IN-DEPTH ANALYSIS

Requested by the ECON committee

Monetary Dialogue Papers, September 2024

One Money, One Financial Market

The Capital Markets Union

Economic Governance and EMU scrutiny Unit (EGOV)
Directorate-General for Internal Policies
PE 760.250 - September 2024

EN

One Money, One Financial Market

The Capital Markets Union

Abstract

Bringing all European financial markets under one roof, the Capital Markets Union (CMU), stands to provide European savers and borrowers with better opportunities. This, in turn, is expected to boost long-term growth and to improve the functioning of the Economic and Monetary Union (EMU). Yet, powerful private and public interest groups have been able so far to stand in the way of this transformation. Most governments are torn between the benefits from CMU and the pressure of these interest groups.

This document was provided by the Economic Governance and EMU Scrutiny Unit at the request of the Committee on Economic and Monetary Affairs (ECON) ahead of the Monetary Dialogue with the ECB President on 30 September 2024.

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

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LINGUISTIC VERSIONS
Original: EN

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Manuscript completed in September 2024

This document was prepared as part of a series on "How relevant is the Capital Markets Union for monetary policy?", available on the internet at:
https://www.europarl.europa.eu/committees/en/econ/econ-policies/monetary-dialogue

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LIST OF ABBREVIATIONS

CMU	Capital Markets Union
ECB	European Central Bank
EP	European Parliament
ETF	Exchange Traded Funds
EU	European Union
EMU	Economic and Monetary Union
ESMA	European Securities and Markets Authority
UCITS	Undertakings Collective Investment in Transferable Securities
GDP	Gross Domestic Product
USD	US dollar

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EXECUTIVE SUMMARY

- **The benefits of the Capital Markets Union (CMU) have been well understood for a long time**. The completion of the CMU would boost long-term economic growth by easing the funding of private investments, and would facilitate borrowing by governments. In addition, it would offer savers a wider menu of options at better conditions. The CMU would also strengthen the transmission of monetary policy to euro area economies.
- **Without the CMU, national financial markets are fragmented and inefficient**. Banks continue to dominate in collecting savings and lending to corporations, but they are generally quite conservative in risk-taking. A large financial market would make it easier for start-ups to find the resources that they need to flourish globally.
- **The absence of a CMU also reduces the effectiveness of monetary policy**. The main concern is that policy actions have different effects on borrowing costs in different countries, thus preventing monetary policy to be truly "single". While some of the existing distortions stand to be eliminated by the creation of the CMU, the main source is the diversity of the sizes of public debts.
- **A number of "low-hanging fruits" have been proposed by the European Commission and a few of them were accepted**. They are essentially technical and narrow and, while they represent useful steps in the right direction, they are not sufficient to achieve the CMU.
- **There is a general agreement among analysts that the necessary condition for the creation of the CMU is to adopt a single rulebook enforced by a single supervisor**. Currently, the rules applied to financial markets are broadly agreed at the European level and then formally adopted at the national level with small but important variations. Similarly, there is a European supervisor but it operates under the control of the national supervisors.
- **Powerful particular interests have been successful in standing in the way of the CMU over a decade**. Judging from the recent official statements, they are still able to discard the key measures that would trigger the shift to the CMU.
- **These particular interests are promoted by three groups**. First, market participants who have developed longstanding relationships with their national authorities. Second, the national authorities themselves, who would lose their powers in the CMU. Third, foreign financial markets, which attract the businesses of European savers and borrowers who avoid the weak and relatively inefficient European financial markets.
- **The adoption of the CMU will not happen as long as these particular interests influence the national governments**. The governments themselves benefit from easy access to financing of their debts and deficits and are keen to protect their own financial markets.
- **The recent official statements are a response to two challenges that governments now face**: financing more public spending and accelerating long-term economic growth, which has been weak over recent decades. It is an open question whether these priorities will tilt governments into confronting particular interests.

1. INTRODUCTION: A REFORM LONG IN WAITING

Even before the adoption of the euro, it was realised that many of the benefits expected from the single currency would require a complete integration of financial markets. The presence of different currencies had been a natural source of poor integration because exchange rate fluctuations resulted in country-specific risks, which would disappear under the right conditions. However, it was also recognised that the loss of the exchange rate would close a key channel for adjustment of asymmetric shocks – shocks that do not affect the Economic and Monetary Union (EMU) Member States in the same way or only affect a subset of Member States. Moderating this adverse effect would call for either fiscal policy interventions or international private borrowing. The latter, however, would require capital mobility. Financial integration would not just be an additional benefit from the euro adoption, it would be a condition for its smooth functioning. Sadly, financial integration remains an objective, not an achievement.

The conditions for achieving financial integration were largely ignored in the official literature. The historical "One Market, One Money" (European Commission, 1990) paper and the Delors Report (1988) explicitly noted that one benefit of the single currency would be to deepen financial integration within EMU. But they did not pay much attention to its role in helping to absorb asymmetric shocks, nor the need for the European Central Bank (ECB) to deal with a unified financial market. "One Market, One Money" mainly talks about one market, the goods market. The academic literature was concerned by the need for what eventually became the Banking Union, reflecting the limited role of financial markets in Europe.

Section 2 presents the theory behind the importance of a full-fledged financial integration in Europe, especially in the monetary union. It also explains why the financial integration objective has become urgent: Europe's humiliating deterioration of its position in high technology and the limited room for additional public spending in many countries, at a time when geopolitical considerations have become acute. An innovative private sector has to be part of the answer. Channelling abundant private spending toward dynamic entrepreneurs must be a crucial part of the answer.

This logic, backed by substantial empirical evidence, would seem incontrovertible. Section 3 shows that a combination of special interests, both private and public, and both European and foreign, has been effective at delaying the necessary changes. They have opted to respond to the pressure by circumscribing policy responses to small and ultimately ineffective measures that maintain the status quo.

Section 4 notes that it will not be easy to overcome these powerful roadblocks. In the past, major progress has followed spectacular crises. In the present case, the lack of capital market integration is most unlikely to result in a full-blown crisis. Instead, we face a slow, almost painless decay, which is explained by many factors, including weak financial markets. Adopting the Capital Markets Union (CMU) is a necessary, but not sufficient condition for raising long-term growth and achieving resilience in front of geopolitical challenges.

Two European institutions have thrown their weight in favour of the CMU. The ECB has long been calling for better financial markets integration. To the risk-absorbing and growth-enhancing motives, it has added the benefits for monetary policy transmission. Indeed, monetary policy operates through its impact on financial markets. If these markets are segmented, monetary policy actions stand to have quantitatively different impacts from one country to another, which complicates the central bank's task. The ECB's campaign to establish the Banking Union only came to fruition after the debt crisis that started in 2010, but then it was put in charge of bank supervision. In the event of the creation of the

CMU, it will likely be involved as well, but its role remains to be thought through. Tasked with encouraging further integration, the European Commission too has long supported the CMU and will seek to be involved. The European Parliament, on the other hand, has not taken a clear side about the CMU.

2. THE LOGIC OF THE CAPITAL MARKETS UNION

2.1. Shock absorption

When the possibility of creating a common currency became a live issue, policymakers and academic economists travelled different paths. Both agreed that the common central bank should be independent and that its mandate should be, first and foremost, price stability. But, while policymakers focused on building robust institutions, academic economists were primarily concerned with the costs and benefits of a common currency, initially at least. Eventually, they turned their attention to financial stability.

The loss of national exchange rates was identified as a potential cost, in addition to major benefits. Adjusting the exchange rate had been the primary tool to deal with asymmetric shocks. Without this instrument, depending on whether the shock affecting a particular country was contractionary or expansionary, sizeable recessions or bouts of inflation were likely (Mundell, 1961). What could replace this instrument? Flexible labour markets or trade flows could play a role, but many estimates that compared the prospective EMU with the United States (US) suggested that Europe was likely to respond poorly (Blanchard and Katz, 1992; Decressin and Fatas, 1995). Countercyclical fiscal policy was seen as more promising, but it raised issues of budgetary discipline. The comparisons with the US showed that private borrowing and lending played a more important role there than in the EU because of the combination of integrated financial markets and strict borrowing limits on US states' borrowings (Sachs and Sala-i-Martín, 1992; Masson, 1996; Eichengreen and Wyplosz, 1998).

This observation led to broader questions about the impact of the common currency on the role and structure of financial markets. Early analyses (e.g. Begg et al., 1991, 1998; Danthine et al., 1999; Favero et al. 2000) warned that banks could be prone to crises and that regulation and supervision should be centralised. They also noted that the ECB should be in charge not just of monetary policy but also of financial stability.

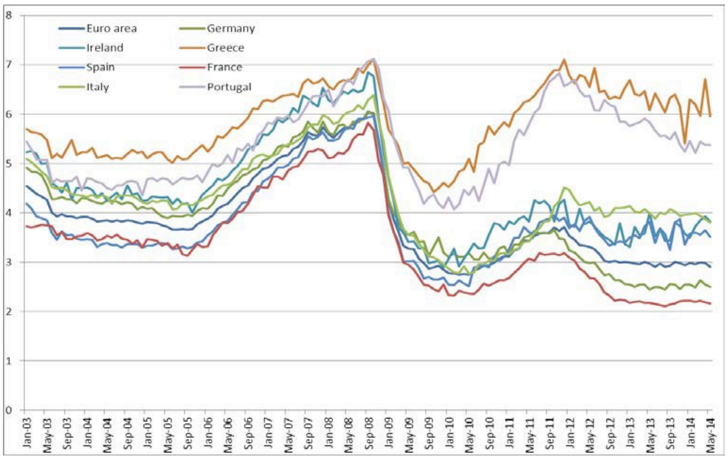
More broadly, a recent paper by Asdrubali et al. (2024) reviews empirical studies on shock absorption and provides new evidence concerning the advanced economies. They show that shock absorption is hampered by "financial frictions", i.e. dysfunctions in the financial markets. This is especially the case when they are most needed at times of recessions. The main distortions concern exchange rate depreciations, which raise the costs of foreign borrowing, and a tightening of credit availability, which makes it difficult for households and firms to borrow during bad times. EMU eliminates the first friction, but national-based financial markets magnify the second one. They conclude that the evidence strengthens the case for a CMU.

2.2. Effectiveness of monetary policy

Since monetary policy mostly operates through financial markets, its effectiveness largely relies on financial conditions throughout the euro area. This concerns the lending activities by banks and prices in both the bond and share markets. Figure 1 provides an illustration of this phenomenon. Using the example of market developments after global financial crisis, it is evident that national costs of borrowing by corporations move together in response to policy actions by the ECB but at different levels, with fluctuating differences.

A long-held issue is that financial conditions differ from one country to another, for several reasons. National banking systems are shaped by the number and sizes of banks, the degree of competition among them, by local regulation and supervision, and by their integration with other countries' systems, both within and outside the euro area. Bond and stock markets differ for a host of reasons including taxation, trading rules and relationships among participants. The Banking Union has sought to erase most of the national idiosyncrasies of national banking systems, but it remains to be completed. An indication that national idiosyncrasies remain substantial is provided by the fact that the much-expected consolidation of banks has occurred within EMU Member States, not across them. A number of measures – summarised below in Section 3.2 – have been taken but remain far short of the creation of single financial market.

Figure 1. Cost of borrowing by non-financial corporations



Source: Feraboli (2015).

Furthermore, as they set the policy interest rate, central banks typically intervene in the money market by trading standardised safe assets, typically public bonds of very short maturities (although they have traded longer maturities during their quantitative easing operations). In the euro area, monetary decisions are made by the ECB, which then instructs each national central bank to enforce the policy interest rate by intervening on its money market. Because national financial markets differ widely, the Eurosystem has drawn up a list of eligible assets that can be accepted by the national central banks.[1] The list includes more than 3,000 assets, both public and private. Since many of these assets are not considered as safe, the Eurosystem imposes haircuts on many assets on an individual basis. This is extremely cumbersome. With the CMU, the list could be drastically reduced.

In addition, the Eurosystem would still have to trade in national public bonds, which are not considered by the markets as equally safe. However, in order to remain neutral vis-à-vis national Treasuries, the Eurosystem officially treats all public bonds as perfectly safe. This can lead to tensions within the Eurosystem and even among member countries when some of these bonds are subject to market pressure, which occurred during the public debt crisis. Eventually, the Eurosystem decided not to accept bonds issued by the Greek government.

In the end, Figure 1 shows that the dominating reason for differences in borrowing costs is the perceived riskiness of national public debts and the evolution of fiscal policies – an issue taken up in Section 2.6 below. This not something can be alleviated by the CMU. A clean solution would be the issuance of a single safe asset, either by the ECB or collective by all member governments.

[1] The list is available on https://www.ecb.europa.eu/mopo/coll/assets/html/list-MID.en.html.

2.3. Long-term growth

The purpose of financial markets is to collect savings and to invest them into productive projects, both public and private. The more efficient they are, the faster productivity rises and, therefore, the more personal incomes increase. Efficiency depends on a number of conditions.

2.3.1. Competence and competition

The tasks of financial markets are inherently complex. Attracting savings requires designing products that meet the needs of large numbers of different savers. This includes their preferences in terms of maturity – how long do they wish to part from their monies – and whether they primarily seek high interests or capital gains, which may be shaped by the tax regime. It also concerns their willingness to take risks in the hope of achieving large returns.

Investing the savings involves choosing among a myriad of opportunities available. Banks offer various deposits, and bonds and shares are available from specialised markets. Various intermediaries offer access to these markets, often proposing bundles of these elementary assets that are designed to achieve particular objectives of the savers. Risk can be dealt with conditional assets that promise to pay under various scenarios. Crypto assets are new instruments that rely on a particular trading technology (distributed chains). These instruments can become quite complex. Designing and managing them often requires high technical skills.

Much the same concerns the borrowing side of the markets. Whether there are individuals or corporations, borrowers have specific needs and face all sorts of risk. Of course, they wish their borrowings to be as cheap as possible. The financial markets strive to attract borrowers by designing specific instruments which are also matching the savers' needs. This is another reason for the instruments to be complex.

Finally, savers and borrowers need to be reassured that the instruments on offer are the best possible. A financial market is efficient when it is impossible to find a better instrument for any need. If the market is inefficient, savers and borrowers do not have access to opportunities that exist. This reduces saving and borrowing, wasting resources.

A key condition for market efficiency is that the financial institutions master all this complexity and strive to achieve the best results for savers and borrowers. Advances in both theory and technology continuously lead to innovations that redefine what "best" means. The most powerful incentive to innovation, in turn, is competition, which determine the breadth of markets in terms of the variety of existing instruments. Various regulations imposed by the authorities may reduce market efficiency by tying the hands of the intermediaries. The authorities, whose mission is to protect savers and borrowers from misbehaviour and collusion by the intermediaries, must find the appropriate balance between consumer protection and market efficiency. The task is equally complex and constantly challenged by innovations.

2.3.2. Trading efficiency

Market breadth, the range of available financial products, is often contrasted with market depth, which concerns the ability of rapidly buying or selling assets. This requires that each asset exists in sufficient quantity so that, at each point in time, there are savers who want to sell and others who want to buy, and enough borrowers seeking to raise money. Liquid markets, which constantly offer depth, are preferred by savers and borrowers to illiquid markets where it may take time to achieve their objectives.

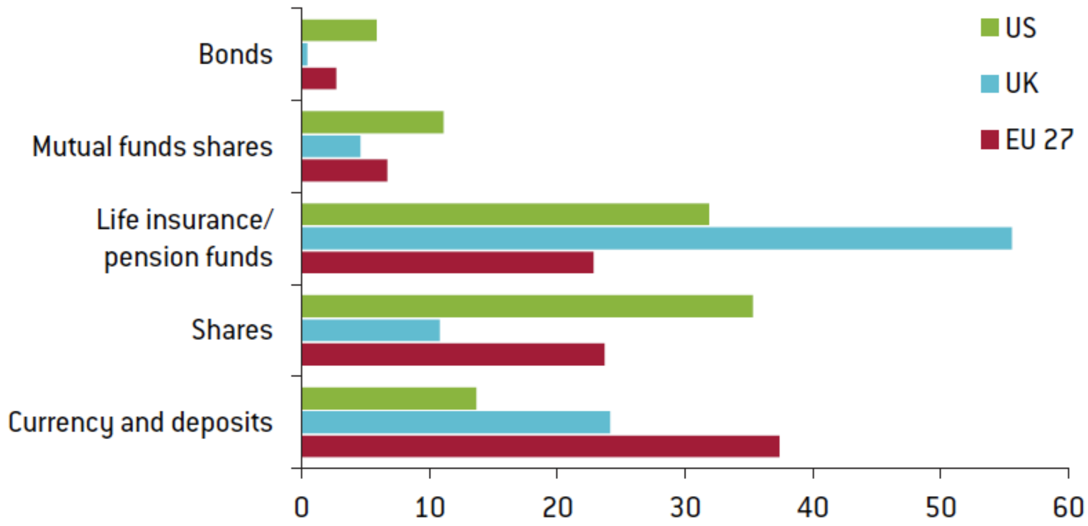
Both breadth and depth are subject to rising returns to scale. The more borrowers and lenders are present on a market, the more financial institutions will also be present, further increasing breadth and depth. This is why financial markets tend to become increasingly large. But, since the overall size of financial markets is limited by the amount of money that savers bring and that borrowers seek, the result is that financial markets compete against each other. An important implication for EMU is that there cannot exist broad and deep markets in each Member State. Financial market efficiency calls for consolidation of the existing markets.

2.4. Evidence on the lack of integration

2.4.1. The domination of banks in Europe

Although European households save a much larger share of their incomes than US households, they keep nearly 40% of their savings on bank current accounts or even in cash, as Figure 2 indicates. Their second preference is to acquire pension funds, which finance retirement benefits. Since their direct customers are households, most of whom are seeking primarily safety for their savings, both banks and pension funds are highly regulated. As a result, they are compelled to invest their resources more conservatively than the other financial intermediaries.

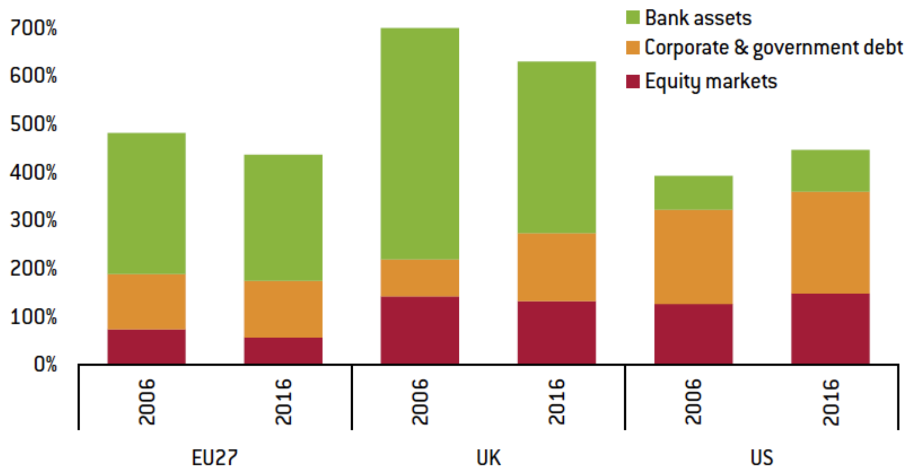
Figure 2. Financial portfolio of households in the EU and US (% of total financial assets), in 2016



Source: Sapir et al. (2018).

Households are not the only savers, corporations also save parts of their earnings. Looking at what the intermediaries do with the savings that they collect – the assets that they hold – Figure 3 shows that banks remain by far the largest financial intermediaries in Europe. The main source of corporate borrowing, which provides resources for productive investments, are bank loans, in contrast with the situation in the US where corporations mostly finance themselves through borrowing by issuing bonds or through floating shares on the stock markets.

Figure 3. Sizes of financial assets (% of GDP), in 2006 and 2016



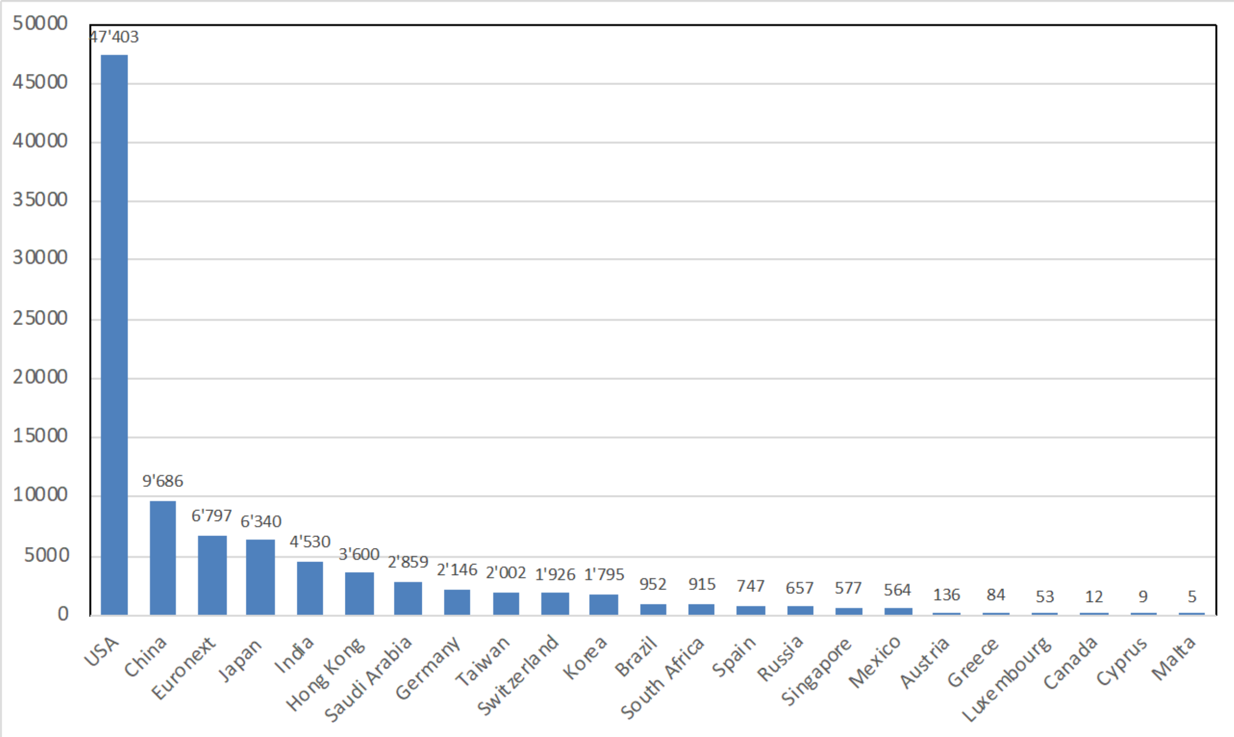
Source: Sapir et al. (2018).

It matters how savings are turned into investments. The dominance of banks has an effect on how savings are turned into borrowings and, therefore, on how productive is the use of savings. Any financial operation involves an information asymmetry whereby each side of the deal know less about its counterpart than the counterpart itself. This is an inherent source of risk that affects the conditions of the transactions, such as the interest rate, the duration of the deal and the protection measures (e.g. guarantees or clauses for termination). Banks and their individual clients – both savers and lenders – develop long-term relationships built on mutual trust, in contrast with the impersonal an often-flimsy links that drive financial markets. Banking relationships are desirable for both lenders and borrowers, as well as for banks as intermediaries. In this way, they cut on the costs of acquiring information and they provide for stable dealings. However, they tend to make it harder for newcomers to enter into such relationships, which adversely affects lending to budding firms, which can be highly innovative but risky. It also reduces the market power of small savers who are often led to choose between standardised portfolios while facing substantial management fees. Banking relationships may also lead banks to keep lending to "zombie" firms that are no longer competitive rather than facing the costs of bankruptcies, which may be unavoidable. All in all, there is a trade-off between stability and dynamism, and over-reliance on banking relationships are detrimental to long-term growth and a potential source of bank distress, as shown by the extensive review of the evidence in Popov (2017).

2.4.2. Sizes of European stock markets

The limited use by European households and firms of financial markets imply that they are small. This concerns primarily the stock markets and the bond markets. It also concerns the various players on these markets, including brokers, settlement systems, various funds such as the Undertakings for Collective Investment in Transferable Securities (UCITS), the Exchange Traded Funds (ETF), the Hedge Funds and more. Figure 3 shows that Europe is currently far behind the US as far as stock market sizes are concerned. Relative to the two largest US markets (New York Stock Exchange and NASDAQ), Euronext, which includes seven stock markets, has a size that is 15% of the US markets, out if which Frankfurt is 4.5%. Such differences imply that the breadth and depth of European markets, and therefore their efficiencies, pale in comparison to the US. Small markets are comparatively less attractive than larger ones and limited attractiveness keeps market small. As a result, many European savers invest in the US, which is also where many firms borrow from. It is not just that the US financial markets "steal away" a significant share of European business, but that the financing of firms is much easier in the US given the information asymmetry that favours local corporations, big and small. Breaking this vicious circle is a key reason for creating the CMU.

Figure 4. Size of stock markets in Europe and selected countries (US dollar billions), in March 2024



Note: The US adds the New York Stock Exchange and NASDAQ. China includes the Shanghai and Shenzhen markets. Euronext brings together the stock markets in Belgium, France, Ireland, Italy, the Netherlands, Norway and Portugal.

Source: World Federation of Exchanges: https://focus.world-exchanges.org/issue/march-2024/market-statistics.

2.4.3. Innovation, risk diversification and global integration

Market effectiveness is not only providing savers and borrowers with better opportunities, it also plays a crucial role in promoting innovations, as explained by Aghion and Howitt (2009). Given that R&D is always highly uncertain, potential inventors need to convince investors to take the risk. Investors, on the other hand, can reduce the risk by diversifying their lending across a large pool of R&D projects. The original savers need the services of intermediaries who can evaluate, monitor and diversify the risks. Large pools of opportunities are not national, nor European, they are global instead

It is increasingly recognised that, when compared to the US performance, Europe's relatively poor growth over the last two decades is partly explained by the small number of firms that have developed and implemented major innovations. The quasi absence of competitive European firms in high tech sectors such as biotechnology, artificial intelligence or even computer hardware and software reflect a parochial approach to innovation in all its dimensions. The recent statement by the Eurogroup (2024) makes the point very clearly:

> *"Today, Europe is at risk of falling further behind globally in terms of competitiveness, growth, and prosperity of its citizens. European capital markets need to be urgently developed into globally competitive markets. The EU needs a capital market that can*

channel domestic savings and foreign capital freely and effectively into innovative companies, allowing them to develop into engines of long-term growth and, ultimately, help the EU to become a global leader for innovation and new industries."

2.5. Policy implications

The CMU is the official response to these shortcomings, as indicated in Section 3.1. The present section lists the key measures needed for establishing the CMU, all of which are widely agreed in principle by policymakers and analysts.

2.5.1. Regulation and supervision

For a financial market to be integrated, all its components must be subject to a single set of regulations and to a single supervisor. At present, each market is regulated and supervised by local authorities. Véron (2024a) provides a detailed description of what is needed. The single set of regulations has come under the label of a "single rulebook". At present, the rules are commonly agreed but enshrined in national legislation. As is turns out, once translated into national legislation, the rules are not always precisely the same. In addition, the implementation of regulations requires a supervisor. The European Securities and Markets Authority (ESMA) could do that but, currently, it has limited authority alongside national supervisors, and it mainly acts as supervisor of national supervisors with little power. Indeed, national supervisors sit on the decision bodies of ESMA, which gives them effective veto rights on its decisions.

This may look like as a detail, but it is not. Whether because rules differ, even very little, or because enforcement may vary, the result is that both investors and borrowers regard national markets as separate entities. This even applies to Euronext, which owns some national stock markets each subject to non-identical rules and under different supervisions. The natural next step would be to make financial markets a European prerogative, with European-wide regulations and national supervisory authorities folded into ESMA. It is worth noting that none of the official statements mentioned in Section 3.1 endorses such a step.

2.5.2. Choosing financial repression

Financial institutions are tightly regulated. One aim is to protect participants who face massive asymmetric information: most of them are not well equipped to collect information about their counterparties, including intermediaries, about their rights and about the myriad risks that can affect their earnings. However, there is a trade-off between protection and market efficiency since rules that seek to reduce risks also limit the ability to take risks, a key function of financial markets. A good example is the proliferation of sophisticated financial instruments that allow savers and borrowers to make bets on a wide range of possible events. These instruments have become highly complex to the point that advanced technical expertise is needed to fully understand what they offer. It would seem logical to limit the extent of this information asymmetry by reducing the degree of complexity that is acceptable for most participants. But such measures stand to deprive technically savvy participants from services that can be useful to them. In other words, financial repression – as these measures are called – reduces the efficiency attractiveness of markets relatively to more lightly regulated ones.

Determining the "right" limits, however, is fraught with difficulties. A good example is provided by the deep deregulation of the London Stock Exchange in 1986. The so-called "big bang" was intended to make it more efficient and competitive. As London grew, deregulation proceeded in many other countries, including the US and throughout Europe in an effort to retain customers. This wave of deregulation is usually recognised as a major contributing factor to the global financial crisis of 2008

(Bernanke, 2012) and was followed by a wave of re-regulation (Basel 2 and 3). It is not surprising that different EMU Member States have adopted different regulations even though they all adopted the Basel agreement and some of the measures listed in Box 1 were designed to harmonise the national regulations. Some difference remains, still.

2.5.3. Insolvency and taxation

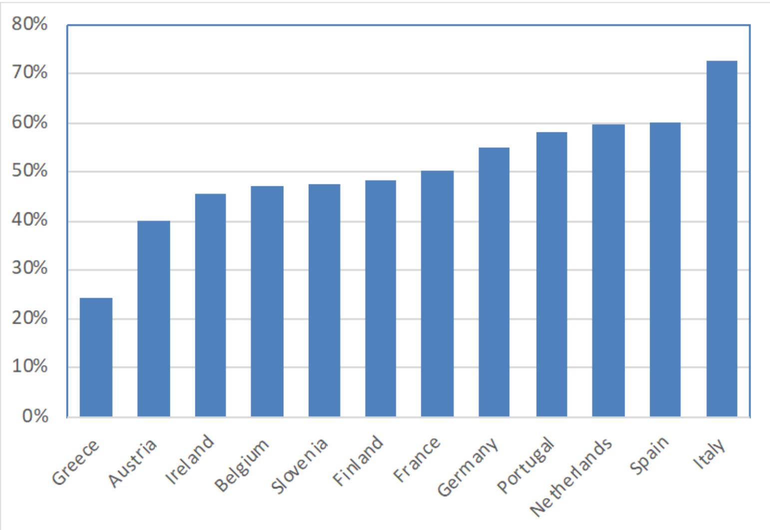
When firms go bankrupt and enter insolvency proceedings, national authorities take over. This affects savers who invest in corporate shares. Bankruptcies are usually complex events as they involve detailed legislation and long legal proceedings. Bankruptcy legislation and legal procedure precedents squarely belong to each country's tradition. That means that investors can be at the mercy of legal decisions that they poorly understand, or not at all. Borrowers must be careful about the legislation that governs the markets where they raise funds. Only large investors and firms can afford finding out the relevant information and pursuing litigation. The result contributes to a preference for operating on markets that they know best, including – among other characteristics – those of their own countries. Home bias, however natural, undermines a true CMU.

Much the same can be said about taxes related to financial matters, including transaction, income, profit and inheritance taxes. While some effort has been dedicated to reducing tax interference into saving and borrowing, this remains an important source of home bias.

2.6. Public vs. private investments and public indebtedness

Another aspect of home bias is related to the existence of public debts. Figure 5 shows that, in general, a substantial proportion of public debts is held domestically. This observation implies that, when the public debt is large, a large proportion of domestic savings is not available for private investments, a key long-term growth factor.

Figure 5. Domestic holding of public debts (% of total debt) in 2023Q4



Source: IMF.

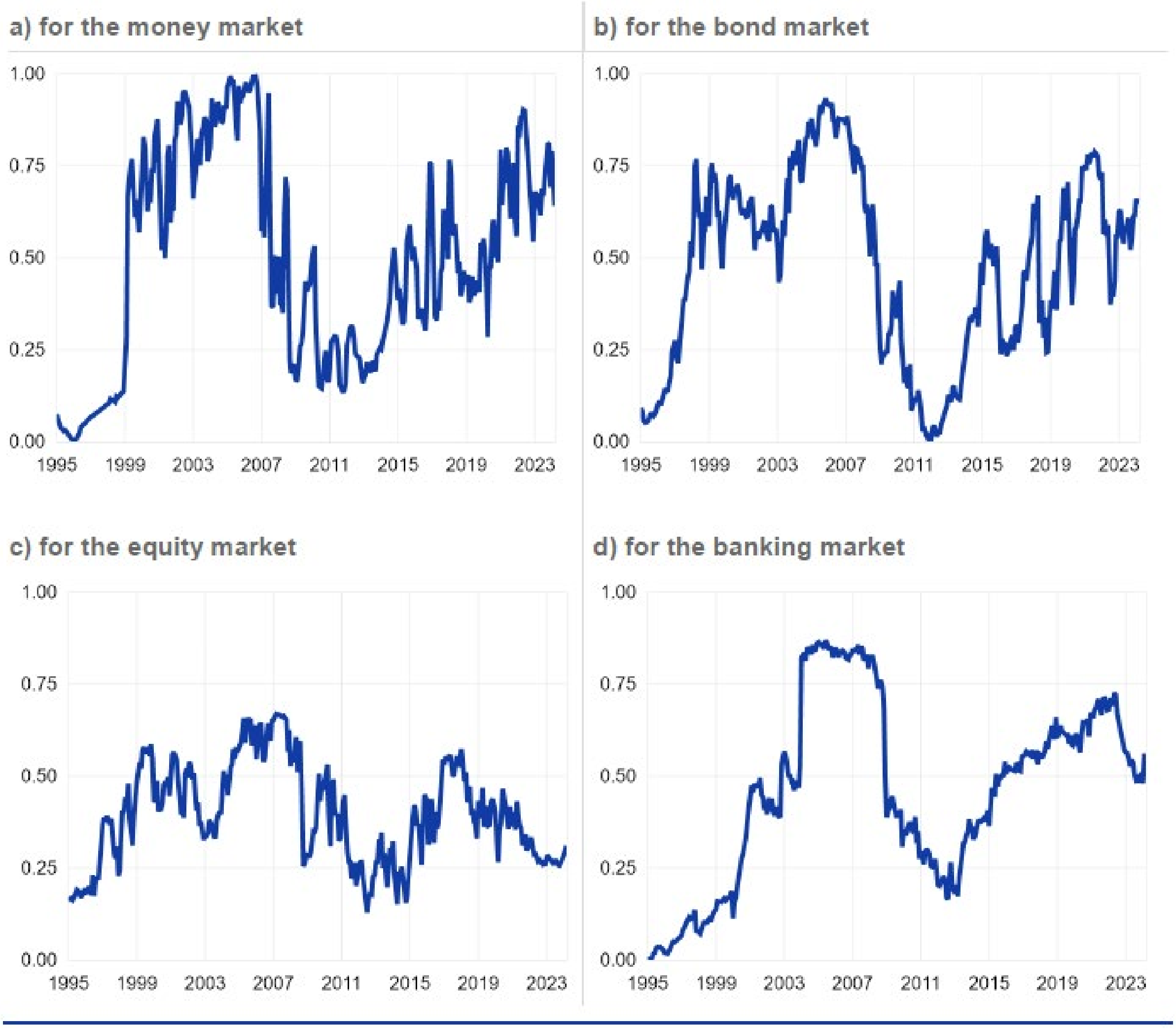
This is not too much of a problem when the domestic financial markets are well integrated into global financial markets for, then, domestic firms can borrow from foreign savers. Yet, that often means either borrowing in foreign currencies, which creates an exchange rate risk for the borrower, or borrowing in the domestic currency, which creates an exchange rate risk for the lenders. Sharing the same currency eliminates the exchange rate risk altogether, but the markets need to be well-integrated. The ECB has recently developed an index of financial integration for the four main financial instruments (see Figure

6). The figure shows how financial integration rose in all four market sub-segments from virtually nil since the euro was launched in 1999, a testimony to the elimination of exchange rate market risk. However, these gains were largely eliminated in the wake of the global financial crisis of 2008 and the ensuing debt crisis that started in 2010. Since then, the indices gradually recovered but did not rise to the pre-2008 levels.[2] The figure suggests more observations:

- First, the index is highly volatile at short frequencies, which indicates that national idiosyncrasies still play an important role, presumably for the reasons previously outlined.
- Second, Panel (b) shows that the bond market, where public debts are traded, can quickly disintegrate when government face a debt crisis. Integration today does not mean that it will remain in place tomorrow when it is needed most.
- Third, the two previous observations expose a key mechanism. A national debt crisis means that the government will have to either cut spending, or raise taxes, or restructure its debt. In all cases, this will have adverse effects on the domestic economy. It explains the impact of the debt crisis on the other financial market segments. Crucially, it suggests that financial market integration is not robust as long as several countries exhibit large debts and unsustainable budget deficits.

[2] ECB Committee on Financial Integration. (2024) includes other information which shows that previous integration has not recovered at all, for example the collaterals required from banks by the ECB for liquidity creation remain dominated by domestic assets.

Figure 6. Index of intra EMU integration by market segments



Source: ECB Committee on Financial Integration. (2024).

Note: The index measures how asset prices co-move within the EMU. Zero represents no-integration and one a high degree of integration.

3. POWERFUL ROADBLOCKS AND HISTORY SO FAR

3.1. Strong official support but little action

It should be clear by now that a CMU, when fully in place, stands to bring significant economic improvements as it extends the Single Market to reap the benefits of the common currency, mitigates its drawback and boosts long-term growth. The European Council, the Eurogroup, the ECB and the European Commission have all indicated recently their support for the CMU, each emphasising some or all of the arguments further developed in the present section.

- In a statement issued on 11 March 2024, the European Council declares that *"the capital markets union (CMU) is the EU's initiative to create a truly single market for capital across the EU. It aims to get investment and savings flowing across all member states for the benefit of citizens, businesses and investors."* (European Council, 2024)
- In its statement mentioned above, the Eurogroup writes: *"The EU needs a capital market that can channel domestic savings and foreign capital freely and effectively into innovative companies, allowing them to develop into engines of long-term growth and, ultimately, help the EU to become a global leader for innovation and new industries".*
- Upon releasing the report of its Committee on Financial Integration (2024), the ECB stated that *"the euro area has demonstrated resilience during crises, but progress in financial integration has been disappointing. Indicators of financial integration have declined significantly over the past two years, with no sizeable increases since the start of monetary union. Policy action is now urgently needed to mobilise available savings, develop euro area bond and equity markets, and make these markets more attractive to foreign investors."* (https://www.ecb.europa.eu/press/pr/date/2024/html/ecb.pr240618~40223d7e1b.en.html)
- The European Commission has long sought to promote the CMU. On 10 April 2024 it reiterated the case as follows: *"EU capital markets have come a long way in the past few decades. However, they remain considerably less integrated than markets for manufactured goods or labour. And this means they fall short of what the EU needs. This situation brings with it enormous opportunity costs: lower potential economic growth, less resilience to economic shocks and less choice in financial products for EU citizens. And more opportunity costs are emerging, for instance there is less capacity for financing the transition to a climate-neutral and digital future. There is also less capacity for innovation, due to a lack of financing opportunities for higher-risk projects, which need direct funding sources provided by capital markets. […] The Capital Markets Union is not just a 'nice-to-have' but a 'must-have' for Europe – it is crucial that we remain ambitious on this pressing matter."* (https://finance.ec.europa.eu/news/capital-markets-union-2024-04-10_en).

These statements were preceded by an article jointly written by the French and German Finance Ministers (Le Maire and Lindner, 2023) and followed by the Letta Report (Letta, 2024) and by the Draghi Report (Draghi, 2024). Normally, such an alignment of all major European institutions should result in the prompt adoption of the CMU. Yet, it has been proposed long ago and, so far, measures taken are quite modest.

3.2. History of past efforts

The concept of a CMU was first articulated by Juncker (2014). According to Véron (2024a), the incoming President of the European Commission wanted to build a European financial market around the City of London and to sideline the debate about fiscal integration. These motivations did not fare well but the idea itself opened the road to the objective of financial integration shortly after the creation of the Banking Union. Over time, the need for the CMU has been amplified over and beyond the justifications developed in Section 2 by the emergence of new expensive collective priorities such as post-COVID concerns about supply chains, defence after the invasion of Ukraine and the European Green Deal. These new considerations explain the strong official interest in making the CMU a priority.

Until then, the CMU was perceived as too ambitious to happen in one go. Instead, since Juncker's proposal, the strategy has been to move into this direction by focusing on reasonably uncontroversial "low-hanging fruits". The Commission has announced or updated several action plans in 2015, 2017, 2020 and 2021, each one of which included long and detailed lists of measures to be quickly adopted. European Council (2024) and Hallak (2024) present the measures finally adopted, or in the process of being adopted. A brief summary is presented in Box 1. With one exception, these measures are still in the final adoption process, several years after they were proposed by the European Commission.

Box 1: Selected integration measures adopted since the CMU proposal

- **European Single Access Point**
Proposed in 2011, adopted in 2023 and due to take effect in 2027, the European single access point is meant to make publicly available information on all EU companies and investment products.

- **European Long-Term Investment Funds Regulation**
These funds will be distributed on a cross-border basis to both professional and retail investors.

- **Alternative Investment Fund Managers Directive**
Approved by the European Parliament in 2023 and by the Council in 2024, this directive concerns managers of hedge funds, private equity funds, real estate funds and a wide range of other alternative investment schemes in the EU. The stated objective is to develop and integrate these disparate markets.

- **Review of regulatory framework for investment firms and market operators**
Approved by the European Parliament in 2023 and by the Council in 2024, the intention is meant to update the markets in financial instruments regulation (MiFIR) and the secondary markets in financial instruments directive (MiFID II) in order to provide EU-wide information.

- **European Market Infrastructure Regulation**
Agreed upon by the European Parliament and the Council in 2024, various pieces of legislation intend to improve clearing within the EU.

- **Listing Act**
Provisionally agreed upon by the European Parliament and the Council in 2024, the intention is to make it easier for companies of all sizes to list on European stock exchanges by reducing the administrative burden.

These measures are useful as they concern details of how financial markets operate and will reduce several hurdles that stand in the way of effective integration, but there is nothing about supervision and limited steps toward the common rulebook. The list indeed concerns low-hanging fruits, which merely adapt the existing framework, following the usual pace of regulatory harmonisation as seen before CMU was invented. They do not follow the analysis presented above in Section 2.5 and they do not meet the objectives set forth in the recent official declarations reported in Section 3.1.

3.3. Powerful opposition

The gap between what CMU requires and what has been done so far is not innocent. The gap between the official intentions as stated in Section 3.1 and the policy requirements listed in Section 2.5 is even more startling. The clear impression is that policymakers are not ready to take the steps needed to achieve the CMU. The reason is the presence of strong resistance by powerful interest groups. This resistance is clearly spelled out in Bini-Smaghi (2024) and Véron (2024b), who mention the following sources of opposition.

3.3.1. National regulators and supervisors

As noted above, regulations remain in national hands and ESMA coexists with national supervisors who effectively control it. Centralising regulation and supervision at the European level would obviously undermine these national administrations, possibly (and hopefully) eventually leading to their suppression. This is a necessary condition for CMU to exist. These national authorities know it, and they strenuously work toward to delay power transfers.

3.3.2. National financial institutions

The major stock exchanges and other market infrastructures have long developed close relationships with their regulation and supervision authorities. They appreciate these historical and geographic links, with protectionist undertones, to obtain favourable treatments and are in no hurry to give them up. If, as need be, financial integration results in few European markets, most of the markets currently existing in small countries will have to be closed. For a large number of markets, CMU means elimination. This is a key reason why many governments managed to tone down the collective statements mentioned above.

3.3.3. Foreign financial institutions

According to Bini-Smaghi (2024), *"Non-EU financial institutions play a relevant role, possibly a dominant one in most segments of the 27 national markets. When it comes to asset management, market making, primary dealership, depository institutions, private equity, rating, auditing, the markets are dominated by US institutions. […] The dominant position of non-EU, in particular US, players in the capital markets has systematically strengthened over the last 10-15 years, at the expense of European institutions."* They benefit from their base in US financial markets and they adroitly exploit the differences listed in Section 2.5 to choose where to establish their European headquarters. As a consequence, they have every reason to maintain the status quo and to prevent the emergence of a CMU, and they can use their substantial influence to that effect.

4. IS PROGRESS POSSIBLE?

4.1. The Banking Union precedent

The limited progress achieved so far is a reminder of the history of the Banking Union. The need for integrated banking regulation and supervision was discussed but rejected during the Maastricht Treaty negotiations in the early 1990s. Begg et al. (1998) warned that "more generally, financial regulation within EMU is at present unsafe. No secure mechanism exists for creating liquidity in a crisis, and there remain flaws in proposals for dealing with insolvency during a large banking collapse. Asymmetric national exposure to risky foreign loans may lead to conflicts about the appropriate response. In the longer run, centralisation of regulation is essential." Bini-Smaghi (2024) describes how many commentators brought the issue up over time but resistance to the Banking Union has been as fierce as it is now against the CMU, for very similar reasons.

The tide turned in the aftermath of the global financial crisis in 2018 and the European debt crisis in 2010. The crises not only proved these warnings correct but they also were very costly, including because of the recessions that followed. These events broke the opposition and made it impossible for the authorities to keep ignoring the warnings and postponing the policy changes. In 2012, it was decided to create a single bank supervisor, hosted by the ECB, and the single rulebook for banking was adopted in 2014. The Banking Union, however, remains work-in-progress. The single deposit insurance has been under negotiation since it was formally proposed by the Commission in 2015. While the Single Resolution Fund has been established, utilisation is in the hands of the Single Resolution Board that operates alongside national resolution authorities, which raises doubts about its timely use. For the Single Resolution Mechanism to be effective, the European-level Board should control the national authorities and not the other way around. It is interesting to note that opposition to the completion of the Banking Union comes from the same interest groups that block the CMU.

This precedent shows that it takes a crisis to supersede powerful opposition and, even so, this opposition can partially give in only to block some decisions once the initial sense of urgency wanes. Could a financial market crisis similarly allow progress on CMU? Probably not, because a financial market crisis is different from a banking crisis. A banking crisis affects all bank customers, which means nearly everyone. For this reason, a banking crisis requires the instantaneous injection of massive amounts of cash. A financial market crisis, instead, affects a much smaller number of voters as Figure 2 makes clear, unless it puts banks under stress, which is what happened in 2008.

4.2. Conflicted governments and their champions

Why are financial institutions so successful in convincing their governments to support them? Part of their influence rests in the belief that a country needs to have national champions in banking and, more generally, finance. The argument rests on home bias, the belief that citizens and corporations are better served by local institutions, which is the negation of the usefulness of a Banking Union and CMU. There is no evidence in favour of this view.[3]

Another argument is that national banks make it easier for highly indebted governments to borrow when they face large budget deficits. This has been the case, indeed, in a number of EMU member countries, including Italy and Greece. However, this advantage is a double-hedged sword. The European sovereign debt crisis has revealed the existence of a diabolic loop – sometimes referred to as a doom lop. Much as a banking crisis can push the government into a debt crisis, as happened in the

[3] Indeed, the Baltic countries have achieved a remarkable development since they joined the EU by relying largely on foreign banks.

2010s in Iceland, Ireland or Spain, a public debt crisis may trigger a banking crisis when domestic banks hold large amounts of the national public debt. The deep relationship between a government and its banks may be an advantage in normal times, but it can turn into a serious threat in bad times. The argument extends to the bond markets that also absorb part of the public debts, and to the other market segments as shown in Figure 5.

The cozy relationship between governments and their financial institutions is conflicted. As described above, financial crises may shake this relationship and lead governments to pare it down, but the experience is that this is a temporary reaction. When the situation eases, the relationship tends to return to normal. The official statements mentioned in Section 3.1 indicate that the governments are well aware of the wider costs of this relationship but the histories of the Banking Union and of the CMU show that the conflict endures.

4.3. Mid or high-hanging fruits?

This is why the approach to building the CMU has been to first reap the low-hanging fruits and wait before trying to reach higher. Meanwhile, there is no CMU. Véron (2024b) convincingly argues that there are no more low-hanging fruits left. At the same time, the realisation that European countries will need to borrow significant amounts to meet threats (climate change, a worsening geopolitical scene) and challenges (the digital transformation) enhances the need for the CMU.[4]

Many proposals have been advanced recently, but they reach different conclusions. Some have been provided by committees set up by official bodies, others by academics.

4.3.1. Official reports that deal with the CMU

The European Council has commissioned a report from Enrico Letta, the French Finance Ministry has produced a report by Christian Noyer and another report by Mario Draghi, requested by the President of the European Commission, has just been published. Beyond changing the name from CMU to "Savings and Investments Union", Letta (2024) proposes a number of technical measures that follow the path of the Commission's action plans but, taken together, these measures are unlikely to deliver the stated integration objectives. Similarly, Noyer (2024) advocates some technical measures – new savings instruments, a securitisation platform, improved settlements – but recognizes that "a true single market cannot tolerate a fragmented supervision". Recognising the political roadblocks, the report advocates proceeding in steps, favouring a bottom-up approach that would let individual financial institutions opt in to move to an adapted ESMA.

The Draghi report (Draghi, 2024) is more ambitious. For all the reasons mentioned in Section 2, it argues that CMU has to be part to the effort to enhance European competitiveness. Like the academic reports (see below), it argues in favour of a strongly independent single regulation and supervision authority. Mindful of the opposition from national authorities, he advocates the Banking Union model, where national authorities are maintained but operate under control of the single authority based at the ECB. The report also suggests a number of high-hanging fruits like harmonising insolvency legislation, taxation of financial products, and pensions, as well as centralisation in clearing and settlements. It advocates the issuing of a single safe asset, which would underpin the functioning of the CMU, but this proposal is likely to hang too high for the time being.

[4] Wyplosz (2024) argues that the need for sharp increases in public spending are is not warranted, but the official perception seems solid.

4.3.2. Academic reports, including the ECB

Bini-Smaghi (2024) and Véron (2024) argue that time is of the essence and explicitly note the political opposition to the CMU. Lagarde (2024) is very much in line with these two academic papers. All three consider that the essential step is to have a single supervisor enforcing a single rulebook.

Bini-Smaghi (2024) argues that once this measure is applied to all participants "the incentive to deviate and to arbitrage regulation would be significantly reduced and the centrifugal forces pulling towards market fragmentation would be reversed into centripetal forces towards greater integration." In order to make this step more acceptable politically, he suggests postponing other politically-delicate requirements such as the harmonisation of taxes, the harmonisation of bankruptcy laws and of securitisation. Véron (2024b) follows the same logic. He characterises common supervision and rulebook as mid-hanging fruits, in contrast to high-hanging fruits such as harmonisation of taxation, insolvency and pensions. Lagarde (2024) considers that "to mitigate fragmentation in EU capital markets, a more ambitious approach should involve the creation of a single rulebook enforced by a unified supervisor".

4.3.3. Assessment

The official reports are in line with the statements presented in Section 3.1 as they strongly advocate the rapid creation of the CMU. But, with the notable exception of the Draghi report, they sidestep the key measures identified by the academic reports. The bottom-up approach is also rejected by the academic proposals because it implies a slow process. It is also rejected by Lagarde (2024) who advocates a top-down approach.

5. CONCLUSION

The outlook for the CMU remains cloudy. The economic arguments for and against the CMU have been well-known for many years and it is unlikely that new ones will surface. Ringing official endorsements fail to include the key measures that are required but still opposed by powerful interests, both private and public. Instead, they tend to produce long lists of relatively low-hanging fruits that focus on technicalities. For the stalemate to be broken, some key actors would have to change their positions. Here is a non-exhaustive list of possibilities.

Private European financial players could recognise that they collectively stand to benefit from an efficient and large architecture. That many of them are active in the US suggests that they are well aware that this is the case, but their individual strategies are to have best of both worlds: they operate at the frontier level in the US and enjoy explicit and implicit protections in the domestic markets. This is why Noyer (2024) suggests some measures that could change their incentives, including the shift to a single supervisor. But for this key step to be accepted, the incentives must change first, which the other measures proposed in the report are probably insufficient to produce.

In the public sector, national regulators and supervisors stand to lose much of their power, as has been the case with the Banking Union, even though it is not yet complete. In addition, many of the current financial markets are bound to eventually disappear under the CMU, which triggers a classic protectionist reflex. Governments can ignore this opposition for the better collective good of Europe, but they would have to spend some political capital to that effect. Véron (2024b) hopes that the perceived need to fund large new public spending to tackle climate change, higher defence and technology challenges might change the incentives of enough governments to tilt the balance at the European level, but it is far from certain.

This leaves the possibility that some European public institutions push harder in favour of the CMU. The Commission has produced Action plans, but the contents have remained largely geared toward low-hanging fruits and the results have been disappointing. The Commission would have to focus on the two key requirements, the single rulebook and the single supervisor, but progress would require strong support from enough governments. As mentioned above, this has been lacking and seems destined to remain lacking.

The ECB is the European institution that has pushed hardest for the CMU. This is understandable. It is independent and therefore less subject to private and public pressure. In addition, the CMU would enhance the power of monetary policy. The ECB was also the European institution that most forcefully championed the Banking Union – in the event it was rewarded with being given authority on supervision – and it still argues tirelessly for its completion. The ECB would not have achieved this goal without the crises of 2008 and the 2010s. Sadly, this precedent suggests that success of the CMU seems to rest on the occurrence of a deep crisis of financial markets, which would be devastating.

Finally, the European Parliament is another institution that could throw its weight in favour of a full-blown CMU. So far, it has voted two resolutions. The first one (European Parliament, 2015) endorses the view that the CMU stands to enhance economic growth. Its focus is to ensure that "capital markets provide companies with better access to capital and investors with diverse, transparent, affordable saving opportunities". But it also seems to defend the dominant role of banking as it notes that "*bank financing and the intermediary role of banks in capital markets are important pillars in business financing*" so that "*the CMU should be based on complementing the fundamental role of banks, not about displacing them, as bank financing should continue to play a key role in the financing of the European economy*". It is ambiguous on the crucial issue of a single rulebook and a single supervisor as it asks to "*identifying* *existing financial structures which have proven to be effective and should therefore be retained, and those structures which need substantial improvement*" so that "*effective structures should also be promoted for local and decentralised financial institutions*". The second resolution (European Parliament, 2020) reiterates its support for the CMU for all the reasons indicated in Section 2 and provides many detailed recommendations that now appear in the Draghi report. While is now accepts that the role of banks could decline over time, it remains ambiguous on supervision as it "*stresses the need for efficient and effective cooperation between European and national supervisory authorities, in order to overcome their differences and to work together towards genuine supervisory convergence to promote a common European model of supervision and enforcement, guided by the European Securities and Market Authority (ESMA)*".

The importance of CMU for the conduct of monetary policy, as noted in Section 2.2, is less often discussed, even by the ECB. The fact is that borrowing costs are not the same across the euro area for many reasons. Some of the suggestions mentioned in the proposals put forward by various reports and discussions – such as the harmonisation of taxes, solvency rules, and pensions – stand to reduce existing differences, but the impact of public indebtedness can only be alleviated by the adoption of a strong fiscal discipline framework or by the issuance of a collective public safe asset. This is a requirement included in the Draghi report. [5]

In the end, the creation of the CMU rests on ending a vicious circle whereby private interests block public actions and the preservation of public administration interests mute decisions likely to shape private interests. At the same time, national interests undercut European-level action, while European-level interests do not prevail over national interests. All these interests are more perceived than real, since they are based on how the status quo operates. The creation of the CMU stands to benefit most, but not all parties. This is almost always the case with reforms and the reason why reforms consume political capital.

[5] The report by Draghi does not mention the benefit of this measure for the conduct of monetary policy.

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Bringing all European financial markets under one roof, the Capital Markets Union (CMU), stands to provide European savers and borrowers with better opportunities. This, in turn, is expected to boost long-term growth and to improve the functioning of the Economic and Monetary Union (EMU). Yet, powerful private and public interest groups have been able so far to stand in the way of this transformation. Most governments are torn between the benefits from CMU and the pressure of these interest groups.

This document was provided by the Economic Governance and EMU Scrutiny Unit at the request of the Committee on Economic and Monetary Affairs (ECON) ahead of the Monetary Dialogue with the ECB President on 30 September 2024.

PE 760.250
IP/A/ ECONMD/FWC/2020-002/C8/SC16

Print ISBN 978-92-848-2275-1| doi:10.2861/0122994| QA-01-24-024-EN-C
PDF ISBN 978-92-848-2274-4 | doi:10.2861/7563731| QA-01-24-024-EN-N