STUDY

Requested by the ECON committee

Monetary Dialogue Papers, September 2024

The Capital Markets Union – an extra feather to the EMU

Are Capital Markets Important for Monetary Policy?

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PE 760.256 - September 2024

EN

The Capital Markets Union – an extra feather to the EMU

Are Capital Markets Important for Monetary Policy?

Abstract

The first 10 years of the Capital Markets Union (CMU) have been marked by minimalistic progress. The unfinished nature of the CMU has direct relevance for the ECB by affecting financing conditions in Member States and eroding the risk-sharing ability of the EMU, imposing a higher burden on the ECB to act as "the only game in town". It has even bigger implications for the long-term investment opportunities and economic performance of the EU. This calls for a renewed approach and narrative on the CMU to gather political support to move forward.

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
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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

CEF	Connecting Europe Facility
CESR	Committee of European Securities Regulators
CMU	Capital Markets Union
ECB	European Central Bank
EGG	European Green Guarantee
EIOPA	European Insurance and Occupational Pensions Authority
ELTIF	European Long-Term Investment Fund
EMIR	European Market Infrastructure Regulation
ESAP	European Single Access Point
ESCB	European System of Central Banks
ESMA	European Securities and Markets Authority
EU	European Union
EUR	Euro
GDP	Gross Domestic Product
MiFIR	Markets in Financial Instruments Regulation
OCA	Optimal Currency Area
PEPP	Pan-European personal pension
SEC	Securities and Exchange Commission
SMEs	Small and medium-sized enterprises
UK	United Kingdom
US	United States
VC	Venture Capital

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EXECUTIVE SUMMARY

- **The concept of a Capital Markets Union (CMU) represents a strategic initiative aimed at integrating and developing a unified capital market across EU Member States.** This ambition is based on the need to facilitate the flow of capital across borders, to enhance financial stability and foster economic growth by ensuring abundant private capital is available for investments.
- **However, the journey towards a genuine CMU has been rocky and progress on many of its important dimensions has been minimalistic.**
- **European capital markets continue to be small in comparison to the United States (US) and the EU finance landscape continues to be strongly dominated by banking finance.** The differences between capital markets in the EU and the US can be seen across many different dimensions: the size of bond and equity markets, the participation of households, the structure of firms' financing sources and financing conditions, the role of large institutional investors and the role of venture capital and start-up financing.
- **The completion of the CMU is relevant for the European Central Bank (ECB) and its monetary policy through a number of ways.** Firstly, the current financing structure in the EU can contribute to diverging financing conditions across Member States. The completion of a unified capital market with less home bias can reduce the divergence of financing conditions and the risk of fragmentation during acute crisis periods. This helps the ECB monetary policy transmission, also benefitting financial stability.
- **More importantly however, the lack of sufficient risk-sharing in the European Monetary Union (EMU) contributes to a high burden on the ECB to be "the only game in town" in terms of macroeconomic stabilisation, as long as there is no common fiscal budget as a form of risk-sharing.** The completion of the CMU will enable private capital and private risk-sharing to contribute to the smoothing of macroeconomic and idiosyncratic shocks. By affecting the duration of economic downturns, this will have a direct effect on the supply and demand in goods and labour markets. Therefore it will influence price developments after macroeconomic shocks, which determines the necessity of the ECB to act in different situations. This will reduce the pressure on the ECB to contribute to the macroeconomic recovery, which overburdens it and forces it to keep interest rates low for longer.
- **At the start of the new EU legislative period, the new European Commission and the European Parliament are at a cross-roads over how to achieve further progress on the CMU.** The unfinished nature of the CMU has direct relevance for the ECB and its monetary policy decisions, but even more considerable implications for the long-term investment opportunities and economic performance of the EU. Moving from a piece-meal approach where a few well-targeted policy decisions often take years to reach a consensus to a different narrative makes sense. Rebranding the CMU project through a "Kantian shift" which admits the increased investment needs the EU is facing is an opportunity to present it in a more popular way and to reach more political support. This does not neglect the concrete policy issues to be solved in the near future – harmonised supervision and common rules (e.g. insolvency laws, tax treatment), better and more efficient infrastructures (e.g. mergers in the area of exchanges), the role of big institutional investors and greater participation of citizens and firms in EU capital markets – but it approaches them in a different way.
- **Importantly, the introduction of a European safe asset continues to be a vital part of achieving a genuine CMU.** Neglecting this will hinder real progress on CMU.

1. INTRODUCTION

The concept of a Capital Markets Union (CMU) represents a strategic initiative aimed at integrating and developing a unified capital market across EU Member States. This ambition is based on the need to facilitate the flow of capital across borders, to enhance financial stability and foster economic growth by ensuring abundant private capital is available for investments, while addressing the diverse economic challenges and idiosyncratic economic shocks faced by Member States.

In the basic economic sense, a CMU means a unified market for financial securities in Europe where the law of one price holds – the same asset has the same price wherever it is sold, even if it is sold on different platforms. In theory, this can happen if there is common information on the securities traded and their prices available to all trading parties, common rules and supervision, and the same treatment in terms of post-trading settlement infrastructure and taxation of trading activities.

The EU should have proven to be the right landscape for the development of a large and well-integrated single capital market. The Single Market with its four freedoms, combined with EU regulation, should have provided fertile ground for the development of a harmonised cross-border capital market. Yet in practice, the capital and less so the banking market continue to be characterised by divisions across borders and a domestic focus. National capitals and vested interests often have incentives to hinder the CMU, as it can result in loss of domestic control over national capital markets.

Fragmentation across national borders hinders the efficient usage of capital in the EU and leads to considerable costs from the unfinished nature of the CMU project. These include the extra costs that firms pay as they are not receiving funding under more beneficial financing conditions. The EU economy also suffers costs deriving from the underutilisation of EU private savings for investments and by the weak EU economic performance after large shocks due to insufficient macroeconomic stabilisation. Arguably, the most important of these implications for the European Central Bank (ECB) is that greater private cross-border risk sharing can support economic growth, convergence and shock absorption and therefore is related to the ECB mandate. Financial stability concerns also require for the CMU to be completed with an efficient and harmonised oversight and supervision at the EU level to be able to counteract periods of capital flight, market panic and contagion between Member States.

Since public cross-border risk sharing is limited by the EU Treaties and the lack of true EU fiscal union, private capital has an important role as a risk-sharing tool through banks and capital markets. It can mobilise savings into investments for important EU priorities, it can contribute to the smoothing of shocks and it can deepen the innovation landscape and technological capability of EU firms by providing them with the necessary capital.

While the economic performance of individual Member States or regions and the risk-sharing arrangement between them are not a central consideration for the European System of Central Banks (ESCB), they are directly relevant as much as they influence the economic performance of the whole euro area. Since economic developments determine inflation developments, they are therefore directly relevant to the primary mandate of the Eurosystem. As far as the missing CMU has implications for the resilience of the financial system after shocks, it is also relevant for the ECB in terms of its competence over financial stability (Article 127 TFEU)[1].

Despite the costs from the unfinished nature of the CMU, its necessity to ensure the needed private capital for investments and its relevance to the ECB, the CMU has made disappointing progress in the past decade. As pointed out by Lagarde (2023), Europe's capital markets remain fragmented. "*Financial integration is lower than before the financial crisis. Bond markets are three times*

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A12016E127.

smaller than in the United States. And EU venture capital lags significantly behind the United States, at just one-fifth of the size." According to the Merriam-Webster dictionary, the word demure is an adjective meaning "reserved, modest". This is a very suitable adjective to describe the developments of the CMU of the past 10 years, which were modest at the very best**.**

Yet the CMU is very important for the functioning of the European Monetary Union (EMU) and the euro. Famously, the euro is like a bumblebee – according to nature it should not be able "to fly" (to function), yet it does (Draghi, 2012). **Completing the CMU can help the common currency "fly" and most of all achieve "soft landing" when necessary because it affects the ECB transmission mechanism and unburdens it from playing the role of "only game in town"**. Yet the CMU is not a "wing" of the CMU – it cannot solely carry the common currency. It is a smaller component that enables "flying" and especially a "soft landing". The CMU is one of many components for the common currency to "fly", therefore it is like a feather – as birds extend or retract their feathers to descend properly when landing. **This paper dissects how modest and "demure" the evolution of the CMU was in the past 10 years and its current state (Chapter 2), comparing it with the unified capital market in the US, exploring its relevance for the ECB (Chapter 3) and assessing different ways to approach the issues at hand going forward (Chapter 4).**

2. EVOLUTION OF THE CAPITAL MARKETS UNION AND CURRENT STATE

The journey towards the CMU begins with the recognition that the EU's financial markets are fragmented and underdeveloped. This fragmentation hinders the efficient allocation of capital and limits access to finance for businesses, particularly small and medium-sized enterprises (SMEs). In response, the European Commission launched the CMU initiative in 2014. Then President of the European Commission Jean-Claude Juncker argued that: *"Over time, I believe we should complement the new European rules for banks with a Capital Markets Union. To improve the financing of our economy, we should further develop and integrate capital markets. This would cut the cost of raising capital, notably for SMEs, and help reduce our very high dependence on bank funding"*. The CMU was then embedded as part of the Five Presidents' Report (Juncker, 2015) with the goal to enhance risk-sharing and economic stability. The idea of the CMU and its significance goes back even further[2]. Importantly, in 2014, the initiative was seen as a reaction to the ongoing discussion of a possible Brexit referendum (Véron, 2024). Then UK Chancellor George Osborne argued that the framework of the common currency would lead at some point to a fiscal risk-sharing which the UK did not want to enter in[3]. The idea of CMU was therefore developed as an alternative way to fix EU economic problems through the provision and mobility of capital, while ensuring that London remained a central capital markets hub[4]. Even though after Brexit part of the reason to take a low-hanging fruit approach disappeared, the opportunity to pursue the CMU project with more ambition was not used (Véron, 2024).

The importance of developing the CMU was also supported by the ECB at the time. In presenting the ECB Annual Report (ECB, 2015a), then Vice President of the ECB Vítor Constâncio argued that "*Monetary policy can and will smooth and accelerate the transition to a sustainable growth trajectory, but it cannot lift that trajectory. For this to happen, it is essential that available financial resources are well allocated and used productively. In this regard, the capital markets union agenda can also make an important contribution"*. According to this view, the CMU if pursued and developed with ambition could have a decisive role for the economic growth potential for the EU, especially by helping the euro area recover faster from economic downturns.

This view implicitly takes a money neutrality view of monetary policy. This view means that monetary policy cannot increase economic growth in the long-run, but rather has an important role in smoothing the business cycle in the short to medium term, thereby also bringing prices back to the inflation target. The deepening and integration of capital markets could therefore help the ECB by enhancing risk-sharing and the absorption of shocks in the euro area during crises and smooth business cycle volatility. As suggested by the statement, however, this is only a side effect of the expansion of the CMU, with its main benefits being the expansion of capital supply and the long-run growth enhancing effect this can have for the EU economy given the increased public investment needs the EU faces (see Felbermayr and Pekanov, 2024). On top of that, a genuine CMU can have structural implications for the European financial system by reducing the dominant role of bank finance in the EU (ECB, 2015b; 2016a) which has on occasions amplified financial instability. According to the ECB Annual Report 2014 a genuine CMU thus would have required a high level of financial integration

[2] Former ECB President Willem Duisenberg argued about the importance to integrate EU capital markets as early as 1999 . Such ideas were also part of the "Financial Services Action Plan" presented by the then Internal Market Commissioner Mario Monti (European Commission, 1999) and the Lamfalussy Report (2001) and led to the introduction of the Committee of European Securities Regulators (CESR) – the first attempt at supervisory integration, later developed into the European Securities and Markets Authority (ESMA).

[3] Chris Giles and George Parker, "Osborne urges eurozone to 'get a grip'", Financial Times, 20 July 2011.

[4] Furthermore, the British Commissioner, Jonathan Hill, was appointed to the newly created portfolio of Commissioner for Financial Stability, Financial Services and Capital Markets Union.

characterised by a single set of rules for all market participants; equal access to the same set of financial instruments and services; and equal treatment in the market.

Based on these active discussions, in 2015 a CMU action plan was adopted by the European Commission with a focus on six main areas:

(1) financing for innovation;

(2) raising capital in public markets;

(3) facilitating long-term investment, especially in infrastructure;

(4) fostering more choice for retail and institutional investors;

(5) supporting securitisation; and

(6) reducing barriers to a unified EU capital market (European Commission, 2015).

This was followed in 2020 by a second CMU action plan[5], focusing on 16 actions to deliver on three key objectives: making financing more accessible to European companies for the green and digital transition and economic recovery; making the EU a safer place for individuals to save and invest long-term and integrating national capital markets into a genuine single market. Table A1 in the Annex provides a concise list of the policy actions and recommendations in the two action plans.

The concrete follow-ups on these plans have however been disappointing. Progress on the CMU has been uneven, and most of the challenges remain. The initial phase of the CMU focused on removing barriers to cross-border investment and improving market infrastructure. Key measures included the harmonisation of prospectus requirements, the establishment of a framework for simple, transparent, and standardised securitisation, and the development of a pan-European personal pension product (PEPP). The legislative act on the European Single Access Point (ESAP) was adopted. ESAP will be a platform to facilitate investor access to unified financial information, since a unified capital market requires equal information for all market participants. Yet, this platform will become fully operational only by 2027. The Commission also introduced a harmonised vehicle for investment in long-term illiquid assets, the European Long-Term Investment Fund (ELTIF), which was recently revised after its initial introduction in 2015. Some progress was achieved on reducing administrative burden e.g. through unified prospectus regulation. Member States have recently agreed on the FASTER[6] initiative to introduce a digital tax residence certificate so that taxpayers can benefit from fast-tack, harmonised procedures on withholding taxes. Further progress was also made in 2021 and 2022 on the Review of the Markets in Financial Instruments Regulation (MiFIR), on a stronger clearing system and on the European market infrastructure regulation (EMIR).

In 2019, an IMF study identified through a survey of capital market practitioners some key barriers to further integration in the areas of transparency, regulation and insolvency practices (IMF, 2019). The results identified as main problems the insufficient informational transparency on securities markets and tax relief withholding, the uneven regulatory quality cross-borders and unequal insolvency regimes (IMF, 2019). This required addressing transparency issues by standardised and harmonised reporting requirements; supervisory and regulatory convergence; and the harmonisation of insolvency regimes. On these dominant concerns for market participants there has been almost no progress in the past years. Beyond some low-hanging fruits that have taken a long-time to complete (ESAP, the FASTER initiative[7]), there have been not many bigger milestones achieved. **As the next sub-**

5 https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/capital-markets-union/capital-markets-union-2020-action-plan_en.

6 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A52023PC0324.

7 ESAP will improve transparency when it is fully functional, but this is still due. A political decision between Member States on the FASTER initiative was reached in May 2024, yet the full implementation will happen by 2028 with the transposition of the directive by Member States.

section however makes clear, the EU has a sizeable, order-of-magnitude underutilisation of its capital in comparison to the US. Small incremental changes therefore seem inadequate if the EU is serious about closing this gap.

2.1. EU and US capital markets

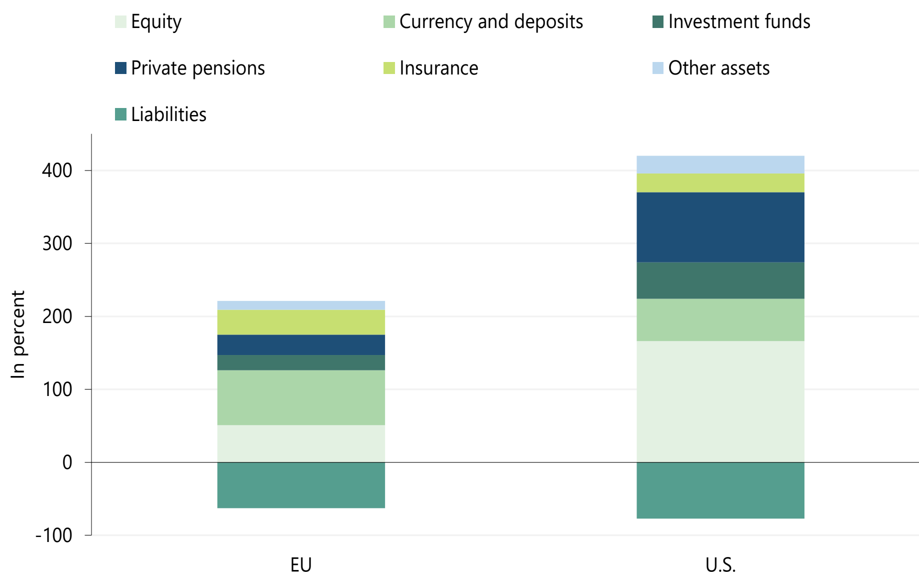
European capital markets continue to be small in comparison to the US and the EU finance landscape continues to be strongly dominated by banking finance. The differences between capital markets in the EU and the US can be seen across many different dimensions – the size of bond and equity markets, the participation of households, the structure of firms financing sources and financing conditions, the role of large institutional investors and the role of venture capital and start-up financing. The Association for Financial Markets recently argued that intra-EU integration in capital markets has even declined since 2019 (AFME, 2023). This section summarises quantitatively these differences.

The EU banking system has traditionally been large in relation to the size of the EU economy. Some authors have spoken of Europe’s bank bias and excessive bank dependence (Langfield and Pagano, 2016). Such structural features of the financial system change very slowly so using data from past years can be sufficient to build a coherent picture. Looking at pre-pandemic data, bank assets were at around 300% of the EU’s Gross Domestic Product (GDP) in comparison to a mere 85% in the US, yet below the 500% in Japan (IMF, 2019). The equity market on the other hand is small – listed equity amounted to a mere 68% of the EU’s GDP, while in the US and Japan it was at 170% and 120% of their respective GDPs. Combined with a large number of exchanges and infrastructure providers, this means low market depth and liquidity, and therefore many smaller capital markets. The difference in capital markets sizes across EU Member States are sizeable. While countries like France, the Netherlands and Sweden have equity and debt securities of more than 200% of their GDP, this share is well below 100% in countries like Poland, the Czech Republic and others (IMF, 2019). The Letta Report (2024) also concluded recently that “the EU's share in global capital market activities - including equity issuance, total market capitalisation, and corporate bond issuance - does not align proportionately with its GDP”.

European households participate to a limited extent in EU capital markets. The EU currently is home to EUR 33 trillion in private savings, but one-third of them are hold in current accounts with low returns (Letta, 2024). A significant part of them – around EUR 300 bn according to the Letta Report – is even diverged from EU markets towards foreign markets, dominantly the US. Only around 20% of households in the euro area holds stocks or have invested in investment funds and around one-third invests in voluntary pension and insurance schemes, while in the US more than 50% of households have retirement accounts for investment (ECB, 2016a). A clear preference by European households for bank deposits over securities can be identified from the data. This combined with the dominant role of public pension systems leaves small space for capital markets to develop through private investments. The IMF (2019) points that 40% of EU households’ savings are held as secure and low-return bank deposits, while in the US this is only around 10%. More recent data comparing the share of different type of households’ assets and liabilities as a percentage of GDP shows the much bigger role for equity and investment funds for US household assets, whereas in Europe currency and deposits, yielding very low returns, dominate (Figure 1). This leads to the conclusion that Europeans seem to be unwilling to take risks in comparison to the US.[8] According to this view, the lack of an integrated CMU contributes significantly to the fact that around EUR 10 trillion are idle in the bank accounts of European citizens instead of being invested in the stock market where they can contribute to economic growth.

[8] https://www.politico.eu/article/europe-10-trillion-euro-gamble-saving-investment-economy

Figure 1: Household financial assets and liabilities as a share of GDP, 2022

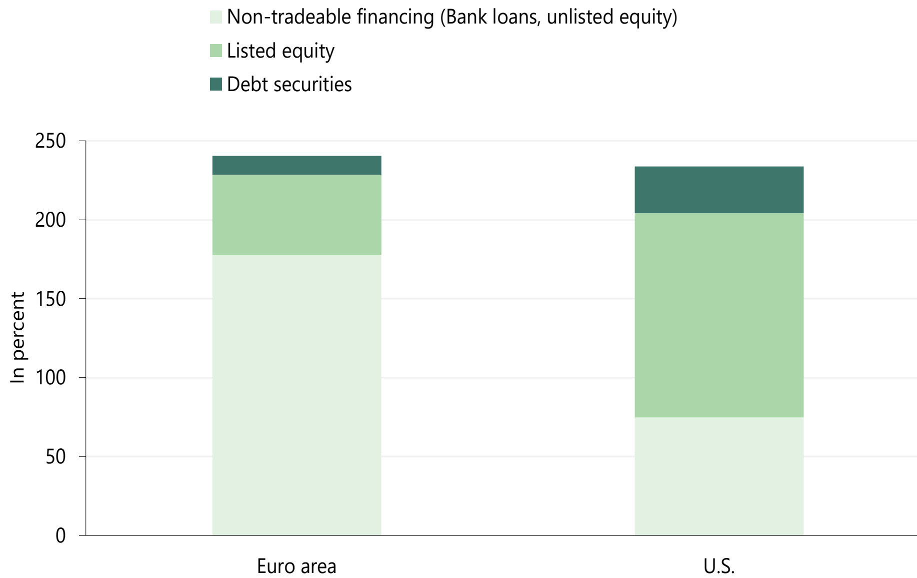


Source: IMF (Nathaniel Arnold, Guillaume Claveres and Jan Frie; 2024), OECD.

The different finance landscape between the EU and the US is also apparent when looking at non-financial firms. Non-financial firms in the EU use much less market-based finance with only 30% of non-financial firms in the EU using tradable funding instruments. Instead. In the US such instruments were used by more than two-thirds of non-financial firms in 2019 (IMF, 2019). The funding structure of non-financial corporations (NFCs) in 2022, presented in Figure 2, shows a similar picture. In 2022, the funding structure of non-financial firms in the US was dominated by equity and debt securities, whereas in the EU it was dominated by bank and non-bank loans and unlisted equity.

A similar picture emerges when looking at large institutional investors in the EU and the US. In the EU, the size of the private pension funds industry is much smaller and the long-term institutional investor base in the smallest in comparison to all other advanced economies (IMF, 2019). Arnold et al. (2024), report that assets held in private pension funds and insurance companies collectively amount to around EUR 10.7 trillion (USD 11.9 trillion) in the EU, which is about ¼ of the size of roughly EUR 38.1 trillion (USD 42.5 trillion) estimated for the US. Hedge funds and private equity funds are also much smaller in Europe than in the US and before Brexit were dominated by the UK. Furthermore, there is a significant home bias in investments of insurance funds and pension funds, with pension funds investing heavily in their domestic equity markets (IMF, 2019).

Figure 2: Non-financial corporations funding structure as a share of GDP, 2022



Source: IMF (Nathaniel Arnold, Guillaume Claveres and Jan Frie; 2024), OECD.

The infrastructure of trading in Europe is also fragmented – Europe has 34 listing exchanges, 41 trading exchanges and 18 central securities depositories, while the US has 3 listing exchanges, 16 trading exchanges and 1 central securities depository (Arnold et al., 2024). At the same time, capital market services are often outsourced to entities outside of Europe. According to the ECB (2023), about 45% of the banks involved in bond issuance activities of NFCs in the euro area were foreign banks in 2021. This reliance on foreign partners for key services presents a challenge in terms of its strategic autonomy for the EU.

Finally, the size of the venture and risk capital market in Europe is multiple times smaller than in the US. This is a problem, since numerous studies have pointed to the important positive effects on innovation and growth from increased venture capital (VC) financing through the proliferation of non-rivalrous ideas (Greenwood et al., 2022; Akcigit et al., 2022; Jones, 2005). Figure 3 demonstrates that annual VC investments have been much more sizeable in the US than in the EU in each year of the past decade, up to a magnitude of 10 to 1. For the years between 2013 and 2023, this accumulates to the considerable sum of EUR 924 billion in VC investment in the US compared to a mere EUR 130 billion in Europe – more than seven-fold more (Figure 4). Similarly, according to Demertzis et al. (2021),the overall availability of risk capital in the EU is roughly ten times lower than it is the US (0.044% of GDP versus 0.633% of GDP). According to a recent Politico article, based on IMF data, the VC market in Europe is even 1/20 the size of the market in the US[9]. The ECB evaluates that the total growth capital of business angels, VC and private equity, in the EU equalled a mere 0.2% of GDP in 2021, while it was 1.5% of GDP in the US (ECB, 2023). Finally, the problem of this lacking capital becomes apparent when looking at firms' exits, where outward migration of European ideas can be documented. The firm exit is the stage where the realised equity gains are realised for founders and investors. In 2023, nearly half of the acquisitions of EU start-ups were done by non-EU acquirers (Kraemer-Eis and Croce, 2023).

Table 1 summarises all of the above characteristics and shows the huge gap between EU and US supply of private capital and functioning of a unified capital market.

[9] https://www.politico.eu/article/europe-10-trillion-euro-gamble-saving-investment-economy

Figure 3: Venture capital investment (annual flows) as a share of GDP between 2012 and 2022

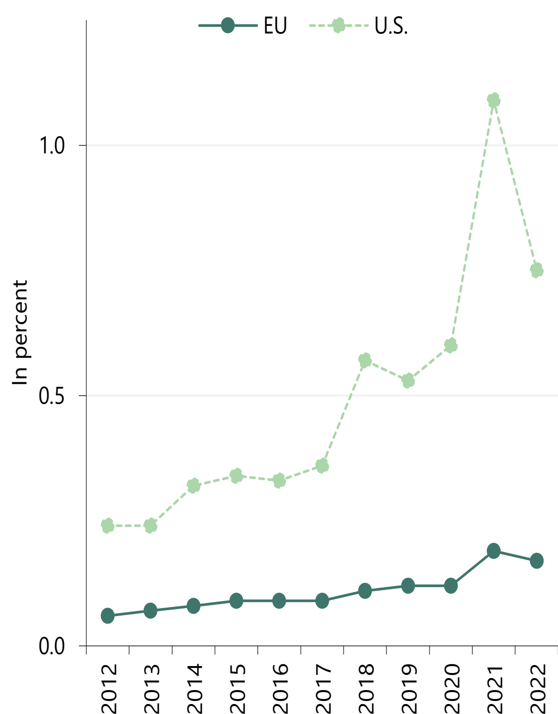
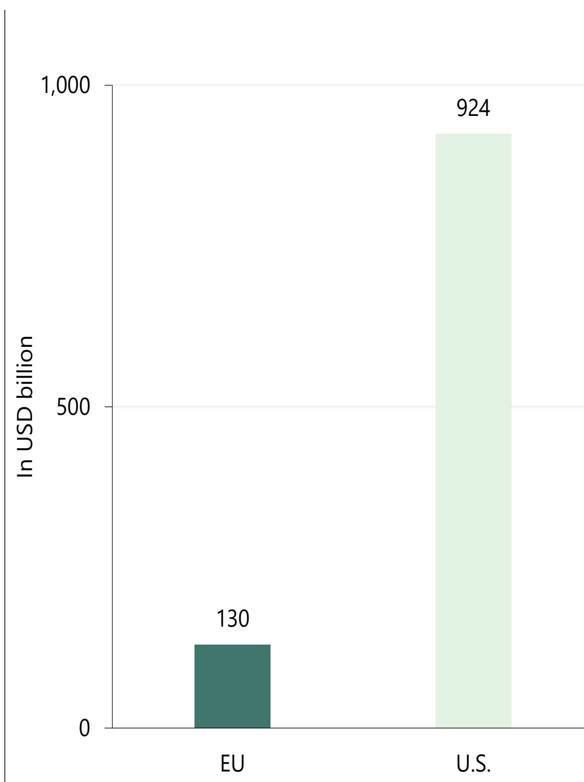


Figure 4: Total venture capital funds raised between 2013 and 2023



Source: IMF (Nathaniel Arnold, Guillaume Claveres and Jan Frie; 2024), OECD, Invest Europe, PitchBook Data.

Table 1: Comparing the EU and US financing landscape

Dimension of capital markets	EU	US
Equity market size	68%	170%
Bank assets to GDP	300%	85%
Households participating in the stock market	Around 20%	More than 50%
Non-financial corporations funding through financial securities	30%	More than 66%
Assets held in private pension funds and insurance companies	EUR 10.7 trillion	EUR 38.1 trillion
Venture capital market – total funds raised 2013 - 2023	EUR 130 billion	EUR 924 billion
Number of listing exchanges	34	3

Source: Own elaboration. Based on ECB (2016a), IMF (2019), IMF (2024), Letta (2024).

3. RELEVANCE OF THE CAPITAL MARKETS UNION FOR ECB MONETARY POLICY

This section discusses the question how the CMU and its incomplete nature is relevant for ECB monetary policy. Firstly, the incompleteness of the CMU affects funding conditions for firms and deprives them of funding opportunities. This can contribute to divergence and fragmentation with direct implications for the single monetary policy of the ECB. Additionally, the bank-dominated structure of financing in the EMU has implications for financial stability. Finally, and most importantly, the unfinished nature of the CMU constitutes a challenge for the EMU to respond to asymmetric shocks in that risk-sharing through capital markets is incomplete. As an implication, this has repercussions for economic activity and price developments after economic shocks. It is therefore directly relevant for the conduct of monetary policy as it influences the ECB primary mandate to achieve price stability.

The considerably smaller size and fragmentation of capital markets in the EU impose additional costs of funding for EU Member States and the private sector. First, corporate funding costs are starkly different across the EU. According to the IMF (2019), firms in some euro area countries pay up to 250 basis points more on their funding in comparison to their peers in other countries. The IMF (2019) discusses how private risk-sharing and improving the insolvency framework can improve funding costs in individual Member States. The study evaluates that a smaller euro area country such as e.g. Estonia could see a decrease in average corporate debt funding costs by 0.48% if it can improve its insolvency framework and credit recovery rate to the best possible level. By doing this, Estonia could attract cross-border bond flows from the savers of a higher income country, which would thus receive higher returns than on their domestic bank deposits.

This has implications for monetary policy since interest rate changes aim to affect financing costs for firms and individuals. While there can be reasons for a dispersion of financing costs across Member States due to different risk premia and other country specific characteristics, a significant increase in the dispersion of financing costs leads to fragmentation, hence representing a challenge for the single monetary policy of the ECB.

Secondly, firms with insufficient collateral, such as for example start-ups, face credit rationing and might be unable to obtain credit. This can also be a problem in specific sectors e. g. in digitalisation or decarbonisation. According to a recent ECB survey of SMEs, nearly 40% of participants characterise the lack of funding for green investments as a considerable obstacle (Lagarde, 2023). The missing capital markets not only deprives SMEs of funding opportunities, but also can reduce the appetite of banks to provide riskier loans. Start-ups in Europe manage to attract less than 50% of the funding their US counterparts do, while investment in scale-ups is four time higher in the US (Lagarde, 2023). According to an ECB analysis, the rapid development of CMU would lead to extra funding of around EUR 535 billion a year for an additional 4,800 companies (Lagarde, 2023). Fragmentation therefore also means that especially the youngest, most disruptive firms face challenges on acquiring funding (Lagarde, 2023).

Thirdly, funding choices in the EU for firms are limited and the banking sector dominates the funding structure. This has direct implications for the ECB mandate because of its financial stability implications. Adrian and Shin (2010) argue that economies dominated by banking finance take a longer time to recover from financial crises on average as legacy asset problems and other challenges may impair bank financial intermediation for longer after a shock. The lack of funding opportunities for firms then results in negative effects on economic growth and innovation. Langfield and Pagano (2016) document that in countries with higher ratios of bank assets to stock and bond market capitalisation banks are more exposed to systemic risks and serious economic slowdowns, especially when house prices and stock prices crash. The mechanism is due to overextension of credit by banks during good times, followed by a sharp drop after an asset price correction. In a seminal paper, Bernanke et al. (1999)

explain this financial accelerator channel as working through the bank equity and collateral affecting the volume of bank lending. Similarly, Becker and Ivashina (2014) showed that when banks are highly leveraged, as they are in the EU, this results in more volatile credit creation than in bond markets, especially so in crisis, thereby endangering financial stability. This led to the "spare tyre" view on the need for CMU as a way to provide extra financing channels rather having just one through banks.

Finally, but most importantly, the EU does not have enough risk-sharing for the absorption of macroeconomic shocks. This element of the lacking CMU in Europe is the most relevant for the ECB. The unfinished nature of the European EMU has been at the heart of economic policy debates for decades (for a summary see Constâncio, 2017; Pekanov, 2019). In a common currency area, national monetary policy is not available to react to diverging economic developments in parts of the union, as interest rate decisions are based on the whole currency area. This presents a challenge for achieving macroeconomic stabilisation, as discussed ever since the seminal work of Mundell (1961) and Kenen (1969). When different regions of the common currency area are hit by asymmetric shocks and their economic performance is not synchronised, the interest rate response by the central bank may not be suitable to address country specific or regional shocks (Farhi and Werning, 2017). This can lead to periods of economic stagnation and an accompanying inability of the central bank to achieve the inflation target. In the EMU formation phase, there was a belief that trade integration would help synchronise the business cycle of Member States through a so-called "Rose effect"[10] (Rose and Engel, 2002), yet the full magnitude of this effect has not materialised (Glick and Rose, 2015).

To address this issue, the optimal currency area (OCA) theory argues additional channels to smooth out regional macroeconomic shocks are necessary either through a common federal budget or through private capital mobility, as would be the case with a genuine CMU[11]. Federal states such as the US, Canada and Switzerland with a common currency traditionally smooth local shocks through these channels. After an economic downturn, economic stabilisation is driven to a different extent by these channels smoothing the shock. If they are unavailable, the shock is left unsmoothed and results in a prolonged period of sub-par economic performance and possibly inflation undershooting.

Numerous studies[12] show that the EU lacks both channels because of the unfinished nature of the CMU. Allard et al. (2013) analyse the absorption of shocks through different risk-sharing channels. Alcidi et al. (2017) also compare the euro area and the US with data up until to the global financial crisis. Alcidi et al. (2017) document that in the euro area 75% of asymmetric shocks are unsmoothed, while this is only 17% in the US. In the US, all the other channels contribute to macroeconomic stabilisation – fiscal risk-sharing through the US budget, labour market mobility and capital mobility due to the well-developed and integrated capital market. Cimadomo et al. (2018), for example, show that in the US 60% of state-level shocks are shared and 30% of this is done by financial markets, whereas in the euro area only 20% of shocks at the country-level are shared and only 10% of them through financial markets.

The IMF (2019) evaluates that local consumption in the EU is four times more sensitive to idiosyncratic local shocks in the EU in comparison to the US. This results in insufficient macroeconomic smoothing for the EU and contributes to subdued economic growth. When domestic GDP in a country falls by 1% more than the average GDP in the EU, private consumption in Europe and

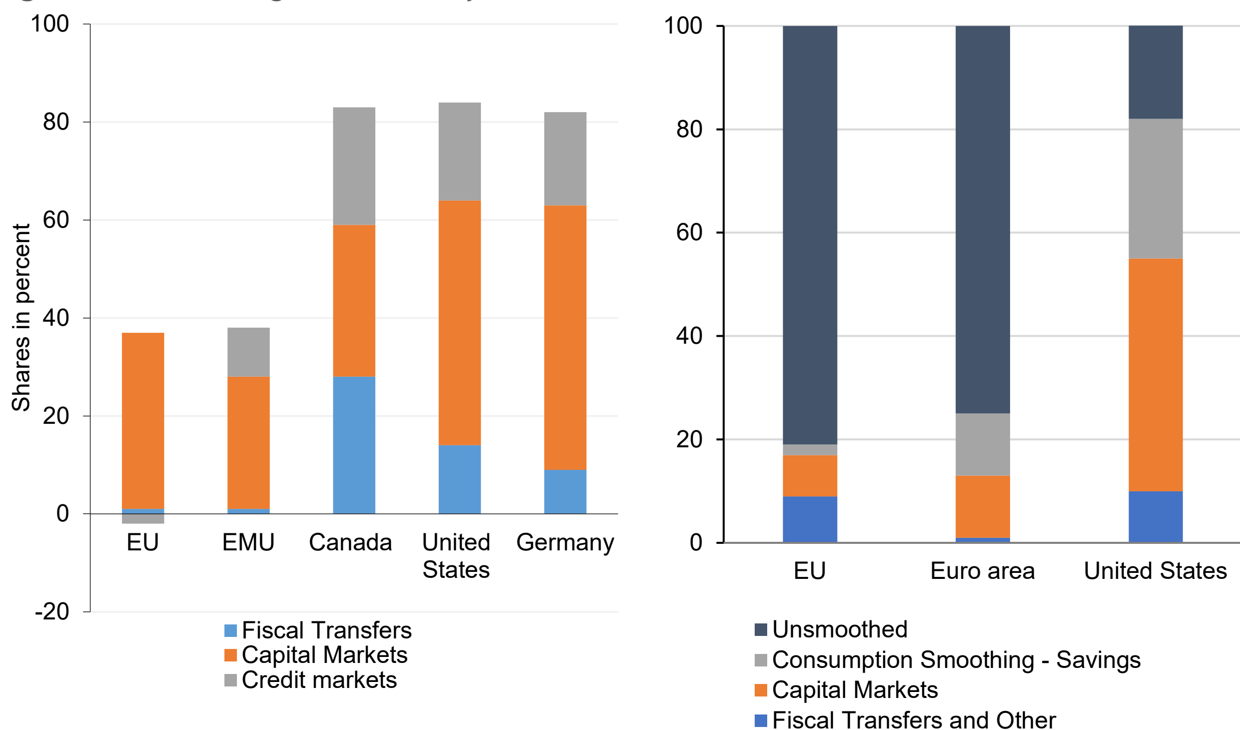
[10] Through increased trade integration, the business cycle of the EU should have become more synchronised.

[11] These channels should provide a way for local economies to adjust either through labour inflows and outflows, capital inflows or outflows or through direct fiscal policy redistributing to stabilise consumption, fund public investments or unemployment benefits acting as an automatic stabiliser.

[12] The literature categorises the risk-sharing ability through evaluating the change in aggregate regional consumption to fluctuations in regional income. In theory, if consumption moves one-to-one with domestic GDP, i.e. if it is very sensitive to domestic GDP, then there is no risk-sharing with the rest of the world.

in the euro area respond by decreasing by 0.8% and 0.75% respectively. For the US and Canada the drop in local private consumption on the other hand to the 1% drop in GDP is a mere 0.2%. In comparison therefore, the lack of the three risk-sharing channels in the EU results in up to 75% to 80% of the shock not being smoothed in comparison to only around 20% in the US and Canada. The capital market channel in particular has a small effect on income smoothing with only around 0.1% of domestic growth shocks smoothed through EU capital markets, while in the US this amount to 0.45% (IMF, 2019; European Commission, 2016; Balli et al., 2012).[13] In theory, by holding cross-border assets, firms and households should be able to insure themselves to domestic economic downturns by being able to receive foreign capital market income or selling foreign assets. Similarly, in such an arrangement domestic demand shocks are smoothed because they are partly absorbed by foreign holders of assets – the response of local consumption and therefore GDP would be less sensitive to local economic shocks.[14] Yet the incomplete CMU means that this mechanism is missing in the EU, as per the above estimates.

Figure 5: Risk-sharing and shock adjustment in the EMU and other countries



Source: Allard et al. (2013) (left-hand side), Arnold et al. (2024) (right-hand side).

Note: Left-hand side: Risk sharing (Percent of regional income shock smoothed by channel); Right-hand side: Shock smoothing in the US and the euro area between 1998 and 2016; Percentage of shocks to GDP absorbed through each channel.

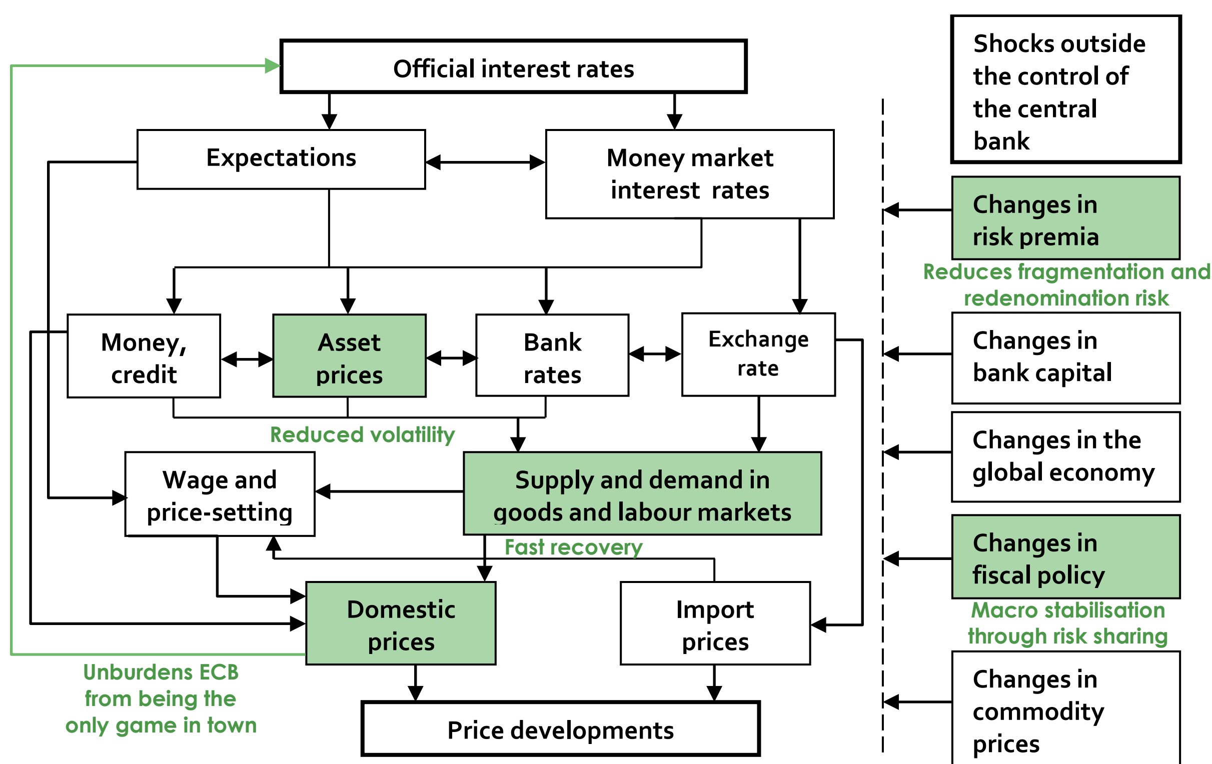
Figure 5 summarises the above estimates on the magnitude of risk-sharing in some federal states compared to those in the EMU. All studies show that asymmetric economic shocks are largely left unsmoothed in the EMU. All macroeconomic channels to smooth idiosyncratic shocks are much stronger in the other analysed countries. Because of the lack of such absorbing channels, the EMU lacks the ability to recover faster from economic downturns. In this set-up, the ECB is the "the only game in town" for economic recovery, which overburdens it and requires it to keep interest rates lower for longer.

[13] In these estimations, the labour, investment and other external income channels are not separated.

[14] This channel is especially strong in the case of cross-border equity claims. If the ownership of firms' equities in Member State A is dispersed through its citizens and foreign owners, the domestic shock, which decreases economic activity and firm profits, will be absorbed not only by domestic citizens, but also by foreigners. Income transfers from home and abroad therefore help smooth domestic shocks.

The following graph (Figure 6) uses the stylised illustration of the ECB[15] for the transmission mechanism of interest rates to prices to visualise the implications of a completed CMU. The graph presents how a change in the ECB interest rate affects financing conditions in the financial and banking sector. These changed conditions then lead to changes in the goods and labour market and finally affect domestic prices and therefore inflation with some "long and variable lag".

Figure 6: Implications of a completed CMU on ECB monetary policy transmission



Source: ECB and own elaboration.

Note: In general, a change in the ECB interest rate affects financing conditions. This leads then to changes in the supply and demand in the goods and labour markets, which determines domestic prices and therefore inflation. A completed CMU will affect the transmission mechanism by reducing fragmentation and therefore risk premia, which would reduce periods of divergence of interest rates throughout the euro area and will reduce volatility of asset prices. The CMU would provide a risk-sharing function and would provide macroeconomic stabilisation, substituting for the missing EU-wide fiscal capacity. This would lead to faster economic recoveries after shocks and, by affecting the goods and labour markets, would unburden the ECB from being the only game in town.

In conclusion, the completion of the CMU is relevant for the ECB and its monetary policy through several ways.

Firstly, the current financing structure in the EU contributes to diverging financing conditions in Member States. The completion of a unified capital market with less home bias will partly ameliorate some of the changes in risk premia. During crises, the wider dispersion of financing conditions risks fragmentation of the ECB monetary policy – addressing this dispersion via the completion of the CMU will support the ECB monetary policy transmission. Risk premia and redenomination risks also have a negative effect on asset prices.

Secondly, the bank-dominated landscape in the EU might impede economic recovery through subdued credit to other sectors of the economy following economic downturns, while also having negative financial stability implications.

[15] https://www.ecb.europa.eu/mopo/intro/transmission/html/index.en.html

Finally, and most importantly, the lack of sufficient risk-sharing in the EMU contributes to a high burden on the ECB to be the only game in town in terms of macroeconomic stabilisation, as long as there is no common fiscal budget as a form of risk-sharing. The completion of the CMU would reduce the burden both on monetary policy by the ECB and for common fiscal policy to act against crises and will enable more private capital to realise the smoothing of macroeconomic and idiosyncratic shocks**.** By affecting the duration of economic downturns, this will have a direct effect on the supply and demand in goods and labour markets, which determine price developments and with it the necessity of the ECB to act in different situations.

Beyond these direct effects, a unified capital market with the underlying richer supply of private capital should in theory reduce interest rates overall in the euro area. While lower interest rates are not an explicit goal or even desirable per se as part of the ECB mandate, as long as they do not interfere with the price stability mandate and do not lead to increased inflation, they can have growth enhancing effects. This effect is not directly relevant for the ECB, but more broadly for EU growth and investment, especially during periods of increased investment needs. On the other hand, lower interest rates for longer can also be a burden for the ECB, if they imply the risk of hitting the zero lower bound more often.

4. THE WAY FORWARD

Progress on the CMU over the past decade has been minimalistic and cannot be identified as transformational or equal to the financial sector reforms enacted after the Global Financial Crisis (Véron, 2024). The path forward to a fully integrated CMU is fraught with challenges. This chapter serves as a summary of recent official statements by the Eurogroup and the Governing Council of the ECB, combined with the enhanced analysis provided by the Letta Report and the Draghi Report, to focus the further steps in achieving progress on the CMU for the new legislative term of the European Parliament and the new European Commission.

Primary obstacles remain the regulatory divergence among EU Member States and the current fragmented supervision. Differences in national regulations, tax regimes, and insolvency laws create barriers to cross-border investment and impede the functioning of a unified market. Harmonising these regulations requires significant political will and coordination, which can be difficult to achieve given the diverse economic interests of Member States. The lack of a unified supervisory framework remains one of the major challenges. Going forward, Véron (2024) sees potential for short-term movement in terms of supervisory integration early in the new legislative terms of the European Parliament and in the new mandate of the European Commission. This view was also expressed by ECB President Lagarde in 2023 that the European supervisory model should progress more towards an integrated framework as in the US. *"Creating a European SEC, for example by extending the powers of ESMA, could be the answer. It would need a broad mandate, including direct supervision, to mitigate systemic risks posed by large cross-border firms and market infrastructures such as EU central counterparties"* (Lagarde, 2023). While ESMA plays a key role in overseeing capital markets, its powers are limited, and supervision remains largely national. Strengthening ESMA's mandate and enhancing its supervisory capabilities are crucial steps towards ensuring consistent enforcement of regulations and fostering investor confidence.

In March 2024, the Governing Council of the European Central Bank issued a statement[16] that for "the Eurosystem achieving a single market for capital is imperative". Among the many other reasons for that, it also explicitly listed its relevance for the ECB: *"A genuine CMU would improve private risk-sharing across the euro area and the smoothing of idiosyncratic, local shocks to which monetary policy is not able to respond properly. This should reduce financial fragmentation and protect the ECB monetary policy transmission".* The GC statement recommends taking a top-down approach in the 10th legislative term, while also pointing to concrete actions on a number of priorities including the harmonisation of insolvency rules, integration and strengthening of supervision, consolidation of stock exchanges and the inclusion of citizens through better financial education, among others. Finally, the Governing Council states that: *"While many of these initiatives will take time and the Capital Markets Union remains a long-term project, urgent and decisive action is now needed to make real progress in the integration and development of EU capital markets. There are no more low-hanging fruits to pick (…), and the EU must now address the most important and structural challenges."*

The Eurogroup issued a statement in a similar direction in March 2024 arguing that *"open, well-functioning, and integrated European capital markets are crucial to promote the single market and to attract the necessary investments, and thereby to boost the EU's global competitiveness, innovation, sustainable growth, and job creation"*. As part of its statement, the Eurogroup in inclusive format puts 13 priority measures, grouped in 3 main categories, as a concrete direction to be taken in the coming years including supervisory convergence through a strengthened role and governance of the European Supervisory Authorities, a reduction of regulatory burden, integration of market structure and exchanges and stronger citizen participation, among others.

[16] https://www.ecb.europa.eu/press/pr/date/2024/html/ecb.pr240307~76c2ab2747.en.html.

Further to the specific policy recommendations on concrete policy action to be taken, a broader shift in the narrative on the CMU has taken place in the last two years. The EU is facing the challenge of mobilising sufficient private and public capital to achieve its ambitious goals for the green and digital transition. A genuine CMU can substantially contribute to the supply of such capital. While this argument has less relevance for the ECB and monetary policy, it provides a more direct and broadly relevant argument for a genuine CMU that can gather the political will to move forward on unsolved issues.

Comparing the ECB Governing Council and Eurogroup statements, the ECB clearly sets the tone on rebranding the CMU focusing on its main purpose: a savings and sustainable investment union. The ECB therefore seems to steer the direction of the CMU towards political feasibility and further away from its relevance for the ECB mandate itself. This is argued to help innovation and growth through capital and only indirectly, in the second-place, to enhance a risk-sharing arrangement beneficial to the ECB and protecting its monetary policy transmission from fragmentation. The strengthening of international role of the euro and the benefits to the EU's banking sector are mentioned as additional advantages.

Already back in 2023, Lagarde (2023) argued for a "Kantian shift" in the approach towards the CMU. This calls for moving from a piece-meal approach of incremental change to a radical approach recognising the urgent investment needs the EU is facing. Such a shift leading to a true integrated capital market can ensure that these needs are met, making the EU stronger economically and geopolitically. This argument builds on the view that the initial development of the unified US capital market had a similar background. It was based on the wide scale need for infrastructure investments, mostly railroad, at the turn of the 19th century (Gordon and Judge, 2018). Since the market in goods and services was integrated, US companies were growing on a national scale but were lacking the necessary infrastructure for that. Banking finance was however fragmented and could not provide the high-risk financing at a national scale to ensure the realisation of such projects. According to Gordon and Judge (2018) this pushed the development of capital markets in the US in the form of bonds. In the view expressed by Lagarde (2023) the necessities of the climate and digital transition constitute a similar situation for the EU requiring its capital markets to evolve faster and in a more integrated way.

According to Lagarde (2023), the first decade of the CMU revolved around the argument of providing stabilisation benefits in terms of private risk-sharing for the monetary union during crisis to make it more resilient to crisis and acting as a "spare tyre" to the banking sector. And while these are important beneficial sides, especially for the ECB, they have not been enough to achieve political progress on solving the open challenges for a true European CMU. Much more, according to this view, it is the imperative of mobilising the needed capital for the twin transition that should motivate a more ambitious approach in the coming years. On top of that, the increased geopolitical tensions have led to numerous calls and EU-wide discussions on the need to increase defence spending considerably.

Lagarde presents a sceptical view to a piecemeal approach of continuing to achieve the low-hanging fruit reforms. She insists on a top-down approach instead by pointing that common institutions were crucial in the case of the development of the US capital markets. This is especially the case with the creation of the Securities and Exchange Commission (SEC) in 1930, which as a federal agency was central into hindering individual states from further retaining the fragmented structure of US securities markets. The EU therefore requires a truly singular supervisor at the EU level in the face of the ESMA. This would change the current framework where there are common EU rules, but national

supervisors implement them resulting in fragmentation in their application[17]. A truly singular ESMA would require an extended mandate to empower it with direct supervision for the mitigation of system risks posed by large cross-border firms and market infrastructure according to this view. Furthermore, the creation of a single rulebook and a single supervisor to oversee it will also require consolidated market infrastructure and exchange groups on a larger scale to ensure efficiency, activity and liquidity.

Eurogroup president Pascal Donahoe argued that the EU needs to mobilise private capital through a genuine CMU to close the investment gap of almost EUR 1 trillion a year it faces in the light of climate, digital and defence needs.[18] He argued that the new European Commission will have to focus on the delivery and implementation of the further steps of the CMU, based on the currently available political will to move forward. As a response former ECB Vice-President Vítor Constâncio however points out that to truly move forward on CMU a really ambitious set of actions will be necessary. Constancio noted that a genuine CMU requires a sizeable market for an EU safe bond (around EUR 3 trillion), high degree of harmonisation on taxation of financial products and transactions, the harmonisation of stakeholder rights and bankruptcy law, consolidation in the number of stock exchanges, and the creation of a Single Regulator for Capital Markets. Only fulfilling these conditions would ensure that investors are indifferent in making financial decisions regardless of their constituency.

In a similar vein to Lagarde (2023), the Letta Report (Letta, 2024) emphasises the need of a changed narrative towards the CMU. It calls for the creation of a Savings and Investments Union, developed from the incomplete CMU to mobilise private capital and savings into productive investments. Letta states that the "*the Capital Markets Union over the past decade has not been successful, among other causes, because it has been perceived as an end in itself*". The completion of the CMU can therefore be successful only if citizens identify that the CMU is not only beneficial for finance, but also for the broader EU economy. The CMU so far "*fell short of translating into concrete and tangible results on the ground, mainly due to the absence of a strong political mobiliser going beyond the intrinsic financial markets dimension.*"

Letta identifies three general areas for action: improving the supply of capital, the demand for capital, and the institutional framework and market structure governing capital mobility, which should include both smaller technical fixes and bigger more ambitious structural changes. To improve the use of funding by institutional investors an auto-enrolment EU Long-Term Savings Product is proposed, together by upgrading the already existing, but underperforming PEPP. Policies to mobilise the investments of the insurance sector as well as to best enable private savers to invest in alternative funds, partly by integrating national tax incentives with the ELTIF, are also discussed. Furthermore, the report argues for the creation of an EU Deep Tech Stock Exchange to provide a dedicated unified platform for high-growth technology companies, facilitating their access to capital and supporting the digital transformation, while for SMEs a single entry point to public capital markets should be enacted. This can also show the benefits of mergers in the realm of exchanges, already discussed above.

[17] In many countries there is even more than one national supervisors and therefore enforcement powers are split further and under even more national discretion.

[18] https://www.ft.com/content/fc4abed6-2150-402a-b5b0-76816059c3d2.

Table 2: Comparison of explicit policy recommendations with concrete proposals

Policy recommendation	ECB GC	Eurogroup	Letta Report	Draghi Report
Strengthened ESMA with enhanced governance, resources and oversight powers	Yes	Not explicitly – "more efficient use of existing powers" and "possible targeted strengthening of role & governance"	Yes	Yes, European SEC (similar governance to ECB)
Reduce regulatory burden and transaction costs	No	Yes	Yes	Yes
Prudential treatment of securitisation for banks and insurance companies, reporting and due diligence	Yes	Yes	Yes	Yes
Rebranding into Savings and Investment Union	Yes	No	Yes	No
Harmonisation of corporate insolvency rules	Yes	Yes, targeted	Yes	Yes
Harmonisation of tax-withholding	Yes	No	Yes	Yes
Addressing debt bias in taxation	Yes	Yes	Yes (integrated tax incentive with ELTIF)	Yes
Build-up of central clearing capacity	Yes	No	Yes	Yes
Consolidation/integration of stock exchanges & market infrastructure	Yes	Yes	Yes	Yes
Improve conditions for growth/scale up venture capital	Yes	Yes	Yes	Yes
Supporting large EU-based institutional investors	Yes	Yes	Yes	Yes
Initiatives on financial education and participation in financial markets	Yes	Yes	Yes	No
Safe asset	No	No	Partly	Yes
Tax treatment of long-term retail savings investment products	No	Yes	Yes	No

Source: Own elaboration

The Draghi Report (Draghi, 2024) also argues along similar dimensions on the importance of completing the CMU. It mentions as concrete next steps the encouragement of increased enrolment in private pension plans, the creation of a European Security Exchange Commission with a modified governance similar to the ECB (as proposed by the Letta Report) and insolvency framework harmonisation, among others. While it makes clear that the mobilisation of private capital is crucial for addressing the investment needs Europe is facing, it points that it will need to be amended by further public capital through the EU budget.

Table 2 summarises the policy recommendations discussed in the ECB Governing Council statement, the Eurogroup statement, the Letta Report and the Draghi Report.

All in all, to advance to a genuine CMU, the EU and Member States will need to take a multi-faceted and bold approach in the coming years. Firstly, regulatory harmonisation is needed. The EU should continue to streamline and simplify regulations, particularly in areas such as prospectuses, securitisation, taxation and insolvency regimes. This can reduce compliance costs and facilitate cross-border investment. Secondly, the supervisory framework needs to be strengthened. Enhancing ESMA's role and capabilities will ensure more consistent oversight and enforcement of regulations across the EU. This will help build investor trust and promote market stability. Furthermore, increasing coordination among national regulators and fostering a culture of cooperation will be essential to prevent regulatory arbitrage. Thirdly, innovative financial instruments and funding mechanisms should be developed to mobilise private capital for the EU's strategic priorities. Finally, fostering a culture of long-term investment is critical. Encouraging the adoption of long-term savings products and promoting financial literacy among citizens will help channel savings into productive investments. The introduction of an EU Long-Term Savings Product with auto-enrolment can play a significant role in this regard, providing individuals with accessible and attractive investment options. All of this can be seen as demand-side measures to be taken to increase the appetite of citizens to be active on financial markets.

One cannot oversee however that the statements by the ECB and the Eurogroup largely ignore one crucial and necessary element of a true CMU: the creation of a true, permanent EU safe asset. The Letta Report mentions the combination "safe asset" only twice in 147 pages and speaks about centralising the current EU bond issuances under a single brand to achieve higher rating.

Importantly, the Draghi Report (2024) is the only one that explicitly discusses the need for a European safe asset and its direct connection to achieving a genuine CMU. "*It is unquestionable that the issuance of a common safe asset would make the CMU much easier to achieve and more complete*". It will contribute to the CMU across different dimensions by providing a benchmark for bond and derivatives pricing, by creating a safe collateral to be used in all Member States and by creating a safe asset with an extensive liquid market both for investors from abroad and for EU households.

A European safe asset is a necessity to achieve an integrated, deep and liquid European bond market (Constâncio, 2018). It will create a single term for risk-free interest that can serve as a euro area pricing benchmark for the valuation of some assets, especially for securities linked to activities where sectoral considerations dominate country ones. The creation of EU safe assets have benefits on their own and has been long in the discussion.[19] The ESRB High-Level Task Force discussed safe assets and many important proposals have been made in recent years (see Brunnermeier et al., 2017; Zettelmeyer and Leandro, 2018). Safe assets can have also beneficial effects on financial stability, as they decrease the safe asset shortage in the EU documented previously and will result, if indeed

[19] For analysis of safe assets in terms of the risk-sharing versus market discipline discussion, see Bénassy-Quéré et al. (2018). For an overview of the literature on safe assets see, for example, Zettelmeyer and Leandro (2018) provide a good overview of the literature on safe assets.

designed to be safe, to their increased demand during times of geopolitical stress ("flight to safety"), enhancing financial stability, integration and the international role of the euro.

A European safe asset will also have benefits for monetary policy and therefore for the ECB. The safe asset will enable the creation of a true risk-free yield curve, unlike the ones currently used, which suffer from "convenience yield" problems, flight-to-quality bias and are not representative (ECB, 2014). A real, representative risk-free yield curve will be beneficial for the ECB, both because the ECB wants to follow and analyse it to understand better financing conditions over the longer term, but also because it wants to influence it to influence financing conditions (Constâncio, 2019). Furthermore, the availability of such a European safe asset will be an important component of any future Quantitative Easing programme, thereby enabling the ECB much easier implementation than previously.

The issuance of safe assets will therefore bring mutually reinforcing benefits related to the better functioning and deepening of banking and capital markets. Yet even so, this important part of the CMU has been left out of the current discussions. This is due to the lack of political willingness to pursue the subject and given the unsuccessful experience of the 2015-2020 episode where multiple proposals for such a European safe asset have been developed yet no decision was taken at the end.

Ignoring the importance of a safe asset is all the more regretful in the statements of the Eurogroup and the ECB Governing Council given the strong performance that NextGenEU bond issuances since their introduction. NextGenerationEU bond issuances have so far been well received, which is proven by their very high subscription rate as they were oversubscribed by between 2 to 20 times (European Commission, 2022). The high demand persisted even through the changing market conditions and overall tightening due to interest rate increases since mid-2022. The European Commission (2022) argues that NextGenerationEU bonds have increased the contribution of the EU to the overall pool of safe assets denominated in euro to 27%. Temprano Arroyo (2022) analyses how the issuance of high quality bonds under NextGenerationEU and SURE has contributed to an improvement of the international role of the euro.

Figure 7 summarises briefly and not exclusively some of the main points discussed so far – the first years of the CMU, its relevance for the ECB and the EMU more broadly and the way forward.

Figure 7: Summary of discussions so far and the way forward

Progress so far on the CMU

- EU priority since 2014
- First Action Plan 2015
- Second Action Plan 2020

Selected concrete actions taken:

- Introduction of ESAP
- Introduction of European Long Term Investment Fund
- Initiative to introduce PEPP
- MiFIR review
- Improvement to clearing system
- Improvements to the European market infrastructure regulation (EMIR)

Relevance for the EMU and the ECB

Way forward

Piecemeal approach

- Targeted harmonisation of corporate insolvency rules and tax withholding and treatment of long-term savings products
- Reducing hindrances to cross-border investments especially by institutional investors
- Increased inclusion of citizens through enhanced financial literacy

"Kantian shift" to the CMU (Lagarde, 2023)

- Transforming the narrative of CMU into a Savings and Investments Union
- Top-down approach to supervision with common institutions, single supervisor (ESMA)
- Mobilising private capital through truly innovative financial instruments and funding mechanisms, creation of EU Deep Tech Stock Exchange
- **In addition: European safe asset (Draghi Report)**

5. CONCLUSION

The CMU is a vital initiative for the future of the EU's financial system and economic growth. While progress has been made since its inception, achieving a fully integrated and efficient capital market requires addressing regulatory divergence, strengthening supervisory frameworks, and mobilising capital for strategic investments. The challenges are considerable, but with continued commitment and coordinated efforts, the CMU can become a cornerstone of the EU's economic resilience and competitiveness. By fostering a more integrated and dynamic capital market, the EU can better support businesses, investors, and citizens, ultimately contributing to a more prosperous and sustainable future for all Member States.

At the start of the new EU legislative cycle, the new European Commission and the European Parliament are at cross-roads in how to pursue further on achieving progress on the CMU. While the unfinished nature of the CMU has direct relevance for the ECB and its monetary policy decisions, it has even further and more considerable implications for the long-term investment opportunities and economic performance of the EU. Moving from a piece-meal approach where a few well-targeted policy decisions often take years to reach a consensus between EU institutions and Member States, if at all, to a different narrative makes sense.

Rebranding the CMU project through a "Kantian shift" which admits the increased investment needs the EU is facing, is an opportunity to present it in a more popular way that might reach more political support. This does not neglect the concrete policy issues to be solved in the near future – harmonised supervision and common rules (e. g. insolvency laws, tax treatment), better and more efficient infrastructure (e. g. mergers in the area of exchanges), the role of big institutional investors and increased participation of citizens and firms in EU capital markets but approaches it in a different way. In the words of Lagarde (2023) "*Faced with such an immense financing challenge, the moment for action is now. So I encourage all of us to be bold and not to let this moment pass*".

Given the above discussions, there seems to be a consensus ensuing in the ECB Governing Council, the Eurogroup and the Letta Report on the necessary steps involved in moving the CMU project forward. However, one should not underestimate the important challenges for the success of the CMU project. First, there are inherent vested interests of incumbents, whether in the area of exchanges and infrastructure or of price competition between different products. These vested interests will continue impeding the process going forward. Second, there are institutional impediments that slow down the process. The harmonisation of insolvency laws, for example, is to be decided by justice ministers in the Council of the EU. Unlike for the finance ministries, EU harmonisation of national corporate laws (which have so far fallen outside of the scope of the Single Market) is not a major point on the agenda of justice ministries so far and is therefore to be expected to move very slowly. To solve this issue, the new Commission should set a tight deadline for some of the steps discussed above and commit to an annual reporting and evaluation of the progress made.

Going beyond this, there continue to be 27 national views on how to approach CMU going forward based on national interests. The EU is made of 27 different countries and 24 different official languages. In the US, a single federal country with a federal government and one language, the creation of a real capital market union took 40 years. Policymakers therefore will need the patience, resilience and determination to work on this important project until convergence and harmonisation necessary for a unified capital market is achieved.

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ANNEX

Table A 1: Summary of first and second action plan for CMU

First Action Plan on CMU	Second Action Plan on CMU
Support venture capital and equity financing Proposal for pan-European venture capital fund-of-funds and multi-country funds Revise EuVECA and EuSEF legislation Study on tax incentives for venture capital and business angels	Making companies more visible to cross-border investors
Overcome information barriers to SME investment Strengthen feedback given by banks declining SME credit applications Map out existing local or national support and advisory capacities across the EU to promote best practices Investigate how to develop or support pan-European information systems	Supporting access to public markets
Promote innovative forms of corporate financing Report on crowdfunding Develop a coordinated approach to loan origination by funds and assess the case for a future EU framework	Supporting vehicles for long-term investment
Strengthen access to public markets Proposal to modernise the Prospectus Directive Review regulatory barriers to SME admission on public markets and SME Growth Markets Review EU corporate bond markets, focusing on how market liquidity can be improved	Encouraging more long-term and equity financing from institutional investors
Support equity financing Address the debt-equity bias, as part of the legislative proposal on Common Consolidated Corporate Tax Base	Directing SMEs to alternative providers of funding
Support infrastructure investment Adjust Solvency II calibrations for insurers' investment in infrastructure and European Long Term Investment Funds Review of the CRR for banks, making changes on infrastructure calibrations, if appropriate	Helping banks to lend more to the real economy

Ensure consistency of EU financial services rulebook Call for evidence on the cumulative impact of the financial reform	Empowering citizens through financial literacy
Increase choice and competition for retail Green Paper on retail financial services and insurance	Building retail investors' trust in capital markets
Help retail investors to get a better deal EU retail investment product markets assessment	Supporting people in their retirement
Support saving for retirement Assessment of the case for a policy framework to establish European personal pensions	Alleviating the tax associated burden in cross-border investment
Expand opportunities for institutional investors and fund managers Assessment of the prudential treatment of private equity and privately placed debt in Solvency II Consultation on the main barriers to the cross-border distribution of investment funds	Making the outcome of cross-border investment more predictable as regards insolvency proceedings
Strengthen local financing networks Explore the possibility for all Member States to authorise credit unions outside the EU's capital requirements rules for banks	Facilitating shareholder engagement
Build EU securitisation markets Proposal on simple, transparent and standardised (STS) securitisations and revision of the capital calibrations for banks	Developing cross-border settlement services
Support bank financing of the wider economy Consultation on an EU-wide framework for covered bonds and similar structures for SME loans	Consolidated tape
Remove national barriers to cross-border investment Report on national barriers to the free movement of capital	Consolidated tape
Improve market infrastructure for cross-border investing Targeted action on securities ownership rules and third-party effects of assignment of claims Review progress in removing remaining Giovannini barriers	Supervision

Foster convergence of insolvency proceedings Legislative initiative on business insolvency, addressing the most important barriers to the free flow of capital	
Remove cross-border tax barriers Best practice and code of conduct for relief-at-source from withholding taxes procedures Study on discriminatory tax obstacles to cross-border investment by pension funds and life insurers	
Strengthen supervisory convergence and capital market capacity building Strategy on supervisory convergence to improve the functioning of the single market for capital White Paper on ESAs' funding and governance Develop a strategy for providing technical assistance to Member States to support capital markets' capacity	
Enhance capacity to preserve financial stability Review of the EU macroprudential framework	

Source: European Commission (2015); https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/capital-markets-union/capital-markets-union-2020-action-plan_en

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The first 10 years of the Capital Markets Union (CMU) have been marked by minimalistic progress. The unfinished nature of the CMU has direct relevance for the ECB by affecting financing conditions in Member States and eroding the risk-sharing ability of the EMU, imposing a higher burden on the ECB to act as "the only game in town". It has even bigger implications for the long-term investment opportunities and economic performance of the EU. This calls for a renewed approach and narrative on the CMU to gather political support to move forward.

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 760.256
IP/A/ECONMD/FWC/2020-002/C5/SC16
Print ISBN 978-92-848-2277-5 | doi:10.2861/ 7626389 | QA- 01-24-025-EN-C
PDF ISBN 978-92-848-2276-8 | doi:10.2861/ 2055837 | QA- 01-24-025-EN-N