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The future of Capital Markets in the European Union :

Towards deeper integration ?

I will try, in my presentation, to give my views on the future of the Capital Markets in the European Union as well as on the role of European Supervisory Authorities (ESAs) in as much as it relates to an improvement of financial markets.

I will organize my thoughts in three sections :

1. The classical arguments in favour of a stronger European Capital Markets.
2. Why, in spite of these strong arguments, has there been so little progress in that field ? I will try to stress here some basic issues that, in my view, have to be understood if we want to move forward.
3. What type of supervisory reforms seems necessary ?

I - The classical arguments in favor of stronger European Capital Markets.

1. The size and liquidity of European Capital Markets are dwarfed by the situation in the US :

- ✓ Banks finance 75% of the European funding and 25% are financed by the markets.

- ✓ In the US it is the reverse.

- ✓ Equity capitalization is 30 trillion $ in the US and only 12 trillion in Europe.

Therefore, wider, more liquid and open European capital markets would facilitate the financing of our economies and allow the increasing development of investment. Growth is still low in the Euro area (see Graph 1) :

2010-2017 Annual growth rates

EUZ	1,2%
USA	2,1%

2. ***The second argument has to do with risk sharing.***

In case of asymetrical external shocks in a Monetary Union, most of the remedies or smoothing comes normally from Capital Markets.

In the US, for example, 80% of shocks are smoothed through :

- ✓ Capital markets flows (for ½)
- ✓ And fiscal stabilizers (for ½)

In the EU only 20% are smoothed, essentially through capital markets (i.e. 4 times less than in the US).

Therefore we cannot underestimate the importance of risk-sharing : through cross ownership of assets and through mobility of savings that can migrate from surplus parts of the Union towards underfunded regions needing of more resources.

This private risk sharing process is a strong argument for greater integration of European Capital markets.

3. ***These arguments lead, logically, to promote remedial actions in order to reduce the existing national fragmentation of financial markets.***

Indeed, the Capital Market Union project is aimed at reducing the national barriers (in the field of insolvency laws, company laws, judicial procedures ….) in order to create a true integrated market that would reduce the impact of country specific shocks and, thus, lower the amount of fiscal risks sharing.

But that reminder of the classical arguments leaves me somewhat uneasy. Given the validity of the rationale, why has so little been achieved ? Are there not more fundamental obstacles ?

II - The structural issues in the background should not be left uncovered.

I see several factors that are holding back progress.

1. Heterogeneity within Europe has increased over the years and a serious macroeconomic set of imbalances has appeared.

- During 2000 to 2010, economic divergence widened in the field of :
  - ✓ Wages
  - ✓ Fiscal deficits
  - ✓ Current account imbalances

- On a structural plane, a monetary union tends to sharpen specialization.

  The leader in terms of productivity growth and high quality brands tends to increase its competitive edge because of exchange rate fixity (and implicit currency depreciation).

- Therefore, economic models and patterns (some based more on services, others on high quality manufactured goods) tend to diverge as well as incomes.

It is fair to say that corrective measures have been taken after 2010 (because of the market sanctions when the sovereign debt crisis erupted).

These measures have reduced the abnormal policy divergencies :

- Income divergencies that flourished between 2000 and 2010 are now reducing.

  Southern members per capita incomes are reducing versus the ones of Northern economies, which is helping convergence.

Fiscal positions in the South are improving significantly. ***(See Graph 2)***

Deficits have shrunk :
2009 = from -14 to -4% GDP
2016 = from - 3% to +4%

- All peripheral countries are now running current account surpluses. ***(See Graph 3)***

But, in spite of these corrective actions, it remains that the current account of the EU shows unsustainable imbalances :

+ 8% GDP in Germany + 10% NL

This is the manifestation of a "fundamental desequilibrium" that calls for corrective measures, in particular in the North.

One cannot ask countries that have achieved balanced current account positions and are regaining fiscal credibility (through large primary surpluses) to be the only ones to adjust by reducing their incomes.

If we refuse a more symetrical adjustment, populism will expand.

2. ***This examination of heterogeneity and imbalances casts a shadow on the Capital Market Union.***

The more fiscal and structural divergencies (high public debt in some countries, high current surpluses in others) tend to get ingrained, the more negative trends creep in the Union.

- ✓ Trust in the willingness and ability of some countries to achieve fiscal discipline erodes and sovereign spreads are always subject to widening ;

- ✓ Therefore national authorities tend to "ring fence" cross border banks in terms of capital and liquidity, thus weakening banks in their capacity to become pan-european players.

- ✓ In a Union where banks account for 75% of the financing of the economy, the non-recognition of pan European banks penalizes the integration of capital markets. If regulators do not feel comfortable with cross-border banks, the latter will not be inclined to finance host countries. We should not forget that without strong cross border banks, there can be no true capital market.

- ✓ Capital mobility (from North to South) does not function and current surpluses are channelled to other parts of the world.

In the present debate between :

Reducing risks
and sharing risks,

this confidence factor tends to focus mainly on reducing risks.

Hence the present insistence on reducing non-performing loans, the reluctance on any form of fiscal stabilization or of mutualizing risks in the form of a Deposit Insurance Scheme.

In my view this extreme polarization on reducing risks is self-defeating.

How can we believe that countries – especially in the South of Europe – that have achieved in a few years a very significant degree of fiscal and current accounts adjustment, can accept to be the only ones to have to further adjust their incomes !

The danger here is that if the debate continues to be skewed, confrontation will become the name of the game.

I will just give an illustration of what I am saying.

Studies have shown that in order to correct the present account imbalances in Europe, there would have to be a readjustment of effective real exchange rates of a sizeable magnitude. In fact, large surplus countries have notional currencies that are "undervalued" by 15 to 20%.

How can we expect – and even argue – that surplus imbalances, increased by such currency misalignments, have to be "protected" by a continuous fall in real revenues in the South ? Populism would flourish on such absurd asymmetrical policies.

My point is not to bail out fiscally imprudent countries.

My point is completely different. A "fundamental disequilibrium" (surplus or deficit) – as we used to call them at the IMF – must be tackled by the country that registers such an imbalance.

Without some form of symetrical adjustment, it is an illusion to believe that a well-functioning capital market will pop up though some legal changes in national legislations.

The issue is deep.

We need to restore confidence in the working of the Economic Union.

It can be done.

We know how an unsustainable current account surplus needs to be addressed.

But it calls for vision and a modicum of courage.

Only then can we usefully address the issue of regulation to which I am coming now.

III - What type of regulatory reforms do we need ?

1. Two major factors are at play.

- ✓ We need to remedy the documented fault lines after six years of ESA experience,
- ✓ We need a common level playing field all the more so because of Brexit.

2. How to strengthen ESAs ?

I have presented to the European Parliament on February 27, 2018 my views on the issue and commented on the reforms proposed by the Commission. I will not repeat all my points today (the text of my testimony is on line).

I will just summarize the subject in the perspective of our discussion.

Two issues stick out :

a) *ESAs have done a remarkable job on regulation but have been less successful on supervision.*

The "common rule book" has made considerable progress thanks to the quality of ESA leadership and to majority voting even if a number of national exceptions or peculiarities are still in place.

However, ESAs have been less successful in coordinating and harmonizing supervision practices and policies among member countries. And this harmonization is of the essence if we want a true common financial market.

So we should emphasize the supervisory aspect of ESAs mission and develop these harmonization responsibilities.

b) *In the accomplishment of their mission, ESAs have to cope with the reality of national views as they are expressed by their Boards. But this should be mitigated.*

Peer pressure, which was supposed to help to transcend national minority views, has often been, in fact, a pressure on ESAs not to move.

So, time has come to reinforce the governance of ESAs :

Several suggestions by the Commission have my full support :

- ✓ Increasing arbitration and investigation powers of the ESAs in different areas (breaches of Union Law, settlement of cross-border disagreements, consistent implementation of EU requirements).

- ✓ I also believe ESAs should have the possibility to conduct direct investigations when infringements of rules are observed.

- ✓ However I am not sure that a fundamental modification of the governance structure of the ESAs is needed. Instead of creating a new body which would add an extra layer to the system and increase complexity, I would suggest to strengthen the independence of the existing Management Board, with the addition for instance of two or three independent members coming from academic and corporate circles, particularly to handle conflicts of interest. Moreover, I would extend the mandate of the Management

Board to issues related to supervisory convergence and possible breaches in the consistent application of EU standards that are only addressed at present by the Board of Supervisors, which may create conflicts of interest in some cases. Indeed peer pressure is very often insufficient for tackling such issues. In the case breaches or disagreements cannot be solved through the improved governance processes of the ESAs, the latter should ultimately have the ability, in cooperation with the EU Commission, to request arbitration from the European Court of Justice.

3. ***My last point on ESAs future concerns direct supervisory powers on cross-border activities.***

This subject has to be considered in relation to Brexit.

The decision by the British people to leave the Union has opened new dimensions :

- ✓ A host of financial institutions that were part of the single financial market are going to become third country cross-border entities ;
- ✓ Handling equivalence is going to be a significant task in which ESAs have, in my view, an obvious competitive edge ;
- ✓ Thus it will be essential for the European Union to dispose – in particular with a strengthened ESMA – of a strong body of regulation and supervision in the field of financial markets.

Increasing the direct supervisory powers of the ESAs and particularly ESMA makes sense in areas where a European approach has a real added value i.e. areas which are highly cross-border and of a wholesale nature, where strong synergies can be achieved at the ESA level and where domestic supervision may, on the contrary, lead to inconsistencies, inefficiencies or regulatory arbitrage. Credit rating agencies and trade depositories which are supervised by ESMA both have these cross-border characteristics. I agree with the EU Commission proposal that some other entities such as data providers and administrators of critical benchmarks could also be directly supervised by ESMA, given these criteria. This is also the case for certain Financial Market Infrastructures that have a strong systemic and cross-border dimension for the whole Union, such as CCPs, which would be best monitored at the EU level. I personally support the proposal recently made for ESMA to play a stronger and direct role in the supervision of EU and third country cross-border CCPs with the support of the central banks concerned, which is consistent with this idea. However I believe that the activities related to the supervision of CCPs would be best performed within the existing governance structure of ESMA and should not require the creation of a new entity within ESMA.

But I have reservations on some proposals that would, in my view, distract ESAs from their essential mission (like charging ESMA to authorize certain types of funds and check prospectuses).

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And last, but not least, what would be the future of post-Brexit ?

I believe the name of the game is cooperation at the European level :

- ✓ Europe – with the UK – is going to remain one of the most important financial markets in the world ;

- ✓ Europe will need a state of the art set of rules and supervising practices ; (as good as the SEC) ;

- ✓ Between the UK and other European countries or regions we will need cooperation – not a battle between the ECB and BoE.

If the European Union handles successfully the devolution to ESAs of the management of interactions with third countries and the on-going monitoring of such activities, we will have shaped its future.

We will have preserved the ability for the ESAs to become the platform of European cooperation with EU financial centers such as the City (and Switzerland) to the mutual benefit of all parties.

A very last word.

I would like to briefly mention the need to review the functioning of the ESRB. The proposals of the EU Commission focus on the management and the governance of the ESRB which are valid topics, however in my view they miss a major point which would be to put the ESRB in a position where it can continuously assess and monitor all vulnerabilities in the EU financial system and notably those related to the monetary policy of the ECB. This would imply in particular reinforcing the independence of the ESRB vis-à-vis the ECB (with the appointment of some eminent experts) and not further integrating it in the functioning of the ECB as is currently proposed (see my previous testimony at the EU Parliament in May 2016).

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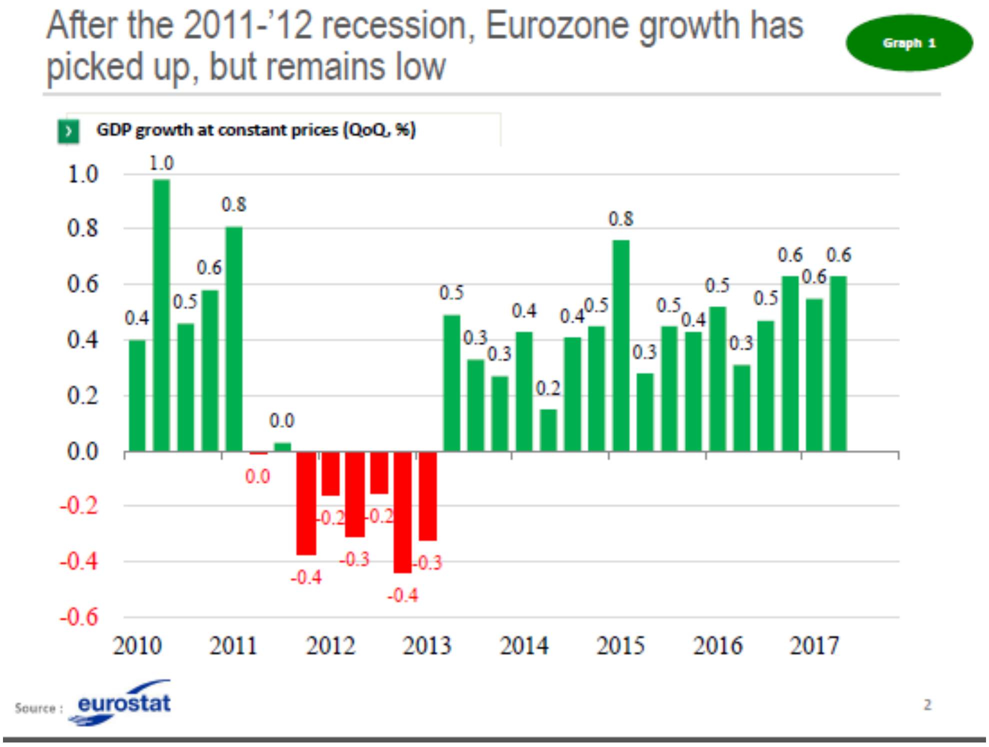
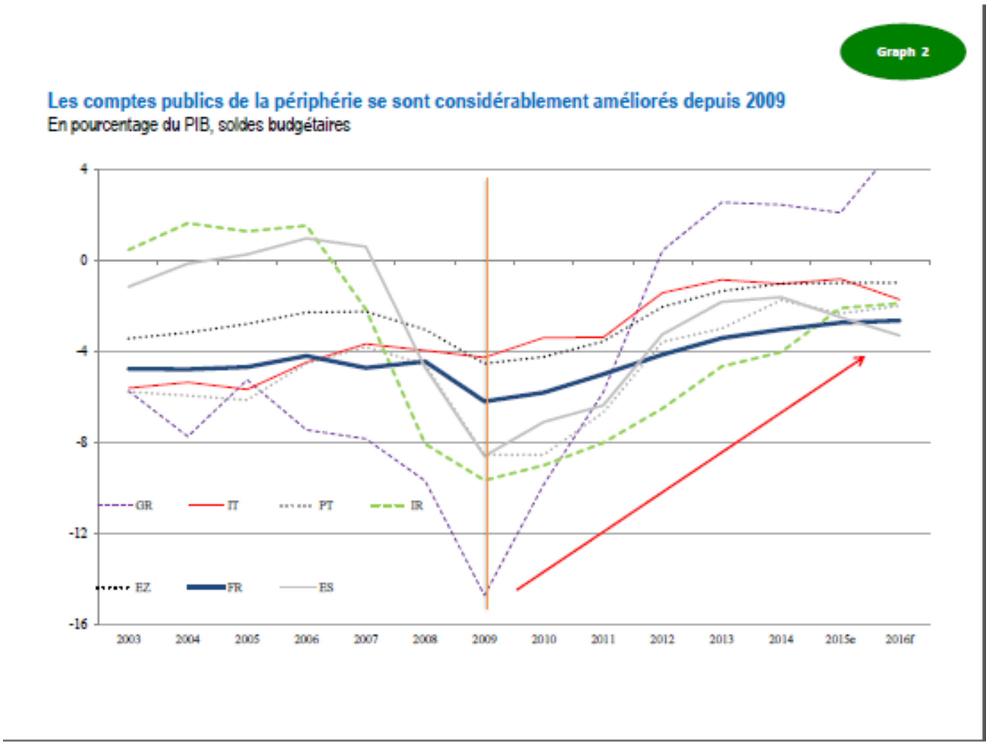
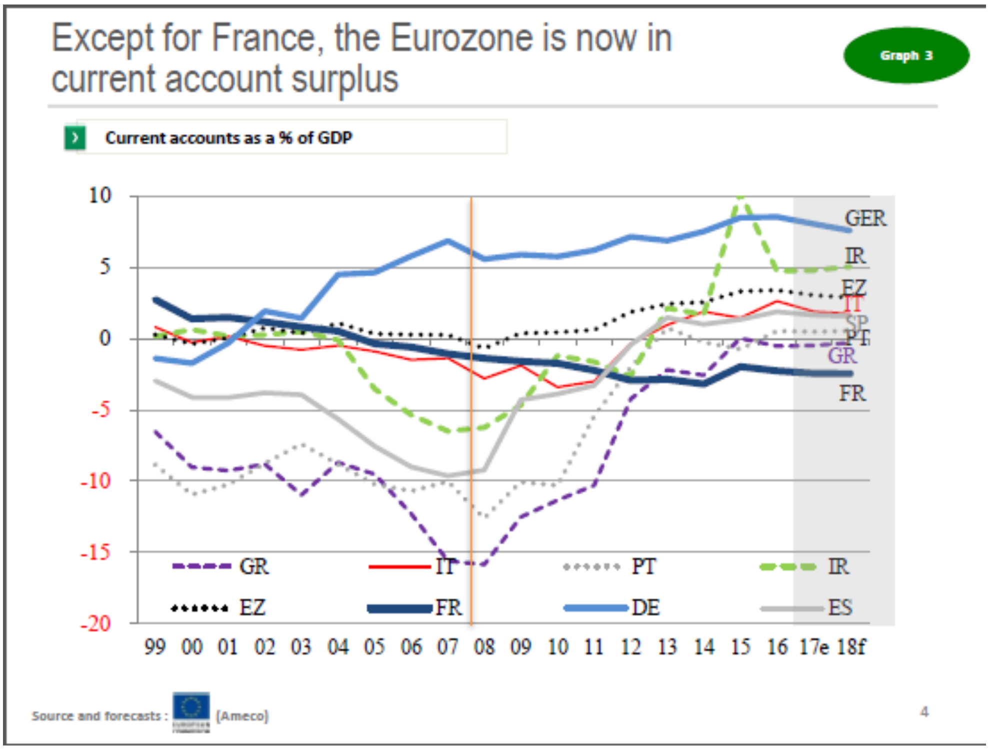
Enc. ANNEX : Three GRAPHS


After the 2011-'12 recession, Eurozone growth has picked up, but remains low
Graph 1
GDP growth at constant prices (QoQ, %)
1.0
0.8
0.6
0.4
0.2
0.0
-0.2
-0.4
-0.6
2010
2011
2012
2013
2014
2015
2016
2017
Source :
eurostat
2


Graph 2
Les comptes publics de la périphérie se sont considérablement améliorés depuis 2009
En pourcentage du PIB, soldes budgétaires
GR
IT
PT
IR
EZ
FR
ES
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015e
2016f



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