or parts of the union. In welfare economics terms, the CMU is not perceived to be Pareto superior to the status quo, in the sense that not all participants expect to gain from a move to CMU. Those who are negatively affected or fear being penalized by CMU have been successful in mobilizing political support to delay and possibly even bury the project.

As for banking union

This is not new in the process of European integration. Consider for instance the banking union project, in particular the adoption of a single regulatory and supervisory framework. The case for such a move, especially after the adoption of the single currency, was discussed for years.[7] Progress was nevertheless very slow.[8] The reason is that the forces which opposed such a move had superior political strength and prevailed for a long time.

At least three forces were playing against the banking union.

The first was the fear of national bank supervisors to lose their powers in favor of a newly created European institution. This can be easily explained by public choice theory. National supervisors were perfectly conscious that the creation of a banking union would ultimately entail a transfer of responsibilities to the European level. They consistently exercised their influence over their respective political authorities, in particular finance ministries, against moving towards banking union, especially in countries where supervision was not independent. The typical argument raised against single supervision was that the latter could not cope with the alleged country-specificities. Another argument was that the ECB would become too powerful if it also received supervisory responsibilities.[9]

[7] T. Padoa Schioppa, *EMU and Banking Supervision,* London School of Economics, 24 February 1999.

[8] L. Bini Smaghi, *Regulation and Supervisory Architecture – Is the EU on the Right Path?* Brussels, 12 February 2009.

[9] J. De La Rosiere, *Report of the High-Level Group on Financial Supervision in the EU*, Brussels, 25 February 2009.

The second opposition against banking union came from some banks, which were fearful that the transfer of regulatory and supervisory authority to a European institution would reduce their ability to influence their respective supervisory authorities and would lead to stricter standards and lesser discretion.

The third opposition to banking union came from the countries that feared losing from such a move. Some countries considered that a banking union would force them to bail out, through their public finances, the weaker banking systems in other countries of the union. Any move towards risk-sharing was thus subjected to reducing risk in national banking systems. Another argument against banking union was that it would make it easier for banks in large countries to acquire those in smaller countries. Typically, the host countries supervisors were much less keen than the home supervisors to proceed towards banking union.

Banking union would have probably never happened without the 2008-09 great financial crisis and the 2010-12 European bank-sovereign doom loop, which showed that the main arguments put forward against banking union were unjustified. The crisis weakened the political support of those against banking union. The inability of local supervisors to assess and address banks' weaknesses was clearly exposed. National supervisors systematically projected an overly optimistic situation of their respective banking systems. They thus lost credibility in the eyes of the markets and of the political authorities. The first stress tests conducted in the Spring 2010, which suggested a capital shortfall of slightly above 3 billion euro for the whole European union proved unrealistic, especially considering the subsequent bail outs.[10]

The loss of credibility of both the banks and their supervisors weakened their ability to oppose a transfer of responsibility from the national to the European level. It nevertheless took the severity of the European crisis to foster a consensus amongst the Heads of state and Government, at the June 2012 European Council, which preceded the July "whatever it takes" statement by the ECB.

Ten years later, while few would still consider that the previously decentralized supervisory system was preferable, the banking union remains incomplete, largely due to the persistence of contrarian forces. The remaining discretion allowed to national regulators in the interpretation and implementation of regulation is the biggest obstacle to a single banking market. This is due to a persistent lack of trust, especially between host and home supervisors. This prevents the free flow of liquidity and capital within the union, thus leading to fragmentation. [11]

The lack of progress in the second and third pillars of the Banking union, concerning the resolution procedures and the common insurance scheme, is also linked to the fear of some countries that their taxpayers would have to bail out other countries' banks. This means that there is still a lack of trust in the member states towards the Single Supervisor and the work that has been achieved over the years to substantially reduce risks.[12]

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[10] W. Xoual, *The Evolution of Stress Testing in Europe, Moody's, September 2013*

[11] L. Bini Smaghi, *Banking Union, Ten Years After,* IEP@BU Policy Brief, January 2024

[12] ECB, *Annual Report on Supervisory Activities*, 21 March 2024

Opposition to CMU is even stronger

The slow progress in achieving a Capital Market Union can be explained with similar factors.

First, the national regulatory and supervisory authorities have shown their lack of enthusiasm towards a single financial market. Their powers would be severely restricted by any further strengthening of the European Securities and Market Authority. It is not surprising that the current ESMA's statutes and rules of procedures require its decision-making bodies, which are composed of representatives of the national authorities, to "strive for consensus when taking decisions", which basically consists in preserving a veto right for national authorities. The recent ESMA position paper, while recognizing that "variations in supervisory practices and interpretations of regulations can create regulatory arbitrage, hinder efficient cross border operations, and undermine the effectiveness of the single market" only calls for greater "supervisory consistency", knowing perfectly that national authorities have few incentives to harmonize practices and ensure uniform interpretation of regulation.[13] The same words were used at the time in the reports made by European bank supervisors, including within the European system of central banks, prior to the Great financial crisis, to oppose the creation of a single bank supervisor in Europe.

Second, as for the banking union, the major market players in the 27 different markets, in particular the stock exchanges and market infrastructures, have the incentive to oppose unification of regulation and supervision, for several reasons. The most important one is the preference for maintaining the link to the local regulator and supervisor, with whom they have been working for a long time, that they know well and believe they can influence. Having a single regulator located far away might reduce the scope for discretion and eventually preferential treatment or even capture.

The third factor against CMU is the asymmetric effect that it may produce across countries. Some countries fear being negatively affected by the implementation of a single rulebook and supervisory framework. It would undermine in particular their ability to attract financial institutions, especially from outside the EU, through lighter regulation and supervision. Especially smaller countries are afraid that a more integrated capital market would weaken their local markets to the benefit of the larger ones. This is not that different from the debate which preceded and delayed the creation of the single market or the monetary union. Incidentally, these fears proved wrong with the benefit of hindsight.

A fourth factor in the discussion on the CMU, which was not present with the banking union, is the position of non-EU actors. Non-EU financial institutions play a relevant role, possibly a dominant one in most segments of the 27 national markets. When it comes to asset management, market making, primary dealership, depository institutions, private equity, rating, auditing, the markets are dominated by US institutions. They have a double advantage over the European ones. First, they benefit from their position in the large domestic US market, where European competitors have a marginal role. Second, they can choose where to locate their headquarters within any of the 27 European jurisdictions and organize their activities based on their assessment of the different regulatory, prudential, tax and other advantages. The fragmentation of the EU market may entail costs for US

[13] ESMA, *Building a more effective and attractive capital markets in the EU*, 2024

institutions, which are however much lower than for the European ones.

The dominant position of non-EU, in particular US, players in the capital markets has systematically strengthened over the last 10-15 years, at the expense of European institutions. This is true both at the global level, comparing the US and European markets, and within the European market. In other words, US players have been able to gain market shares in the EU while the EU market has become smaller compared to the US. This has hampered the development of global European players that can compete in the US market.

The dominant position of US financial institutions in the European market has also provided them with substantial influence in the technical and political discussions on the further integration of the financial markets in Europe. Some of them have direct access to the political authorities of the member states and the EU institutions.

Going forward

It's about politics

The creation of an integrated European financial market is a political decision, which implies some transfer of sovereignty. The decision thus needs to be taken at the highest political level, by the heads of state and government of the member states. Experience shows that such a decision may happen only when all the participants realize that they may lose from the status quo and may benefit only by sharing responsibility.

Typically, the "time of reckoning" for a European solution is during a crisis. As Jean Monet anticipated long time ago. Amid a crisis the lack of trust between countries and the fear of having to pay for others, which prevents making progress in normal times, tends to disappear in front of the urgency to find a solution in the interest of all.

The question is whether we can afford waiting for the next financial crisis to convince the politicians of the 27 member states that the time has come for making a more decisive step towards financial integration. Or, alternatively, whether a more rational political process can be designed to achieve the CMU.

Such an alternative could benefit from four main suggestions.

Don't be naive

The first ingredient of a better decision-making process is the awareness that there is strong opposition to the project, which is often motivated by the self-preservation of interest groups that do not necessarily coincide with the general interest of society. One example, already mentioned, is the

contrarian attitude of national market regulators and supervisors (with some exceptions) [14] towards the establishment of common rules and institutions which would deprive them of their current powers.

These interest groups often have a direct access to the decision makers and contribute shaping their views through the knowledge of the technicalities involved in the discussions. For example, regulators and supervisors, and finance ministries representatives, are generally responsible for preparing the documentation for the meetings of the European Council where financial issues are discussed. They are also generally responsible for the implementation of the agreements reached at the highest European level. This is the reason why European Council Conclusions are often disregarded or only partly followed during the implementation phase, by the various technical groups which bring the specific interests back to the table.

The solution is to ensure that the European Council discussions are informed not only by national preparatory documents but also by a broader view, independent of specific national or sectorial interests. The (next) European Commission should thus be expected to play a stronger leadership role, with a view to present the common interests. The European Council should also devote greater attention to the implementation of their decisions.

The optimum is the enemy of the good

The second ingredient consists in a clear definition of the objective that should be achieved by a Capital Market Union. Overburdening the CMU agenda is the best way to make it very complex and impossible to realize.

Achieving from the start a deep and liquid capital market like the one currently existing in the United States is obviously unrealistic. The creation of a market is the result not only of the existence of rules and institutions but also the behavior of economic agents that react to incentives. The objective should thus be to set minimum requirements that can generates an irreversible dynamic towards an increasingly integrated financial market.

Setting a single rulebook and its uniform interpretation is essential to avoid that national regulators exploit regulatory loopholes to re-introduce new distortions and fragmentations.[15] The institutional framework, in which decisions are taken swiftly and rapidly, is a key ingredient for a sustainable unification process. The experience with monetary union or the banking union shows how national authorities try using any leeway available to create new barriers for to their domestic institutions and thereby reinstate fragmentation. Such a leeway should be minimized or eliminated.

The single rulebook and uniform supervision should be imposed on the systemic players, in particular the large market infrastructures such as the stock exchanges and central security depositories, as well as the non-EU market participants, starting from asset managers, which are amongst the

[14] For instance, De Nederlandsche Bank and AFM, *Next Steps for the European Capital Markets Union*, 16 February 2024.
[15] N. Veron, *European Capital Market Union: make it or break it*, Bruegel 19 March 2024.

strongest opponents to CMU.[16] Once this is done, the incentive to deviate and to arbitrage regulation would be significantly reduced and the centrifugal forces pulling towards market fragmentation would be reversed into centripetal forces towards greater integration. It will indeed be in the interest of the major players that become subject to the single rulebook that the latter is widely applied.

Another area where progress is needed is the completion of the banking union, especially concerning the free flow of liquidity and bank capital within the union. There can be no capital market unless there is a market for the most liquid asset, which is bank deposits. Achieving CMU is closely associated and cannot be done unless there is further progress in the banking union. Suggesting that CMU is an alternative to banking union is plainly wrong.

On the contrary, setting unnecessary criteria for the CMU ultimately produces the effect of indefinitely postponing the result. One example is tax harmonization. This is certainly a desired objective, but not a necessary condition to foster financial integration. Tax harmonization may ultimately be the result rather than the pre-requisite of CMU. Another example of a false prerequisite, in particular for securitization, is the harmonization of bankruptcy laws, which is an impossible task for the near term. Securitization, for instance of bank mortgages, can hardly aim at bundling mortgages originated in different countries, that have widely different market practices. The objective is rather to facilitate cross-border sale and trading.

Another “false” pre-requisite for CMU is the existence of Eurobonds, that would be play the role of safe asset. A safe asset would certainly be useful but is not an absolute necessity. What would be needed instead and could be adopted with little cost and limited risk sharing, are mechanisms similar to those which support the core US financial markets, in particular for SMEs loans and mortgages, such as Fannie Mae and Freddie Mac or the Small Business Administration.

To sum up, the search for the optimum is often the best way not to achieve the good, also when it comes to financial integration. And some know it well.

There is no such a thing as the Status Quo

The third ingredient for an effective decision-making process at the heads of state and government level is a clear understanding of the alternatives. Many think that the alternative to moving towards a CMU, with all its unknowns, is the status quo, characterized by 27 different national markets. This is an illusion. It assumes that the EU is a closed system, with no interaction nor competition with the rest of the world. This is obviously wrong. The interaction with the global financial system is pervasive and is affecting the shape of the European markets even in the absence of any change. In other words, the status quo does not exist.

Based on the developments recorded over the last few years, the current features can be extrapolated for the near future.

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[16] C. Noyer and al., *Developing European Capital Markets to finance the future*, 24 April 2024

First, the financial markets of the 27 countries are shrinking, especially in relative terms, compared to the rest of the world. The number of companies listed in the stock market fell almost everywhere in Europe, on average by 16% between 2012 and 2022, while it increased by 13% in the US.[17] This affects both large corporates and start-ups. The barriers raised by national authorities to protect their respective markets, in the fear that companies would move to neighboring countries, is producing a lose-lose situation, as the overall size of the cake shrinks at the benefit of the US market. The access to the deeper US market, which drives valuations up, is a strong incentive for European companies to move across the Atlantic.

One may wonder how long it will take for the national authorities to become aware of their myopic behavior.

Second, the financial markets of the 27 countries are becoming dominated by non-European (i.e. US) institutions which exercise significant market powers. This is true in practically all sectors of the regulated and unregulated market, from asset management to private equity or depository institutions. Local institutions are most often too small to compete and settle for the role of distributing products originated elsewhere. The result is that there can be no transformational transactions, between corporates – such as mergers and acquisitions – or in given strategic sectors such as infrastructure investment, which can be implemented in Europe or in one of its member states without a key role being played, in the design and financing, by a major US institution.

As a result of the above, CMU becomes more and more difficult to realize over time, because of the lack of critical mass and significant players. It is an illusion to believe that the European financial market can be founded on non-European (i.e. US) players alone.x

The consequences of non-CMU

The fourth and final ingredient of the required decision-making process is an understanding of the implication of not achieving a CMU within a reasonable time frame. In other words, the costs of non-union of the capital markets. This is an issue on which substantial work has been done and presented to the political leaders, although it is not clear whether it has been well digested and fully understood.

The main consequence of not achieving an integrated financial market is that Europe will not be able to finance the huge investment requirements needed for its ambitions in the field of the climate transition, energy security, digital evolution, defense, etc… Public funds will not be sufficient, given the deer state of national public finances. Bank financing is limited by banks' capital requirements and profitability. Market financing is therefore essential.

The other effect of non-CMU is on the competitiveness of the European economy. Without the support of an efficient financial system, European companies will find it more difficult to compete at the global level. They will have an incentive to move outside Europe, in particular in the US.

[17] Data from the World Federation of Exchanges.

European savers will have to pay more for financial products and will have lesser choice for their portfolio diversification. Risk sharing in Europe will continue to be impaired.

Further evidence of the costs of non-CMU is contained in the recent and forthcoming reports to the political leaders of the 27 member states. Will they be enough to convince the political leaders to stop focusing only on their respective local markets, which are slowly disappearing, and to start building a true European financial market?

We will know soon.