CAPITAL MARKETS UNION AND BREXIT – FUTURE CHALLENGES AND ACTIONS

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Abstract
As the single market was created for free movement of goods and services, the main objective to create the Capital Markets Union was to reduce the reliance on banking sector and to have alternative sources of funding. The paper tries to emphasize some of the challenges that still exist even after 5 years since its launch and to put some question marks for reflection on the future of the CMU in view of the scale and nature of the present challenges facing the European Union like the departure of United Kingdom from the European Union.

Keywords: capital markets, CMU, financial integration, proportionality, Brexit

JEL classification: G15, F15, F36, D53

"The challenge of the unknown future is so much more exciting than the stories of the accomplished past" – Simon Sinek

1. Introduction

Single market means for European Union no borders or regulatory obstacle to the free movement of goods and service. This led to greater competitiveness, more efficient allocation of the work force in the markets, improved trade and quality, just to name a few and all these contributing to growth and economic integration.

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It is interesting to remark that EU countries have tried to create also the so called „single financial market" meaning that a free flow of capital and easy access to financial services from one country (home) to other countries (hosts) were the core of the concept. And this could be translated into cross-border integration and better access to financial products and services.

The European Commission proposed in November 2014, following June 2014 European Council request to address low levels of EU investment in order to boost growth and employment, the Investment Plan for Europe (the Juncker Plan) to mobilize of at least EUR 315 billion in private and public investment by 2018.

The Capital Markets Union (CMU) was set as one of the essential pillars of the Junker Plan.

Its aim was to strengthen the European financial system by providing alternative sources of funding and expanding opportunities for consumers and institutional investors, therefore including structural transformation of the European economy away from over-reliance on bank lending to other forms of financing. For enterprises, especially for SMEs and start-ups, capital markets union means access to more financing opportunities, such as venture capital and crowd-funding. So by similitude, the idea was to create a single market but for capital markets.

We may affirm that the concept of single market practically appeared in early 1957, same as the Treaty of Rome establishing the European Economic Community, and has evolved in different directions, be it on the financial markets side, capital markets side or regulatory side.

2. Objectives and key features

Once the initiative was launched, it was complemented with an Action Plan aimed to strengthen the contribution of capital markets to investment, growth and jobs in the EU. CMU was seen at that time as going hand in hand with a strong banking system in the EU and provide tangible benefits across the EU.

The Action Plan focused also on facilitating access to finance, reducing barriers and difficulties and providing investors with the necessary protection and information; greater development of corporate securities markets by creating incentives for investment in infrastructure; unlocking funding especially for SMEs; assessing the differences between the various tax and insolvency regimes inside EU member states in order to harmonize them; encouraging cross-border investments.

European financial markets rank well below United States markets in terms of volume, depth, and liquidity. This is partly due to their fragmentation. And we are talking not only about fragmentation of the markets, but also in terms of regulatory framework. So it is as paramount important in this respect to understand financial markets at individual member state level, its specificities, needs and constraints. Even if the final aim was to have more integrated and competitive markets from the point of view of financial and supervisory convergence, proportionality was a key issue to be considered. With the intention to have compliant and liquid markets, sometimes overregulation and further prudential rules can be burdensome for small, not so developed markets and this result in a decline of liquidity, underperformance and even inhibiting the development of innovation.

3. Overview of the European capital markets and the importance of United Kingdom in this context

Great deal has been achieved since the launch of the initiative regarding the capital markets union.

But in view of the scale and nature of the present challenges facing the European Union, it is time to stop and rethink or reshape some of the overall elements. Initially, it was designed for EU28 in order to harmonize the conditions and regulations in the European capital markets.

The uncertainty regarding the situation with United Kingdom and the future relations between EU and UK makes us wonder if everything that was possible has been done in order to create a strong capital market union that is going to be able to adapt to sudden shocks and discontinuity.

It is true that Brexit will create short-terms implications and even if preparedness and contingencies plans were made in the field of financial services in order to avoid disruptions, there will be areas of uncertainties and risks as UK is a systemically important market for EU and continuity must be ensured. Brexit also gives the chance of deep backing understanding of the CMU.

Political commitment and strong cooperation between European Union Member States is still going to be the right “recipe” in continuing the efforts for achieving the desired results. This is due to the fact that differences in the level of development of the capital markets still exist and also from the perspective of access to capital markets for companies, driven by existing financial products on the market, tax incentives, and the company's habit of addressing the capital market for financing in relation to the banking sector. Banks do also contribute to CMU as they are a massive investor in capital markets products.

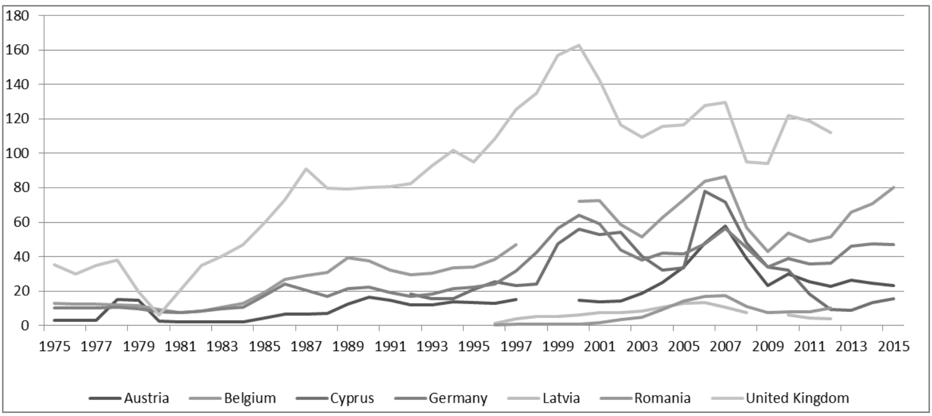
"Almost any interesting economic problem has the following characteristic: what is true for the individual is the opposite of what is true for everybody together" - Milton Friedman (1980), so the idea to create same rules for everybody or better said a-one size fits all approach should be avoided.

Capital markets bear a different level of development across member states and this can be proved by simply looking at the stock market capitalization to GDP ratio for a number of years as in Figure no.1.

Countries were selected randomly from the 28 member states, but to include high, medium and low levels of data in order to be able to support the statement below.

For example at the level of 2010, stock market capitalization in UK was 121,79% of GDP while at the opposite side countries like Latvia, Romania did not even get to 10% of GDP and somewhere in the middle there are countries like Belgium (53,57%) or Germany (38,83%).

Figure 1. Stock market capitalization to GDP (%)



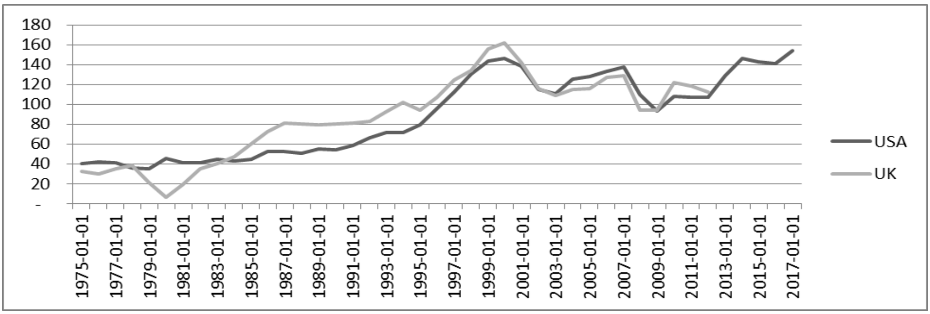
Source: Processing based on World Bank data for the countries mentioned above

Another striking feature can be depicted by comparing UK stock market capitalization with the US one (see figure no. 2 below). In the last 20 years, US stock market capitalization was on average 125% of GDP and the UK was around 103%. This proves the high importance of the UK's capital markets not only inside EU but also worldwide.

The city of London is considered the world's number one financial center within the EU (according to the Global Financial Centers Index 21, which classifies financial centers according to their ability to perform high quality financial activities) and alongside New York dominates the Anglo-Saxon world.

The UK national economy is quite dependent on the demand for financial services in the EU. Also, the EU demand for financial services provided by UK firms currently set up is relatively high and amounts to at least a quarter of total EU27 demand for financial services.

Figure 2. Stock market capitalization to GDP (%) in United States vs United Kingdom



Source: Processing based on Federal Reserve Economic Data

According to TheCity UK 2015/2016, UK is the largest banking center in Europe ($ 9800 billion in total assets in 2015, followed by France with $ 9 billion and $ 8500 billion in Germany), the world's largest exporter of financial services and the insurance industry is the largest in Europe and the third largest in the world.

So these are only some important features of what UK and implicitly city of London mean for capital markets and for the world itself.

4. Future challenges and actions

Even in a Europe facing continuously challenges the core objectives of the CMU would still stand, but maybe they need to be reshaped and adapt to the needs, realities and specificities of the markets.

There are still issues to be addressed and hereby we name a few:

- Cultural factors that can have important effects on the supply and demand side and culture differences that influence investment behavior
- Sometimes opening too much the national markets for cross-border operations can create movements of capital flows from less developed ones (frontier/emerging markets) to more developed ones (more liquid and effectively)
- Proportionality has and will be an issue that not even in the present is totally addressed
- Blending the CMU with a fiscal union as well for long time results (if not investors might migrate to more tax friendly regimes and markets)
- Increase financial education
- Equivalence regime for third countries: more resources needed and monitoring; size and importance of the markets should be considered when granting equivalence

We need to avoid further fragmentation and not to harm the existing markets! In the long run, it will be necessary to provide a strong motivation for the effective functioning of the CMU by strengthening three pillars that rely on each other: the EU single market, clear and proportionate rules, effective supervision.

CMU cannot function effectively as long as the markets in southern Europe are underdeveloped compared to western markets.

Its beneficial effects would manifest itself most clearly, both at national and European level, only in the context of joining the Monetary Union and at achieving a greater degree of convergence.

In the context of the Capital Markets Union, supervision should be carried out on two pillars: a pillar for group supervision and a pillar for the supervision of national entities, with the effect of lowering authorization, supervision and control powers of national authorities.

There is also a need for convergence and cooperation between supervisory authorities to really achieve a European level supervisory.

CMU can be a three folded structure or a three Pillar structure (see figure no. 3 below):

Figure 3. Possible three folded structure of the CMU:

Pillar I
ISSUERS, COMPANIES

Pillar II
LIQUIDITY

Pillar III
RESEARCH & INNOVATION

Source: personal processing based on the discussions taken place during the The Eurofi High Level Seminar 2019, Bucharest

- Pillar I refers to the parts of the market: firms, companies, issuers, the actors in the market and their size, importance, business model define them;
- Pillar II refers to liquidity and its importance in a market as it allows market participants to sell and buy easily. This pillar implies also the need of adequate regulatory and supervision frameworks;
- Pillar III is the future of the CMU as research is needed for companies (or for example SME) to develop new, innovative products to gain competitive advantages.

But the CMU should be integrated globally in order to preserve or enhance the financial stability.

For the next European Commission to be in charge, CMU should still remain a priority, together with the Banking Union so we may be able to speak about free allocation of capital, liquidity, efficiency, better shock absorption and an important point the need for private sector implication.

Also the need of consistency should be tackled with and here some issues can be underlined:

- Improve relationship between home and host countries in order to limit fragmentation
- Review the deposits in the central banks
- Implement a securitization system in the context of CMU and support the growth of equity markets as a major source of mobilization of financial resources

Diversification of the market participants, better investments in terms of horizons, stimulation of pension funds as a mechanism for savings, simplicity in taxation, greener products on the markets are only a few others challenges and priorities to be consider for the next programming period.

Future actions should also reflect the impact of Brexit on financial markets and especially by keeping the continuity of the critical functions inside the EU's capital markets.

5. Conclusions

CMU future actions should comply and have to be designed not only for deepening the markets, creation of jobs and growing the economy (by improving access to financing, increasing and diversifying the sources of funding and making markets work more effectively) but primarily for reaching the others Europe 2020 objectives that need immediate action (**climate change and energy sustainability**, **education** and **fighting poverty and social exclusion)** in order to have in the next 50 years a Europe where our children would be proud to live, a place of harmony and prosperity.

This means that we should not have in mind only methods designed to increase the complexity and opacity of financial products and the risk transfer, but methods to finance projects that sustain the real economy, the real life of Europe citizens.

Stronger integration of the EU capital markets results in more competitive and resilient markets, less costly and ready to offer funding alternative sources for the economy. But we cannot overlook the fact that the financial sector is becoming more and more technology – dependent and for liquid markets we need to be more flexible, proactive and to offer fast response to technological evolution!

In order to have more harmonized markets, even if we speak about financial or capital markets, here including the regulatory part, it seems that cooperation at all levels is needed and integration of capital markets would support economic growth in the long run.

The human being should be in the center of all our actions and endeavors as the final beneficiary of the goods and services resulted. United in diversity!

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