EU Capital Markets Union: an alluring opportunity or a blind alley? The macro-perspective: CMU and risk-sharing

HANS-HELMUT KOTZ AND DOROTHEA SCHÄFER

Hans-Helmut Kotz, Center for European Studies, Harvard University, Cambridge, MA, SAFE Policy Center, Goethe-Universität, Frankfurt a. M., e-mail: kotz@fas.harvard.edu
Dorothea Schäfer, German Institute for Economic Research DIW Berlin, CeFEO at Jönköping International Business School and CERBE Center for Relationship Banking and Economics, Rom, e-mail: dschaefer@diw.de

Fostering cross-country risk-sharing via capital markets is the central macro objective of the Capital Markets Union. What does this goal imply? In April 2016, ECB Vice President Victor Constâncio[1] argued that,

> *"In theory, in a perfectly integrated world, full risk-sharing [would] be achieved when consumption in regions or countries grows at a constant pace and is insensitive to local fluctuations in income and wealth".*

In other words, individuals, firms or public sector authorities, located in a region or country suffering from a temporary and idiosyncratic economic shock, would be able to compensate the regional output gap (i. e., lack of aggregate demand, increasing unemployment and pressure on wages) via income arising from financial claims on the output of unaffected member states within the monetary union. Likewise, difficulties in access to funds for households or firms in a crisis country would be mitigated as sources in the financial markets of partner countries, unconstrained by the umbilical nexus to 'their' state, are tapped.

Of course, such complete risk-sharing is not achievable; neither in a bank-based nor in a market-based financial system. However, the CMU action plan is expected to enable European Union member states to make substantial steps in this direction. In the light of these high expectations, the question arises: Does the CMU action plan set the appropriate priorities and can it ultimately deliver, that is: Is the risk-sharing potential suggested in the plan realistic?

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1 www.ecb.europa.eu/press/key/date/2016/html/sp160425_1.en.html

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Andreas Breitenfellner and *Helene Schuberth* emphasize that any action for improving overall risk-sharing among European Monetary Union member states must acknowledge the current lack of risk-sharing in sovereign bond markets. In their contribution, "Europe needs more than a Capital Markets Union—focus on the integration of euro area sovereign debt markets," they highlight the importance of setting priorities correctly. They propose that sovereign debt markets are crucial for completing the Economic Monetary Union (EMU). Specifically, they examine design features of EMU that threaten to structurally undermine the stability of the sovereign bond markets as well as, as an unintended consequence, financial stability. Against this background, they discuss improvements resulting from recent governance reforms. Specifically, they assess how European Safe Bonds might contribute to fixing such design failures. They express concern that the current non-integration of the sovereign bond markets threatens the viability of the euro area, amplifying centrifugal forces in critical environments. Their conclusion is straightforward: the integration of the euro area sovereign debt markets is seen as the conditio sine qua non for the success of euro area institutional reforms envisaged, including the CMU project.

Complementary to this analysis, *Jürgen Schaaf* stresses that more developed capital markets in the euro area are neither sufficient nor necessary conditions for the effective conduct of monetary policy. Credibility of the central bank, a well-functioning and flexible operational framework, as well as appropriate, targeted instruments, compatible with the respective financing structures, are more important. However, he also emphasizes that a more efficient pricing and sharing of risks along with less reliance on banking intermediation—more opportunities to access funds and diversify risks—could increase the effectiveness of monetary policy implementation in the euro area. In crisis times, this might also ease operational restrictions, particularly binding at the effective lower bound of interest rates. Schaaf concludes that the indirect benefits from a broader, more diversified (and hence more resilient) set of funding sources, speak in favor of the promotion of the CMU, including from a monetary policy perspective.

Hans-Helmut Kotz, *Willi Semmler* and *Ibrahim Tahri*, in "Capital Markets Union and monetary policy performance: comes financial market variety at a cost?" start from the fact that Europe's financial landscape is characterized by substantial institutional variety, reflecting different societal answers to (or preferences with regard to) trade-offs. Therefore, monetary policy faces a challenging environment, especially in times of financial crises. They document diverging responses to an identical monetary policy impulse, especially between two states of nature (regimes). Crucially, with such heterogeneity, in countries in crisis, monetary policy can become, counter-intentionally, de-stabilizing. They concede that a more homogenous financial infrastructure may mitigate such counterproductive policy effects. However, the authors also stress that convergence must not necessarily be towards a stronger emphasis on capital markets.

Jan Friedrich and *Matthias Thiemann* ("Capital Markets Union: the need for common laws and common supervision") ponder priorities as they are set in the CMU action plan. They focus on stability risks potentially arising in the infrastructure of financial markets, an important (given that this is about the oft neglected plumbing) cornerstone of the CMU project: the role and functioning of Central Clearing Counterparties (CCPs) in clearing and settlement in Europe. Their research suggests that a nationally organized supervision of CCPs necessarily implies substantial opportunities for regulatory arbitrage. This exposes the euro area to a significant financial risk, especially against the context of Brexit. Their analysis leads them to propose a central (Europeanized) capital market supervisor in charge of underwriting the singleness of EA capital markets. Otherwise, a socially detrimental regulatory race-to-the-bottom becomes plausible. In their view, intermittently the ECB could be a suitable central monitor, while, going forward, the European Securities Markets Authority (ESMA) with significantly extended competences should be charged with this supervisory task.

Paolo D'Imperio and *Waltraud Schelkle* explore the potential risk-sharing capacity of capital markets within the EU in their article, "What difference would a Capital Markets Union make for risk-sharing in the EU?" Their empirical analysis raises doubts that market-based risk-sharing can be achieved through the CMU as presently conceived. They provide evidence that (i) cross-border (and intra-regional) financial flows are generally pro-cyclical; (ii) market-based risk-sharing mechanisms tend to break down in times of crises, i. e. when they would be most needed; and (iii) even the most developed capital markets become dysfunctional during a systemic financial crisis. They also emphasize that during the Great Recession, when private markets were essentially loath to risk-sharing, the ECB's TARGET2-system (of cross-border payments settlement) as well as Troika programs provided funds, the latter with strong conditionality. They conclude that for a resilient monetary union, public safety nets must be robust enough to substitute for markets in times of crises. Thus, in terms of risk-sharing within the euro area, they conclude that the CMU is unlikely to make much of a difference.

Hans-Helmut Kotz and *Dorothea Schäfer* assess potential benefits as well as risks of the CMU's core goal of promoting securitisation and subsequent distribution of claims against cash-flows arising from SME loans across the European Union in "Can the Capital Markets Union deliver?". Furthermore, the authors explore consequences as they arise from the CMU's explicit objective of tilting the balance towards a more capital-markets-based financial system (as opposed to bank-oriented one). Given the institutional complementarity between finance and other societal sub-systems, this comes with tensions. For example, in most EU member states a social security systems (in particular pensions and healthcare) are based on pay-as-you-go (defined benefits) principles, funded through "payroll taxes" and managed by public sector institutions as well as underwritten by taxpayers. A stronger emphasis on capital markets would obviously fit better with less pay-as-you-go. This not only implies substantial issues of transition, but also, given the legacy institutions, those issues are different across EU member states. It obviously comes with challenges around corporate governance as well as the level of redistribution. EU member states have answered up to now those questions in a variety of ways. Making these challenges transparent is essential for assessing and improving the intended Capital Markets Union.