Europe needs a Financing Union for Investment and Innovation

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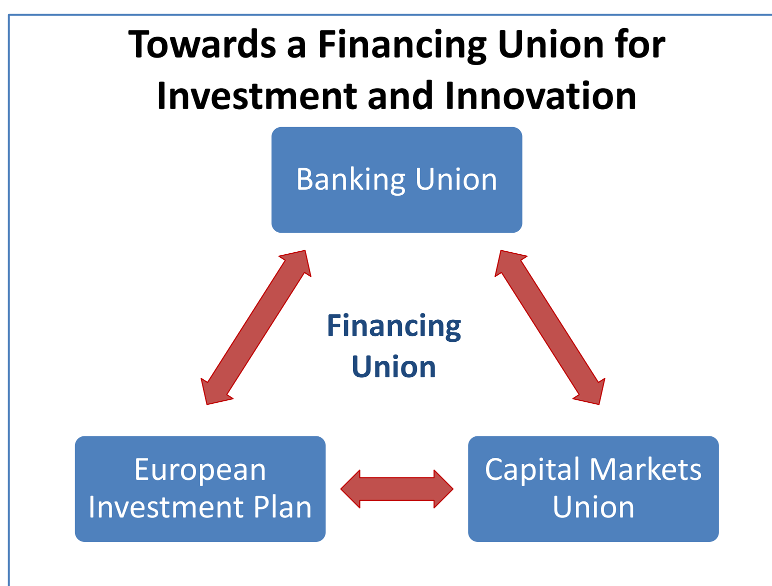
Deeper financial integration through capital markets can support European growth and resilience to shocks by spurring cross-border equity investment. Completing the banking union requires parallel progress in credit risk reduction and risk-sharing, while keeping systemic risks in check. These priorities should be seen as part of the same agenda and are all the more critical in a post-Brexit EU.



Brexit notwithstanding, the European project is gathering political momentum. In that context, Banque de France has highlighted the benefits of pursuing a collective "growth triangle" strategy by combining three levers: national structural reforms; the euro area policy-mix; and a genuine financing union (F. Villeroy, 2017). While deeper governance reforms may take time, there is much to gain from swiftly improving financial integration with a shared purpose: investment and innovation. Clearly laying out these objectives is necessary to make the link with jobs and welfare gains for European citizens. Coordinating energies behind an ambitious agenda would help obtain broader political support within the euro area (EA), the focus of this post.

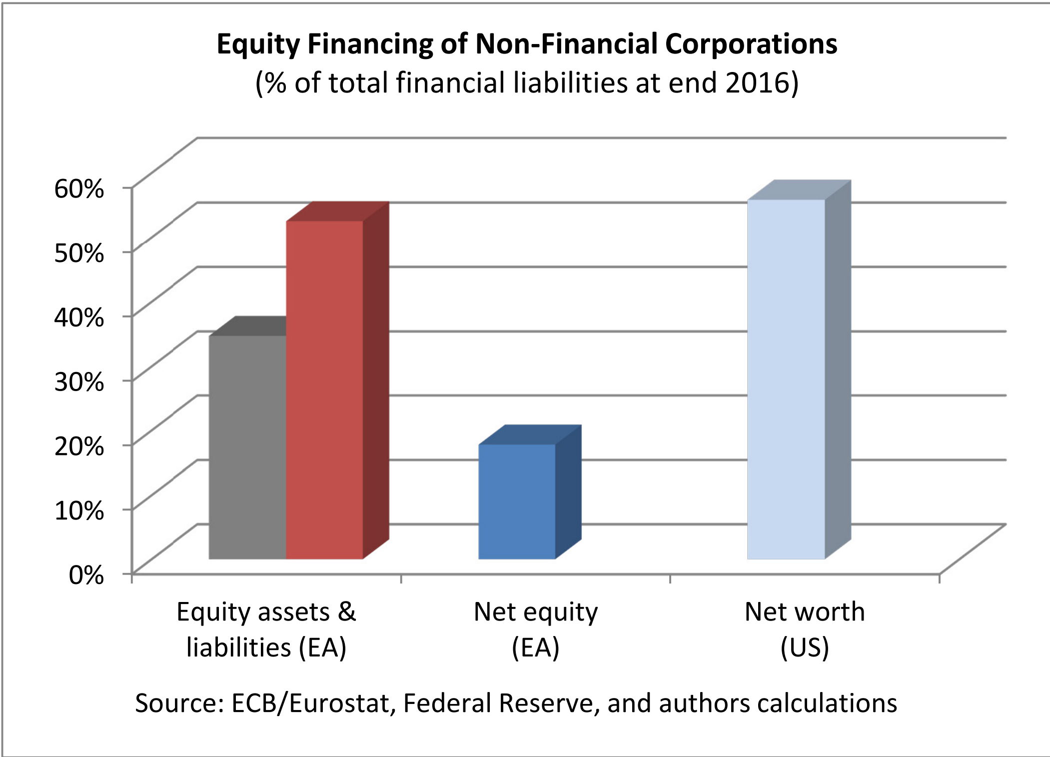
Aggregate EA savings largely exceed total investment

In spite of the recent pick-up in the EA growth, the protracted post-crisis weakness in activity has left aggregate savings largely in excess of investment, to the tune of around 350 bn euros per year (more than 3 % of EA GDP). The picture varies across countries and sectors, but total investment (public and private), at around 20 % of GDP for the EA as a whole,

remains well below its pre-crisis levels. Importantly, non-financial corporations in aggregate have turned from net borrowers to net lenders.

Meanwhile, gross corporate financing sources continue to be largely dominated by debt, especially bank credit; and financial fragmentation along national borders persists. This intermediation channel may correspond to savers' home bias, preference for safety, and the bank relationship model; but insufficient equity financing is detrimental to innovative investment and private risk sharing. Innovation financing is indeed riskier than run-of-the-mill investment. Most innovative businesses can't generate regular cash-flows in the first stage of their development. Equity financing, where investors expect an upswing in the net value of the firm over the medium run, is therefore an efficient way of funding businesses in the early stage of the innovation cycle. While equity financing accounts for around half of non-financial corporations liabilities in the euro area, in net terms it is much smaller, compared in particular to the net worth of US firms.

The reviews of the European Venture Capital Funds Regulation (EuVECA) and European Social Entrepreneurship Funds (EuSEf) provided in the Capital Market Union action plan are a necessary first step, but much more would be needed both at the national and Euro Area levels for the European economy to come closer to the US as far as equity financing is concerned.



Asymmetric shocks across Europe would be better smoothed, and balance of payment crisis risk reduced with more active cross-border ownership of equity capital (see for example Garnier, 2014). Besides, the recent developments in banking regulation call for a more

diversified financing mix of European economies where market-based financing is needed as a complement to bank-intermediated financing.

When aggregate investment falls short of abundant savings, with large cross-country discrepancies, and savings remains dominated by risk aversion there is scope to better channel financing capacity towards investment needs across Europe for the benefit of long term growth. This should unlock more financing for SMEs, the energy transition, and the development of the digital economy.

Efforts are underway to enhance financial integration

Following up on the 2015 Five presidents' report, the European Commission's Reflection paper on the deepening of the EMU rightly called last Spring for further steps toward a financial union, encompassing the completion of the Banking Union as well as the Capital Markets Union (CMU).

Completion of the Banking Union remains a priority, as set out in the roadmap agreed in 2016 under the Dutch presidency of the EU, although progress has been slow.

In the context of the Juncker plan's aim to create an investment friendly environment, the objective of the CMU to achieve a diversification of the financing mix for the real economy towards more market-based financing is equally desirable. The consultation conducted by the Commission on the occasion of the mid-term review of the CMU has helped broaden its ambition and renew its impetus.

The reinforcement and expansion of the European Fund for Strategic Investment will also contribute to financing and mobilizing private capital for risky and innovative projects, including by smaller companies.

Predicated on the same objectives of free flow of liquidity and capital to ensure smooth financing of European growth, enhanced integration of capital markets must be seen as a complement to the Banking Union. Within a strong Banking Union framework, EA banks will be in a position to initiate cross-border consolidations on a sound and safe basis and thereby contribute to reducing financial fragmentation. Jointly deepening the Banking Union *and* the Capital Markets Union, while extending the European Investment Plan, will allow a better overall allocation of savings in Europe and a more effective financing of the real economy.

An ambitious agenda that requires effective coordination

Progress towards a Financing Union for Investment and Innovation requires fleshing out proposals in some key areas that all have to do with financial *risks*: the financing union needs to further address credit risk reduction and risk-sharing, equity risk taking and risk distribution, as well as systemic risk control. Progress requires finding the right balance between varying degrees of risk culture across member states and institutions.

Accordingly, the remaining policy work must focus on the following:

- ***Parallel progress on risk reduction and risk sharing is needed to complete the Banking Union.*** As a priority, this means finalizing the resolution pillar of the Banking union by advancing work on the common fiscal backstop to the Single Resolution Fund. Further risk reduction measures include dealing with NPLs, harmonizing insolvency regimes for businesses, and ensuring the availability of safe assets. Encouraging the emergence of genuinely pan-European banking groups is also key.
- ***Cross-border equity risk taking needs to be fostered by reviewing incentives***, in particular with respect to taxation and regulation regimes. Further convergence and transparency in accounting standards should also be promoted.
- ***Adequate distribution of risks also requires addressing intermediation failures***. This means deploying new pan-European savings instruments (e.g. pension products), and supporting market initiatives notably in green finance, and private placement. Fostering standardized information will facilitate equity investment as well as financing of SMEs. Venture-capital in particular, on a European scale, is also critical for the development of the digital economy.
- ***Yet vital financial activities and risks for European economies need to be properly controlled.*** This is especially the case for euro-denominated clearing activities that are systemically important for the euro area.

The various existing work streams have sometimes lacked impetus, because of disagreements between countries, and institutions, on priorities and pace. The banking and capital market building blocks should not be seen as an end in themselves, but rather as part of an integrated ambition for investment and growth, to which the European Fund for Strategic Investment is also providing support. A comprehensive approach would foster synergies between existing initiatives, across different institutions and various sources of European funding, while ensuring consistency of European Union policies.

With entities involved as diverse as – among others – various DGs of the Commission and the European Investment Bank (EIB), not to mention the crisis resolution role of the European Stability Mechanism, a more integrated method does raise the question of the overall steering of the project, in order to ensure effective coordination between institutions and their services. This could mean endowing a future euro area Finance Minister with competencies regarding financial services.