CRS Insights

The European Capital Markets Union
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Overview

On February 18, 2015, the European Commission released a draft proposal for a Capital Markets Union (CMU) to complement its current efforts to create a Banking Union. The CMU is intended to strengthen capital markets in the 28-member European Union (EU) in order to provide a viable alternative to the current bank-centered funding model commonly used by European firms. The Banking Union is distinct from the CMU because it is intended to break the link between private bank failures and government debts; it also is intended to provide stability to the financial system in ways that will support the CMU. The 2008-2009 financial crisis and the European sovereign debt crisis of 2010-2012 continue to hamper prospects for economic recovery in Europe; new investments by European firms continue to lag behind the levels reached prior to the financial crisis and bank lending to firms remains sluggish. Currently, EU financial markets are characterized by a lack of standardization in important financial products and resistance at the national level to ceding sovereignty over domestic financial institutions to the EU. While some of these impediments may be overcome by the measures envisioned in the CMU, others likely will continue to fragment EU financial markets for some time to come.

Initial Steps

The initial steps in creating the CMU involve identifying and addressing current impediments to capital market funding. Although the proposal is expected to be a long-term project, the European Commission intends to have the basic building blocks in place for a "well regulated and integrated" Capital Markets Union by 2019. The EU's main objectives for the CMU are to (1) make it easier for small and medium enterprises (SMEs) to raise funds; (2) equalize the costs of investing and access to investment products throughout the EU; (3) make the process of obtaining financing through capital markets more straightforward; and (4) eliminate unnecessary legal or supervisory barriers that complicate efforts to gain funding in another EU member.

Capital markets serve as intermediaries that channel funds from savers to businesses for investment. This intermediation process can take place with banks acting as the direct provider of funds through loans, or it can occur through established capital market activities, primarily equity (stock) and corporate debt (corporate bond) markets, In contrast with the United States, European equity, debt and other financial markets play a smaller role in financing economic growth and business investment, and European businesses rely primarily on direct bank lending for their funds. Although the EU and U.S. economies are roughly the same size, in 2013, the U.S. stock market was capitalized at $22.3 trillion, or 130% of U.S. GDP, compared with a capitalization value of $12.6 trillion for the EU-wide stock market, equivalent to 78% of EU GDP. However, the assets of EU banks in 2013 were valued at $44 trillion, nearly three times the size of EU GDP, compared with the assets of U.S. banks, which were valued at $16 trillion, or slightly smaller than U.S. GDP. Corporate bond issues by EU firms have been dominated by the largest European firms in the largest European markets.

The European Commission views the CMU as a way of diversifying funding and reducing the cost of raising capital, especially for smaller firms. It also argues that more integrated capital markets, especially for equity, would improve the flow of capital through a more efficient structure and through intermediaries and would enhance the ability of the European economy to absorb economic and financial shocks without increasing the level of public debt.

The CMU builds on the Investment Plan that the European Commission and the European Investment Bank (EIB) initiated in November 2014 to provide €315 billion (about $340 billion [$1.08 = €1]) to stimulate private-sector investment in Europe. The Investment Plan calls for the EU to create a

European Fund for Strategic Investment that will leverage a combination of €16 billion ($17.3 billion) in guarantees provided to the EIB through the EU's budget and €5 billion ($5.4 billion) in public and private funds to complement existing EU programs. Investments provided through the fund aim to provide funding for energy networks and efficiency, broadband, transportation, education, and research and innovation projects that fulfill certain objectives.

Impact on the United States

For the United States, the CMU proposal, should it succeed in developing more efficient European capital markets, could facilitate the activities of U.S. firms operating in Europe and improve the competitive position of Europe's financial markets and European firms relative to U.S. firms. Successful implementation of the CMU also could help stabilize international financial markets. Although European banks generally had sufficient capital at the beginning of the 2008-2009 crisis, their reliance for liquidity on short-term dollar funding markets through banking intermediaries proved to be destabilizing.

Reports by the Bank for International Settlements (BIS) indicate that the short-term dollar funding markets served as a major conduit through which financial distress was transmitted across financial markets and national borders during the crisis. Uncertainty about other banks' credit exposure and the size of potential losses spurred banks to hoard liquidity, severely limiting the ability of European firms to gain access to funding. U.S. banks, in particular, withdrew liquidity on a massive scale from their affiliates abroad, affecting all financial markets, including the wholesale deposit and foreign exchange swap markets. When these markets collapsed in the early stages of the crisis, the U.S. Federal Reserve had to engage in extraordinary measures, including a vast system of currency swap arrangements with central banks around the world, to provide liquidity to the global financial system. Policy initiatives that promote greater efficiency and access to a stable source of funding for firms could potentially avert a repeat of the financial crisis. Despite the relative merits of the proposal, however, prospects for flat economic growth over the near term and growing concerns over the prospects of deflation could undermine efforts to stimulate corporate investment through a CMU.