Capital Markets Union, or else what?

Description

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The EU will need 600 billion additional net investments every year from now to 2050 to meet its climate objectives. It also needs strategic investments to digitalise its economies, increase resilience, defend its borders and deal with the increasingly frequent "once-in-a-lifetime" shocks it faces.

Those who will finance these investments must be able to take on high levels of risk. That's why the EU needs to turn to capital markets that can deal with such risks better than any other financial intermediary. Therefore, a Capital Markets Union (CMU) in the EU remains a necessary ingredient to deal with its future financing needs. But despite all the efforts by the European Commission to nudge its creation through legislative proposals, there is little shift in the way that the EU financial system works.

The CMU has always been a rather complex project because many policy authorities need to talk to each other and coordinate their actions. It is also not an easy one to sell to wide constituencies precisely because there are so many that are involved with varying degrees of resistance to change.

A fully unified market for capital in the EU requires harmonising laws and institutions but also consumer preferences. This cannot be done either top-down or by nudging incentives into laws. It needs a lot of bottom-up structural changes, including in consumers' appetite for risk, that are neither easy to achieve nor can be done within one generation.

Two more observations are instructive in understanding this complexity.

First, the EU created a Banking Union that is a Union only in institutional terms, in that there is a common supervisor for all national banks. But it has not created a unified market for EU banks. Cross-border banking is insignificant in the EU and it has even reduced after the financial crisis. So why do we believe that we can create a unified market for capital when despite all the progress in the Banking Union we have not created a common market for banks?

Second, it is not just about unifying many markets. In some countries, capital markets are rather small and underdeveloped. In some instances, the EU may have to create markets before it can think about unifying them. At the same time, the UK's departure from the EU itself reduced the size and scope of the EU capital market, as a whole.

Beyond complexity, incentives are also not properly aligned. Ultimately it comes down to how the EU's financial model intermediates consumer savings. Currently, a big part of consumer savings rests in banks. In turn, banks end up holding their respective government's debt, either because they must, through regulation on what constitutes a safe asset, or through moral suasion. If capital markets were to develop substantially, they would necessarily draw some of these consumer savings and reduce the amounts invested in government debt. It is not immediately appealing for these governments to take actions that will reduce their ability to borrow from their consumers.

While the EU will be trying to find a new impetus for the CMU agenda, it must also recognise that a developed market for capital is not the answer to the EU's immediate financing needs in the next few years. So, it must put alternatives in place.

The reality is that there is only one alternative and that is the taxpayer. A big part of the investment gap that the EU must close will have to come from government coffers. Again. If consumers cannot find ways to finance risk projects through the markets, they will have to finance them through their governments. For many overindebted governments, this will not be easy, and this is why the EU needs to pull resources together and pay for what it collectively identifies as strategic for its future.

There is no doubt that despite its complexity the CMU agenda is necessary to increase the resilience of the EU economy. But it is very difficult to make substantive progress at the speed at which EU problems need solutions and therefore the EU must have contingency plans. It must identify the main strategic objectives that it must meet and pool the fiscal resources to pursue them.

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