Andreas Dombret: What can capital markets deliver?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the ILF (Institute for Law and Finance) Conference on "The European Capital Markets Union, a viable concept and a real goal?", Frankfurt am Main, 18 March 2015.

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1. Introduction

Ladies and gentlemen

Thank you very much for inviting me to speak at this year's ILF conference. The topics of this conference are very well chosen, and I am therefore grateful for the opportunity to speak at today's event and to share my thoughts on the European capital markets union. But let's begin by taking a step back.

As some of you will know, I spent ten years of my life working for JP Morgan. The legend goes that one day, old John Pierpont Morgan was approached by a young man who asked about the secret of the stock market. John Pierpont Morgan looked at the young man and replied: "it fluctuates".

In my view, that is an important thing to know about the inner nature of capital markets, but it is certainly not all there is to know. My short intervention today will therefore address a different question: what can capital markets deliver?

Given the current discussions about a European capital markets union, it seems that we expect quite a lot from capital markets. Let's take a closer look and discuss whether these expectations are justified.

2. Diversification – strengthening capital markets

In essence, the European capital markets union has two objectives. The first objective is to increase the share of capital markets in the funding mix of the real economy. The second objective is to integrate capital markets more closely across borders.

Some people relate the first objective to the question of whether a capital markets-based financial system is superior to a bank-based financial system. Well, to sum up the empirical evidence: it is impossible to tell.

There is certainly some evidence indicating that capital markets-based financing might increase pro-cyclicality.[1] Nevertheless, the recent crisis shed light on these issues from another angle. A system in which the real economy relies on a single source of funding will most certainly run into trouble when that source dries up – regardless of whether it is bank funding or capital market funding.

Therefore, it is not a question of "either/or". The objective of the European capital markets union is not to abandon bank-based funding but to supplement it with capital markets-based funding. And in Europe above all places there is ample room to do so. The European stock market is only 60% the size of the US stock market when measured in relation to GDP.

[1] Adrian, T; Shin, H S (2010), Liquidity and Leverage. In: Journal of Financial Intermediation, Vol 19 (3), pp 418–437. Leroy, A (2014), Credit Procyclicality and Financial Structure in the EU". Available at SSRN: http://ssrn.com/abstract=2568112 or http://dx.doi.org/10.2139/ssrn.2568112.

Likewise, the European market for venture capital is 20% the size of the US market, and for securitisation the percentage is even lower.[2]

In the end, it comes down to the uncontested argument of diversification. Increasing the share of capital markets will improve and broaden access to funding particularly for small and medium-sized enterprises. At the same time, it will improve the matching of investors to financial risk, thereby increasing the efficiency of the financial system. As a result, the financial system will be able to better support sustainable economic growth.

3. Integration – forming a single capital market

The second objective of the European capital markets union is to improve the integration of capital markets in the entire European Union. What is it that integrated capital markets can deliver? One of the main arguments is that they can improve private risk sharing. The technical question is: to what degree does a shock to the economy affect consumption?

Empirical studies for the United States show that integrated capital markets cushion around 40% of the cyclical fluctuations among the US federal states. A share of around 25% is smoothed via the credit markets, while fiscal policy cushions 10–20% of shocks. Altogether, around 80% of a given economic shock is absorbed before it can affect consumption[3] Studies for Canada yield similar results.[4]

In Europe, the picture looks different. Here, it is mainly credit markets that cushion economic shocks – and they are not very effective in doing so. Altogether, only around 40% of a given shock is absorbed before it can affect consumption.[5] Increasing the share of capital markets and integrating them across borders would therefore help improve risk sharing in Europe and reduce the volatility of consumption.

4. How to get there

Increasing the share of capital markets in the funding mix of the real economy can contribute to economic growth. At the same time, integrating capital markets across borders can help improve private risk sharing within Europe. The Bundesbank therefore believes that the European capital markets union is a goal worth pursuing.

But how do we get there? The argument for a capital markets union is straightforward, while its implementation is much less so. The capital markets union is a complex undertaking that touches upon many different areas. Consequently, the European Commission's green paper on this subject[6] includes a wide variety of suggestions and steps to be taken.

With regard to the objective of increasing the share of capital markets, we should focus on equity markets. Against this backdrop, let me emphasise the issue of taxes. Currently, tax treatment still favours debt financing over equity financing. Removing this bias in taxation would encourage companies to strengthen their equity base and thus turn more towards equity capital markets in their search for sources of funds.

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2 Bank of England (2015), A European Capital Markets Union: Implications for Growth and Stability. Financial Stability Paper No 33, February 2015.

3 Asdrubali P; Sørensen, B E; Yosha, O (1996), "Channels of Interstate Risk Sharing: US 1963–1990", Quarterly Journal of Economics, 111(4), 1081–1110.

4 Balli, F S; Kalemli-Ozcan, S; Sorensen, B E (2012), Risk Sharing Through Capital Gains. In: Canadian Journal of Economics, Vol 45(2), pp 472–492.

5 Afonso, A; Furceri, D (2007), Business Cycle Synchronization and Insurance Mechanisms in the EU. ECB Working Paper No 844, December 2007.

6 European Commission (2015), Building a Capital Markets Union – Green Paper.

In terms of the objective of integrating capital markets across Europe, there are some areas where standardisation could give us some early gains.

The market for high-quality securitisation is one of these areas. So far, a number of policy initiatives have been launched to restart European securitisation markets, including an initiative by the European Commission to develop a framework for simple, transparent and standardised securitisation.

Other areas for early action include private placements, crowd-funding or the harmonisation of prospectuses. With a view to the long-run, it might also be beneficial to further the development of funded pensions in order to enlarge and deepen European capital markets. Another long-term objective could be to harmonise insolvency laws across Europe.

In any case, we should not exclusively focus on the institutional and legal framework in our efforts to create a European capital markets union. There might also be soft factors at play, such as cultural preferences for certain forms of funding or the level of financial education. We also should address these issues in order to achieve our objective.

5. Conclusion

Ultimately, the path towards a European capital markets union will be long and arduous. There will certainly be resistance, and there will be difficulties. Therefore, we should remain realistic about what can be achieved.

Nevertheless, we embarked on the path of financial integration by adopting a single currency in 1999. And we must not stop there but deepen integration in order to make the European monetary union work. In November 2014, we took a major step by establishing a single European mechanism for banking supervision; now, we should consider taking another key step by forming a European capital markets union – one that not only includes the euro area but extends to the entire European Union.

I would therefore like to conclude with a quote that is attributed to Robert Kennedy, although he allegedly borrowed it from his brother John F Kennedy, who – according to his advisor Ted Sorensen – borrowed it from someone else. In any case, the quote goes like this: “Some see things as they are and say “why?”. Others dream of things that never were and say “why not?”. With regard to the European capital markets union, I suggest we should join the latter group.

Thank you for your attention.