TOWARDS THE CAPITAL MARKET UNION

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Abstract: *This paper discusses the main characteristics of the proposed Capital Markets Union in Europe, as they are introduced by the European Commission and various authors, and emphasises some important advantages and disadvantages of this project for the developing and frontier markets in UE, especially for Romania.*

Key-words: capital markets, developing and frontier markets, convergence, access to finance, volatility

JEL Classification: F36, G15, G18

1. Introduction

The Capital Markets Union is a European Commission draft designed to facilitate the increase of the scale of capital markets and a better level of integration at the level of the entire European Union. This draft is a key component of the Investment Plan - one of the priorities of the agenda of the European Commission under the chairmanship of Mr. Jean-Claude Junker, which comes in response to the difficult economic situation in Europe also determined by the significant decrease in investments (eg. the gross formation of capital). Thus, while GDP and private consumption in the EU were in the second half of 2014 at levels close to those of 2007, the investments were approximately 15% below the level of the same year, and in some countries the decline was even stronger (source: Eurostat).

The document whereby the European Commission proposed operating principles of the Capital Markets Union ("Green Paper - Creating a union of capital markets") was published in order to initiate a debate at the EU level regarding the difficulties and possible short-term, medium and long term actions with the goal of developing capital markets (liquidity, capitalization, lower costs, higher transparency, better access to the market etc.) and especially the diversification of financing solutions for European companies, and the decrease of the cost of capital, especially for small and medium enterprises. The indirect effect of these should consist in economic growth and implicitly in creating new jobs.

During February 18 to May 13, 2015, the European Commission conducted a public consultation on this document, attended and with views expressed by 422 individuals and entities working or related to the capital market. Following the outcome of this consultation, the European Commission will adopt in the third quarter of 2015 an Action Plan on the necessary steps and timetable until 2019 for the main pillars of the Capital Markets Union.

2. Main features of the Capital Markets Union draft

The principles underlying the Markets Union draft are:

- Increasing the benefits that the capital market generates in the economy (sustainable economic growth and creating new jobs);
- Establishing a single capital market for all 28 Member States by lifting all currently existing barriers to the free movement of capital and cross-border investments in the European Union;
- Strengthening the financial stability in the European Union through effective and uniform application of a single regulatory framework for financial services;
- Investors protection;
- Enhancing the competitiveness of EU companies and facilitating the attraction of investments from outside the EU.

The objectives of the Capital Markets Union are:

- Developing and reducing fragmentation of capital markets in the EU;
- Increasing the contribution of capital market to the financing of European companies and reducing the dependence on bank lending;
- Improving the access to financing for companies, especially for small and medium enterprises (which have a significant weight in the formation of the gross domestic product and provide a significant number of jobs), and last but not least;
- Facilitating the movement of capitals and reducing financing costs.

In the short term, from an operational perspective the draft aims at:

- Smplifying and reducing the number of procedures for drafting the public offer prospectuses (amending Directive 71/2003 / EC on the prospectus)
- Stimulating the creation of high-quality securitized financial products, by setting high standards on processes, legal predictability and comparability between securitization instruments through a higher degree of standardization of products,
- Proposing uniform criteria regarding the credit risk (creditworthiness) of small and medium enterprises,
- Fcilitating long-term investments by European specialized investment funds (ELTIF)
- Facilitating private investments by clarifying the legal and supervisory regime thereof.

It is important to consider that Romania will hold the European Council Presidency during the period when it is estimated that the implementation of the main pillars of this draft is to be completed (2019).

3. Advantages and disadvantages of the Capital Markets Union Draft for frontier markets and emerging markets in the EU

After the onset of the global financial crisis (2007), European capital markets (like many markets from other geographic regions) showed a decline in terms of liquidity (eg. the average daily value traded) and have become increasingly fragmented (instruments traded simultaneously in multiple trading places, poorer operation of interconnections, increase in the number of deposit certificates, certificates of interest, etc.). A consequence is that the access to financing through the capital markets has deteriorated in general and often companies in countries at the periphery of the euro area or outside it incur funding costs higher than other companies with a similar scope, risk profile and activity operating in a developed country within the monetary union. Therefore, the fragmentation of markets slows

down the real convergence and recovery pace after an economic crisis. From this perspective, a union of capital markets would be an important asset for the economic development of Member States and for reducing disparities between countries.

Beyond this major advantage mentioned above, there are many difficulties regarding the operation of such a union, mostly coming from the differences between countries in terms of the development of the markets, the regulatory environment, economic efficiency, governance, tax system etc.

Thus, we can identify at least the following challenges at the level of all 28 member states of the European Union which would be potential candidates for inclusion in the Capital Markets Union:

- Significant differences between Members States regarding access to funding and the cost of funding
- Different rules and practices regarding the operation of markets (eg. Post-trading infrastructure) and of instruments traded (eg. private placements, securitized products, derivatives)
- Different access, sometimes difficult, of investors to financial information necessary for decisions
- Preference for investments in local assets ("home bias"), both of retail investors and of institutional ones (eg. massive share of local government securities in the portfolios of banks, insurance companies, investment and pension funds)
- Major differences (still) between the national legal systems (eg. Commercial Companies law, insolvency and bankruptcy law) and in particular regarding the degree of enforcement of law and surveillance (and control) powers of national financial authorities
- large differences regarding the degree of implementation of governance principles
- different tax systems.

Without a harmonization of tax provisions and without a single fiscal authority for all Member States, the Capital Markets Union as the Banking Union will operate with difficulty and will probably not produce the expected results.

The Capital Markets Union cannot operate effectively as long as southern European markets are underdeveloped as compared to Western markets. Its beneficial effects would manifest most clearly, both at national and European level only in the context of accession to the Monetary Union and of achievement of a higher degree of convergence. Otherwise, the economic and financial shocks will be felt more intensely than in the case of non-participation in such a union. Contrary to the objectives and expectations, the Capital Markets Union could generate advantages for investments precisely in developed countries, rather than in the countries at the periphery of the European economy.

One of the effects of Capital Markets Union Draft implementation will be likely the continuance of the trend of over-regulation in this sector of the financial market which could generate additional costs for intermediaries and issuers ("Regulatory Tsunami").

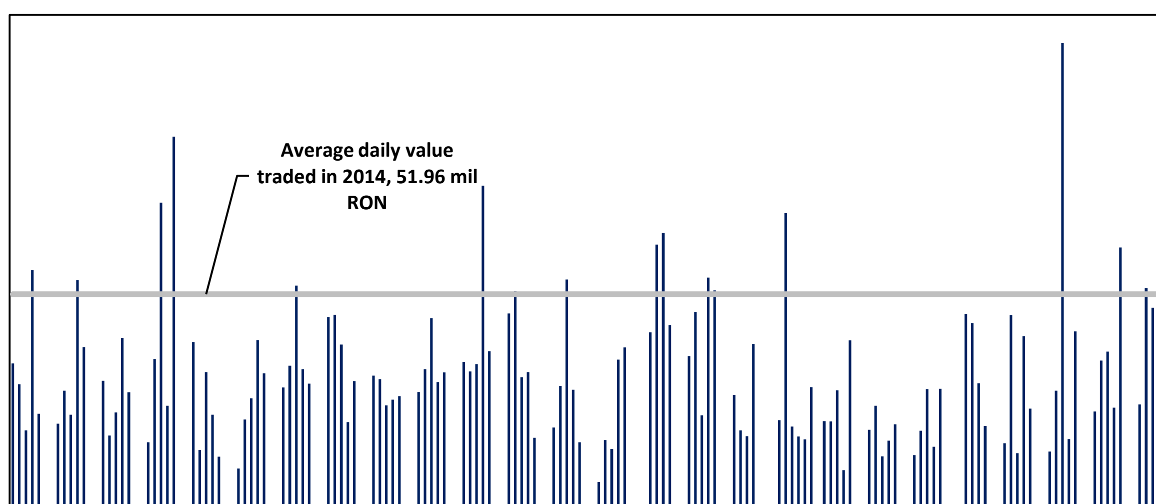
In the context of Capital Markets Union, the supervision should be carried out on two pillars: a pillar for the supervision of groups and a pillar for the supervision of national entities, with the effect of lowering the powers of authorization, supervision and control held by national authorities.

Most of the items listed above are found and are sent by respondents within the public communication.

4. The capital market in Romania and the impact it could have the Capital Markets Union draft on it

The capital market in Romania experienced a significant increase in the years 2010-2013 due to new listings of SOEs and to the positive international conjuncture. The growth manifested in almost all sections: liquidity and capitalization indexes developments. The period 2014-present, however, was one of stagnation, although the general European context remained relatively favourable. The negative developments have occurred mostly in terms of liquidity. The graph below shows that during 2015 almost in most trading sessions at BSE the transaction value was lower than the daily average for the year 2014.

Fig.1 The evolution of daily value traded in 2015 vs. the daily average for the year 2014



Source: BSE, own calculation

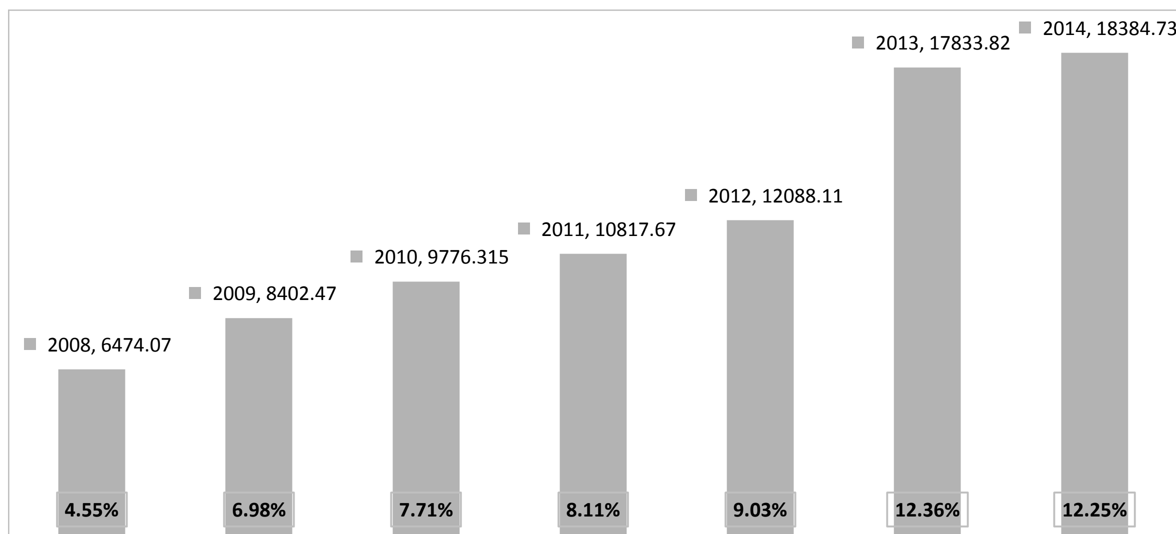
The graph below shows the significant progress made by the Romanian capital market in the period since the onset of the global financial crisis and the flattened tendency during 2014 and the first half of 2015. Even in the context of this accelerated growth, the size of the capital market related to the Romanian economy scale remained at least modest.

The accession to the Capital Markets Union of small countries in course development, which are not yet part of the eurozone, or of the Banking Union could create and exacerbate structural weaknesses. Ideally, the accession to such a market should take place after the moment when a more consistent stage of real convergence process is traversed and not very long before the time taken for joining the eurozone. If Romania joins the Capital Markets Union before achieving this, then the volatility of capital flows could be difficult to control and could be transmitted over the exchange rate volatility, it could create distortions in the financing of the economy and in maintaining external balances (eg. a low current account deficit).

As shown in the experience of countries participating in the Monetary Union, the accession to such a pan-European construction must be done when our economy / the degree of development and competitiveness / the stage of real convergence allow it. Otherwise, the economy of a State that joined the Union without being sufficiently prepared may suffer for many years. In case of Romania, a membership at a time when the economy and capital

markets are still insufficiently prepared could place it in a situation where subsequently it should seek and negotiate waivers and deferrals during the implementation of various measures of harmonization.

Fig.2 Romanian stock market capitalization (mld. RON) related to GDP(%) from 2008-2014



source: Eurostat, the European Federation of Stock Exchanges, own calculations

It is very difficult to make an economic, objective quantification of the effects of accession. Most often, the debate goes towards the strategic policy area, because the effect of integration (positive or negative) cannot be estimated in cash.

The question is whether a European authority (in this case ESMA - European Securities Market Authority) could be a more efficient supervisor than a national authority (in the case of Romania - FSA). From the experience of the Monetary Union and of the Bank Union it was proved, at least so far, that ECB has not been a more powerful a supervisor: the effects of the crisis on euro area banks were generally stronger than those Romanian banks had experienced (of course history, the level of development and sophistication and their situation before the crisis are probably much different therefore such a comparison is interpretable.

Even so, it is quite plausible that a pan-European supervisor will have to establish a unified policy starting more likely from the needs of the big markets or from European priorities and be less concerned with the specific needs of the small emerging markets. However, local economic realities are often different from general ones or from the European average. Therefore a local supervisor may take measures / specific actions more effective in tackling local problems.

For example it is unlikely for the future supervisory authority of such a Capital Markets Union (whether it will be ESMA or another) to be more interested in the specific conditions from Romania than from Germany, France etc. Therefore it will be more tempted to take measures to correct problems in large markets than have policies focused on solving the problems and vulnerabilities on the Romanian market.

So, whenever the issues of the emerging markets are going to be different from those of mature markets (and this often happens), probably they will be insufficiently addressed by the policies of the pan-European supervisory authority, so they will remain largely unresolved and will worsen.

For example, Europe is super-financialized, according to a report issued in 2014 by the European Committee for Systemic Risk and the latest statistics show an increasing trend in the parallel banking sector ("shadow banking") in Europe. Romania, on the other hand, is significantly sub-financialized. So, Europe represented by the mature markets needs policies to reduce / temper the scale of the financial system (it is about the size of the institutions, not about the amount of funding which obviously has declined in recent years and is at an insufficient level) while in Romania the situation is completely reversed. What will choose the supervisory authority of the Capital Markets Union in order to pursue its policies? Most likely these policies will be aimed at a reduction of the size of institutions and of the complexity thereof, while in Romania we need a development policy.

In case of Romania, as for all EU countries who are also members of the Monetary Union, the eventual membership in the Capital Markets Union without a firm and feasible timetable for joining the euro area is very difficult and could create internal tensions (eg. the risk geneated by cross-border transactions, by holding securities in foreign currency etc.)

As mentioned, before the establishment of the Capital Markets Union, probably at the level of the Member States of the European Union topics such as: harmonization of the charging system and harmonization of legislation on establishment and operation of companies should be clarified and addressed. This uniformity may sometimes be disadvantageous to Romania due to the current lower level of economic development: there are prerequisites in order for the tax level to rise after the harmonization process.

Another positive effect for Romania of the Capital Markets Union foundation could be the reduction of the fragmentation of financial markets and the support of the funding offer for SMEs and for long-term investment projects. The single capital market may increase investors' confidence in the economy and reduce the cost of financing of the economy.

Other possible benefits to Romania are:

- easier access of Romanian companies, including SMEs, to foreign capital, so a potential for faster growth;
- increasing investors’ confidence and possibly reducing the cost of funding in the context in which BSE is still classified by MSCI and Standard & Poor's in the category of frontier markets (eg so reduced accessibility and high risk);
- decreasing the dependence on bank financing (currently about 90%) and increasing the resilience of the economy (countries where the share of financing through the capital market is significant - eg. USA – came back faster to the economic growth after the crisis);
- improving the governance and competitiveness of Romanian companies (as a result of competition with companies from other countries in order to attract capital);
- a higher level of protection for consumers of financial services specific to capital market.

5. Conclusions

To strengthen the transmission mechanism in the economies of Member States of the positive effects of setting up the Capital Markets Union, given the reluctance of investors and lack of investment opportunities connection instruments able to transfer the capitals traded on financial markets in the real economy are necessary.

These instruments may take the form of the European investment funds, issuing bonds listed on a regulated market, possibly consolidated with the guarantee of the European Central Bank. Instruments with a similar role could be the existing funds from the European

Commission, such as: transnational investment fund for strategic objectives at EU level with the objective of investment in transport infrastructure. In economics, investments in transport infrastructure have the highest multiplier. A third example of an instrument that would enhance the link between markets and the real economy may be the European Investment Fund in small and medium issuing bonds and with guarantees at European level.

The subject of a Capital Markets Union in Europe is very recent (the debate being initiated and launched only in mid-February 2015), therefore scientific research and academic publications in this field are very few, which shows the novelty of the topic addressed by this article and its contribution to the development of literature in the field.

5. References

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