## Joint Statement

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# Enhancing EU Capital Markets

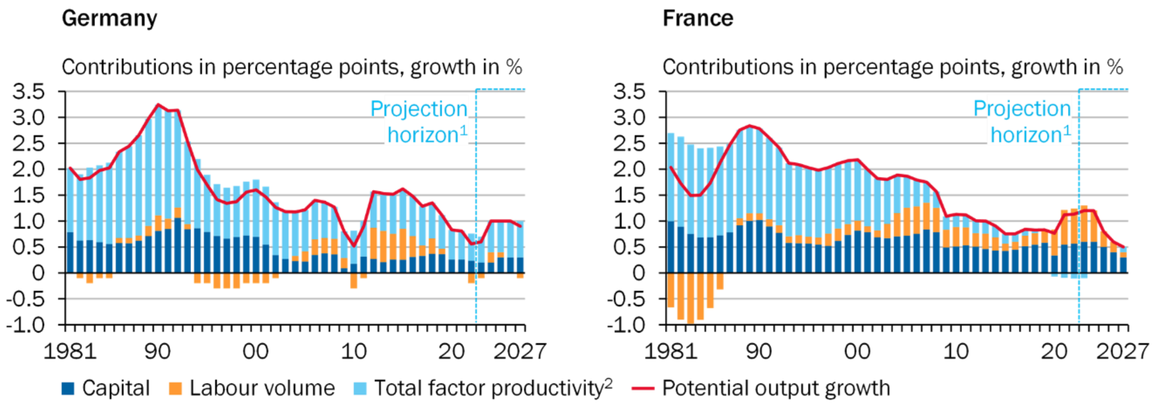
Camille Landais, Nicolas Véron, David Sraer, Monika Schnitzer, Ulrike Malmendier

Like most advanced economies, the EU is suffering from a long-term decline in growth potential. New opportunities like the Green transition or the rise of Artificial Intelligence have emerged, but our capacity to fund the investments and benefit from these opportunities remains uncertain. Recent crises, like the Great Financial Crisis or the Euro sovereign debt crisis of the mid-2010s, have also highlighted the lack of resilience of our economies in the face of financial shocks. We need to build a stronger, deeper capital market to face these challenges. In other words, the time for a Capital Market Union is now.

Deep and liquid capital markets are essential for providing long-term growth. They help allocate capital to the most productive and innovative companies. Market-based financing fosters investment in new, riskier technologies and in research and development. The European financial architecture however is still excessively bank-based and financial flows remain primarily national. Ten years ago, there was a strong push for a Capital Markets Union (CMU), yet with limited progress. We believe now is the time to make use of current momentum to deliver on the capital markets union's potential.

This decade's potential output growth in almost all advanced economies across the EU will lag behind its historical trends according to projections by the European Commission. Specifically, demographic ageing will tighten labour supply and thus depress growth in Germany in the coming years, and with some delay in France. Furthermore, declining growth contributions from total factor productivity (TFP) are particularly worrying, as they point towards a slowdown of technological progress and input factor reallocation to productive enterprises. For instance, in France, TFP contributions to growth are forecasted to fall to zero by 2027, compared to 0.5 - 0.7 percentage points per year in the United States.

**Low potential growth in Germany and France**




1 – From 2023 onwards, projections by the European Commission. 2 – Total factor productivity and human capital.

Sources: European Commission, own calculations

Innovation-driven growth requires strengthening capital markets rather than expanding the banking sector. Capital markets can finance innovative and risky sectors that rely on intangible assets like patents. Venture Capital is particularly well suited to provide start-ups not only with funds, but also with advice, access to networks and monitoring. Deeper capital markets are vital for providing strategically important and future-oriented growth industries and technologies. The financial architecture in the EU however remains very bank-biased, and banking is still essentially domestic with limited cross-border lending. Strengthening capital markets, especially equity markets, would broaden the funding base of firms. Equity markets can provide a “spare tire” in corporate funding in times of crises and improve resilience.

We propose five policy actions for a growth-oriented CMU agenda.

1. Simplifying the valuation of foreign assets would improve cross-border investment opportunities. Bankruptcy codes vary widely across EU countries, making it difficult to assess liquidation values of assets when investing across borders. Improving and harmonising national insolvency regimes in Europe serves several purposes: reduce costs, better reallocate resources to more efficient or innovative companies, encourage cross-border investment and reinforce financial stability. Harmonisation of insolvency laws has the potential to deepen Private Equity markets by establishing larger EU-based funds that invest across borders. Moreover, it may facilitate pan-European securitisation, benefitting smaller countries with smaller asset pools.

   A lack of standardised financial reporting across EU countries makes it difficult for investors to build comparable indicators and value private assets in foreign markets. This especially concerns larger SMEs, for which market finance would be an attractive borrowing source. Extending the existing European Single Access Point (ESAP) initiative to private firms would increase transparency and simplify access. EU member states would need to harmonise reporting requirements for private firms.

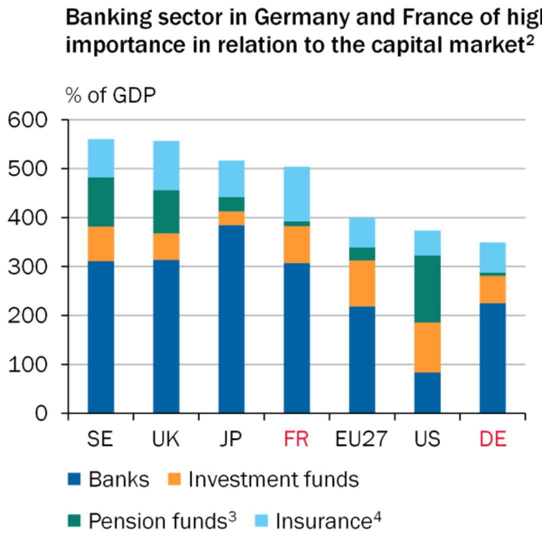
2. The EU should reinforce its supervisory effectiveness and make it conducive to greater market integration by strengthening and reforming the European Securities and Markets Authority (ESMA). Supervisory fragmentation along national lines has emerged as a bigger obstacle to EU capital markets integration than the remaining regulatory differences. Transformative progress can realistically be achieved in this area to catalyse the next steps of the CMU. A reformed ESMA could entail a compact decision-making executive board and funding from a levy on the supervised entities and market segments. The expanded mandate should include supervision of financial market infrastructures that are critical on an EU scale, such as central counterparties and securities depositories, as well as possibly stock exchanges, significant audit firms, and enforcing corporate financial and sustainability-related reporting. Depending on specific mandates, ESMA should be sole supervisor (as it currently is e.g., for rating agencies) or act as decision-making hub for tasks shared with national authorities.

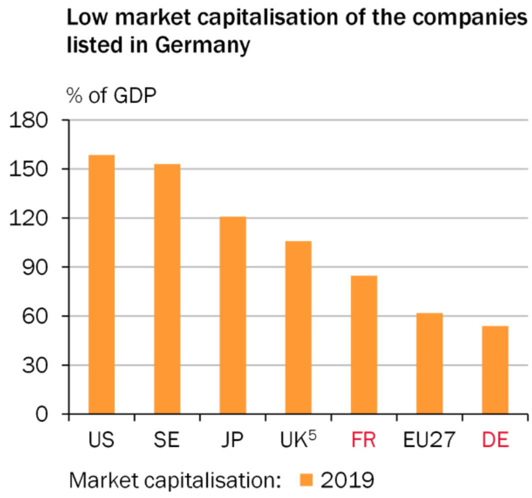
   A multi-location organisational concept with ESMA offices in the main financial centres of the EU, some of which could take an EU-wide lead on specific ESMA mandates, would bring ESMA closer to market participants while reaping the benefits of supervisory integration. It would also help mitigate worries that a stronger ESMA would mechanically result in a comparative advantage for Paris as a wholesale financial centre.

3. EU households have relied on bank deposits to hold their savings, despite the low returns over time. In order to increase capital market participation and build trust in capital markets, we propose implementing EU-funded investment accounts for children. Automatically depositing, for example, 10 € per month and child from age 6 to 18 in the form of a fund share would enable

children to learn from long term investing. They would experience different financial cycles and understand the long-term low risk and high returns of investment in equities. Parents can be given the opportunity to match the savings amount, for example, from their monthly child allowance. A similar scheme was successfully introduced in Israel in 2017.

**France and Germany have small capital and large banking markets**[1]



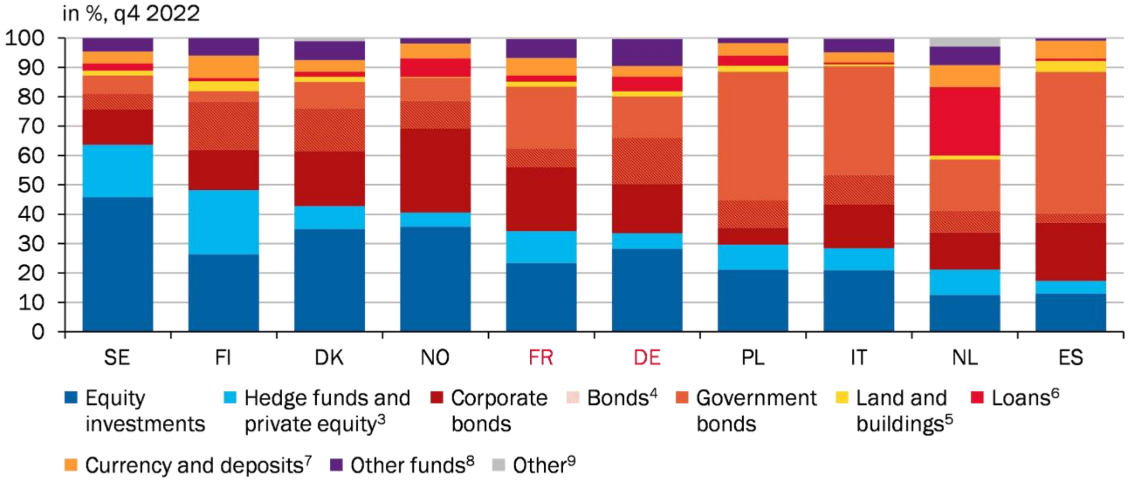

1 – DE-Germany, EU27-European Union, FR-France, JP-Japan, SE-Sweden, UK-United Kingdom, US-USA. 2 – In each case, assets in relation to GDP. Average values from 2010 to 2020. 3 – EU27: Excluding values for Cyprus. 4 – EU27: Excluding values for Luxembourg. 5 – Data for 2018 instead of 2019.

Sources: BoJ, CEIC, ECB, Fed, World Bank, own calculations



4. Institutional investors, such as investment funds, insurance companies and pension funds, typically provide depth and liquidity in capital markets. Private pension funds in both France and Germany are small compared to those in Denmark, the Netherlands or Sweden, reflecting large differences in retirement systems. Insurance companies play a more important role given their larger size. Their asset allocation is tilted towards low-risk sovereign bonds compared to other European countries. This partly reflects their product offering, with a larger share of total liabilities being traditional life insurance products, which provide guarantees to the saver, limiting which asset classes are invested in. Strengthening supplementary funded pensions without guarantees could increase the amount of capital collected by institutional investors and, in turn, invested in equity markets. But equity-averse investment choices of insurers in some European countries are also due to differences in domestic supervisory culture and practices despite all countries sharing the same Solvency II regulation. This in turn could motivate deepening European supervisory integration via a reform of the European Insurance and Occupational Pension Authority (EIOPA).

**Asset allocation of insurance companies differs across European countries sharing the same Solvency II regulation, with many tilted towards low risk bonds[1]**




1 – SE-Sweden, NO-Norway, DK-Denmark, DE-Germany, FI-Finland, FR-France, PL-Poland, IT-Italiy, ES-Spain, NL-Netherlands. 2 – Including equity funds. 3 – Including structured products, asset allocation funds and alternative funds. 4 – Bonds not further broken down. 5 – Including real estate funds. 6 – Including mort-gages. 7 – Includ-ing money market funds. 8 – Infrastructure funds and other funds. 9 – Including collateralised securities.

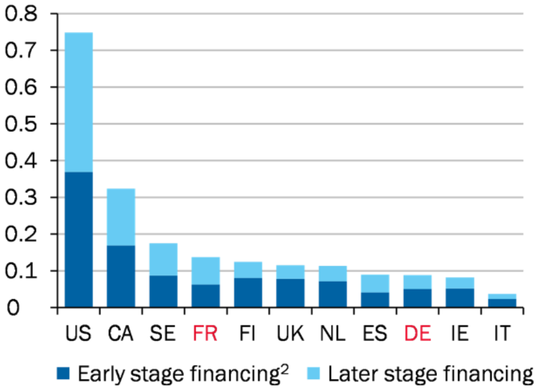
Sources: EIOPA, own calculations


5. While the volume of VC funding available for start-ups has increased, there is still a lack of large institutional investors that can participate in larger-volume late-stage financing rounds. Research has shown a positive association between public and private funding of early-stage start-ups. Increasing government co-financing can help continue to develop this market. This can be achieved by channelling additional funds to the European Investment Fund (EIF). Such a pan-European initiative could pool funds from multiple member states to strengthen large-volume financing rounds for growth-oriented start-ups from European investment funds. In terms of governance, indirect investment via funds (Limited Partner) should be preferred to direct investment.

**Venture Capital funding still severely lags behind in Europe, especially for late-stage funding**

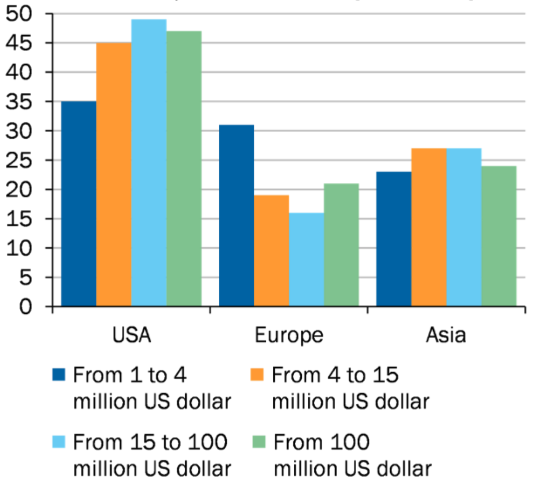
**Venture Capital financing stronger in North America compared to Europe**[1]

Share of GDP in 2022 in %




**European companies realise large financing rounds comparatively rarely**

Share in the period from 2000Q1 to 2023Q3 in %[3]




1 – US-USA, CA-Canada, SE-Sweden, FR-France, FI-Finland, UK-United Kingdom, NL-Netherlands, ES-Spain, DE-Germany, IE-Ireland, IT-Italy. 2 – Including seed, start-up and early stage. 3 – Share of global deal volume in the period by target region. The difference to 100 % is distributed across the rest of the world.

Sources: Dealroom.co (2023), OECD