EU Capital Markets Union: an alluring opportunity or a blind alley? Concept and micro-perspectives of CMUs

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European Union member states show variety in many dimensions, traits that are often appreciated as expressions of Europe's richness. Variety, however, can also lead to tensions, complicating policies. Hence, more institutional 'approximation' (a notion from the Rome Treaty)—or positive integration—might come with benefits. However, Europe's institutional diversity is historically rooted, reflecting preferences as well as hard-established compromises between the pertinent actors at the *national* level.

Variety evidently also characterizes Europe's capital markets and financial institutions. They come with distinctive national trappings. And, placed on a two-polar spectrum between bank and capital-market oriented systems, a majority of EMU member states (still?) relies primarily on bank intermediation, in particular when it comes to financing of its corporate sector. A foremost example of how variety might bear on policy implementation is the common monetary policy. Here, the transmission of its *singular* impulse is mediated by the *plurality* of financial systems in a differential way across Euro Area member states, generating a corresponding plurality of effects.

In the wake of the Great Financial Crisis—some ten years later, yet to be overcome completely—these differential effects gave rise to numerous policy issues as well as proposals to address them. For a number of Euro Area countries, a particularly pressing issue was that access to external funds was becoming difficult, especially for small and medium-sized firms. Banks, fragilized by the crisis and compelled to buttress their capital and liquidity position, reduced their lending activities and, in many cases, shrank their balance sheets. This lack of funding spelled lower levels of capital expenditures and amplified recessionary tendencies. As a result, as one diagnosis claims, it took the Euro Area (on average) significantly longer to catch-up to the level of output it had achieved in 2007 than was the case for the U.S. And a few member states, with notably

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weak banks, are still below that level. The faster recovery in the U.S. was attributed to financial markets working more smoothly. In fact, there was rarely any talk of a credit crunch (traditionally the typical trigger of U.S. recessions). Thus, to buttress Europe's resilience in the face of shocks, the development of substitutes for banks seemed an obvious conclusion. More harmonization in capital markets became the objective.

In light of this, the Capital Markets Union (CMU), launched by the EU Commission in 2015, is one of the lessons drawn from the Euro Area crisis. The CMU notion was coined by the then Commission President-Candidate Jean-Claude Juncker in the summer of 2014. Subsequent to a Green paper (EU COM 2015, *Building a Capital Markets Union*), in September 2015 the Commission swiftly launched the *Action Plan for CMU*, also giving a timeline for implementing the comprehensive package of measures (in Appendix 1 of the Green paper). Original plans of the Commission of having the major elements in place by 2017 did not pan out; meanwhile, completion should be achieved in 2019. In any case, CMU appears to have an irreproachable logic, properly complementing the two other European 'financial' unions, i.e. the monetary (of 1999) and the banking union (in place since November 2014). The goal of a CMU is, thus, also in line with efforts at strengthening EMU's institutional architecture—which was (rightly) found wanting, in need of a redesign.

Thus, there is apparently not much to find fault with the CMU approach. How could one, for example, oppose the (seemingly) uncontroversial objective of the Commission's Green Paper of deepening financial market integration amongst EU member states? To make its case, the Commission concisely spells out in the instructive Green paper that and why Europe's financial system does not deliver. While there is barely any debate about the first proposition, the causes of the subpar performance of Europe's financial institutions, however, has given rise to interesting debates.

Obviously, the CMU is not the first initiative at approximation. A major attempt at approximation was ushered in with the First Banking Directive (of 1977), calling for a large-scale harmonization of prudential standards. The Second Banking Directive of 1989 established the Single License and Home Country Control (in the supervision of banks' branches). While the Financial Services Action Plan (of 1999) was an even more substantial precursor, attempting to redesign Europe's financial markets even more comprehensively and focusing (with 42 initiatives[!], one of them Basel II) on removing regulatory barriers to (financial) market integration. 'Passporting' should apply across all financial products and service providers (including securities firms and insurance companies), going beyond the principle of minimum harmonization, but aiming at a single set of prudential rules and their supervisory implementation.

What is remarkable, just as these efforts at integration, the new CMU initiative touched off intense debates amongst scholars, policy makers as well as practitioners, often reiterating arguments made in earlier discussions. Proponents classify CMU as a plan aiming at reducing financial fragmentation in Europe, allowing for more cross-border financial flows and fostering access to finance, especially for SMEs. In contrast, critics consider CMU as an initiative ignoring the lessons taught by the crisis, putting an emphasis on a line of products (securitized credit), indelibly tarnished by the Lehman insolvency, and supporting non-bank banks (shadow banks) intermediation, which also had proven vulnerable. At its core, this is a controversy about the relative merits of market- vs. bank-based systems. (And the response to this is, for sure, not a foregone conclusion, see Grégory Levieuge and Jean-Paul Pollin in this volume.) It also concerns issues

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of complementarity between the different institutions which national systems are made up of. Hence, given this complementarity, changing building blocks comes with ramifications. Finally, within a monetary union those issues evolve against a particular background. A big question thus, is how much variety, in this case in finance, can a monetary union accommodate?

Against this background, Vierteljahrsheft 1-2017 and 2-2017 assess the consequences of the CMU from a policy-oriented perspective. Issue 1 addresses mainly micro-oriented and structural topics while issue 2 focuses on macroeconomic topics, including questions about risk diversification in a working monetary union.

Issue 1 starts with a “A methodological perspective on the Capital Markets Union: using economics to derive effective policy measures”. *Michael Thiel* interprets the Capital Markets Union (CMU) as a crucial policy experiment. It might allow assessing whether the treatment (changing rules of the game, more comprehensive and transparent information and well-designed economic incentives) leads to more robust, marked-based financial activity. Evidence-based policy making is impeded, as the author shows, by, for instance, a lack of knowledge about the legal determinants which are actually holding back the capital market development. Moreover, there are severe data gaps and missing analytical tools, amounting to important obstacles for realizing the CMU project’s ambition.

Grégory Levieuge and *Jean-Paul Pollin* examine “Ambitions and limits of financial disintermediation in the Euro Area”. Specifically, the authors deal with the causes and consequences of the financial disintermediation in Europe since the last financial crisis. The evolution of bank and capital markets funding is explained against the background of a Europe’s rather singular economic trajectory since the Great Financial Crisis broke in 2007. Furthermore, they assess the objectives pursued by some national and European institutions, aiming for less bank intermediation and more market-based financing. Finally, the authors critically evaluate the potential effects of disintermediation for the access to funding of (in particular small) companies, as well as the consequences for economic and financial stability.

Andreas Bley and *Jan Philip Weber* argue that CMU makes, in principle sense, as an instrument to deepen and complement the Single Market. However, the authors express skepticism with respect to CMU’s ambition to improve SME financing and to enable better absorption of asymmetric country-specific shocks (“Capital Markets Union: deepening the Single Market makes sense, but don’t expect too much”). The authors question whether the desired deeper financial market integration can be achieved given the severe political and economic uncertainties.

Mark Demary warns in his contribution “Challenges for the European Capital Markets Union: reviving financial integration and safeguarding financial stability” that a Capital Markets Union, which aims at promoting financial integration by means of harmonization and common standards, is not sufficient to achieve its goals. He suggests, in particular, that a CMU needs to promote cross-border equity holdings rather that short-term debt flows to deal with the looming threat of fast capital reversals. He also calls for establishing a single capital market supervisor at the EU-level with a focus on non-bank financial investors.

Karl-Peter Schackmann-Fallis and *Sonja Scheffler* consider “Aligning financial systems to meet the needs of citizens and enterprises” as the ultimate goal of CMU. Therefore, the authors call for a CMU complementing the existing classic bank-based approach to SME financing, rather than

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searching for a substitute that probably cannot deliver. Moreover, the authors hold that a critical review of existing financial market regulations is needed. It should focus on achieving an integrated regulatory framework, avoiding regulatory duplication and inconsistencies.

Horst Gischer and *Christian Ilchmann* ("CMU—a threat to the German banking sector?") take stock of the German banking sector as well as of its decisive role in corporate financing in Germany. Against this background the authors assess measures of the Capital Markets Union and evaluate possible impacts on the German Banking Sector and German industry.

Helmut Kraemer-Eis and *Frank Lang* ("Access to funds: how could CMU support SME financing?") focus their attention on three goals which the CMU pursues: improving the framework conditions for SME financing, strengthening bank lending, and diversifying the range of potential financing sources for SMEs. They highlight the SME financing-related objectives by concentrating initiatives to enhance the lending capacity of banks. Moreover, in line with this approach, they also focus on the potential effects of securitization and the availability of venture capital, stressing the benefits of the most recent regulatory developments related to CMU.

Easing the access to risk financing (venture capital) and funds for restructuring and growth (private equity) beyond banks is a core element of diversifying financing sources within the CMU-framework. *Peter Cornelius* evaluates on a comparative basis "The structure and integration of the European buyout industry". After a brief discussion of financial intermediation in the private equity space, the author depicts the industry structure of the European buyout industry, also taking stock of the cross-border dimension of committed flows to Europe-focused private equity funds. Furthermore, Cornelius explores most recent trends with regard to deal sizes, leverage, and geographies, uncovering and evaluating a certain home bias of European private equity funds.

Finally, *Dorothea Schäfer* and *Andreas Stephan* ("Innovation and investment funding in the post-crisis period: have financing patterns and financial constraints of German firms changed?") conduct a case study on innovative German SMEs. Specifically, they assess whether the aims of the CMU action plan ease the access to funds of German SMEs when they seek financing for innovation and investment activities. Using firm data from the Mannheim Innovation Panel, the authors observe fairly stable funding patterns of innovative German SMEs over the years and a reluctance of firms to rely on capital market-related financing products. In addition, they find no indication that financial constraints have become more severe in the post-crisis period. In the light of this descriptive evidence, the authors propose that the observed funding patterns are the result of firm owners' preferences rather than a consequence of restrictions from the supply side. Schäfer and Stephan conclude that more research on the innovative firm owners' financing preferences as well as on the specific structure of a region's financial system is essential for designing a beneficial CMU framework.