



CMU and It's Backdrop



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ABSTRACT

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SPEECH

The note that we are presenting today quantifies the macroeconomic benefits of CMU and—based on a survey of market participants as well as empirical work—identifies three main obstacles to more capital market integration in Europe: not enough transparency, variable regulatory quality, and divergent insolvency practices. Based on these findings, we lay out a set of actions to directly address these barriers.

My colleague Ashok Bhatia will make the main presentation. But before he does so, let me put our proposal in the broader context of EMU architectural reforms. With this paper on Capital Markets Union the Fund completes its contribution to the discussion of architectural reforms of the EMU in that we have already made proposals for how to



complete the banking union, reform the fiscal rules, and introduce a fiscal stabilization mechanism.

First, a comment on **banking union**. This is an area where impressive progress was made in a short span of time: the SSM shows how much Europe can achieve with some fire under its feet.

But even in this relatively successful area, the proverbial cup is still only half full. Let's recall that the original purpose of banking union was to break the bank-sovereign loop by creating a single European banking market. This goal remains elusive—the fact is that home bias is stronger today than before the crisis because the capital and liquidity costs incurred by banks engaged in cross-border banking is being increased by ring-fencing at the national level.

And, unfortunately, there are good reasons why this is so. The SSM is by construct dependent on national resources and fragmented national rules, which limits its freedom of manoeuvre and in effect diminishes the confidence that national authorities have in it. National authorities, in turn, persist in ring-fencing bank capital and liquidity because they know that when banks fail many of the costs still remain a national burden—they act, quite rationally, to protect themselves by insisting on domestic buffers.

We at the IMF argue that the way to address this conundrum is twofold: to strengthen the SSM's effectiveness by tackling the fragmentation of rules along national lines; and to reduce countries' incentives to ring-fence by improving resolution processes and central backstops.

On the latter, we have repeatedly advocated for a common deposit insurance scheme and a public resolution backstop. I am encouraged by the decision taken last December to designate the ESM as the backstop to the Single Resolution Fund. But there is much less progress on a European deposit insurance scheme—EDIS—which we view as a desirable medium-term objective.

Second, let's consider **fiscal institutional reforms**—the pursuit of simpler fiscal rules to secure better compliance and stricter enforcement as well as structures to permit an element of fiscal risk-sharing.

On the fiscal rules, I need not remind you that the record on SGP compliance has been dismal. It remains to be seen, but the new Commission could prove more receptive to making the rules less complex. We would support this, reminding that our preferred way forward would be to adopt a framework with an expenditure growth rule and a debt anchor.



On fiscal risk-sharing too, progress has been limited. Leaders have backed a euro area budget for convergence and competitiveness, but its size will be small and there is no mandate for macroeconomic stabilization. This falls far short of the countercyclical central fiscal capacity, or CFC, that we proposed last year.

When we wrote our CFC paper, we were fully aware that there are deep concerns about moral hazard, fears that a CFC might be a first step to establishing a transfer union. The fact is, we totally understand the hesitation to embrace more risk-sharing, given how evident it is that the moral hazard concerns are real.

Mindful of this, our main idea was to suggest a solution that would explicitly link stabilization to risk-reduction. We proposed to make access to CFC resources conditional on compliance with the fiscal rules, and we showed that even a relatively small CFC could make a real difference.

Admittedly, our proposal has had very limited traction despite its explicit linking of risk sharing and risk reduction. We knew that it would be a hard-sell to preface our CFC proposal on fiscal rules compliance when the reality we face is so different—with major countries showing open disregard for the rules and the Commission unable to do much about this. But the important thing is that our solution addressed the challenge in an incentive-compatible manner, proposing that fiscal discipline would open the gates to macroeconomically significant central support—only countries that complied with the fiscal rules would be allowed to utilize the CFC.

Regrettably, however, in both the deposit insurance debate and the CFC debate, it has become apparent that the gap is vast between those who push for more risk-sharing and those who insist on more risk-reduction.

I doubt that we will see major architectural changes before there is evidence of a stronger resolve at the national level to overcome the structural problems that give rise to large differences in productivity and public debt levels. This is a personal view and I hope that I am wrong.

In any case, against this backdrop, we decided to approach the CMU project with a strong focus on “actionability.” We focus on a small number of steps that we think are doable without new grand bargains at the political level, in order to try to get the process underway. Ours are not recommendations that require EU summits and communiqués from leaders.

Instead, you will find that our specific recommendations are relatively technical, and very focused on the obstacles we identify. They include introducing centralized, standardized, and ongoing electronic reporting by all issuers; moving to centralized prudential oversight of systemic nonbank actors; taking steps to improve the new portable pension product; setting minimum EU standards for insolvency processes; and so on.



You might say that our proposals are somewhat timid. There is no big and controversial idea—no suggestion, for instance, that there cannot be CMU without a euro area safe asset. This is, as I have explained, by design.

At the same time, we believe that our proposals will make a real difference—that they will be an important step forward.

We are discussing CMU today not only because this was a missing piece in the Fund's contribution to the debate on architecture, but also because it makes sense at this stage to give priority to measures that could facilitate increased private risk-sharing. At a time when we seem far from reaching a political consensus on more public risk-sharing, it makes sense to focus on achieving more **private cross border risk-sharing** through the capital markets.

Here, the comparison is often made with the United States, where strong private risk-sharing means that a much smaller burden of adjustment falls on each individual state in the event of a local shock. In Europe, this stabilization through private risk-sharing is only about one-fourth of what it is in the United States.

The comparison to the United States is indeed a useful illustration of how capital market integration can facilitate the eurozone's robustness to shocks. This being said, it is wise to manage expectations in this regard from the outset: even in a best-case scenario, Europe will not be achieving anything close to a U.S.-style capital market integration anytime soon. Yes, we should set our sights on getting closer to the U.S. position—but, equally, we must know that CMU will be about catch-up, not convergence.

I can identify at least two reasons why European capital markets may never reach U.S. levels of integration.

First, there are economic and cultural factors. Europe's industry structure has a much larger role for SMEs and family-owned businesses in many countries, which favors relationship-based financing through secured bank loans and unlisted equity—which of course means smaller markets for tradable, arm's-length instruments. And language no doubt plays a role too in promoting home bias.

Second, there are political and legal factors. In banking, oversight involves a strong element of *ex ante* prudential guidance. In the capital markets on the other hand, oversight focuses much more on laws, rules, and *ex post* punishment to deter misconduct—and, when issuers run into trouble, insolvency regimes become important.

Yet these areas—crime and punishment, bankruptcy and liquidation—cut to the heart of national sovereignty. Countries may cede control over monetary policy to a shared central



bank, they may harmonize many areas of legislation, but generally they don't cede control over domestic law-and-order or, for that matter, corporate insolvency practice.

This is where Europe is *not* the United States. There is no central European authority vested with powers to arrest persons accused of insider trading or other types of securities fraud. And there is no European bankruptcy code, no Chapter 11 for the EU at large. In fact, I would suggest that the wide heterogeneity of Europe's legal landscape, coupled with the importance of crime and punishment in managing the capital markets, means that CMU will need to retain a strong role for national securities regulators, leveraging local expertise. We at the Fund do favor more harmonization—and stronger supervisory convergence tools for ESMA—but we **do not propose** an SSM for the capital markets.