The Euro: The Next Step of CMU

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The Euro: Voices from the Commonwealth
Central Bank of Malta and
Queen Mary University of London
Friday, 13 April 2018

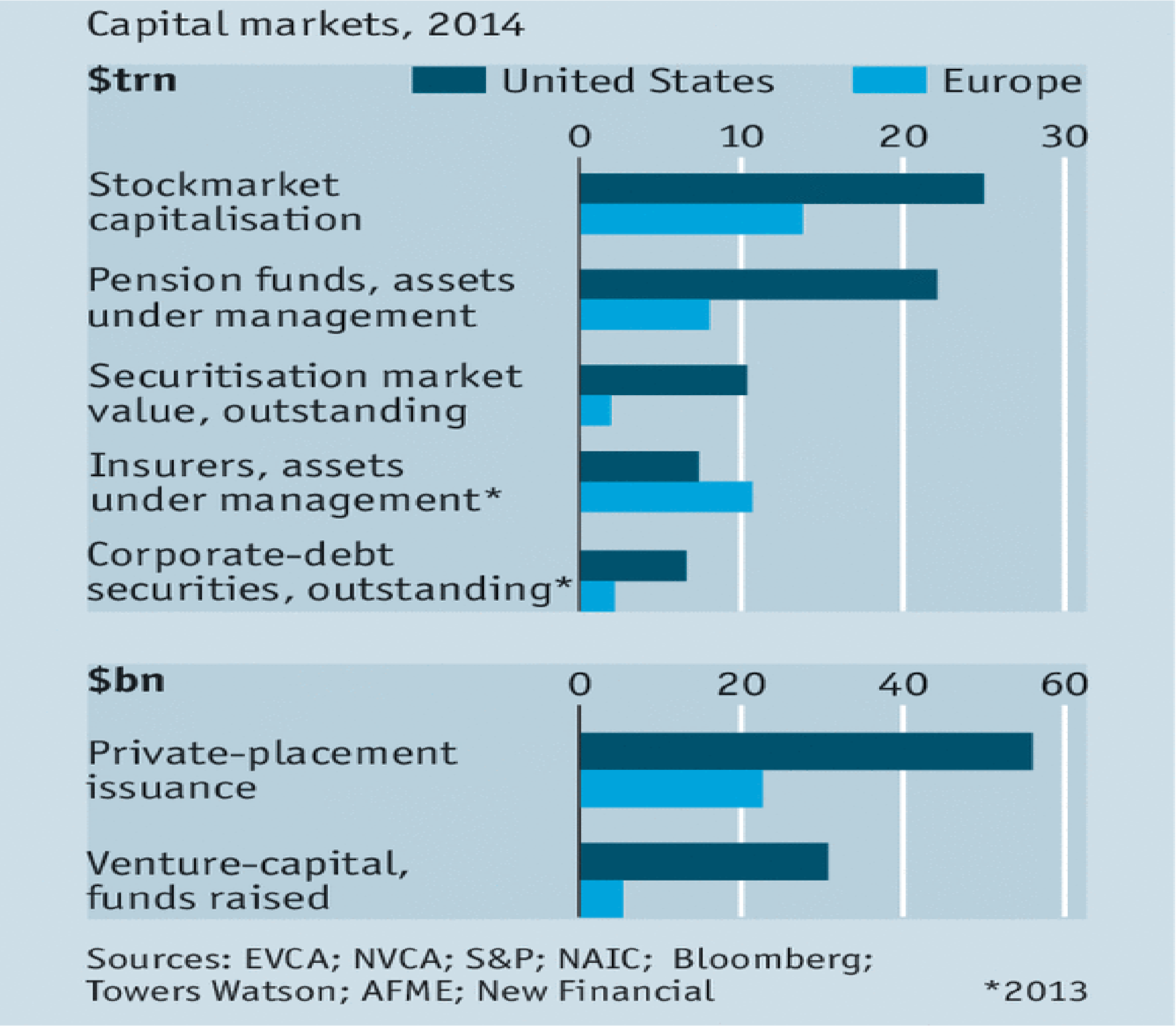
CMU: The Idea

- Likely next milestone in European integration
  - After monetary union (1999), banking union (2014)
  - Less centralized, more nebulous
- Purpose:
  - Develop and integrate European capital markets
  - Aim for a single EU market for capital by 2019
- Process:
  - Gradual, “bottom-up”. No “big bang” legislation. No new EU-level institutions, no single regulatory body.
  - Removing obstacles to the single market one by one

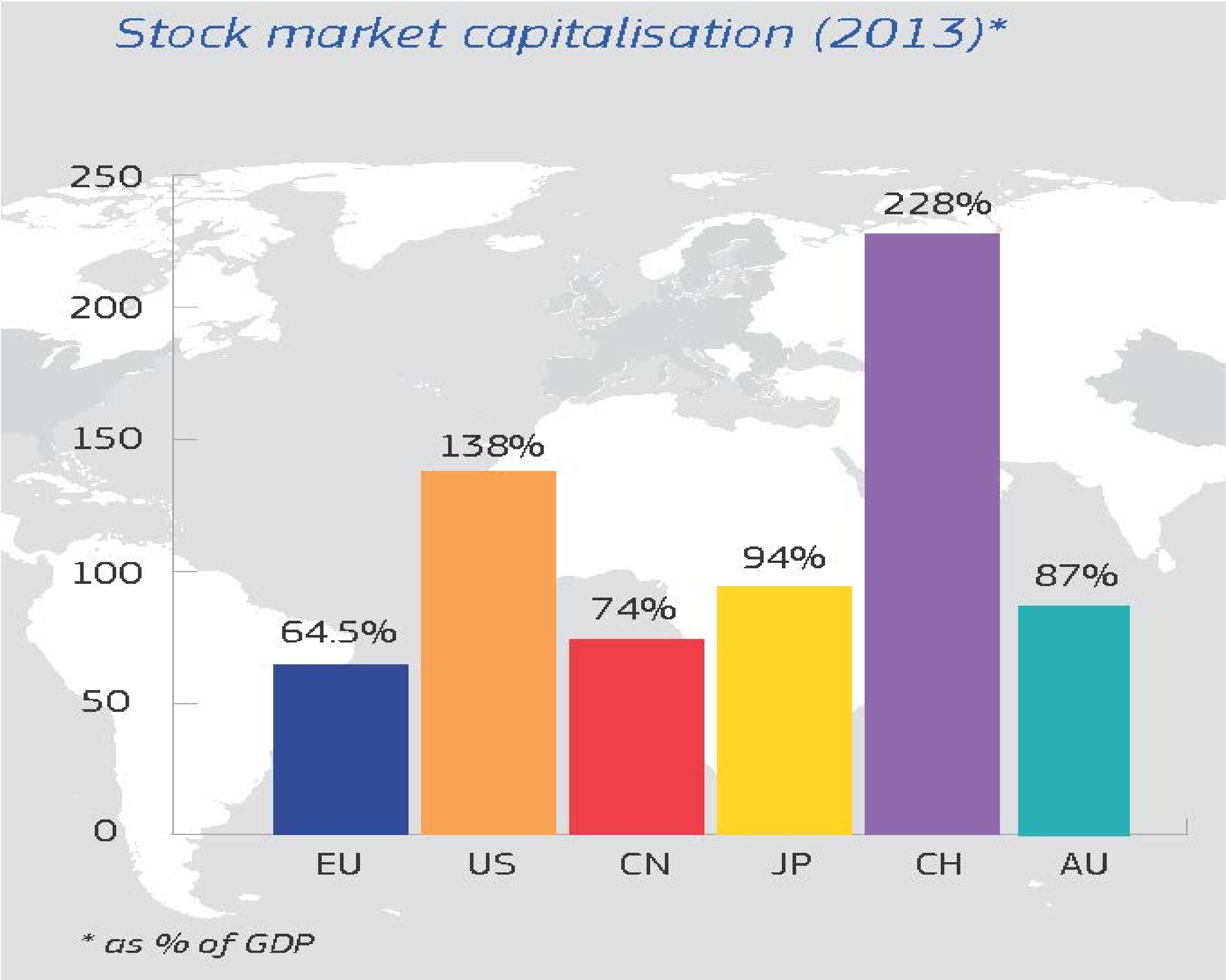
Timeline

- Nov 2014: CMU first announced by the European Commission as part of the "Juncker plan"
- Feb 2015: Green paper
  - Principles, objectives, priorities; launch consultations
- Sep 2015: Action plan
  - Simplify prospectus rules; standardize securitization; ease capital requirements for infrastructure investments by insurance companies
- Apr 2016: First status report
  - Good but slow progress on action plan items
- Jun 2017: Commission midterm review
  - 20 of 33 measures in action plan implemented

Why CMU?

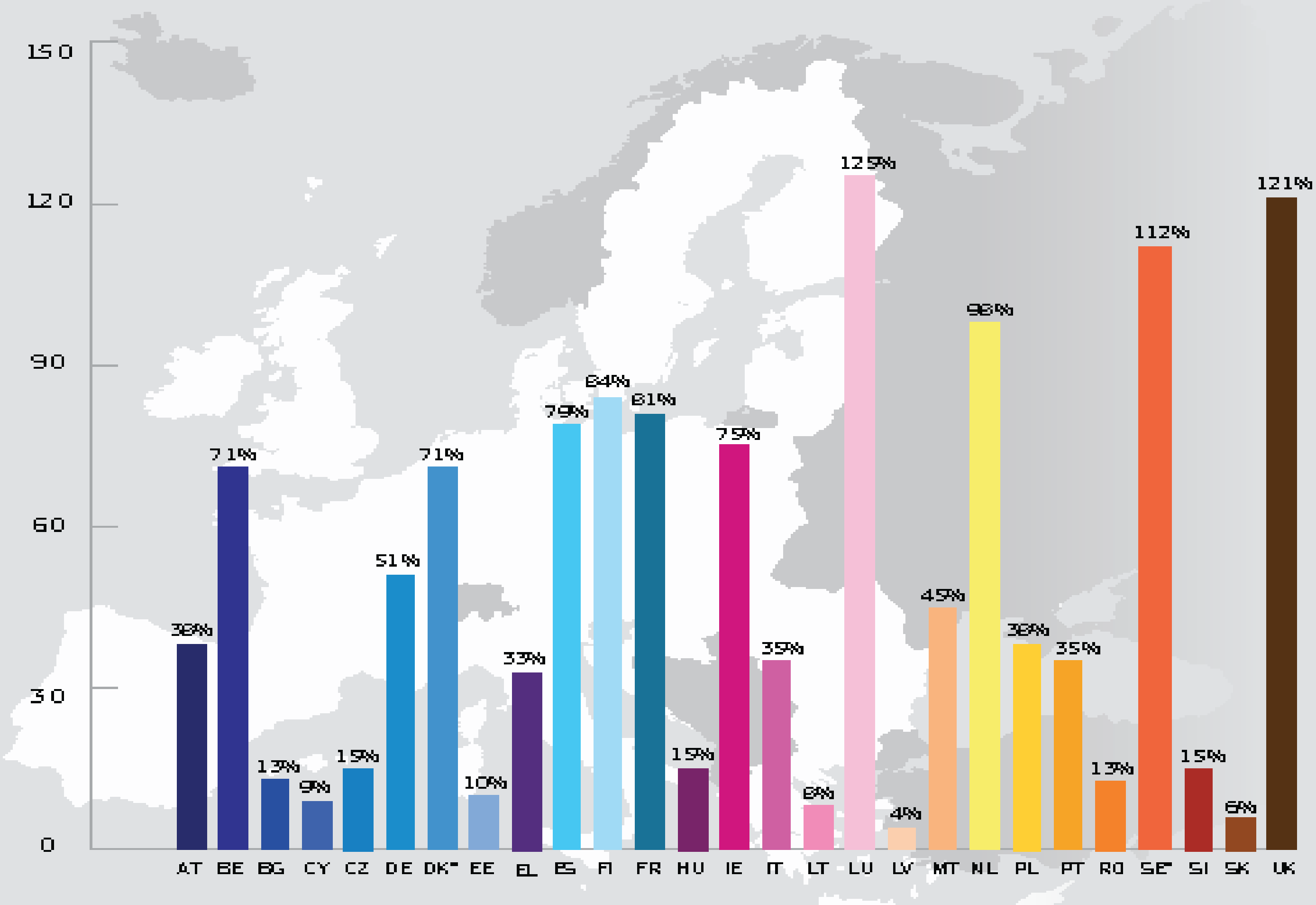


Capital markets, 2014
$trn
United States
Europe
0
10
20
30
Stockmarket capitalisation
Pension funds, assets under management
Securitisation market value, outstanding
Insurers, assets under management*
Corporate-debt securities, outstanding*
$bn
0
20
40
60
Private-placement issuance
Venture-capital, funds raised
Sources: EVCA; NVCA; S&P; NAIC; Bloomberg; Towers Watson; AFME; New Financial
*2013


Stock market capitalisation (2013)*
250
200
150
100
50
0
64.5%
138%
74%
94%
228%
87%
EU
US
CN
JP
CH
AU
* as % of GDP

And the situation in EU Member States varies greatly

*Stock market capitalisation (as % of GDP) in 2013 in each EU28 country (*2012)*



Benefits of More Developed Markets

- Firms:
  - Alternative to banks as a source of financing
  - Increased competition will put pressure on banks to perform better
  - Helps SMEs because of improved securitization of commercial loans

- Households:
  - New investment opportunities
  - Less home bias
  - Attractive risk-return tradeoff

Benefits of More Developed Markets (cont.)

- Society as a whole:
  - More resilient financial system (more cross-sectional risk-sharing)
  - Faster growth (improved capital allocation)
  - Increases venture capital by providing an exit option and this increase allows more innovative firms to be developed

The Plan's Strengths and Weaknesses

- The Dark Side of Capital Markets
  - While they are good for *cross-sectional risk sharing* they are not good for *intertemporal smoothing of risk* (Allen and Gale 1997, 2000-Chapter 6)
  - Long-lived financial institutions such as banks and insurance markets can provide effective intertemporal smoothing provided they are not subject to competition from financial markets

The Plan's Strengths and Weaknesses (cont.)

- The Enforcement of Securities Regulations
  - In the 1930's the U.S. passed a series of securities regulation acts that set up the Securities and Exchange Commission and prohibited a large set of market abuses such as insider trading, manipulation, and so forth.
  - Much of Europe only adopted these kinds of regulations in the 1980's and 1990's and they are still not effectively enforced in many cases
  - E.g. Germany

The Plan's Strengths and Weaknesses (cont.)

- Bottom-Up vs. Top-Down Approach
  - Commission plan is a bottom-up approach that identifies and removes obstacles to the CMU
  - This approach was pushed for by the UK but after Brexit there is much less of a constituency for this
  - A top-down approach with more involvement by EU institutions seems desirable

The Plan's Strengths and Weaknesses (cont.)

- Harmonizing Rules and Standards
  - Good in the long run but not essential in the short run
  - What would be good is to clarify what rules apply in what situation
  - Unequal levels of development probably also not a problem

Challenges to European Capital Markets

- Financial transactions tax
- Low interest rates
- Knowledge and culture
- Political support

Conclusions

- On balance, the strengths of better cross-sectional risk sharing and innovation outweigh the disadvantages

- Need more ambitious program with greater top-down approach

- In particular role of ESMA needs to be expanded