The Politics of Capital Markets Union

Law Working Paper N° 469/2019
August 2019

Wolf-Georg Ringe
University of Hamburg, University of Oxford and ECGI

ECGI Working Paper Series in Law

The Politics of Capital Markets Union

Working Paper N° 469/2019
August 2019

Wolf-Georg Ringe

Abstract

EU policymakers are currently implementing the capital markets union (CMU) agenda—a collection of individual steps that, taken together, should strengthen cross-border market integration in EU capital markets. However, the imminent departure of the United Kingdom from the EU reshuffles the cards in this project, since the absence of the United Kingdom as the continent's most developed capital market jeopardizes the objective of creating a truly Europe-wide deep and liquid market that merits its name.

This paper argues that the purpose of the CMU project can and should be redefined. The initial thrust behind the project in 2014–2015 seems to have been to court the British public in a bid to influence the Brexit referendum. After the UK's vote to leave, that objective no longer provides the glue that holds the CMU agenda together. Instead, I show that CMU can helpfully be redefined and reexplained in an entirely new context. Specifically, the CMU agenda provides a sensible set of measures to strengthen the architecture of the Eurozone: cross-border integration of national financial markets holds the promise of promoting so-called 'private risk sharing' that can serve as an important boost to reinforce the fragile framework of the common currency.

This paper makes two points. First, it explores the initial motivation behind launching the CMU agenda. The paper argues that the initial purpose was—among other things—a political bid to influence the growing anti-EU attitude and to win over the City of London. Since this strategy was ultimately unsuccessful—at least, it did not suffice to secure a majority voting for a UK-wide 'remain' vote—the entirety of the CMU project was put into question. In a second step, the paper shows that the CMU agenda currently on the table—if sufficiently reinforced and expanded—may find a new purpose in strengthening the Eurozone architecture. The latter point comes amid the ongoing policy debate on the future of the Euro.

Keywords: capital market union, political economy, Brexit, Eurozone, private risk-sharing

JEL Classifications: D72, G28, K22

Wolf-Georg Ringe*
Professor of Law & Economics
University of Hamburg, Faculty of Law
Johnsallee 35
20148 Hamburg, Germany
phone: +49 404 283 877 87
e-mail: georg.ringe@uni-hamburg.de

*Corresponding Author

Universität Hamburg
DER FORSCHUNG | DER LEHRE | DER BILDUNG

FAKULTÄT
FÜR RECHTSWISSENSCHAFT

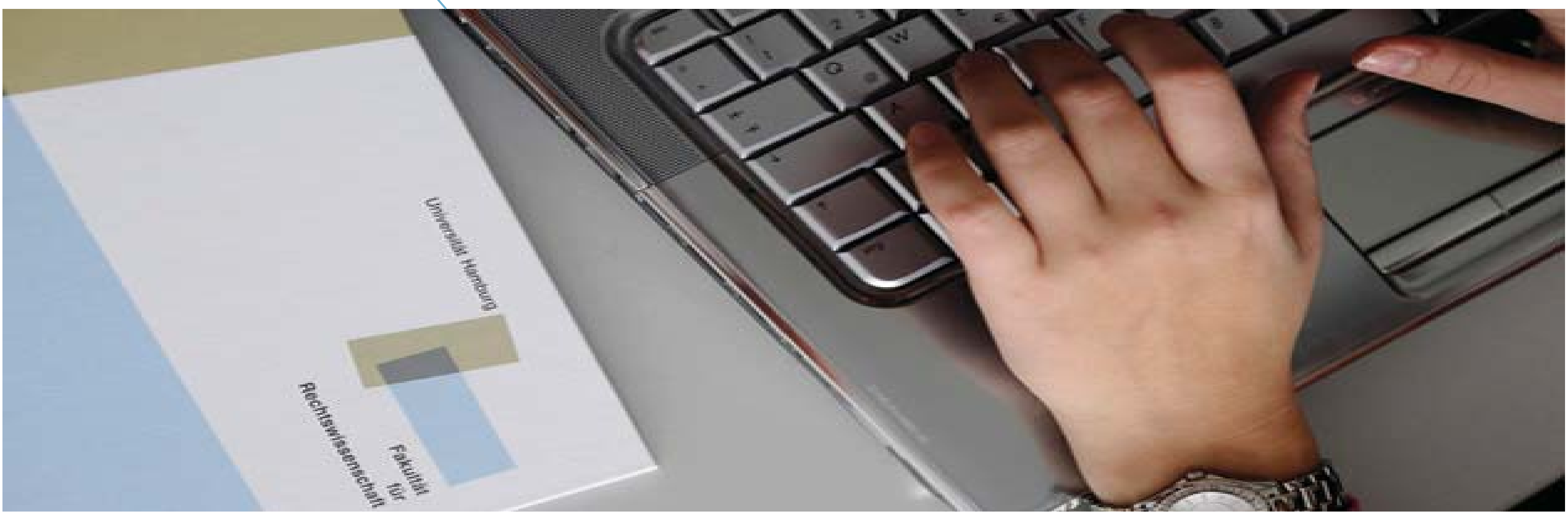
INSTITUTE OF LAW AND ECONOMICS
WORKING PAPER SERIES

The Politics of Capital Markets Union

Wolf-Georg Ringe

Working Paper 2019 No. 26

July 2019



NOTE: ILE working papers are circulated for discussion and comment purposes.
They have not been peer-reviewed.

The Politics of Capital Markets Union

Wolf-Georg Ringe*

Forthcoming as chapter 18 in
Franklin Allen et al. (eds), Capital Markets Union and Beyond (MIT Press 2019)

EU policymakers are currently implementing the capital markets union (CMU) agenda—a collection of individual steps that, taken together, should strengthen cross-border market integration in EU capital markets. However, the imminent departure of the United Kingdom from the EU reshuffles the cards in this project, since the absence of the United Kingdom as the continent's most developed capital market jeopardizes the objective of creating a truly Europe-wide deep and liquid market that merits its name.

This paper argues that the purpose of the CMU project can and should be redefined. The initial thrust behind the project in 2014–2015 seems to have been to court the British public in a bid to influence the Brexit referendum. After the UK's vote to leave, that objective no longer provides the glue that holds the CMU agenda together. Instead, I show that CMU can helpfully be redefined and reexplained in an entirely new context. Specifically, the CMU agenda provides a sensible set of measures to strengthen the architecture of the Eurozone: cross-border integration of national financial markets holds the promise of promoting so-called 'private risk sharing' that can serve as an important boost to reinforce the fragile framework of the common currency.

This paper makes two points. First, it explores the initial motivation behind launching the CMU agenda. The paper argues that the initial purpose was—among

* Professor of Law and Director of the Institute of Law & Economics, University of Hamburg; Visiting Professor, University of Oxford. Comments welcome to georg.ringe@uni-hamburg.de.

other things—a political bid to influence the growing anti-EU attitude and to win over the City of London. Since this strategy was ultimately unsuccessful—at least, it did not suffice to secure a majority voting for a UK-wide ‘remain’ vote—the entirety of the CMU project was put into question. In a second step, the paper shows that the CMU agenda currently on the table—if sufficiently reinforced and expanded—may find a new purpose in strengthening the Eurozone architecture. The latter point comes amid the ongoing policy debate on the future of the Euro.

I. CMU’s Original Goal: To Avoid Brexit

Even before he was even elected president of the European Commission, Jean-Claude Juncker announced that the creation of a CMU would be one of the key priorities for his time in office.[1] The idea was to strengthen the integration of the divergent national capital markets across the EU. The reasons for this initiative were twofold. First, strengthening the integration of national capital markets across the EU promised a more efficient allocation of resources across the continent and more diversified investment possibilities for European firms. Secondly, as banks and financial institutions had been blamed for large parts of the 2008–2009 global financial crisis, policymakers sought to find ways of making alternative means for firms’ access to finance more attractive.

In February 2015, then-commissioner Jonathan Hill launched a green paper outlining intermediate steps and long-term goals of the CMU agenda.[2] This included a revival of (‘high quality’) securitizations, strengthening of credit information on small and medium-sized enterprises (SMEs), bolstering of a private placement regime, and a revision of the prospectus directive. The long-term goals of CMU were to improve access to finance for SMEs and mid-sized firms, to increase and diversify the sources of funding from international investors, and to ensure that markets work more efficiently. To these ends, the European Commission sketched a number of vague policies. Among them were the development of an integrated market for

[1] Jean-Claude Juncker, ‘A New Start for Europe’, opening statement, European Parliament plenary session, 15 July 2014, <http://europa.eu/rapid/press-release_SPEECH-14-567_en.htm>.

[2] European Commission, *Green Paper: Building a Capital Markets Union*, COM(2015) 63 final, 18 February 2015.

covered bonds and more support for alternative financing measures such as venture capital, private equity, and also environmentally conscious bond instruments. Further, the Commission proposed to lower the costs for setting up and investing in investment funds and to reform rules on occupational pensions. Among the broader initiatives were plans to address obstacles to cross-border capital flows, such as insolvency, corporate, taxation and securities laws. Finally, the Green Paper sought views on how EU markets can be made more attractive to international investors from outside Europe. The menu of initiatives that are united under the roof of CMU represents a motley collection of policies united by a common desire: to better integrate capital markets across the EU as an alternative to bank financing. The reasons for this are not only sound economic objectives but also—and possibly equally as important—political goals.

The *economic* underpinnings of this initiative are clear: A deeper and more liquid capital market should contribute to a more efficient allocation of capital within the single market. As a complementary consideration, traditional portfolio theory has long established that an efficiently diversified international portfolio carries a higher rate of return for a given level of risk tolerance;[3] a segmented capital market, therefore, does not allow investors to gain the full benefits from diversification. Finally, the global financial crisis drastically demonstrated that bank financing, traditionally strong in Europe, may collapse and thus fail to fulfil its purpose. Banks provide about 70% of business finance in Europe compared to just 20% in the United States, a state of affairs that some have said helped the United States recover from the recession more quickly. Critics may argue that all of these points are nothing new. Indeed, the reasons for the CMU project echo the economic rationale underpinning the principle of free movement of capital already enshrined in the European Treaties since the 1950s.[4]

There was, however, an equally strong *political* case for promoting the CMU agenda, above all concerning the difficult relationship between the EU and the United Kingdom. In fact, the initial thrust of the CMU project can be understood as an attempt to repair the strained bond between London and Brussels. Amid a

---

[3] Herbert G. Grubel, 'Internationally Diversified Portfolios' (1968) 58 American Economic Review 1299; Haim Levy and Marshall Sarnat, 'International Diversification of Investment Portfolios' (1970) 60 American Economic Review 668.

[4] See today Treaty on the Functioning of the European Union (TFEU) Articles 63–66.

growing alienation between the UK and the EU and rising approval rates for the UK Independence Party, then Prime Minister David Cameron announced in 2013 that if the Conservatives won the next general election, they would seek to renegotiate the United Kingdom's relationship with the EU and then give the British people the opportunity to vote in a referendum on whether to leave or to stay in the EU.[5] From the outset, the reaction of EU policymakers has been conciliatory, seeking to do everything to keep the United Kingdom in the club. It is in this context that the CMU agenda was launched by the incoming Juncker administration in 2014–2015. The political contribution of the plan is along two lines.

First, the launch of the CMU agenda was a political signal to strengthen the single market as a project of all twenty-eight Member States instead of just the Eurozone countries. While some projects—like the creation of the banking union—during the crisis response years had been largely confined to the Eurozone (plus voluntarily participating Member States), this had raised fears of a growing bifurcation of the EU single market and, most importantly, leaving out the United Kingdom. In contrast, by early 2015 the CMU project sent a strong signal to the UK to remain an active part of the EU and represented a commitment to the overall single market idea. This point is illustrated by the fact that the European Commission portfolios were reshuffled to form a new 'Directorate-General for Financial Stability, Financial Services and Capital Markets Union', which Juncker eventually awarded to a British national.[6]

Secondly, the CMU is a project that found political support in the UK and thus was a possibility to help to further its rapprochement to the EU. Against the growing frustration in British politics and the looming threat of an anti-EU referendum as promised by then Prime Minister Cameron, the prospect of a deeper market for capital was an attempt to appease the heated atmosphere in London. The City of London stood to benefit from a continent-spanning market, which would have facilitated transactions and promised economies of scale. It was therefore no surprise that the CMU initiative was welcomed by British business groups and

---

[5] BBC News, 'David Cameron Promises in/out Referendum on EU' BBC interview, January 23, 2013, <http://www.bbc.com/news/uk-politics-21148282>.

[6] European Commission, 'The Juncker Commission: A Strong and Experienced Team Standing for Change,' press release, 10 September 2014, <http://europa.eu/rapid/press-release_IP-14-984_en.htm>.

politicians, including then-chancellor George Osborne.[7] The House of Lords even hailed the initiative as a 'a golden opportunity for the UK' and 'a means to demonstrate afresh that the City of London, and the financial sector which is centred there, is an asset not only to the UK economy but to the EU as a whole'.[8] Seen from this perspective, proposing a united capital market was a smart move to win back the trust and sympathy of the United Kingdom (at least the City of London) and to overcome the various confrontations between Europe and Britain that were not just limited to political disagreement concerning financial regulation but increasingly included serious courtroom battles over financial laws.[9]

Beyond being an offer to Britain, CMU was also to be understood as a promise of a better future for all other EU countries, mostly at the periphery, which were weary, at that time, of their long post-crisis experience of austerity. By putting the proposal in the context of 'jobs' and 'growth,' the CMU idea served as a beacon of hope for light at the end of the tunnel. Finally, and maybe most importantly, CMU was a step that signalled a return to a more traditional EU activity of 'market building'. In the long history of EU efforts to promote a single market for capital, the EU has always been strong at playing the role at which it is most effective: to facilitate the exchange of capital flows across borders by removing obstacles to cross-border investment. This was the leitmotif of most EU activity throughout the 1980s and 1990s, until the financial crisis caused a sharp turn toward a more market-shaping, regulatory approach.[10] Lord Hill's predecessor, Michel Barnier, had produced a flood of initiatives to regulate and contain financial institutions'

[7] Marion Dakers, 'Europe Launches Blueprint for Capital Markets Union' *The Telegraph* (19 February 2015).

[8] Authority of the House of Lords, *The Post-Crisis EU Financial Regulatory Framework: Do the Pieces Fit?* (London: The Stationery Office Ltd., 5th Report of Session 2014–15, 12 February 2015) 16.

[9] Among the many disputes over the last years, consider the recent decisions in cases C-270/12, *UK v Council and Parliament*, ECLI:EU:C:2014:18 (regarding ESMA's powers on short selling regulation); C-209/13, *UK v Council*, ECLI:EU:C:2014:283 (concerning enhanced cooperation for a Financial Transaction Tax); T−496/11, *UK v European Central Bank*, ECLI:EU:T:2015:133 (concerning the location of CCPs). A further case was eventually withdrawn: C-507/13, *UK v Council and Parliament* (concerning CRD IV).

[10] Lucia Quaglia, *Governing Financial Services in the European Union: Banking, Securities and Post-Trading* (London: Routledge 2010).

excessive risk taking and restore stability to financial markets. His time in office had thus been characterized by a more market-curbing or regulatory type of activity. Hill, in contrast, returned to the classic style of EU lawmaking, ensuring continuity, promising greater effectiveness, and avoiding the legal pitfalls of a more sanctions-oriented EU legal framework.

In conclusion, the main contribution of the CMU agenda was its political symbolism—return to the single market, deepening capital markets, more jobs, and growth.[11] Some support for this interpretation can be found in the fact that a number of the initiatives bundled under the label 'capital markets union' had already been pursued or discussed by the European Commission way before the CMU agenda was even initiated. For example, preparations for a revision of the Prospectus Directive had already started as early as 2011 when the Commission charged the European Securities and Markets Authority (ESMA) with exploring options for reform.[12] The ongoing reform efforts could thus readily be inserted into the new CMU agenda to give it some further substance.[13] As the European Commission in all honesty stated: 'It is true that many of the issues at stake—insolvency and securities laws, tax treatments—have been discussed for many years'.[14]

II. CMU and Brexit

If Brexit had been the target, the CMU initiative was unsuccessful. As is well known, to the surprise of many, the British public in June 2016 voted to leave the EU. Maybe wooing the City of London turned out to have the opposite effect for the UK as a whole, and the EU's move of proposing CMU bet on the wrong horse.[15] It is

[11] See in more detail Wolf-Georg Ringe, 'Capital Markets Union for Europe: A Commitment to the Single Market of 28' (2015) 9 *Law and Financial Markets Review* 5.

[12] See Niamh Moloney, *EU Securities and Financial Markets Regulation,* 3rd ed. (Oxford: Oxford University Press, 2014) 122.

[13] See also European Commission, *An Investment Plan for Europe* (Brussels: European Commission, COM [2014] 903 final, 2014) 15.

[14] European Commission, *Green Paper* (n 2) 2.

[15] As is well known, Londoners overwhelmingly voted in favour of remaining in the EU. See BBC, 'EU referendum: Most London boroughs vote to remain' 24 June 2016, <https://www.bbc.com/news/uk-politics-eu-referendum-36612916>.

well known that the public mood informing the Brexit vote was highly anti-establishment[16], and the financial industry in the City of London is typically seen as part of the national elite. Consequently, proposing an agenda that would have been City-friendly may have created a backlash amongst the broader UK public.

In any case, the political and legal calamities of the referendum outcome are legend and should not be recounted here.[17] Instead, a somewhat underexplored question concerns the implications of the referendum outcome for the CMU project. The obvious question to ask is whether the CMU action plan still remains realistic if London, Europe's financial heart, no longer participates.[18]

Opinions on this question were deeply divided. Many clearly believed that CMU without the United Kingdom would be an exercise without purpose and, at the very least, that Brexit would have 'negative implications' for the CMU project[19]—especially since Britain had been the main driving force behind the initiative. Accordingly, British commissioner for financial services Jonathan Hill, who had been a major promoter of CMU, immediately after the referendum tendered his resignation.[20]

The European Commission took the opposite view. After some hesitation, EU policymakers began to understand Brexit as an opportunity towards deeper integration.[21] In a communication of September 2016 entitled 'Capital Markets Union—Accelerating Reform,' they concluded that the CMU agenda was now even 'more important than ever' and that 'the implementation of actions in the plan should

---

[16] See e.g. Evgeniia Iakhnis, Brian Rathbun, Jason Reifler and Thomas J. Scotto, 'Populist referendum: Was "Brexit" an expression of nativist and anti-elitist sentiment?' Research & Politics, Apr-June 2018: 1-7.

[17] See for my perspective on Brexit and financial services: Wolf-Georg Ringe, 'The Irrelevance of Brexit for the European Financial Market' (2018) 19 European Business Organization Law Review 1.

[18] See Danny Busch, 'A Capital Markets Union for a Divided Europe' (2017) 3 Journal of Financial Regulation 262.

[19] David Howarth and Lucia Quaglia, 'Brexit and the Single European Financial Market' (2017) 55 (S1) Journal of Common Market Studies 149, 153.

[20] Jim Brunsden, 'UK's EU Commissioner Lord Hill Quits as British Departures Begin' *Financial Times* (26 June 2016).

[21] Jim Brunsden and Alex Barker, 'City to Be Sidelined by Capital Markets Union Plan,' *Financial Times* (30 June 2016).

be accelerated'.[22]

There is no doubt that the UK departure changes the dynamics of policymaking in EU financial regulation. Since the 2008 financial crisis, there have been new informal political alliances influencing the EU agenda. France, Italy, and other Member States are said to be part of a 'market shaping' alliance, supporting stricter regulation of financial institutions. This contrasted with a UK–led club of countries in favour of 'market making,' championing competition, and market efficiency.[23] For the latter group of countries that typically already have rather developed capital markets, such as Ireland, the Netherlands, or Sweden, the palpable risk was that their coalition, having lost its natural leader, would lose out in the battle for substance in implementing CMU. Put differently, the UK departure meant that the future direction of CMU would change—away from market liberalization toward a more restrictive attitude.

After some period of agonizing, the 'market shaping' coalition saw an opportunity to utilize the crippled CMU agenda for their own purposes. Three objectives seem to have been mainly relevant.

First, the UK departure allowed other EU Member States to change the character of CMU from a modest, 'incrementalist' approach to a more ambitious vision of 'institutional change' and of developing 'centralized institutions'.[24] That approach had suddenly become more achievable as Brexit meant that the United Kingdom would no longer block the creation of new institutions and veto any further reaching centralization.[25] The second opportunity was for the remaining countries of the EU (EU27) to build a deeper capital market 'on their own'. In other words, the departure of the United Kingdom and prospect of a deregulated City of London at

---

[22] European Commission, *Capital Markets Union—Accelerating Reform* (Brussels: European Commission, COM [2016] 601 final, 14 September 2016) 7.

[23] Lucia Quaglia, *Governing Financial Services in the European Union: Banking, Securities and Post-Trading* (London: Routledge, 2010). See also Sérgio Coimbra Henriques, 'Capital Markets Union: Towards Regulatory Harmonisation and Supervisory Convergence' (working paper, SSRN, 2017), <https://ssrn.com/abstract=2983809>.

[24] Philipp Ständer, 'What Will Happen with the Capital Markets Union after Brexit?' (Policy Paper 181, Jacques Delors Institute, Berlin, December 2016) 11.

[25] Dirk Schoenmaker, 'Stealing London's Financial Crown Would Bring Both Benefits and Responsibilities,' *Bruegel* (blog), 17 November 2016, <http://bruegel.org/2016/11/stealing-londons-financial-crown-would-bring-both-benefits-and-responsibilities/>.

their doorsteps left the rest of the EU no other choice than to stand together and hope that their twenty-seven economies combined could represent an alternative capital market. That vision included the imperative to act quickly, since first successful steps were ideally needed to be already in place before the United Kingdom had even left. Finally, as a third hope, in particular the large Member States, such as France and Germany, saw the opportunity of enticing parts of London's financial industry away to bolster their own financial centres. London had long been the envy in particular of French policymakers, and Brexit provided the opportunity to end London's hegemony in Europe. Accordingly, Paris and Frankfurt initiated an unprecedented charm offensive and marketing campaign to woo London-based firms.[26]

All three dreams suffer from one major flaw. They disregard the idiosyncratic nature of the financial market—in particular, they ignore what is called the 'agglomeration effect' of finance as one of the fundamental laws of financial centres. Financial market activities are known to benefit from agglomeration and concentration: the assimilation of financial services in a single hub allows for economies of scale and a depth of capital market activity that cannot be easily replicated elsewhere. Moving parts of the industry to the continent will, therefore, reduce the size of the overall pie. Put differently, it would be to the EU's advantage to leave the formidable ecosystem of the City of London intact.[27]

There is, however, a different justification of why it makes sense to further pursue the CMU agenda in a diminished EU27. A redefined objective of CMU lies in the possibility of reinforcing the architecture of the Eurozone as a common currency through 'private risk sharing'. The next section will explore this rationale in more detail.

III. A Reinvented CMU for the Eurozone

CMU is essentially an agenda to deepen cross-border financial integration. Such integration leads to so-called 'private risk sharing'. It has long been understood

---

[26] 'France Turns Anglophone to Woo UK Businesses,' *Financial Times* (28 September 2016).

[27] House of Lords European Union Committee, *Brexit: Financial Services* (London: Authority of the House of Lords, 9th report of session 2016-2017, HL Paper 81, 15 December 2016) para 37.

by economists that private risk sharing has the potential to strengthen a common currency area, and this insight is now also slowly arriving in legal and policy circles. Thus, different from the original plans, the *CMU Mid-Term Review* for the first time mentioned that the CMU initiative could also 'strengthen […] Economic and Monetary Union (EMU) by supporting economic and social convergence and helping absorb economic shocks in the euro area'.[28] The same idea was floated in the famous 2015 *Five Presidents Report*.[29]

The basic concept is simple. Financial markets are the natural place where private risk sharing takes place. They can function as an insurance structure smoothing asymmetric shocks via cross-country ownership of assets.[30] Consider the example of a simple monetary union composed of two countries, A and B. Assume an asymmetric economic shock which leads country A into a crisis, while the economy of country B is booming. If they are not financially integrated, the consumption level should rise in country B and decrease in country A, leading to social tensions and an increase in discontentment with the union. However, if they are fully financially integrated, their consumption should co-move.[31] For instance, considering the equity market, residents of country A would own shares of companies in country B, thus receiving the gains from the boom. On the other hand, residents of country B would own shares in country A, thus share the losses of its companies. On the top of smoothing idiosyncratic shocks, financial integration can also foster economic growth by increasing the allocative efficiency of capital. Resources would be allocated to where they are higher valued. In the context of the Eurozone, for instance, countries that have a shortage of capital (thus a higher value) would profit from an influx of resources coming from members with abundance (thus lower value). This would promote growth both in the first region and in the second region since a higher international diversification might allow companies to

[28] European Commission, *Communication on the Mid-Term Review of the Capital Markets Union Action Plan* (Brussels: European Commission, COM [2017] 292, 8 June 2017) 2.

[29] Jean-Claude Juncker et al., *The Five Presidents' Report: Completing Europe's Economic and Monetary Union* (Brussels: European Commission, 2015), available at <https://ec.europa.eu/commission/sites/beta-political/files/5-presidents-report_en.pdf>.

[30] Paul de Grauwe, *Economics of Monetary Union*, 11th ed. (Oxford: Oxford University Press, 2016).

[31] John H. Cochrane, 'A Simple Test of Consumption Insurance,' (1991) 99 Journal of Political Economy 957.

invest in higher return domestic investments.[32] The same phenomenon can be demonstrated for a fully integrated bond market and for the cross-border integration of banking. Crucially, greater financial integration would reduce the need for any form of formal fiscal union in Europe.[33]

For countries in a monetary union such as the Eurozone, such private risk sharing is particularly important because the common monetary policy steered by the European Central Bank (ECB) is unable to address asymmetric shocks that affect only one country or region within Europe. With disjointed business cycles across countries, idiosyncratic shocks to individual EMU Member States need to be insured through a robust and integrated financial market. Reducing the volatility of aggregate consumption through various risk-sharing mechanisms can provide significant welfare gains for countries hit by specific shocks. Moreover, by reducing internal divergences and facilitating macroeconomic adjustment, risk sharing can be beneficial for the monetary union as a whole: a truly integrated financial market is a meaningful component of a monetary union, as without it, monetary policy decisions will not be transmitted equally well across all participating Member States.[34]

A number of studies have demonstrated the importance of private risk sharing. For example, when considering the United States, empirical evidence shows that more than 39% of the shocks sustained by individual American states are smoothed by federal capital markets, 23% by the credit markets, and only 13% by the federal budget, while 25% remained unsmoothed.[35] Consequently, even in a full federation, public risk sharing only responds for slightly more than 10% of the shocks. The main responsible for smoothing the shocks faced by the American states is the financial market (smoothing more than 60% of the shocks). Similar results were found in other studies applying different methodologies or analysing different

---

[32] Sebnem Kalemli-Ozcan, Bent E Sørensen and Vadym Volosovych, 'Deep Financial Integration and Volatility' (2014) 12 Journal of the European Economic Association 1558.

[33] Mathias Hoffmann and Bent E Sørensen, 'Don't Expect Too Much from EZ Fiscal Union—and Complete the Unfinished Integration of European Capital Markets!,' *VoxEU* (CEPR Policy Portal), 9 November 2012.

[34] Mario Draghi, 'Rationale and Principles for Financial Union,' speech, Twenty-Second Frankfurt European Banking Congress, Frankfurt am Main, 23 November 2012, <https://www.ecb.europa.eu/press/key/date/2012/html/sp121123.en.html>.

[35] Pierfederico Asdrubali, Bent E Sørensen and Oved Yosha, 'Channels of Interstate Risk Sharing: United States 1963–1990' (1996) 111 Quarterly Journal of Economics 1081.

federations.[36]

In the Euro area, the ECB found that more than 75.7% of the shocks to Member States presently are not smoothed at all, 18.2% are smoothed by the credit markets, 5.4% by capital markets, and 0% by cross-border fiscal transfers.[37] In other words, more than three-quarters of the shocks received by the Eurozone are not smoothed; the small part that is insured is only insured by the financial market.[38] These numbers are not only consistent with the restrictions on public risk sharing in the EU treaties (since fiscal transfers are basically inherent) but also might give a foundation for understanding the discontentment with the euro in the countries most affected by the last crisis (since they faced more than three-quarters of the pain alone). The situation of financial integration with limited risk sharing exposed the Eurozone to a significant capital reversal from the beginning of the sovereign crisis onward.[39]

Why would private risk sharing be necessary at all? The Eurozone was originally designed, in great controversy, as a monetary union of sovereign countries. It received substantial criticism from leading economists at the time who pointed out the difficulties associated with such an approach, as Europe was not considered as an optimal currency area.[40] It did not face symmetric economic shocks and did not have a high mobility of factors or mechanisms to absorb any idiosyncratic shocks. Under this framework, the currency union was clearly fragile.

---

[36] Stefano G Athanasoulis and Eric van Wincoop, ‘Risk Sharing within the United States: What Do Financial Markets and Fiscal Federalism Accomplish?’ (2001) 83 Review of Economics and Statistics 688; Faruk Balli, Syed Abul Basher and Rosmy Jean Louis, ‘Channels of Risk-Sharing among Canadian Provinces: 1961–2006’ (2012) 43 Empirical Economics 763; Ralf Hepp and Jürgen von Hagen, ‘Interstate Risk Sharing in Germany: 1970–2006’ (2013) 65 Oxford Economic Papers 1–24.

[37] Plamen Nikolov, ‘Cross-Border Risk Sharing after Asymmetric Shocks: Evidence from the Euro Area and the United States’ (2016) 15(2) Quarterly Report on the Euro Area 7–18.

[38] The remaining 0.2% is related to cross-border labour compensation.

[39] Diego Valiante, *Europe’s Untapped Capital Market—Rethinking Financial Integration after the Crisis* (London: Rowman and Littlefield International, 2016).

[40] Barry Eichengreen, ‘Is Europe an Optimum Currency Area?’ (Washington, DC: Center for Economic and Policy Research, CEPR Discussion Paper No. 478, 1990); Milton Friedman, ‘The Euro: Monetary Unity To Political Disunity?’ Project Syndicate, 1997. Available at: <https://www.project-syndicate.org/commentary/the-euro--monetary-unity-to-political-disunity> [Accessed 14 February 2019].

Yet the prevailing hope was that the economic momentum created by the EMU would almost certainly provide the ground for subsequent political integration. However, the virtual convergence of interest rates of sovereign bonds issued by EU Member States in the years after the introduction of the euro made policymakers numb, slowing the adoption of the reforms necessary to strengthen the delicate currency framework. In particular, policymakers hoped that the adoption of the euro would lead to economic convergence between EU Member States.

This fragility of the Eurozone has essentially not changed over time. The 2008–2009 global financial crisis saw an almost collapse of the common currency, and it was only ECB president Mario Draghi's courageous crisis management that rescued the euro. More recently, at least since Emanuel Macron's 2017 intervention, a public debate has started on how to secure and improve the Eurozone. A number of reform proposals have been made, and reports are circulating.[41] This is not the place to discuss the relative merits of the different concepts and perspectives. The point here is simple: pursuing the CMU project, probably even expanding it, can find a sensible objective in strengthening the common currency.

This idea of strengthening the EMU through private risk sharing has a number of key advantages. The first is of a political nature. In the EU context, attempts at promoting *public* risk-sharing initiatives have proven unpopular in both the main contributing Member State (with a more resilient economy) and the main beneficiary Member State (with a less resilient economy). The taxpayers of the former are typically reluctant to support a foreign government without seeing the direct benefits of it. On the other hand, such public financing support is usually conditioned on the adoption of austerity measures that are not only highly unpopular in the latter but might also foster a nationalist populist backlash (on the idea that these measures were 'imposed' by foreign nations). Secondly, as international experience shows,[42] private risk sharing may also be more functional. First, cross-border holdings of productive or financial assets can provide members of a currency union with insurance against idiosyncratic shocks. Second, well-functioning credit markets can contribute to smoothing consumption against relative income fluctuations, especially if most cross-border lending takes the form of direct lending

---

[41] In particular, the famous '5 Presidents Report': Juncker et al. (n 29).

[42] See references in House of Lords European Union Committee, *Brexit: Financial Services* (n 27).

to households and firms rather than of wholesale lending and borrowing in interbank markets.[43] The conclusion is that greater progress in risk sharing in the euro area would require significantly more developed and integrated capital markets as well as more banks operating at a pan-European level. Finally, private risk sharing would be advantageous from a legal perspective. As explained above, public risk sharing would require arduous renegotiations of the EU treaties and be fraught with uncertainty and subject to high political resistance. The deepening of financial integration, by contrast, can be achieved within the present legal framework as it corresponds much better to the traditional EU mission of market making.

It is safe to assume that, in the foreseeable future, a number of alternative mechanisms that would have the potential to improve risk sharing across countries will not progress quickly in the EU. For example, labour mobility will likely remain below levels achieved in common-language federations such as the United States or Germany. Similarly, building a European supranational system of taxes and transfers is, at present, not a realistic prospect. Finally, the rules on fiscal deficits imposed by the Stability and Growth Pact will continue to set limits on national governments for smoothing large shocks. Private risk sharing and continuing with CMU, therefore, becomes an even more pressing imperative.

IV. Conclusion

In sum, the economic and political motivations for pursuing a genuine 'capital markets union' are evident. Until now, the driving force has been a political one, namely to sway the UK referendum toward 'remain'. Consistent with this, the substance of the 2015 CMU agenda was modest, and many aspects had a largely symbolic value. The British departure now offers the possibility of reinterpreting CMU as a toolbox to reinforce the euro architecture and so move CMU from a political agenda to an economically sensible instrument. To achieve that, policymakers need to be more ambitious in substance. The goal should be steps on the path toward a fully unified European capital market, probably under the remit of a single market supervisor. As a silver lining, decision making on these issues should

[43] Falko Fecht, Hans Peter Grüner and Philipp Hartmann, 'Welfare Effects of Financial Integration' (Discussion Paper No. 11/2007, Deutsche Bundesbank, Frankfurt am Main, Germany, 2007).

become easier after Brexit, as the United Kingdom has regularly vetoed important steps toward integration in the past. Where the political centre in an EU27 lies is, however, very much uncertain.

about ECGI

The European Corporate Governance Institute has been established to improve *corporate governance through fostering independent scientific research and related activities.*

The ECGI will produce and disseminate high quality research while remaining close to the concerns and interests of corporate, financial and public policy makers. It will draw on the expertise of scholars from numerous countries and bring together a critical mass of expertise and interest to bear on this important subject.

The views expressed in this working paper are those of the authors, not those of the ECGI or its members.

Electronic Access to the Working Paper Series

The full set of ECGI working papers can be accessed through the Institute's Web-site (www.ecgi.global/content/working-papers) or SSRN:

Finance Paper Series	http://www.ssrn.com/link/ECGI-Fin.html
Law Paper Series	http://www.ssrn.com/link/ECGI-Law.html