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Thinking ahead for Europe

Building a Capital Markets Union… or designing a financial system for the euro area?

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When it published its Green Paper entitled "Building a Capital Markets Union" in mid-February of this year, the European Commission (2015) launched a key debate on the development of the EU's financial system. We might ask ourselves, however, if this debate was initiated on the right foundation. First of all, for Brussels, it is not politically correct to make a distinction between EU member states that belong to the Economic and Monetary Union (EMU) and those that don't. The level of urgency, however, is not at all the same for the two groups of countries. Granted, a single capital market could be useful in the European Union, but it is absolutely critical in a monetary union: conducting one and the same monetary policy in an area with broadly varying financial practices and structures is dangerous, as the first 15 years of the euro area's history have vividly shown. Financial integration of the countries in EMU must receive top priority in a process that the rest of the European Union may then subsequently join.

The Commission's Green Paper then calls for the "liberalisation" of capital flows, which raises another important question. The problem in the euro area specifically is not just a matter of suppressing obstacles or eliminating barriers to allow capital to circulate more freely. Rather, the challenge is how to build new channels that will allow economies to more fully mobilise and more efficiently allocate the savings potential that exists in the area.

And for that, we need to have a clear idea of to whom those channels should convey funds. In that respect as well, the European Commission's approach is surprisingly lopsided in that it is almost exclusively focused on companies, and in particular on SMEs. And yet, for several years now, in the eurozone as well as in the other developed economies, household debt has been as important and has been growing as fast, if not faster, than corporate debt. But that's not all! Households are much more sensitive to interest-rate fluctuations than businesses. When the central bank lowers or raises rates, it is household rather than business borrowings and expenditures that stimulate or slow economic activity (Brender et al., 2015). When it comes to conducting monetary policy, household financing conditions, and particularly mortgage lending conditions, are decisive, and that area needs to be addressed as quickly as possible to create a unified capital market. Putting in place common securitisation standards and procedures for the entire eurozone is a powerful tool for achieving this objective, as demonstrated by the United States.

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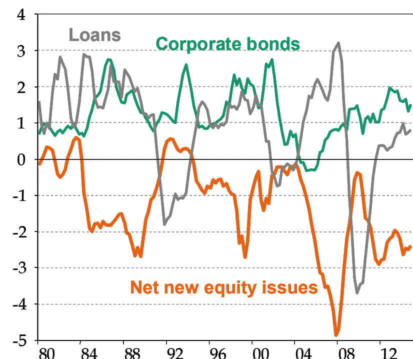
From that standpoint, the weakest financial link in the eurozone is not so much its stock market, but rather the virtual absence of a market for private-sector bond issues. True, in terms of GDP, the eurozone's stock market capitalisation is smaller than that of the US. However, many observers (see, for example, Véron & Wolff, 2015) tend to overlook the fact that the US stock market has for a long time not been a net source of funding for US companies (see Figure 1). Some companies, of course, are continuing to use this market to raise equity, but on the whole, for the past several years US companies have been buying back more securities than they have issued, through share buyback programmes or M&A deals. In short, US companies have consistently been giving funds back to the equity market.

Figure 1. Net financing sources of US non-financial corporations (% of GDP)



Sources: Federal Reserve and Thomson Datastream.

The biggest difference between Europe and the United States, both from the standpoint of monetary policy and private-sector funding, has to do with the role played by the bond markets: in the US, businesses and households alike tap this market for a substantial portion of their financing, either directly or indirectly via securitisations. This portion is much smaller in the eurozone, where banks serve as the primary source of funding.

A large euro private-sector bond market, funded by savings collectors (insurers, pension funds, etc.) in the EU as well as by those elsewhere in the world, should become the key source of funding for both households and businesses. This should be a top goal today. But we won't reach it unless a clear course of action is set.

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