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Overview of the challenges and prospects for EU and EMU reform

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The challenges of Capital Markets Union

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Capital Markets Union (CMU) aims to draw the best from the various financing channels, by expanding opportunities for saving and the availability of long-term financing, and to improve financial integration in the European Union. To this end, the European Commission has drawn up a lengthy but coherent list of actions, some of which have already been completed. Although the introduction of a more favourable legislative framework is essential, Capital Markets Union is a long-term process, whose success will depend above all on the behaviour of economic agents.

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Will 2018 really be the year for jumpstarting European construction? Although it is too early to place any bets, we can already say that ambitions are high. Two of the main European players, French President Emmanuel Macron and European Commission President Jean Claude Juncker, spelled out their visions and submitted concrete proposals last fall. Observers and think tanks have also made numerous contributions in recent months. There has been an outpour of proposals to round out and reform the architecture of the European Economic and Monetary Union (EMU), to increase its solidity and coherence. Often very precise, these proposals thoroughly examine the operating details of one reform or another. The issues are well known and have long been the subject of debate: a banking union, a common budget, fiscal discipline, public debt restructuring and the European Stability Mechanism (ESM), to name a few.

In this article, we will use a series of questions and answers to make it easier to understand the debates and the upcoming decisions. Certain decisions that are likely to be made in 2018 are bound to shape the range of choices ahead. Without being exhaustive, part one will look at questions pertaining to the evolution of the whole European Union, which European leaders are trying to redefine and revitalise in the midst of Brexit. This touches on a broad range of subjects that largely surpass the economic sphere. Part two will concentrate on the eurozone's architecture. In early December, the European Commission published several precise proposals on this subject.

Jumpstarting the European Union

Why now?

The last milestone in European construction dates back to mid-2012 with the launch of a banking union project. Since then, most efforts have been monopolised by the project's implementation, as well as by the migrant crisis and Brexit, without producing a real programme for pursuing European construction. Today, this debate is back on the

agenda for three key reasons, which explain why we are more likely to see progress made this year than in the past.

The Juncker Commission heads into the home stretch

The next European parliamentary elections are set for June 2019, which means that 2018 will be the last "useful" year for the Commission to make progress on its major projects. Jean Claude Juncker, the Commission's president, has devoted his entire career to the EU's mysterious ways and has closely followed every twist and turn of the European crisis. There can be no doubt but that he intends to leave his or his Commission's mark on European construction. Yet to do so, he will have to give it all he's got in the months ahead.

A promising French-German partnership

Given that elections have only been organised last year, the famous "French-German couple" will have a little more time than usual to push forward their projects without being hampered by electoral cycles. Angela Merkel's re-election prospects combined with the arrival of a very Europhile, openly "Germany-compatible" French president raised high hopes and replenished the European agenda with fresh proposals.

The French side has managed to live up to expectations. After completing his labour market reform, President Macron focused the autumn session on Europe, and made a vast array of proposals (see below: "What does Emmanuel Macron's election change?"). In Germany, in contrast, things have proven to be more difficult given the outcome of federal elections (see box 1).

A favourable cyclical environment at last

After dealing with one crisis after another through 2012, in recent years European leaders have mainly devoted their energy to reviving their economies, fostering growth in order to curb unemployment and to amplify its decline. The eurozone unemployment rate has been declining for more than four years now, and just fell slightly below the January 2009 level. In general, a more favourable economic recovery in the short term has allowed European leaders to look further ahead towards medium-term problems.



What does Emmanuel Macron's election change?

France's new positioning

Emmanuel Macron conducted an openly pro-European election campaign at a time when it was "commonly admitted" that Europeans no longer had an appetite for Europe, or in any case for deeper European construction. Disproving the prevailing sentiment, he helped reactivate Europe as a rallying point that set him apart from his rivals. Second, he underscored the need for a strong French-German couple to serve as the driving force of Europe. Third, in what was certainly seen as a decisive move by many of his counterparts, he admitted that it was necessary to consolidate French public finances in order to restore France's credibility in negotiations and its influence in Europe. Yet this time round, the economic environment is also favourable, which should help him achieve his goals.

A wealth of proposals

For all these reasons, Emmanuel Macron's European positioning seems to be more promising than that of his predecessors' for a French-German alignment. As to its content, he spelled out his proposals during a speech at the Sorbonne in late September 2017 (see table 1 and below). In practice, the French president made an extremely broad sweep, apparently to strengthen his chances of finding some points in common with his European counterparts.

In essence, he is asking his EU partners to see the revival of European construction as a way to respond to the growing importance of nationalist movements in many EU countries. He described the internal fiscal, financial and political wrangling between member states as a European civil war, and instead proposed to create a veritable European sovereignty, especially for such far-reaching global issues such as climate change, migration, terrorism and nuclear arms, where one country on its own is powerless.

France and the Juncker Commission: a comparison of two integrated visions

A few days before Macron's speech, European Commission President Jean Claude Juncker used his 2017 State of the Union speech to present his vision of the most suitable and feasible advances that could be made before the end of his mandate. He too covered a vast array of possibilities. In Table 1, we list and compare the concrete proposals that were made during these two speeches. When known, we specify the date by which the Commission hopes to formulate its proposals or to obtain a decision from the heads of state. Note, the European Commission is largely in control of the agenda. There are numerous points of agreement in terms of defence and security policies.

This convergence illustrates the background work that has already been accomplished.

It also confirms that the member states intend to focus their efforts on these areas in the near future, given the circumstances, and because for public opinion, the advantages of cooperating with other member states on security matters is obvious. France's more spirited vision of digital issues, the ecological transition and culture, is also very "commission-compatible", even though they were not necessarily highlighted during Mr. Juncker's latest interventions. On the question of EMU reform, which we will examine in greater detail in part two, the two leaders agree on the need for a common budget or a European finance minister, although they did not describe the post in detail, and did not really touch on other issues vital for the functioning of a monetary union.

Box 1: What about Germany?

As we write these lines, we are unable to describe the content of the coalition's platform on European issues. Just after the elections, when France and the European Commission were spelling out their proposals, it looked like Angela Merkel would have to build a platform around a Jamaican coalition with the liberal FDP and the Greens, who have very different visions of European affairs. Observers were very sceptical about these prospects, and feared that the Chancellor would have very little manoeuvring room.

Since she has entered talks with the Social Democrats (SPD), the situation raises more promising prospects from a European perspective. The future will tell how promising. In anycase, there is a risk that Angela Merkel will be severely weakened by the electoral process, which might compromise her ability to rally German citizens behind more ambitious reforms. In the meantime, the clock is ticking and time is running out.

In contrast, the first fracture lines appear when considering whether to expand or deepen European construction as well as the delimitations between the EU and the eurozone.

In his State of the Union speech, Jean Claude Juncker hoped that Europeans would continue to focus on expansion:

- Expansion of the Schengen area to include Bulgaria and Romania in the short term, with Croatia joining soon thereafter;
- Expansion of the EU to include the Balkan countries, with Serbia and Montenegro the first candidates to join;
- Expansion of EMU to include all EU members, given that after Brexit, Denmark will be the only country that still benefits from an opt-out clause.

By highlighting these priorities, the Commission president was implicitly disapproving a "multi-speed EU", which several heads of state specifically called for in their remarks at the anniversary celebration of the Treaty of Rome. In the next section, we will review the stakes and challenges of a multi-speed Europe.



Institutional proposals

	France's proposals	European Commission's proposals*	Comments
Defence and security	– Integration of European military in national armies – European Intelligence Academy – European Public Prosecutor's Office on organised crime and terrorism – European Civil Defence Force	– European Defence Fund – Permanent Structured Cooperation – European Cybersecurity Agency – European Intelligence Unit (information sharing between member states) – European Prosecutor instructed to fight against terrorism	→ The goal is for an EU defence force to be operational by 2025 → The Prosecutor office already exists, in charge of anti-EU budget fraud only
Migration, development assistance	– European Asylum Office – European Border Police – European Development Programme to assist the home countries of migrants – Joint programme for refugee integration and training	– Expansion of the Schengen Area	→ A European Asylum Office would centralise information on asylum seekers and harmonise procedures → The European Development Programme could be financed by the generalisation of a financial transaction tax → Bulgaria and Romania are to join the Schengen Area immediately, while Croatia is beginning the entry process → Call for member states to beef up the European Trust Fund for Africa
Environmental, fiscal & social policies	Ecology	– A single, significant carbon floor price within the EU – European industrial programme to promote clean vehicles and the deployment of shared infrastructure – Reform of the Common Agricultural Policy (CAP) and creation of a European inspection force to guarantee food safety	→ Goal of creating a carbon tax at Europe's borders within 5 to 10 years
	Digital	– European agency for disruptive innovation – Common digital market initiative to create European regulations and promote the fair taxation of digital platforms	→ To be created within the next 2 years
	Fiscal and social convergence	– Convergence of corporate tax rates, within a range defined at the European level – Definition of a minimum wage adapted to the economic situation of each member state – Management of competition through social contribution rates	→ Compliance with these convergence criteria could be a condition for accessing European structural funds → The European Commission will continue to work on the adoption of the Common Consolidated Corporate Tax Base (CCCTB), a long-standing project

		France's proposals	European Commission's proposals*	Comments
EMU reform		– Common budget Function: stabilise the economy and support investment	– Eurozone budget line within the EU budget. Functions: funding for structural reforms, economic stabilisation, backstop support for banking union, support for the convergence of pre-accession states – Transformation of the European Stability Mechanism (ESM) into the European Monetary Fund (EMF)	→ The Commission presented its detailed proposals on 6 December: Jean Claude Juncker argues for an increase in the EU budget as part of negotiations on the next multiannual financing framework beyond 2020. → For Emmanuel Macron, the necessary budget resources could be derived in part from the harmonised corporate tax at the European level as well as from European eco and digital taxes
	Democratic functioning, Institutions	Institutions	– Democratic conventions throughout Europe in preparation for European elections in 2019 – Election of some MEPs via transnational lists – A smaller, 15-member European Commission – Unlike Jean Claude Juncker, France promotes a multi-speed Europe	– Principle of EU expansion – Expansion of the eurozone to all EU member states – Merging of the positions of Council president and Commission president, a post assigned to the "Spitzenkandidaten", the head of the candidate list of the party that wins the European elections – Merging of the positions of Commission vice-president, Eurogroup president and commissioner in charge of the economy and finances (DG ECFIN) – Greater possibilities for qualified majority voting on issues pertaining to the common market and common foreign policy
Trade talks		– European trade prosecutor – Transparency in trade talks and the implementation of trade issues	– Pursuit of trade agreements – The Commission will publish all negotiating mandates that it submits to the Council, which can then decide whether or not to publish the definitive mandates	
Youth		– Network of European universities – Harmonisation and mutual recognition of secondary diplomas		→ Goal: by 2024, half of a given age group spends 6 months in another EU country before their 25 th birthday

Table 1

Sources: BNP Paribas, from Emmanuel Macron's speech (2017) and European Commission (2017a)



Are we heading towards a multi-speed Europe? Why? At what price?

How can we advance European construction? For what purpose? What implicit choices are hidden in the terms “integration” and “deepening” of the European Union? When member states choose to preserve their national sovereignty over fiscal, social and environmental matters within a common market, they create a competitive environment that could thwart progress in these areas, and even undermine any major achievements. Inversely, harmonisation and integration can only lead to high standards and effective policies if they are accompanied by a significant transfer of sovereignty to the European level. The EU is currently immobilised by the incapacity of its members to reach a consensus on these issues.

To illustrate this point and its consequences, the European Commission published a white book on the future of Europe to mark the 60th anniversary of the Treaty of Rome. It outlines five possible development scenarios for the EU by the horizon of 2025, which range from maintaining the status quo to making a giant leap toward federalism (see box 2).

The leaders of the eurozone’s four biggest countries – which are also the biggest in the EU now that the UK is on its way out – have made their choice. In a meeting organised by François Hollande in Paris last spring, they openly advocated a multi-speed Europe in which those who want to can pursue further integration. More recently, Emmanuel Macron said that we must accommodate “*the reforming ambitions of some while allowing the others to move ahead at their own pace*”.

A choice that has consequences and risks

For these leaders, their choice offers the advantage of operating on a voluntary basis. It can also rely on intergovernmental decision-making, often the method of choice since the outbreak of the crisis. A multi-speed strategy should enable the eurozone member states to deepen integration – which is absolutely necessary to anchor the single currency – without being hampered by the need to convince the entire EU-27. Yet this is precisely why there is no consensus. Several member states fear that a “multi-speed Europe” masks the determination of some eurozone countries to go it alone. And like Mr. Juncker, they worry about what consequences these decisions might have.

So even though these four leaders seem to be firmly set on a multi-speed Europe, they must be careful that it does not create new opportunities for a Europe “à la carte”, with members choosing to opt in or out.

This strategy clearly did not work with the UK. By forming a powerful core group, the four member countries attending the summit are counting on their ability to sway other members. But how can they prevent the smaller member states from adopting free-rider strategies?

One last consideration: the EU’s heavy, troublesome decision-making process is obviously one of the factors, if not the main one, that encourages member states to resort to intergovernmental agreements in smaller groups. This suggests that for Europe, a multi-speed operating mode is not a matter of choice but a necessity in order to progress. Inversely, anything that improves the decision-making process, making it faster and more effective, will invariably facilitate EU dynamics. It is thus no accident that Mr. Juncker has made several proposals along these lines.

Box 2: Five scenarios for Europe’s future

- **Carry on the current path.** Today, the European project boasts vast ambitions, in terms of social harmonisation and the convergence of living standards, with all EU countries striving to integrate the euro... But in practice, progress is limited and gradual, since it is hard to get all 28 member states to agree on these issues. The problem is that the gap between expectations and realisations fuels public mistrust and the rise of Euroscepticism.
- **Nothing but the single market** (basically a programme that would have pleased the UK). It would mean renouncing other common policies like convergence, European structural funds and the common agricultural policy. It would also mean foregoing the ambition to harmonise social welfare and environmental standards between member states. Focusing on new priorities for Europe would offer the advantage of adjusting European ambitions to its concrete realisations. Yet the major risk of this scenario is to trigger a race to the bottom in terms of fiscal, social and environmental policies, through competition between member countries. This non-cooperative strategy would obviously be harmful for the citizens of the EU as a whole. Moreover, under these conditions, what would be the euro’s role and future?
- **Launch a multi-speed Europe**, allowing one or more circles of countries to emerge that are willing to do more in specific areas of integration.
- **Do less but more efficiently.** Member states would still advance altogether, but in fewer areas, with greater financial resources, and with a certain loss of sovereignty. To be more efficient, more restrictive decision-making procedures would be adopted, like those already set up for banking supervision and competition policy.
- **Make a giant leap towards greater integration** with the ultimate goal of creating a federal model.



Democracy or diplomacy? The problem of European decision-making and why it needs to be reformed

Europe has a hard time taking action, but must also justify its actions democratically

EU institutions were built around two ideas: a union of equals (member states) and representation by a common “European people”. This double approach carries over into their decision-making methods (see box 3). Parliamentary decisions are made with a simple majority vote, but MEPs are elected on the principle of digressive proportionality, which means that the smallest states are largely overrepresented. During the last European elections, 14 of the smaller states, representing hardly more than 10% of the EU population, were accorded nearly 20% of the seats. Within the EU Council, most decisions are made using a double majority system (at least 16 member states, representing over 65% of the EU population), which makes it highly unlikely that a decision can be made without the approval of several of the biggest member states (Germany, France and Italy account for about 40% of the EU population). At the same time, it forces the big countries to seek a consensus with their partners. Lastly, for the most sensitive areas, unanimity is required by the representatives of each state (although abstentions are permitted).

Although they exist for a reason, these complex rules are one of the main reasons for Europe’s slow and cumbersome decision-making process. We are not going to re-examine the saga of the eurozone crisis, although we would hardly be exaggerating to say that with Greece, the Europeans demonstrated their ability to act urgently, but once the emergency situation was over, they fell back into their painstakingly slow ways, and were hardly able to co-ordinate themselves. Most importantly, in the eyes of public opinion, and sometimes the institutions themselves (see below), this decision-making process lacks democratic legitimacy.

EU decision-making lacks transparency whereby national reasoning may at times play a big role, not only at the level of the Council but also in the European Parliament. In the end, nothing seems to guarantee that these decision-making procedures will produce an optimum Europe, moreover, an optimum that still remains to be defined, identified and agreed on.

Major consequences: from Euroscepticism to firm resistance to the transfer of sovereignty

In the end, the perceived lack of democratic legitimacy facilitated the rise of Euroscepticism, while the slow pace and complexity of the decision-making process encouraged maintaining the status quo. Throughout the crisis, to regain effectiveness, European leaders often

circumvented EU rules in favour of intergovernmental decision making on the fringes of European institutions (fiscal compact, creation of ESM). Today, this same reasoning calls for a multi-speed Europe. In addition, it is the perceived European Commission’s lack of legitimacy, which is seen as being too “political”, that leads the Germans to try to assign the supervision of European fiscal policies to an “independent” body like the European Stability Mechanism.

Box 3: A few characteristics of European institutions and their decision-making methods

The **European Commission** is comprised of one commissioner per member state. It has a monopoly on legislative initiatives, i.e. it is the only body that can issue proposals for directives and regulations. **Alongside the EU Council, the European Parliament shares the power to vote on draft legislation.** Following the reforms introduced by the Lisbon Treaty, the “ordinary legislative procedure” (formerly known as co-decision) gives equal weighting to the EU Council and Parliament, and stipulates that both institutions must use the same voting method for a given bill. It applies to the vast majority of European rules and directives (in number).

In the **European Parliament**, the distribution of MEPs by country follows the **principle of digressive proportionality**, with each member state assigned a number of seats according to their population, while reducing the representation gap between the big and small countries. As a result, the smaller countries are overrepresented. In the last elections, each of Malta’s six MEPs represented about 70,000 citizens, compared to nearly 840,000 for each German MEP. On average, an MEP represents about 673,000 inhabitants.

Decision making within the **EU Council** is based on a **qualified majority vote** as part of the ordinary legislative procedure. About 80% of all EU legislation is adopted in this manner. When the Council votes on a proposal by the European Commission or the EU high representative for foreign affairs and security policy, a qualified majority is reached when 55% of the member states express a favourable vote, or 16 out of 28 states, and if the proposal is approved by member states representing at least 65% of the EU’s total population.

The Council must **vote unanimously** for a certain number of sensitive areas, as specified by the member states. These include the common foreign affairs and security policy (except for a few clearly defined cases), citizenship (attributing new rights to EU citizens), EU membership, the harmonisation of national legislation on indirect taxation, EU financing (own resources, multi-annual financial framework), certain judicial and domestic affairs measures (European Prosecutor’s Office, family law, operational police cooperation, etc.) and the harmonisation of national social security and social welfare legislation. During voting, abstentions do not prevent a unanimous decision from being reached.

Lastly, the European Council (meeting of heads of state) mostly takes its decisions by consensus (no disagreements).

Sources: BNP Paribas and the European Council
(www.consilium.europa.eu.)

Under these circumstances, the transfer of sovereignty on the scale implied by a fiscal union or a veritable integrated European Defence Force was simply unthinkable. As of 2009, this was the message from the Karlsruhe constitutional court’s ruling on the Lisbon Treaty, a ruling



that laid the foundations for the Bundestag's interventionism in European decisions. This part of European construction cannot be avoided. If the EU and the eurozone want to advance towards greater integration in the future, it is absolutely necessary to close the EU's "executive and democratic deficit"¹.

So far, the proposals are not very bold

Faced with these difficulties, President Macron notably proposed to reach beyond a national reasoning, for example by reallocating the 73 seats of the outgoing UK MEPs to transnational lists during the elections in 2019, or by reducing the number of commissioners (see table 1). Jean Claude Juncker insists on strengthening its decision-making capacity, by expanding the areas requiring only a qualified majority within the EU Council. Progress could surely be made in terms of social and fiscal policies as well as foreign policy. Mr. Juncker also favours transnational lists, and would like to merge the posts of European Council President and European Commission President. Like in 2014, the post would be reserved for the head of the list of the party that wins the European elections², who would become the veritable head of the European executive arm, holding both democratic and intergovernmental legitimacy.

Strengthening EMU

In the second part of this article, we will focus on the Economic and Monetary Union (EMU) and the reforms being considered to improve its functioning and stability. Among political leaders as well as institutional and academic contributors, there is an ongoing debate over striking the right dose, to maintain or strengthen the incentives and solidarity mechanisms that are vital for the smooth functioning of a monetary union.

Which proposals are on the table?

In early December 2017, the Juncker Commission published a series of specific proposals for the eurozone. The documents provide a roadmap for deepening the eurozone in the medium term, and outline a series of measures that could feasibly be adopted before the end of the current legislature. The Commission submitted the following concrete proposals to the Council:

1. A proposal to transform the European Stability Mechanism (ESM) into the European Monetary Fund (EMF). Like its predecessor, the

¹ To use the words of Thierry Chopin, Head of Research at Fondation Robert Schuman. For a much broader analysis of the question of democratic legitimacy in the EU, see Chopin (2017).

² The "Spitzenkandidaten", the head of the list of the party that won the European elections, was first used in 2014 for Mr Juncker's nomination. Taking advantage of their power to validate the presidential candidate named by the European Council, MEPs quickly demanded that the nominated candidate be the head of the PPE list, which won the elections.

EMF's first mission would be to preserve the eurozone's stability by assisting states encountering financial difficulties. Yet it would also be a kind of "lender of last resort" for banks, by serving as a backstop for the Single Resolution Fund (SRF), the mechanism set up to implement the orderly resolution of failing banks.

2. A proposal to integrate the fundamental provisions of the Treaty on Stability, Coordination and Governance (TSCG) into EU law, as originally planned when this intergovernmental treaty was signed in 2012, reforming the eurozone's fiscal rules (also known as the European Fiscal Compact).
3. A communication on new fiscal instruments for the eurozone. They could be created as part of the EU budget, which implies that they would have to be set up for the next multi-annual fiscal framework (post 2020). During the current exploratory phase³, the report examines four budget functions. In addition to the creation of a backstop for banking union as described above, the Commission intends to create a support mechanism for structural reforms carried out by member states, a support mechanism to assist the convergence of member states in the pre-accession phase of the euro, and a stabilisation mechanism to maintain investment levels during major, asymmetrical shocks.
4. A communication defining the possible functions of a European minister of the economy and finance, who might also be a Commission vice-president and chairman of the Eurogroup, as allowed under current EU treaties.

With these proposals, the Commission is making clear its preferences on some issues that have been hotly debated in recent years. In contrast, it also leaves open a lot of options, which leaves the direction of these reforms shrouded in uncertainty. In the next section we will take a closer look at some of these factors.

Dividing missions between European institutions

The Commission's proposals are relatively clear on which European institutions should handle which missions.

The European Commission monitors national policies

The Commission will remain the key player in the "daily" monitoring of the fiscal policies of member states. Some have expressed criticism concerning the management of the Stability and Growth Pact's rules, which they claim to be overly "political" or discretionary. They would like to see this power transferred to the European Stability Mechanism, which is seen as being more independent. It should come as no surprise that Jean Claude Juncker's teams did not adopt this proposal.

³ A pilot phase for the reform support mechanism could be tested during the current fiscal programme.



For the analysis and coordination of economic policies, the Directorate-General for Economic and Financial Affairs (DG ECFIN) is likely to be given even more clout through the commissioner's nomination as Vice President of the European Commission and head of the Eurogroup.

Rules versus Discretion?

Transposing the Fiscal Compact into European Union law could create another occasion for a battle of influence between opponents and advocates of a stricter application of fiscal policies. These advocates, who still believe the absorption of national fiscal deficits is the keystone of a smoothly functioning monetary union, argue for a drastic simplification of fiscal rules. Granted, the European fiscal corpus has become virtually opaque, even for expert observers, since the application of new rules on growth and spending, followed by all the "flexibility" measures introduced by the Commission in January 2015. Another source of conflict has arisen with the introduction of such concepts as structural imbalances and adjustments in the assessment of fiscal positions, which are particularly hard to evaluate⁴. Yet these measures aim to prevent member states from being deprived of their main cyclical policy tool in a monetary union, and to prevent fiscal policies from having a fundamentally pro-cyclical nature within the EMU (see below: "What is the purpose of a fiscal union?"). For the moment, the Commission intends to transpose the intergovernmental treaty by taking these flexibility measures fully into account, but the legislative process is only just beginning.

The European Monetary Fund manages financial crises

The creation of the European Monetary Fund (EMF) is not only another occasion for an intergovernmental organisation that arose from the crisis to be integrated as closely as possible into EU law, but also an opportunity to redefine the responsibilities of each party. From this perspective, it seems clear that as part of the transformation of the European Stability Mechanism (ESM) into the European Monetary Fund (EMF), it is bound to become the institution responsible for managing any crises that risk endangering the eurozone's financial stability. It will become the lender of last resort for member states and the banks (by serving as a safety net for the bank resolution funds).

For member states, the EMF is apparently destined to play a leadership role, alongside the Commission, in designing, implementing and supervising adjustment programmes. Its growing importance should also be accompanied by diminishing roles for the IMF and ECB. Past adjustment programmes, especially the Greek crisis, have shown how the implication of these two institutions can be complex and a source of

conflict⁵. For the ECB, a diminished role is undoubtedly good news, which should prevent it from getting caught up in conflicts of interest during future crises⁶. For the IMF, disagreements with the Europeans over the best way to restructure Greek debt have apparently ended up convincing all parties that it would be difficult to work together (including Germany, who was still asking for the IMF to play a role in the 3rd bailout plan in 2016)⁷. Lastly, recent statements are not as clear concerning the withdrawal of the Commission's teams (who draw up the quarterly assessment reports) in favour of those of the EMF/ESM, but recent trends seem to be heading in this direction (with the Commission monitoring the day-to-day management of fiscal policies, and the EMF focusing on financial crisis management).

Of course, this leaves open the question of sovereignty. The Commission's report states that the EMF will conserve the EMS's financial and institutional structures, "including those concerning the role played by national parliaments", i.e. without calling into question the procedure under which several national parliaments, especially the Bundestag, are asked to give their opinion on a programme's implementation⁸.

What is the purpose of a fiscal union?

As currently presented in the texts, Europe's fiscal capacity will serve both as a fund to support structural reforms for member states (and to facilitate the convergence of states preparing to join the euro), and as an automatic stabilisation mechanism designed to improve the absorption of shocks and economic fluctuations.

For several years, Germany and certain partners have defended a vision of a "fiscal union" in which pooled resources (or certain credit lines of the EU budget) would be used to facilitate structural reforms, and payouts could even be conditioned on their implementation. Whatever the reasoning -- carrot or stick -- the key point is that the funds would not have the least cyclical application: the aim is to reinforce the economic and fiscal adjustment of each member state.

⁵ At the beginning of the crisis, the main reasons for their implication was to seek the best skills wherever they could be found (concerning economic adjustment programmes and the assessment of banking systems).

⁶ When a country is faced with a liquidity squeeze, the ECB can trigger Outright Monetary Transactions (OMT) as long as the country benefits from at least one precautionary programme opened by the ESM. For its refinancing operations, for example, the ECB can only accept public debt instruments that are below investment grade if the member state has undertaken an adjustment programme.

⁷ Should debt relief that restores a member country's solvency in a sufficiently credible manner be the starting point of an adjustment programme, or a last resort measure at its end? This is the question that led to the collapse of cooperation between the IMF and the Europeans in Greece. Everything suggests that this philosophical divergence will continue to plague other programmes, even those with private investors.

⁸ The rule is that the Governing Council must be unanimous for a programme to be adopted. For emergency decisions, however, a procedure exists that allows a programme to be adopted by a qualified majority when necessary. The threshold could be raised to 85%, which would give veto rights to the eurozone's three biggest countries: Germany, France and Italy.

⁴ Structural assessments of public finances are based on estimates of the output gap, which are complex, and estimates differ widely between institutions (in particular between the European Commission and the OECD). Coupled with growth forecasts, which are also necessary to evaluate the current trend in public finances, the risks are high and difficult to assume. Note, however, that the author is not as negative as others on the use of structural estimates for the Stability and Growth Pact.



Many observers counter this position, arguing that with a single monetary policy for all member states, the straightjacket of fiscal rules deprives them of a tool for handling asymmetric cyclical shocks (i.e. that do not affect the eurozone as a whole). Studies show that without greater risk sharing between member states, the eurozone lacks sufficient capacity to absorb shocks. In a previous article⁹, we took a more in-depth look at the arguments supporting this position, the various options under consideration, and their constraints, notably the necessary transfer of sovereignty, as well as fiscal and social harmonisation. Whether orchestrated at the European or national level, it nonetheless seems vital for member states to preserve some sort of countercyclical fiscal capacity.

The mechanism currently envisioned by the Commission is not very bold. Whereas the most ambitious proposals call for setting up an intra-European unemployment insurance system, the Commission is proposing to mobilise funds that could be allocated, or simply lent out to a member state hit specifically by a major shock (such as Ireland in the face of a hard Brexit) to preserve its investment capacity. Whereas numerous studies have shown that during times of fiscal austerity, the State's first reaction is to reduce spending (even though this is not the ideal policy), such a mechanism would encourage investment while introducing a certain counter-cyclical aspect to spending. Only countries complying with the fiscal and economic rules of the European framework would benefit from this mechanism. In the end, the Commission seems to be dragging its feet on the question of fiscal union. The respective and combined power of each of these tools will depend largely on the size of the budget lines allocated to these functions. From this perspective, the Commission should make some proposals next spring, when it begins to prepare the post-2020 multiannual financial framework. The ball will then be in the member states' camp.

Should it facilitate public debt restructuring?

At this stage, this is the blind spot in the Commission's proposals; even though several academic and institutional papers have recommended the adoption of a clear and predictable framework for restructuring the public debt of eurozone members. As the outbreak of the Greek crisis clearly illustrated, a member country cannot necessarily avoid public debt restructuring, and under these circumstances, it can be extremely damaging if the key players are ill prepared. In particular, other eurozone countries must be ready to help, via a combination of adjustment programmes and loans, but within a framework that adheres as closely as possible to the "no bail-out" clause. That said, since 2012, member states have attached collective action clauses (CAC) to their securities issues.

⁹ See Cerisier (2014)

Yet some argue that this is not enough. The Bundesbank in particular made a proposal to implement a systematic moratorium on interest payments on the public debt of a country benefiting from an EMF/ESM programme¹⁰. The moratorium would begin with the start-up of the adjustment programme and would run for three years (an adjustment programme's standard duration). For the Bundesbank (and many others), the concessional loans of the European Stability Mechanism are designed to resolve the liquidity problems of a country that must implement an adjustment programme. Insolvency, in contrast, must be handled by restructuring the country's public debt held by private investors. In practice, it is impossible to distinguish between these two situations in the midst of a confidence crisis. For its advocates, this mechanism would give the key parties involved three years to agree on the diagnosis. At the end of a European programme, if the country has regained the markets' confidence and is in a position to refinance, the moratorium would be lifted (with an ex-post diagnosis of a "liquidity crisis"). If this is not the case, to restore a member state's solvency, the moratorium would allow for the bail-in of investors to be organised in a much calmer environment.

Yet better is often the enemy of good. In the eyes of its opponents, the big fear (which is probably justified) is that this mechanism would overly strengthen mistrust in European public debt, accelerating the drying up of financing whereby ailing states end up in adjustment programmes, through a series of self-fulfilling expectations. Without adopting the systematic nature of the Bundesbank's proposal, other contributors propose to institutionalise a restructuring mechanism for European public debt, which they esteem is indispensable for ensuring the eurozone's financial stability¹¹. The Commission's proposals make no mention of these recommendations. At this stage, it is hard to know if the project has been completely abandoned, or simply postponed until progress can be made on the inseparable project of diversifying the sovereign asset portfolios of banks (see below).

The banking union and Capital Markets Union

For the Commission, these proposals round out the ones presented last October¹², which aim to complete banking union and to begin implementing a capital markets union. A lot has been done on the financial segment since the banking union project was first launched in 2012. The Commission now thinks it should be possible to complete banking union before the end of the current legislature. The communication published in October places priority on resuming negotiations on the European Deposit Insurance System (EDIS) and on setting up a roadmap for reducing the excessive volume of non-performing loans (NPL) in the banking systems. It also aims to prevent

¹⁰ See Deutsche Bundesbank (2016)

¹¹ See for example Sapir A. and Schoenmaker D. (2017)

¹² European Commission (2017c)



NPL stocks from building up again in the future. Lastly, the Commission said it was closely monitoring the work of the European Systemic Risk Board (ESRB) on sovereign bond-backed securities (SBBS). With the completion of their work, the Commission is preparing draft legislation to be presented in 2018 to facilitate the development of SBBS next year.

The other articles in this issue of Conjoncture examine in greater detail the question of the Capital Markets Union (Laurent Quignon). In this article, we nonetheless thought it would be worth repeating how and why certain components of the banking union and Capital Markets Union interact closely with the institutional and fiscal questions we have been discussing, and which are often part of the same agenda.

Private risk-sharing versus public risk-sharing

First, creating a massive common budget is not the only way to increase the capacity to absorb economic shocks within EMU. It can also be achieved through stronger financial market integration (greater intra-zone diversification of private portfolios would provide a more effective buffer against the effects of a shock in just one country) and by strengthening the risk-sharing and solidarity mechanisms incorporated in a banking union (European Deposit Insurance System; Bank Resolution Fund), which are at least partially private¹³. Although there seems to be broad agreement on the need to increase risk-sharing, there is less agreement to say the least on how to get there (greater public versus private risk-sharing mechanisms, fiscal and financial integration). In so far as they are partially interchangeable, these two approaches often clash: those most reticent to fiscal integration are happy to point out that greater capital market integration can achieve the same results, without the need to transfer sovereignty or mobilise public funds.

Does the financial system need “European Safe Bonds”?

The second factor is the deliberate effort to weaken the correlation between sovereign and banking risks, by encouraging financial institutions to diversify their investments in sovereign bonds. Two solutions are being considered to weaken or eliminate the famous “home bias” – the tendency of banks to hold large public securities portfolios from their home state: a change in the regulatory treatment of sovereign bond portfolios (according to which securities holdings, and thus the home bias, are not currently penalised according to risk) and, as we pointed out earlier, the creation of sovereign bond-backed securities. On the whole, European Safe Bonds (ESBs) would be created from the senior tranche arising from the securitisation of eurozone sovereign bond portfolios¹⁴. For the most ardent defenders of the need to strengthen European fiscal discipline, who want to set up a

credible framework for public debt restructuring, it is necessary to push through bank sovereign portfolio reforms (if home bias persist and portfolios don't adjust when risk attached to sovereign bond rises, this will be a clear obstacle to restructuring). For advocates of greater fiscal integration, which can only be imagined from a long-term horizon, ESBs could be created as part of a pilot project. Compared to the Eurobonds considered in 2011, these securities would not result in the least debt sharing between member countries, but could be issued by a public or private vehicle.

Conclusion

Numerous conditions have come together in 2018 to make it the year for jumpstarting European construction. Key political players have high ambitions, a buoyant economic environment allows them to look further ahead than usual, and academic and institutional circles have prepared the groundwork after conducting many long years of in-depth research. By presenting their proposals, Jean-Claude Juncker and Emmanuel Macron did not try to hide the existential nature of these questions. In the midst of Brexit, was the EU built to watch its members run a “race to the bottom” in terms of fiscal and social policy? Are we sure that today's eurozone could resist a second shock comparable to the 2008-09 financial crisis?

Yet several obstacles will need to be removed just as the vast programme described above is set into action. First, the shared determination to move forward does not mean that everyone is in agreement. With its proposals, the European Commission is doing all it can to thwart a multi-speed Europe and the prominence of intergovernmental methods in conducting European affairs. Acknowledging that European institutions lack democratic legitimacy, as well as the stiff resistance to the transfer of sovereignty, some states are focusing on the responsibility of each member state: priority must be given to creating an incentive framework for Europe in order to coordinate behaviour as closely as possible. Others want to go further in combining national interests, even if that means moving forward in smaller groups. Europe is certainly used to advancing on proposals that preserve a “constructive ambiguity”, but eventually a choice must be made. Second, time is running short before the next European legislature (and possibly the next economic slowdown). Yet several of Europe's big countries will have to concentrate on national issues in the months ahead (coalition talks in Germany, questions about Catalonia's autonomous status in Spain, and legislative elections in Italy), increasing the risks of a missed opportunity.

¹³ See also Quignon (2017)

¹⁴ For a detailed description of this mechanism see Brunnermeier & al. (2016). To facilitate the development of this market, an appropriate regulatory framework must be developed for these assets.



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The challenges of Capital Markets Union

Laurent Quignon

Capital Markets Union (CMU) aims to draw the best from the various financing channels, by expanding opportunities for saving and the availability of long-term financing, and to improve financial integration in the European Union. To this end, the European Commission has drawn up a lengthy but coherent list of actions, some of which have already been completed. Although the introduction of a more favourable legislative framework is essential, Capital Markets Union is a long-term process, whose success will depend above all on the behaviour of economic agents.

The liberalisation of financial flows within the European Union since its inception and then, from 1999, the creation of Economic and Monetary Union have ensured better integration of bond and equity markets. However, the dominant form of financing – bank lending – remains fragmented between member countries. Faced with the fact that financial integration was struggling to make further progress, the European Commission proposed its “Capital Markets Union action plan” in 2015. This programme is due to be completed by 2019. This ambitious initiative seeks to create a legal and institutional framework that will be more favourable to the development of capital markets across the European Union. The development of alternative sources of finance does not call into question the importance of bank overdrafts, which meet the needs of the European economy and will remain the dominant form of finance.

Capital Markets Union: mutually-reinforcing measures

The European Commission had already set out its goal of “effective and efficient supply in the capital markets for long-term financial securities” in the green paper on the long-term financing of the European economy. It provided more details of its ambitions in a further green paper, “Building a Capital Markets Union”, published in February 2015 with a three-month consultation period.

Building on Mr Juncker’s EUR 315 billion investment plan announced in October 2014, this initiative formed part of a broader suite of actions by the European executive to promote growth, employment and competitiveness within the EU. Thirty-three actions were proposed, some of which, by virtue of their scope of application, have already been included or are scheduled for inclusion in the legislative process. The actions, and the proposed timetable, were included in the “Action plan on building a Capital Markets Union”, published in September 2015. They were supplemented by nine new priority actions announced in June 2017.

Better circulation of capital to allow more efficient allocation of savings

The goals of Capital Markets Union are set out in the action plan published by the European Commission on 30 September 2015.¹

The ultimate aim is to “strengthen the European economy and stimulate investment to create jobs.”

Over the economic cycle, the ratio of productive investment to GDP in Europe is not very different from that seen in the USA (see Chart 1). In simple terms, it shows greater inertia: productive investment is more resilient when economic activity slows or declines, but is also slower to increase during recoveries, thus limiting their intensity. Trends seen since 2010 are no exception: the ratio rose steadily in the USA between 2011 and 2014, but made more hesitant progress in the euro zone.

Productive investment* as % of GDP

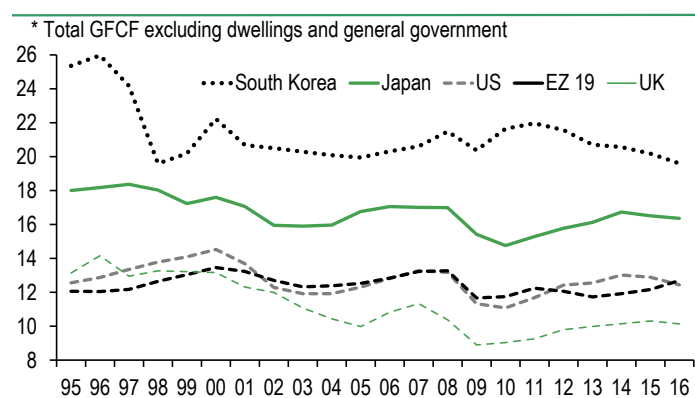


Chart 1 Sources: European Commission (Ameco), Bank of Korea, BNP Paribas

¹Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Action Plan on Building a Capital Markets Union



Noting that the free movement of capital is one of the fundamental principles of the EU (Articles 63 to 66 of the Treaty on the Functioning of the European Union), the European Commission condemned the continued fragmentation of European markets. It also highlighted that they were insufficiently developed with reference to the US economy: *"The European economy is as big as the American one, but Europe's equity markets are less than half the size, its debt markets less than a third."* However, the difference between Europe and the USA stems more from the structure of financing than the total volume (Chart 2), with the European banking system being more than twice the size of its US counterpart². Outstanding equities issued by non-financial firms (by value) do not represent a lower proportion of national wealth in Europe than in the USA, but the listed segment is significantly smaller.

Financing sizes and structures in the eurozone and the United States

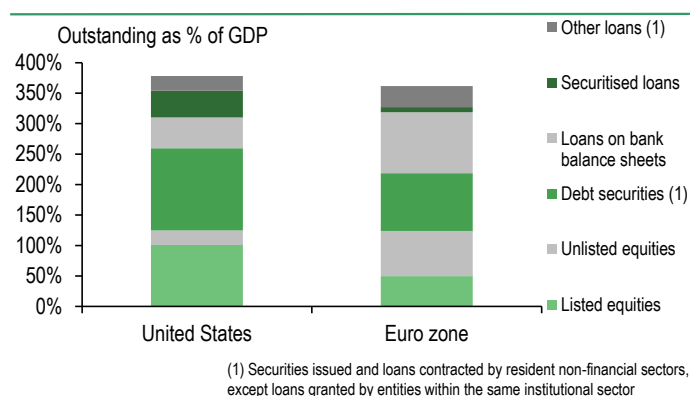


Chart 2 Sources: ECB, Federal Reserve, BNP Paribas calculations

The European Commission set itself five 'main' objectives:

1. Complement Europe's strong tradition of bank financing;
2. Unlock more investment from the EU and the rest of the world;
3. Better connect financing to investment projects across the EU and particularly those countries with less developed capital markets;
4. Make the financial system more stable through financial integration;
5. Increase competition between sources of funding to help "lower costs and increase European competitiveness".

The symmetrical correlative of the third principle is that it would also expand investment opportunities for investors from countries with more developed capital markets. We see one of the challenges of Capital Markets Union as being the difficulty of reconciling some of its objectives. For example, CMU will serve to help reduce and share risk as intended, but will also increase risk, by encouraging the development of financial intermediaries likely to share a number of

characteristics with the banking system, but without the same level of prudential oversight – so-called shadow banking. Similarly, there is perhaps a conflict between the principle of making the financing system more stable and that of increasing competition against a background of interest margins squeezed by lastingly low interest rates, given that adequate bank profitability is an established factor in financial stability.

Forty-two complementary actions

As part of the September 2015 action plan, the Commission set out a timetable (stretching from the third quarter of 2015 to 2017) for thirty-three concrete measures in response to nineteen objectives and split into six main themes. In accordance with its undertakings, in June 2017 the European Commission announced in its "Mid-term review of the CMU action plan" that it had completed more than half (20 of 33) of the actions set out in the initial programme and identified nine new actions it would take.

The thirty-three initial measures of the 2015 action plan

The first category is grouped on the basis of the purpose of its actions (corporate equity and innovation, sustainable infrastructure) according to the dominant criterion included in the content of the measure (table 1 page 23).

These include several actions to create more favourable conditions for investors, whether fiscal (to encourage venture capital) or regulatory (review of the calibration of the Capital Requirement Regulation [CRR] and Solvency II rules for investment by banks and insurers in infrastructure). Others facilitate the expression of demand for capital from companies (reducing the constraints of the prospectus directive, feedback from banks in order to allow companies to address sources of blockage).

The second category covers "ensuring consistency of the EU financial services rulebook".

The third category brings together measures seeking to foster institutional and retail investment. Some are general in nature, such as the green paper on retail financial services, whilst others are specific to certain types of investor ("prudential treatment of private equity and privately placed debt in Solvency II" for insurance companies, and "evaluation of retail investment product markets" for retail investors).

The fourth category covers "leveraging banking capacity to support the wider economy" by establishing a more favourable framework for securitisation which has not yet found a second wind in Europe (Chart 3). Although securitisation is, from an economic viewpoint, closer to market financing than bank financing (as the sale by a bank to a non-banking third party of a portfolio of bank loans 'demonetises' the latter³), its inclusion in this category is justified by the aim of freeing up regulatory capital for reallocation to new uses. With this in mind, the

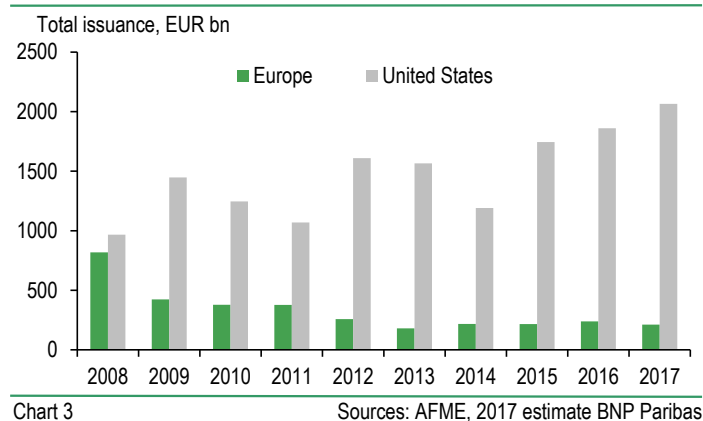
²At the end of 2016, total consolidated bank assets were EUR 42,250 bn in European Union member states and USD 19,818 bn (or EUR 18,830 bn) in the USA (sources: ECB consolidated banking data, Federal Reserve of New-York). Differences between accounting standards in Europe and the USA, which the FDIC estimates reduce reported assets at the eight US G-SIBs by around 23% (or USD 3,156 bn at end-2016), explain only a small part of this difference in size (EUR/USD = 1.05245 at 31 December 2016).

³Loans on bank balance sheets represent the main counterpart of money supply. The sale by a bank of a portfolio of loans to a resident non-bank entity results in the destruction of deposits, and thus money supply, for an amount equal to that of the portfolio purchased (unlike a transfer of assets between two non-banking resident parties, which entails a simple transfer of money from the purchaser to the vendor and does not affect deposits on a system level).



Commission will need to be careful that the relaxation of prudential requirements for certain specific types of establishment does not distort competition. The fifth and final category covers measures seeking to facilitate cross-border investing. These include the convergence of company insolvency proceedings, the removal of cross-border tax barriers and the strengthening of the powers of regulatory authorities to ensure financial stability.

European securitisation struggling to restart the engine



More than half of the measures have been undertaken, according to the European Commission

In the June 2017 update, the Commission congratulated itself on having made progress on more than half of the measures set out in the initial 2015 action plan. For example, European legislators have relaxed rules on prospectuses to make it easier to raise funds, reached agreement on securitisation and brought forward reductions of charges for investment in infrastructure projects. The Commission has also presented a proposal seeking to extend this last group of measures to investment in infrastructure corporates.

Amongst the measures for which preparatory work was announced in the action plan, several regulations have been adopted, notably regarding a “pan-European individual pension product” and the modernisation of the prospectus directive, both in June 2017; to “increase the efficiency and effectiveness of the European Systemic Risk Board (ESRB)” in September 2017; and measures to promote venture capital and social enterprises in October 2017. In addition, the Solvency II delegated act was amended in April 2016 and June 2017. Other legislative proposals, setting out “rules governing conflicts of law for third party effects of transactions in securities” and “a European Union framework for covered bonds” will shortly be brought forward by the Commission.

The European Commission is already continuing the preparatory work already under way in other areas, which were also included in the initial action plan: recommendation on private placements (building on the experience of well-functioning national regimes); consultation on the

removal of barriers to post-trade market infrastructure⁴, or so-called ‘Giovannini barriers’⁵ (based on the recommendation of the European Post Trade Forum [EPTF]), to run from August to November 2017; publication of a report on corporate bond markets in November 2017; and new outlines on withholding tax procedures to encourage cross-border investors, notably the simplification of recovering withholding taxes, issued in December 2017. Amendments to the delegated regulation supplementing Solvency II are planned for 2018.

The nine new priority actions announced in 2017

In the mid-term report of June 2017, the Commission also unveiled nine new ‘priority actions’ that had not been included in the original plan (table 2 page 26). Six of these addressed four of the objectives set out in the action plan (macroprudential supervision of markets, promotion of sustainable investment, improving equity market access for SMEs and developing cross-border investing). Of these six, four address two objectives – improving equity market access for SMEs and developing cross-border investing – reflecting the importance the Commission places on these two areas. Lastly, three of the new priority actions address three new objectives: harnessing the potential of FinTech; supporting the development of local capital market ecosystems; and facilitating the transfer of non-performing loans from bank balance sheets to the capital markets. This last objective might be considered as a version of the initial objective of developing securitisation markets.

Limited prospect of a spontaneous increase in financial integration

The ownership structure by country of residence (across all institutional sectors) for long-term financial securities (loans, long-term debt securities, listed equities, unlisted equities) in the main eurozone countries reveals the marked propensity for investors to hold securities issued by residents of their own country. This national fragmentation, which is more or less pronounced according to the type of security considered, works against the efficient allocation of savings across the EU. The countries that are most open in terms of financial flows (Ireland, the Netherlands and Luxembourg), whether they receive more foreign investment or export more capital, owe this characteristic to their attractive tax regimes, which encourage the legal establishment of a large number of financial intermediaries in these countries. Excluding these specific cases, long-term debt securities (Chart 4a) and listed equities (Chart 4c) are the instruments for which direct ownership by residents is the lowest (and therefore ownership by non-residents the highest), in proportions of between 40% and 70% and between 30% and 60% respectively. Conversely, national ownership is much greater for long-term loans (both bank and non-bank – Chart 4b) and unlisted equities (Chart 4d), where ownership by residents varies between 60% and 100% and between 60% and 90% respectively.

⁴Post-trade refers to the pathway for a security after its sale: it passes through a central counterparty and requires the intervention of a central custodian. The bodies involved in the post-trade sector are clearing houses, central custodians and security custodians.

⁵From the name of the chairman of the expert group set up by the Commission between 2001 and 2003 to examine the legal and operational barriers to post-trade integration in Europe.



An important domestic bias

Long-term debt securities

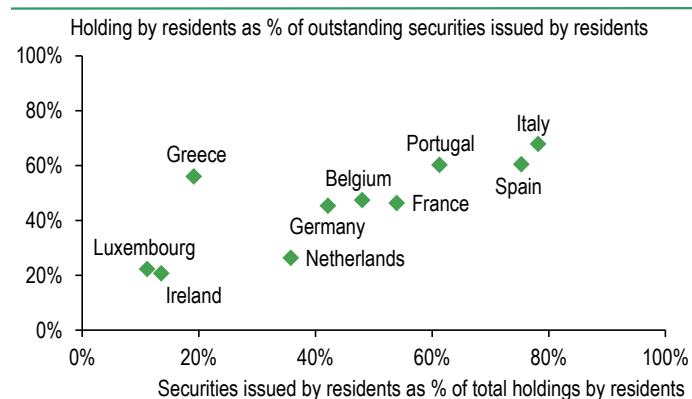


Chart 4a

Listed equities

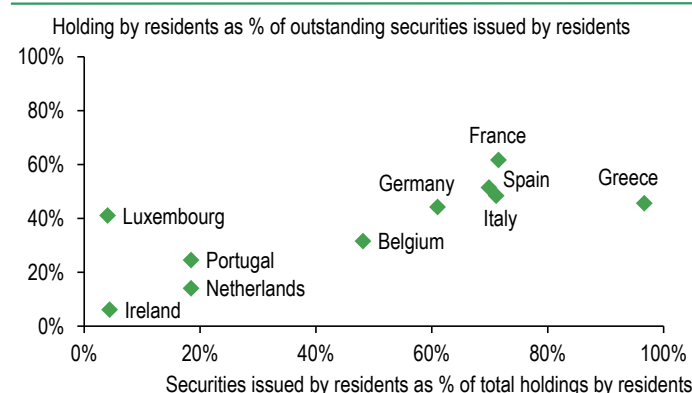


Chart 4c

Overall, having been disrupted by the crisis of 2007-2008, financial integration has been on a rising trend since early 2013, but remains well below the levels it reached in 2006. The ECB highlighted the mixed progress on capital market integration in 2016 in its latest report, "Financial integration in Europe", published in May 2017. The indicators remained stable for integration of the money market, and showed a mixed picture for banking, bond and equity markets. For example, despite rising slightly, bank loans to companies established in other member countries remained at less than 9% of total lending to businesses. This said, interest rates on business lending have continued to converge. Analysis of this indicator is, however, muddled by quantitative easing and does not allow us to conclude that integration has increased. In addition, the variations in the extent to which negative interest rates have been passed on to deposits has widened the spread on company deposits.

Long-term loans

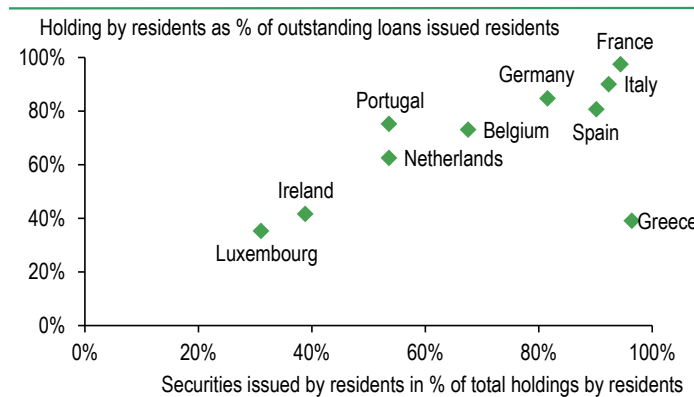


Chart 4b

Unlisted equities

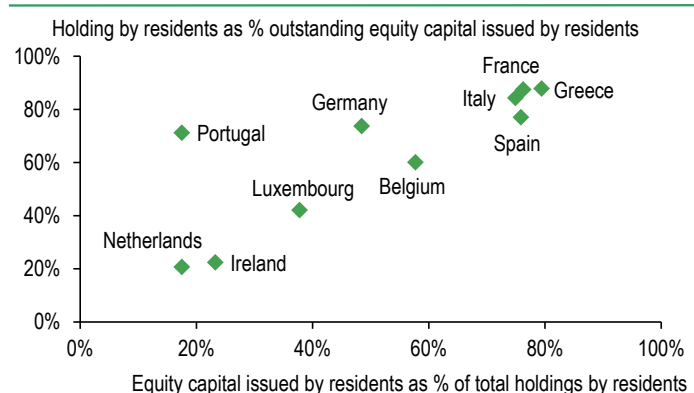


Chart 4d

Sources: ECB, BNP Paribas calculations

In the bond market, the dispersion of yields has seen a mixed trend: it has widened in the areas of sovereign and bank debt (albeit remaining well below the peak of 2011-2012) but narrowed for corporate bonds. Lastly, the level of integration of equity markets, which fell back during the financial crisis and then showed no signs of recovery until 2015, increased in 2016, as shown by the convergence of standard deviations of returns between member countries on the one hand and between sectors on the other⁶.

⁶This measure of equity market integration was first proposed by Adjaoûté and Danthine (2003). When national equity markets are highly fragmented investors initially decide on a geographical allocation of their portfolios and then, in a second stage, on its sector allocation. The standard deviation of returns between countries (which reflects not only the fragmentation between countries but also the differences in the sectoral structures of national economies) is greater than the standard deviation of returns between sectors. Conversely, international integration tends to eliminate differences in returns between countries, over and above those explained solely by differences between sectoral differences, resulting in a convergence of the two standard deviations.



Intermediation rates vary widely within the European Union

The relatively fragmented nature of bank lending and unlisted equities justifies the process of rebalancing the financing of the European economy towards better integrated forms of financing such as market securities. The relative role played by the latter in the main EU countries is very uneven, as shown by the intermediation rates of non-financial corporations debt (Chart 5). France has the lowest bank intermediation rate, at 60%, with Greece and Cyprus having the highest, at close to 100%, and Italy and Germany somewhere in between, at around 85%. One can note a negative correlation to GDP per capita (Chart 5b). This observation fits the theoretical base, which suggests that the role of capital markets tends to increase and that of bank financing to decrease – in relative terms – as economies grow. The theory of financial structure

proposed by Allen and Gale (2000) explains the shift in the structure of demand for financial services, in favour of markets, by the different nature of services provided by banks, on the one hand, and markets, on the other hand, and also by the growth in demand directed to markets as economic growth occurs. Although some empirical studies lend a degree of support to this theory (Demirguc-Kunt, Feyen and Levine (2012)), the considerable dispersion of data points about the trend line nevertheless reveals the multi-factorial drivers of the way in which financing is structured between debt markets and banks.

The preference of consumers for liquidity, the structure of the productive fabric (notably the relative importance of large companies with access to debt and equity markets), the existence, or otherwise, of an institutional savings-based pensions framework, or the degree of development of securitisation (often underpinned by explicit or implied government guarantees, as illustrated by Chart 9 for the USA)⁷ are amongst the other factors.

Bank intermediation, NFCs debt and economic development

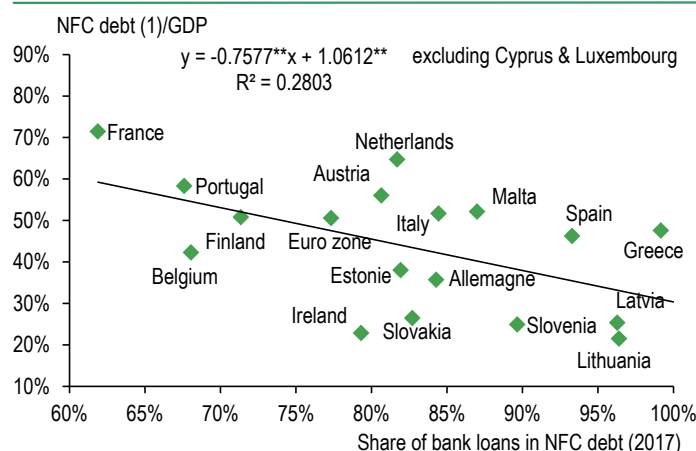


Chart 5a

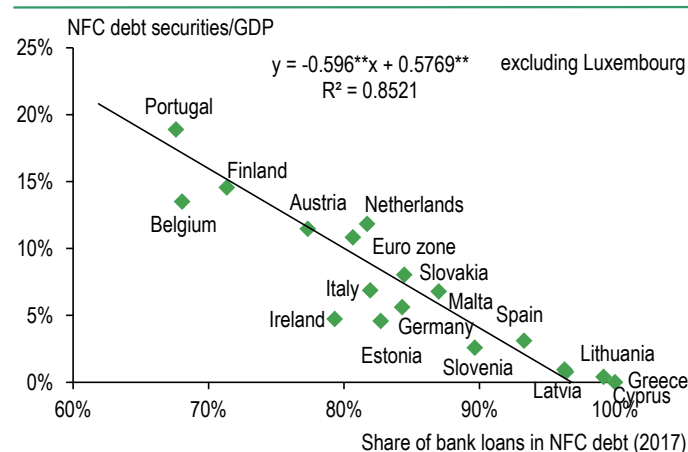


Chart 5c

* Significant variable at 10%
** Significant variable at 5%
(1) debt securities + bank loans

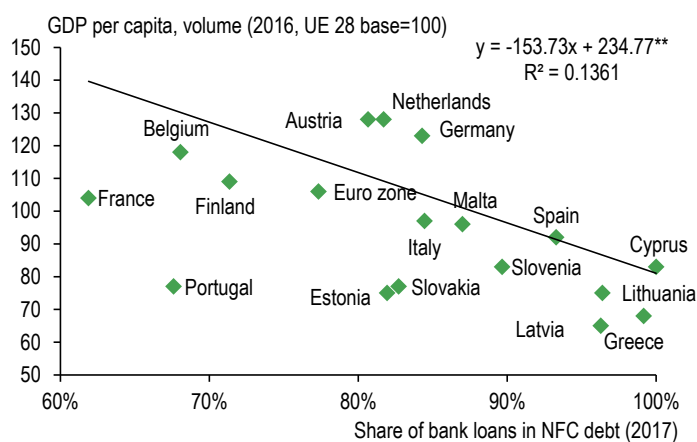


Chart 5b

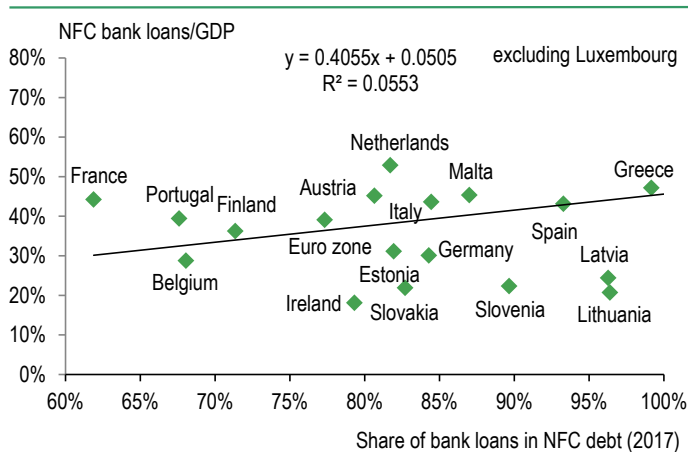


Chart 5d

Sources: ECB, Eurostat, BNP Paribas calculations

⁷ For an in-depth analysis of the factors underpinning disintermediation in the USA, see Choulet and Shulatyeva (2016), *History and major causes of US banking disintermediation*.



Financing: markets vs. banks

Capital markets union is still too often thought of only as the union of financial markets. However, it covers both market and bank financing as well as the alternatives to these two categories. The European Commission rightly believes that non-bank financing complements bank lending. In its report of 8 June 2017 it wrote, *"banks and capital markets are both vital components of the financial system, not competing but complementing each other"* (page 3), and added *"For market-based finance to be a viable and sustainable alternative to bank lending, CMU needs to build the financial circuits, market conventions and technical and legal infrastructure"* (page 16, in setting out the reasons for new priority action n°9, 'Support the development of local capital market ecosystems').

Competitors or complementary?

The figures tend to bear out this interpretation for euro zone countries. First, a fall in the rate of bank intermediation of non-financial corporations debt (from one country to another) is accompanied, on average, by a rise in the latter when expressed as a percentage of GDP (Chart 5a). Although we can demonstrate the negative relationship between corporate market debt and intermediation rates (Chart 5c), there is no statistically significant relationship between company bank debt and the bank intermediation rate (Chart 5d). Empirical relationships show that a fall in the intermediation rate implies an increase in market debt, rather than a fall in outstanding bank debt, and thus by implication a rise in total debt.

Financing structure and economic activity

The economic literature has long been interested in the relationship between financial development, taken as a whole, and economic growth (Goldsmith (1969), Levine (2005)). But it was only in the 1990s that a number of empirical studies (King and Levine (1993), Rajan and Zingales (1998), Beck et al. (2000)) considered the direction of causality, identifying a positive effect, up to a relatively high threshold, of financial development on economic activity.

Literature drawing the distinction between market and bank financing is more recent, and was renewed following the financial crisis. Work published before the financial crisis (Allen and Gale (2000), Levine (2002)) suggested no difference in the effect of direct or intermediated financing on economic growth. Thus, Levine (2005) argued that there was no reason to favour one model of financing over another on this aspect taken in isolation. More recent work (Pagano et al (2014), Cournède and Denk (2015)), the conclusions of which seem weak, suggests that more highly intermediated financial systems are associated with less dynamic growth. Finally, a study from Allen et al (2016) suggests that above all the financial system reflects the needs of the real economy. Economies with relatively larger service sectors will be increasingly financed by markets, whilst more industrial economies will see higher levels of bank financing.

The comparative stability of financial flows (for banks and markets) in the event of an economic shock or pressure on liquidity has provided a second area for analysis. The credit cycle is often seen as a

fundamental determinant of the economic cycle (Eichengreen and Mitchener (2004)).

Empirically, the credit cycle is largely determined by trends in bank lending: this shows greater variations in outstanding loans (net flows) than financing by debt securities (Chart 6). After the first Basel agreements (1998), literature on the credit crunch explained the procyclical nature of credit supply by the influence of bank solvency ratios on their lending behaviour. Thus, according to the theory of bank capital (Bernanke and Lown (1991) and Kashyap and Stein (1994)), the lending channel becomes less efficient when a significant proportion of banks see their solvency ratios move close to, or even below, the regulatory threshold. Bank solvency ratios tend to fall if the economy weakens and to recover as economic conditions improve. The increase in capital losses, whether realised or unrealised, at the bottom of the cycle exacerbates this effect (Adrian and Shin (2010)).

Looking beyond the theory of the bank capital channel, one of the main factors explaining the greater volatility of bank lending is the relative quality of bank business lending books and corporate bonds. Bank loans go primarily to small and medium-sized companies, whose markets are less diversified and are therefore inherently higher-risk than the companies issuing bonds. Counter-intuitively, a study of US and German data from 2003 to 2015 (Grimme (2017)) shows empirically that the cost of bank financing tends to fall during periods of uncertainty, whilst that of bond financing tends to rise. The author offers several avenues of interpretation of this finding. First, the costly acquisition of private information by banks allows them to reduce their own uncertainty relative to that of the markets. They will therefore favour better quality loan applications and protect themselves against adverse selection⁸ without revealing their criteria. The author does not however emphasise the role of monetary policy or the role of the banks as a vector of this policy. However, with interest rates on the bank loans considered being initially fixed for a period of less than one year, they are affected by falling policy rates and a relaxation of monetary conditions. Meanwhile, recent history has tended to show that the greater volatility of bank lending relative to market financing during periods of economic difficulty is not systematic. The market may contract sharply during a crisis (for example the interest rate markets in 2007-2008 and in 2011, Chart 6). The two types of financing can substitute for each other, at least partially, in times of volatility. We should note in passing that greater dependence of an economy on market financing does not shield it from the need for government intervention in the event of a collapse in liquidity. For example, in the USA during the financial crisis, the Federal Reserve intervened not only to help traditional commercial banks, but also markets and their participants such as investment banks (who changed their status in order to have access to the Fed's liquidity) and shadow banking (money market funds, repos, etc.), thus considerably increasing its exposure to private risk.

⁸ Adverse selection is a situation where the lender, faced with a lack of information about the borrower, increases interest rates to cover the additional risk. This has the unintended consequence of discouraging high-quality borrowers and results in the selection of higher-risk loans.



Through the prism of national accounts: the role of money creation

Over and above empirical studies of the stability and relative impact of bank and market financing on economic activity, the two areas have important differences that can be highlighted through the prism of national accounts and monetary analysis.

First, unlike bank financing, market financing does not result in the creation of money supply⁹. It is based on a stock of existing money, which circulates according to new issues of securities. Money is not destroyed, it is simply transferred from the subscriber in the security to the issuer. Bank lending, meanwhile, generally results in the creation of money supply, in the form of bank deposits. Money supply does not, therefore, represent a limit to the creation of new non-monetary financial assets (new securities purchased) and liabilities (the same securities issued), as the process is made possible by simple circulation of money. In the event of a reduction in money supply, this can be offset by increased velocity in the circulation of money for the creation of financial assets and liabilities (as securities are issued in exchange for a transfer of deposits from the subscriber to the issuer).

Against this background, savings, in their definition within national accounts (in flow terms) are not a limit on financing. In itself, an issue of securities (financing) between a subscriber sector and an issuer sector is not reflected in the institutional sectors accounts (non-financial transactions, for production, generation of income and (re)distribution) and therefore does not, as such, modify their respective balances (financing capacity and/or need (in flow terms)). Nor does it affect the net wealth of the two sectors in question. The subscriber sector substitutes securities for money in its assets. The issuer sector, meanwhile, increases its liabilities by the value of the securities issued, but increases its assets by the same amount, reflecting the money received in exchange for the securities. Similarly, the granting of a bank loan (or its equivalent, the subscription of securities by a bank) is not reflected in the sectors' accounts. Neither the flow of net savings of the bank sector nor that of the borrower sector is affected by the transaction, as assets and liabilities increase by identical amounts.

Use of bank loans and debt securities by non-financial companies in the eurozone

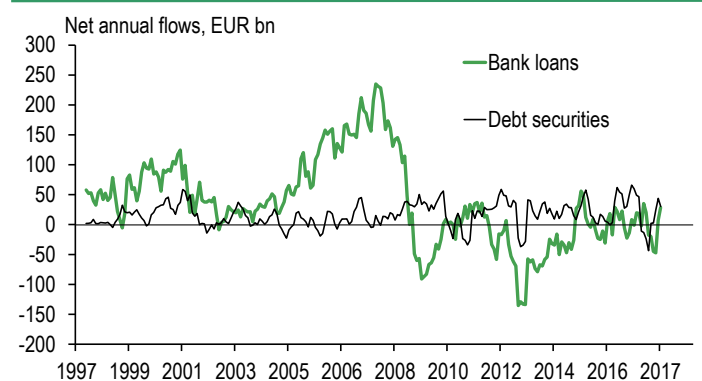


Chart 6

Sources: ECB, BNP Paribas calculations

It is in a second phase, that of the transaction financed (or investment), rather than in the financing itself, that we see an increase in the financing requirement of the borrowing sector, then, as the revenue raised in the transaction is distributed between various sectors, an increase in savings (neither uniquely nor necessarily the sector that originally received the financing) of an amount identical (in absolute terms) to the increase in the financing requirement of the borrowing sector (which is necessarily, all other things being equal, identical to the amount of the investment).

The frequent confusion between saving and financing arises from the fact that savings as viewed in national accounts are net savings. This non-consumed portion of savings is equal to changes in financial assets less changes in financial liabilities (valuation effects being ignored for the purposes of the demonstration). For each institutional sector, net savings (in nominal terms) are created over time by the accumulation of financing capacity and/or requirements. They tell us nothing about the stocks of financial assets and liabilities accrued not solely from this process of accumulation. This means that the financing capacity of an institutional sector shows its net, rather than its gross capacity. From the point of view of potential revenue (GDP) creation, however, it is the gross financing of the transaction that determines its crystallisation¹⁰. Thus, for example, US households, despite a much lower savings rate than their European peers, have a significantly higher ratio of financial assets to income, reflecting a higher gross financing capacity. This results from higher financial indebtedness. US households are more willing to borrow to finance consumption spending and, at the same time, devote a greater share of their gross stock of financial savings to long-term securities (equities in particular, through optional '401K' pension plans and Individual Retirement Accounts, which offer considerable tax incentives, but also bonds).

Two American specificities

The 'Excess Savings View' presents the concomitant accumulation of current account deficits in the USA and, as a mirror effect, current account surpluses in other economies (China, emerging Asian countries, oil exporting countries) as one of the main factors behind the expansion of capital markets in the USA. Critics of this theory accuse it of confusing gross and net flows (or outstandings). Borio (2011) does not condemn the theory outright, but shows that the worsening of the US current account balance is not sufficient, on its own, to support it. Even so, the record shows that the deterioration in America's current account balance from the late 1970s came alongside the expansion of its bond market (Chart 7), whilst the contraction of the current account deficit from 2008 was accompanied by a reduction in the net issuance of debt securities (across all sectors). The net issuance flow of debt securities is, however, significantly higher than the current account deficit, which suggests a relatively loose relationship between the two, notably due to portfolio investment by US residents in the rest of the world.

This said, the direction of causality in the relationship could be argued over endlessly. Given that purchases of securities by non-residents do not in themselves affect current account balances (such purchases are

⁹Other than in the case where the securities are subscribed for or purchased by banks.

¹⁰It should also be noted that interest rate trends and financial stability also depend more on the gross financing capacity of various economic agents than on their net equivalents.



balanced by monetary transfers and are thus simple financial transactions), the assertion that only those economic transactions (and the resulting imports) relating to goods and services cause the US current account deficit to rise, and the surpluses of exporting to do likewise, is accurate. However, for these transactions to be carried out they must first be financed. It is also worth noting that the apparent negative link between the development of financial markets and the observed current account balance in the USA does not hold good – far from it – for all countries.

Current account balance and issuance of debt securities in the United States: debate over direction of (partial) causality

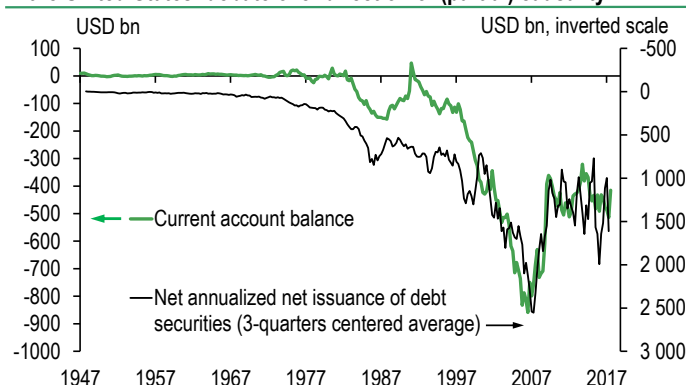


Chart 7 Sources: Federele Reserve of St Louis, BNP Paribas calculations

Rapid growth in United States debt securities market driven by financial sector until 2007...

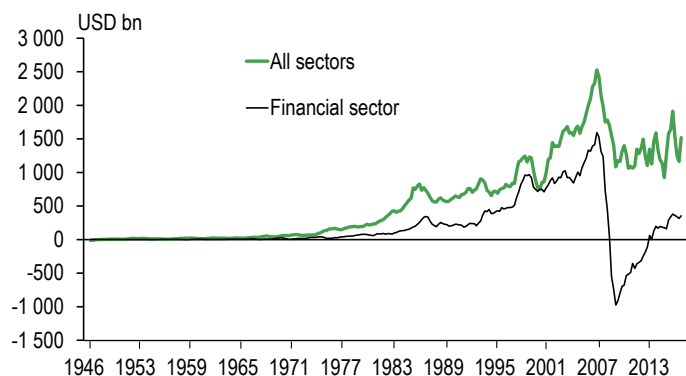


Chart 8 Source: Federal Reserve (United States national accounts)

Lastly, in the USA, between the late 1970s and 2007 the financial sector was responsible for a growing proportion of debt security issuance (Chart 8). The securitisation sector played a dominant role in this (Chart 9), due in particular to the existence of securitisation issues that were not only labelled but also guaranteed or issued directly by the agencies. Without pronouncing on the value of this characteristic, its absence in the European simple, transparent and standardised (STS) securitisation initiative risks holding back the development of the securitisation market in the European Union. The European Commission estimates that the introduction of a parcel of legislation on STS securitisation from 1st January 2019 could mobilise between EUR 100 bn and EUR 150 bn per year in additional funding for the European economy. This figure might look ambitious given the current level of issuance in the European

Union (around EUR 210 bn in 2017), particularly if we strip out UK securitisation (around EUR 45 bn in 2017). It looks more modest, albeit still significant, in the context of global financing flows¹¹ and US issuance.

In summary, bank intermediation results in greater money creation whilst market financing implies higher velocity of a given quantity of money to support the increase in financial transactions. The contribution of the non-resident sector to the financing of a disintermediated economy is not systematic. It can be both the cause (by providing the financing) and the consequence of high final demand (which stimulates the exports and thus the savings capacity of the foreign economy). Where it is a cause, the appetite of foreign investors for securities issued by residents improves financing conditions (relative to where they would be in the absence of foreign investors). This bolsters domestic demand, but can hit the trade balance by driving up the currency.

...and by the securitisation market

Net insurance, USD bn annual cumulative

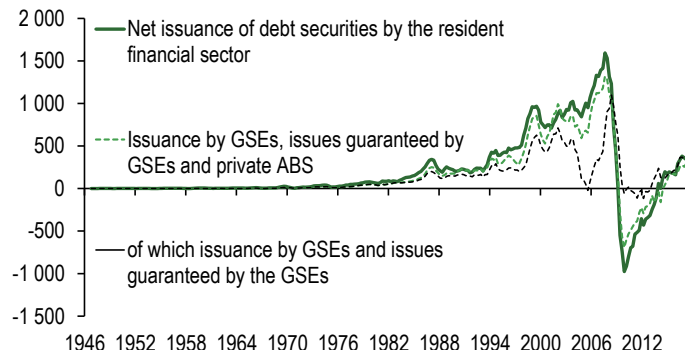


Chart 9 Source: Federal Reserve (United States national accounts)

The role of financial intermediaries in transformation of maturities in the eurozone

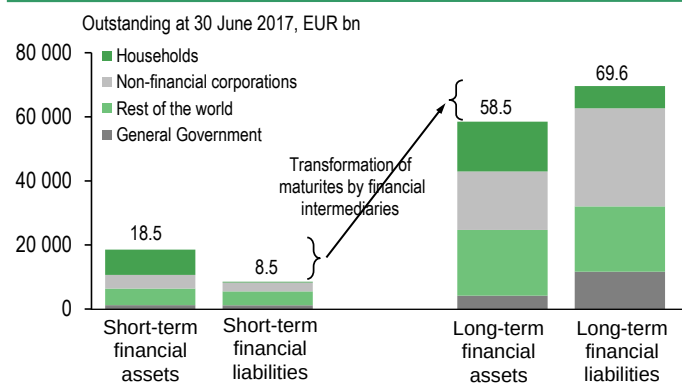


Chart 10 Sources: ECB, BNP Paribas calculations

¹¹ By way of comparison, non-financial companies in the euro zone took out EUR 2,540 bn in new bank lending in 2017 (gross new lending), whilst gross issuance of debt securities was EUR 650 bn.



Most importantly, just as the structure of financing of an economy between direct and intermediate funding meets the needs of businesses (see Allen et al (2016), cited above), it also reflects savers' preferences. Thus the transformation of maturities and risks carried out by banks in the euro zone helps fill the gap, in terms of outstandings, between financing and long-term savings, by transforming surplus short-term savings (relative to short-term financing) into surplus long-term financing (Chart 10). This transformation increases the quantity of long-term resources available and contributes to reducing the cost of long-term financing. This important feature of banking intermediation – which has beneficial effects in the euro zone – does not call into question the need for better developed markets for listed company capital instruments, which banks have no role in financing. This analysis reveals the usefully complementary nature of bank intermediation and market financing. Bank intermediation of certain long-term financing (bonds and company loans) within the eurozone consumer deposits to be preserved and simultaneously protects the share of consumer portfolios that could potentially be allocated to higher risk securities. This propensity of households to invest in listed equity, which is all the more valuable when it is modest, would not remain intact if households devoted a greater share of their portfolio to bonds or securitisation issues.

with economic and monetary “Union” and banking “Union” and thus to emphasise the importance of the subject and the European Commission's ambitions in this area. On a different scale to these two other ‘Unions’, the institutional content of CMU is smaller (with the possible exception of the strengthening of the powers of supervisory authorities). As a result its effectiveness (or indeed its reality) will depend above all on the behaviour of private agents (savers and companies) and/or the efficiency of the incentives – which will not only be fiscal – on offer. The other two ‘Unions’ came into being first through the institutions and institutional mechanisms created specifically for them (although these were then strengthened by the behaviours of economic agents). Thus EMU was founded on the creation of the European Central Bank (ECB) and the European system of central banks, whilst Banking Union was founded on the supervisory role granted to the ECB, on the Single Supervisory Mechanism (SSM), on resolution structures and on the planned European Deposit Insurance Scheme. The process will be different for Capital Markets Union: the European Commission's initiatives will provide some, much needed, momentum, but it will be down to economic agents – savers, companies and the financial community – to transform this into a lasting trend.

Completed on 30 January 2018
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Conclusion

Capital Markets Union is a welcome initiative to improve the allocation of savings in the European Union, based on a broadening of sources of financing for companies and of investment opportunities for savers. The main difficulties lie in reconciling some of its targets and in addressing the cultural preference of savers for investments that are liquid and low-risk, and therefore offer low returns (hence the key role of banking intermediation in bridging the gap between saver preferences and company needs). One potential trap (avoided by the European Commission in its action plan) would be to play capital markets off against the banks, in the belief that the former can replace the latter. Banks are an essential cog in the system. Through the constant rotation of their ‘trading books’ in particular, they ensure secondary market liquidity, which is essential for the proper functioning of primary markets. In addition, some funding, such as equity capital, is destined to come in its entirety (or close to it) from non-bank sources. In such cases intermediation is not the most appropriate solution (a bank has no real purpose in investing a significant share of its portfolio in equity capital), and the European economy would clearly benefit from better developed markets for such securities. As the Commission recognises, moves in this direction will naturally require action both on the side of issuers (e.g. facilitating equity market access for smaller companies) and the side of investors (e.g. persuading savers of the attractions of this type of long-term investment).

The removal of the term “Community” and its replacement with the term “Union” in the Lisbon Treaty that came into effect on 1 December 2009 was about more than semantics. It recognised the establishment of the legal personality of the European Union and reflected the desire to increase political and economic integration. Similarly, the choice of “Union” for capital markets is a clear attempt to create parity of esteem



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Review of the measures in the initial 2015 action plan

Theme 1: Financing for innovation, start-ups and non-listed companies		
Goal	Measure	Progress
Support venture capital and equity financing	1. Proposal for pan-European venture capital fund-of-funds and multi-country funds	Call for expressions of interest completed in January 2017. Selection of managers in Q3 2017
	2. Revise EuVECA ¹² and EuSEF ¹³ legislation	Regulation adopted (October 2017)
	3. Study on tax incentives for venture capital and business angels	Study of national tax incentives (June 2017)
Overcome information barriers to SME investment	4. Strengthen feedback given by banks declining SME credit applications Q2 2016	European banking associations have supported the principle of providing feedback from banks on the reasons SME loan applications were declined (June 2017).
	5. Map out existing local or national support and advisory capacities across the EU to promote best practices	Working document on information barriers in the SME funding market (June 2017)
	6. Investigate how to develop or support pan-European information systems	
Promote innovative forms of corporate financing	7. Report on crowdfunding	Report published (May 2016)
	8. Develop a coordinated approach to loan origination by funds and assess the case for a future EU framework	ESMA opinion received in April 2016
Theme 2: Making it easier for companies to enter and raise capital on public markets		
Goal	Measure	Progress
Strengthen access to public markets	9. Proposal to modernise the Prospectus Directive	Regulation adopted (June 2017)
	10. Review EU corporate bond markets, focusing on how market liquidity can be improved	Publication of "Observations and recommendations" from the expert group and study on determinants of liquidity in the corporate bond market commissioned by the European Commission on 20 November 2017, followed by a public hearing
	11. Review regulatory barriers to SME admission on public markets and SME Growth Markets	<i>Consultation: Building a proportionate regulatory environment to support SME listing</i> (18 December 2017 to 26 February 2018)
Support equity financing	12. Address the debt-equity bias, as part of the legislative proposal on the Common Consolidated Corporate Tax Base	Proposal as part of the Common Consolidated Corporate Tax Base directive for corporate tax to include a "deduction for growth and investment" (November 2016)

¹² European Venture Capital Funds

¹³ European Social Entrepreneurship Funds (EuSEF)

Theme 3: Investing for long term, infrastructure and sustainable investment		
Goal	Measure	Progress
Support infrastructure investment	13. Adjust Solvency II calibrations for insurers' investment in infrastructure and European Long Term Investment Funds (ELTIF)	Amendments to the Solvency II delegated act (April 2016 and June 2017).
	14. Review of the CRR for banks, making changes on infrastructure calibrations, if appropriate	Agreement of co-legislators on initial key measures (November 2017)
Theme 4: Ensure consistency of EU financial services rulebook		
Goal	Measure	Progress
Ensure consistency of EU financial services rulebook	15. Call for evidence on the cumulative impact of the financial reform	Communiqué <i>Call for evidence – EU regulatory framework for financial services</i> adopted in November 2016
Theme 5: Fostering retail and institutional investment		
Goal	Measure	Progress
Increase choice and competition for retail	16. Green Paper on retail financial services and insurance	Green paper (December 2015), action plan on financial services for consumers adopted (March 2017)
Help retail investors get a better deal	17. EU retail investment product markets assessment	Review launched (December 2016)
Support saving for retirement	18. Assessment of the case for a policy framework to establish European personal pensions	Consultation (August-October 2016), Review of fiscal aspects (September 2016), Public hearing (October 2016)
Expand opportunities for institutional investors and fund managers	19. Assessment of the prudential treatment of private equity and privately placed debt in Solvency II	Amendments to the Solvency II delegated act announced for 2018
	20. Consultation on the main barriers to the cross-border distribution of investment funds	Public consultation (June-October 2016)
Theme 6: Leveraging banking capacity to support the wider economy		
Goal	Measure	Progress
Strengthen local financing networks	21. Explore the possibility for all Member States to authorise credit unions outside the EU's capital requirements rules for banks	Proposed directive amending the CRD to give the Commission the power to exempt, under certain conditions, a country's credit unions (November 2016)
Build EU securitisation markets	22. Proposal on simple, transparent and standardised (STS) securitisations and revision of the capital calibrations for banks	Adoption by the Council of rules seeking to facilitate the development of the securitisation market in Europe (November 2017)

Theme 7: Facilitating cross-border investing		
Goal	Measure	Progress
Remove national barriers to cross-border investment	24. Report on national barriers to the free movement of capital	Expert group Report published (March 2017)
Improve market infrastructure for cross-border investing	25. Targeted action on securities ownership rules and third-party effects of assignment of claims	Expert group (March 2017) Consultation (April-June 2017) Directive to promote long-term commitment of shareholders (May 2017)
	26. Review progress in removing remaining Giovannini barriers	Expert group report (August 2017) Consultation (August-November 2017)
Foster convergence of insolvency proceedings	27. Legislative initiative on business insolvency, addressing the most important barriers to the free flow of capital	Proposed directive (November 2016)
Remove cross-border tax barriers	28. Best practice and code of conduct for relief-at-source from withholding taxes procedures	The Commission is working on a code of best practice with member states
	29. Study on discriminatory tax obstacles to cross-border investment by pension funds and life insurers	Review launched (December 2016)
Strengthen supervisory convergence and capital market capacity building	30. Strategy on supervisory convergence to improve the functioning of the single market for capital	Second working party report on supervisory convergence published by ESMA (February 2017)
	31. White paper on ESA's funding and governance	Consultation (March-May 2017)
	32. Develop a strategy for providing technical assistance to Member States to support capital markets' capacity	Regulation "establishing the support programme for structural reform for the period 2017-2020" (May 2017)
Enhance capacity to preserve financial stability	33. Review of the EU macroprudential framework	Consultation (August-October 2016); Public hearing (November 2016); Proposed regulation to improve efficiency and effectiveness of ESRB ¹⁴ (September 2017)

Table 1

Source: BNP Paribas

¹⁴European Systemic Risk Board


The nine new priority actions announced in June 2017

Goal	Priority action
Strengthen the effectiveness of supervision to accelerate market integration	Priority action 1: in September 2017, the Commission proposed a regulation to amend the functioning of ESMA and other European supervisory bodies (EBA, EIOPA) with a view to strengthening the effectiveness and consistency of supervision across the EU and beyond. The Commission wants to strengthen ESMA's powers in certain key areas, including, where necessary, giving it a direct supervisory role, in order to support the operation of Capital Markets Union.
Enhance the proportionality of rules to support initial public offerings and investment firms	Priority action 2: The Commission will explore through an impact assessment whether targeted amendments to relevant EU legislation could deliver a more proportionate regulatory environment to support SME listing on public markets. This analysis could lead to targeted changes in sectoral legislation in the second quarter of 2018.
	Priority action 3: On 20 December 2017, the Commission presented a legislative proposal regarding the prudential treatment of investment firms.
Harness the potential of FinTech	Priority action 4: as part of a comprehensive approach to enable FinTech, the Commission will assess the case for an EU licensing and passporting framework for FinTech activities. Public consultation (March-June 2017)
Use capital markets to strengthen bank lending and stability	Priority action 5: as part of its efforts to address the NPL issue, the Commission will present measures to support secondary markets for non-performing loans. The Commission will also launch an impact assessment with a view to considering a possible legislative initiative to strengthen the ability of secured creditors to recover value from secured loans to corporates and entrepreneurs (Q1 2018), while remaining consistent with and complementary to the Commission proposal of November 2016 on the effective functioning of the pre-insolvency/restructuring systems and doing its utmost to support the co-legislators in finding an agreement on that proposal as a priority.
Strengthen the EU's leadership on sustainable investment	Priority action 6: the Commission will decide by Q1 2018 at the latest on the concrete follow-up that it will give to the recommendations of the High Level Expert Group on Sustainable Finance. In particular, it shall already set in motion work to prepare measures to improve disclosure and better integrate sustainability/ESG in rating methodologies and supervisory processes, as well as in the investment mandates of institutional investors and asset managers. It will also develop an approach for taking sustainability considerations into account in upcoming legislative reviews of financial legislation.
Cross-border investment	Priority action 7: the Commission will launch an impact assessment with a view to considering a possible legislative proposal to facilitate the cross-border distribution and supervision of UCITS and AIFs in Q1 2018.
	Priority action 8: in Q1 2018, the Commission will adopt an interpretative Communication to provide guidance on existing EU rules for the treatment of cross-border EU investments. It will also immediately launch an impact assessment with a view to setting out an adequate framework for the amicable resolution of investment disputes.
Support the development of local capital market ecosystems	Priority action 9: by Q2 2018, the Commission will propose a comprehensive EU strategy on steps that can be taken at EU level to support local and regional capital market development across the EU. This will build on the report of the Vienna Initiative's CMU Working Group and will take account of experience through the growing delivery of on-demand technical support under the Commission's Structural Reform Support Programme.

Table 2

Sources: Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Action Plan on Building a Capital Markets Union, 8 June 2017, COM(2017) 292 final, European Commission, BNP Paribas

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