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Economy and international financing

Developing the Capital Markets Union to mobilise savings and stimulate investment in Europe

The decline in investment in the European Union (EU) since the 2008 crisis can be partly explained by a sharp drop in business investment in South and Eastern Europe, which could be further exacerbated by the Covid-19 pandemic. According to recent survey data, in these countries, firms, and particularly the smallest firms, still struggle to obtain financing. In addition, over the past several years, the net equity financing available to firms in the euro area has been insufficient. These problems worsened during the health crisis, which led to the implementation of credit support measures. The Capital Markets Union (CMU) project aims to respond to these financing constraints by better mobilising European savings, which have increased since 2007, and by encouraging cross-border investments.

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E21, E22,
F36, G15

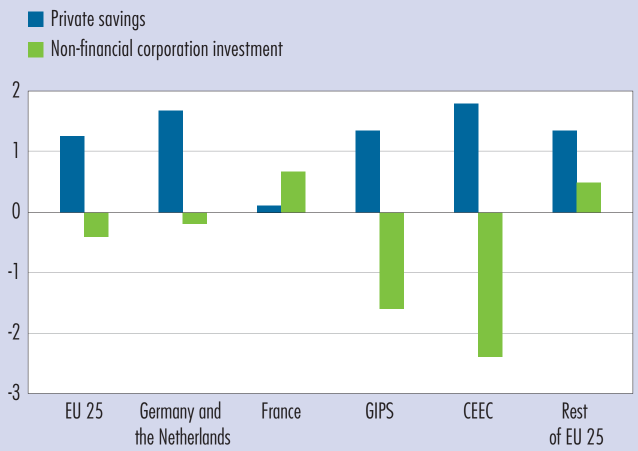
Mathilde Dufouleur was a trainee when she contributed to this paper.

+1.3 percentage point of GDP
the average increase in private savings in the European Union during the decade from 2009 to 2018 compared with the decade from 1999 to 2008

–1.6 percentage point of GDP
the decline in non-financial corporation investment in the "GIPS" countries (Greece, Italy, Portugal and Spain) during the decade from 2009 to 2018 compared with the decade from 1999 to 2008

–2.4 percentage points of GDP
the decline in non-financial corporation investment in Central and Eastern European Countries (CEECs) during the decade from 2009 to 2018 compared with the decade from 1999 to 2008

Change in private savings and non-financial corporation investment between 1999-2008 and 2009-2018
(percentage points of GDP)



Sources: Eurostat, authors' calculations.
Note: EU 25 figures are for post-Brexit EU countries, excluding Croatia and Malta as data were partly unavailable.

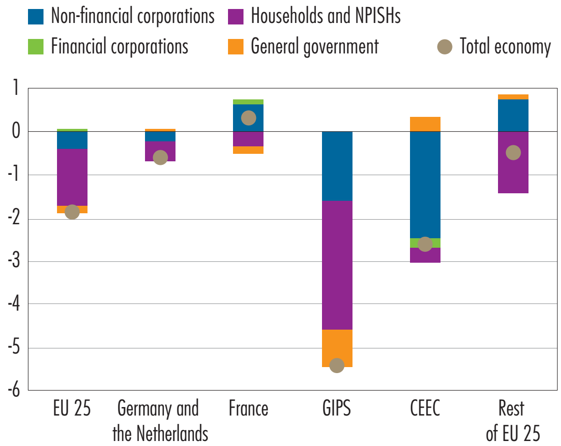
1 A decline in investment in South and Eastern European countries despite increasing savings in the EU

A sharp decline in investment since 2009

In the decade following the 2008 global financial crisis, average investment in the EU declined by 1.9 percentage point of GDP compared with the decade from 1999 to 2008 (see Chart 1). This decline needs to be explained on two levels, as it is mainly the result of a decline in household investment and extremely contrasting situations within the EU. For example, levels of investment varied little in France, Germany and the Netherlands but declined sharply in the so-called GIPS South European countries (Greece, Italy, Portugal and Spain) and in Central and Eastern European Countries (CEECs). This can be largely explained by the decline in non-financial corporation (NFC) investment, which dropped by 1.6 and 2.4 percentage points of GDP, respectively, in the GIPS and CEECs during 2009-2018 compared with the average level observed during 1999-2008.

C1 Change in gross fixed capital formation between 1999-2008 and 2009-2018 by sector

(percentage points of GDP)



Sources: Eurostat, authors' calculations.
Notes: EU 25 figures are for post-Brexit EU countries, excluding Croatia and Malta as data were partly unavailable.
GIPS refers to Greece, Italy, Portugal and Spain.
CEEC (Central and Eastern European Countries) covers Bulgaria, Croatia (not included here due to a lack of data), Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia.
Rest of EU 25 countries are Austria, Belgium, Cyprus, Denmark, Finland, Ireland, Luxembourg and Sweden.
NPISHs are non-profit institutions serving households.

The observation that there is an investment deficit in Europe is nothing new: appeals have often been made for increased investment over the past decade (Enderlein and Pisani-Ferry, 2014). The Juncker Plan, which was implemented by the European Commission in 2015 and extended with the InvestEU programme until 2020, was one of the first initiatives to boost private investment in Europe.

A significant increase in private savings

Over the same period, savings in the EU have trended inversely to investment as the sharp decline in private investment in the CEECs and South European countries has coincided with a drop in public investment since 2008 and a rise in private savings (see Chart 2 below). At the same time, private savings in Germany and the Netherlands settled at a rate of around 25% of GDP and public savings grew in all the countries considered.

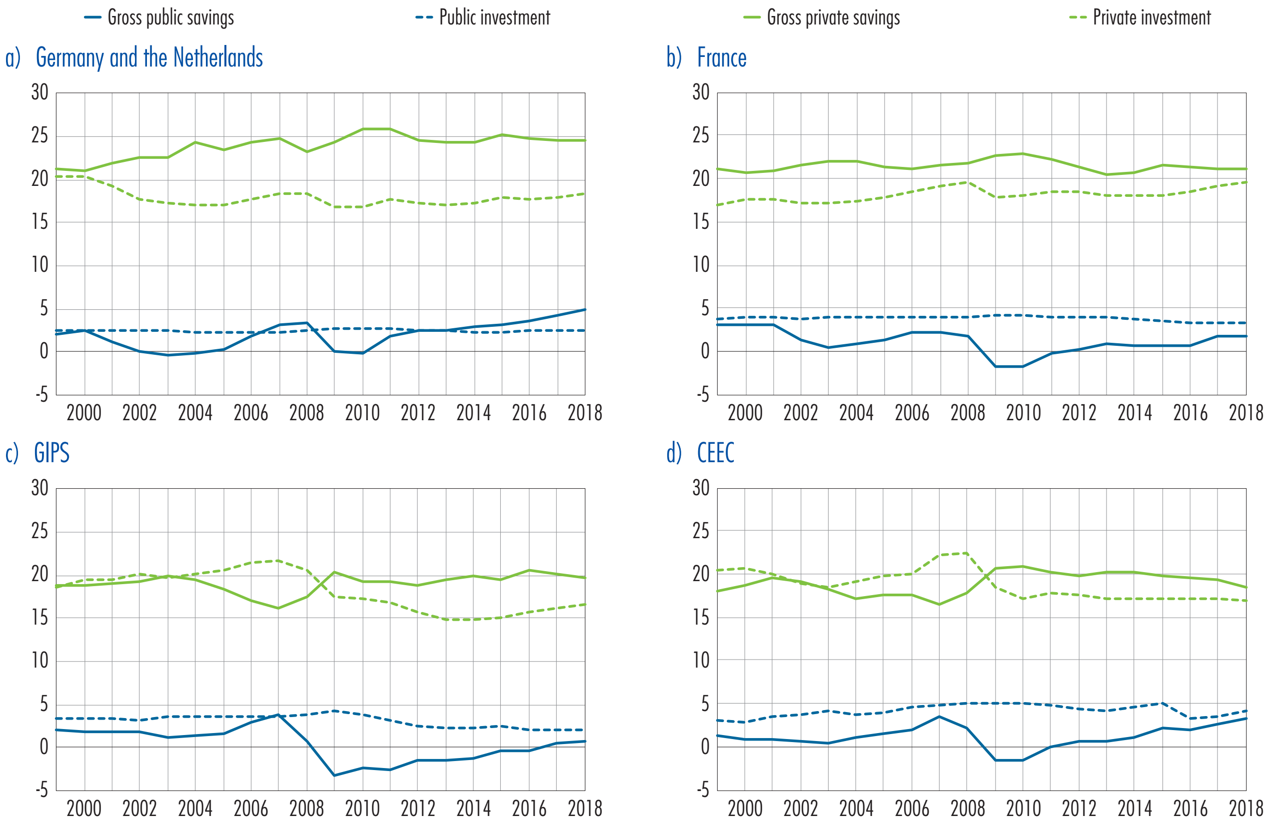
Growth in the EU's current account surplus (see Chart 3 below) is a reflection of these increased savings coupled with declining investment in the GIPS and CEECs since the 2008 crisis. In fact, the financing needs of these countries is far lower than the savings surplus of Germany and the Netherlands, mainly due to the slump in their investments. Ultimately, the CEECs and the GIPS have now even come to be in surplus overall.

The EU is an economically developed area with an ageing population and as such, presents several structural characteristics that could explain a sustainable current account surplus. In the euro area, the monetary union, combined with fiscal rules but without a fiscal union, may also have contributed to this surplus. However, this situation is concerning given the low level of private investment noted above, particularly in catching-up countries where a dynamic of convergence should be boosting investment.

In the context of the Covid-19 crisis, this imbalance between savings and investment could even worsen: the European Commission's spring 2020 projections

C2 Change in investment and savings (1999-2018)

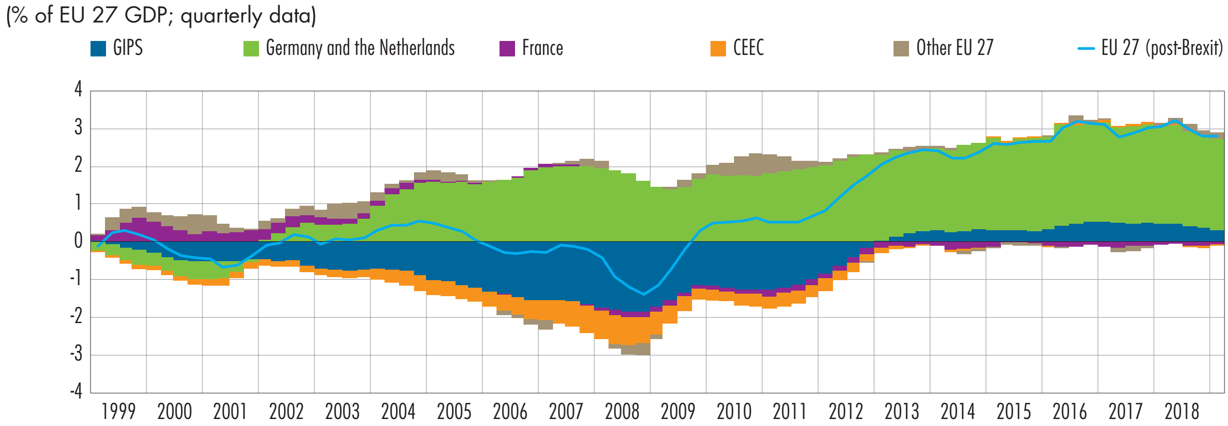
(% of GDP)



Source: Ameco.
Notes: GIPS refers to Greece, Italy, Portugal and Spain.
CEEC (Central and Eastern European Countries) covers Bulgaria, Croatia, Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia.

C3 Change in the European Union current account balance

(% of EU 27 GDP; quarterly data)



Source: European Central Bank (ECB).
Notes: GIPS refers to Greece, Italy, Portugal and Spain.
CEEC (Central and Eastern European Countries) covers Bulgaria, Croatia, Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia.

forecast an EUR 831 billion drop in private investment in 2020-21 compared to its autumn 2019 projections. At the same time, the crisis and the resulting drop in consumption due to the lockdown has resulted in households putting aside large amounts of forced savings.

Major European challenges need financing

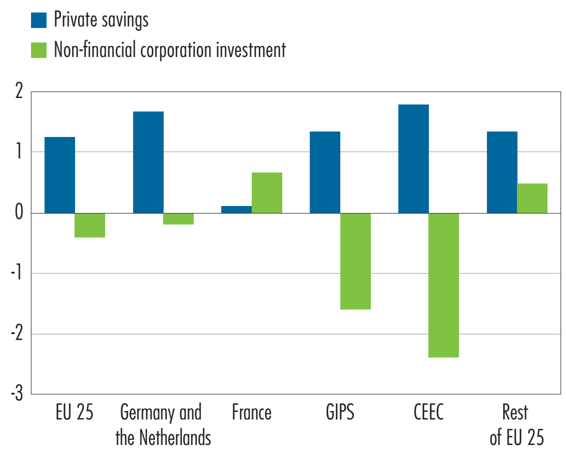
However, the European economy must rise to several major challenges particularly as investment in innovation and the ecological transition remains insufficient.

One of the objectives of the Horizon 2020 programme was to raise spending on research and development (R&D) to the equivalent of 3% of GDP in 2020 (European Commission, 2011) in order to bolster the EU's innovation potential. However, this spending objective stalled at 2.2% of GDP in 2018, reflecting a persistent gap compared to the averages for the Organisation for Economic Cooperation and Development (OECD) and the United States, which devoted 2.4% and 2.8% of GDP, respectively. Furthermore, even though investments in innovation are traditionally more heavily financed through equity as they are inherently riskier, in France and the euro area in mid-2018 equity investments amounted to only 76% and 77% of GDP, respectively, compared with 124% in the United States (Garnier and Gossé, 2019).

There is also a green investment-financing gap in the EU with regard to its ecological transition targets. The European Commission[1] estimates that if the EU's 2030 climate and energy targets are to be met, EUR 260 billion of additional annual investment – 1.5% of the EU's GDP – will be needed.

Stimulating investment, and particularly investment from NFCs, thus becomes critically important. To do so, private savings could be better channelled towards, for example, long-term products aimed at better financing the EU's

C4 Change in private savings and non-financial corporation investment between 1999-2008 and 2009-2018
(percentage points of GDP)



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productive investment needs (see Chart 4).[2] The Capital Markets Union project is aimed at tackling this twofold challenge.

2 The financing constraint: a brake on business investment

Among the factors likely to restrict business investment, the financing constraint seems to have generally abated over the past few years. This trend is expected to bottom out due to the shock from the Covid-19 crisis but, irrespective of this, the financing constraint is still a barrier to investment for certain types of firms, particularly those in the south and east of the EU, while European businesses in general face a shortage of equity capital.

1 European Commission Communication COM/2019/640: "The European Green Deal" of 11 December 2019, p. 15 (estimates taken from Communication COM/2019/285 and the EUCO3232.5 scenario).

2 Calculated by determining the average rates of private savings and NFC investment for 1999-2008 and 2009-2018 as a percentage of GDP. The variations are then obtained as the difference between the rates for the two periods, with a positive (negative) value implying an increase (decrease) in 2009-2018 compared with 1999-2008.

Measuring the financial constraint of European businesses

This article draws on two declarative surveys to measure the financial constraint of businesses in Europe.

The European Investment Bank Investment Survey (EIBIS) has been carried out every year since 2016 by the European Investment Bank (EIB). It covers more than 13,000 firms of all sizes (micro enterprises, small and mid-sized enterprises – SMEs – and large corporations) across the 27 countries of the European Union (EU 27), the United Kingdom, and, since 2019, the United States. In particular, EIBIS allows us to measure the obstacles to long-term investment decisions that are considered major or minor, including the availability of finance (see Table 1). The data do not include businesses that were unable or refused to respond.

The European Central Bank's (ECB) Survey on the Access to Finance of Enterprises (SAFE) is carried out twice a year and primarily targets SMEs. SAFE allows us to analyse financial constraint in greater detail and more specifically, to assess financing needs by type of instrument (see Chart 7) by referring to the answers to survey question 5: "For each of the following types of external financing, please indicate if your needs increased, remained unchanged or decreased over the past six months".

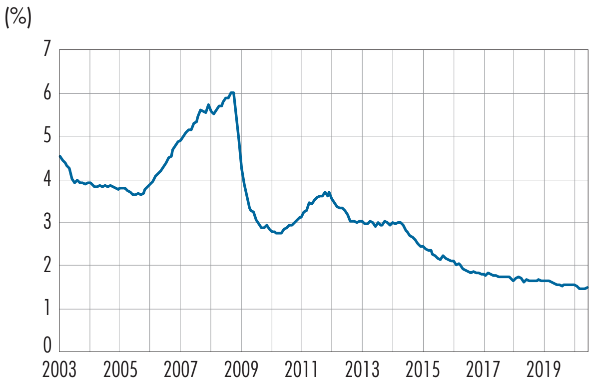
A major constraint, though generally declining until the Covid-19 crisis

The financing constraint can be derived from businesses' perceptions of a barrier to investment linked to access to financing, or from loan applications that result in rejections, limited amounts, or excessively high costs of credit.

Prior to the Covid-19 crisis, studies on financing costs in Europe found that the cost of debt financing for NFCs had declined overall (see Chart 5). The proportion of firms in the EU that stated that access to financing was a barrier to long-term investment has also fallen slightly since 2015, and has particularly declined for firms that described it as a major obstacle. However, it remains significantly higher in the EU than in the United States (43% of businesses compared to 33%).

In any event, the crisis caused by the Covid-19 pandemic will only have exacerbated the difficulties in accessing financing, which thus warranted the European Central

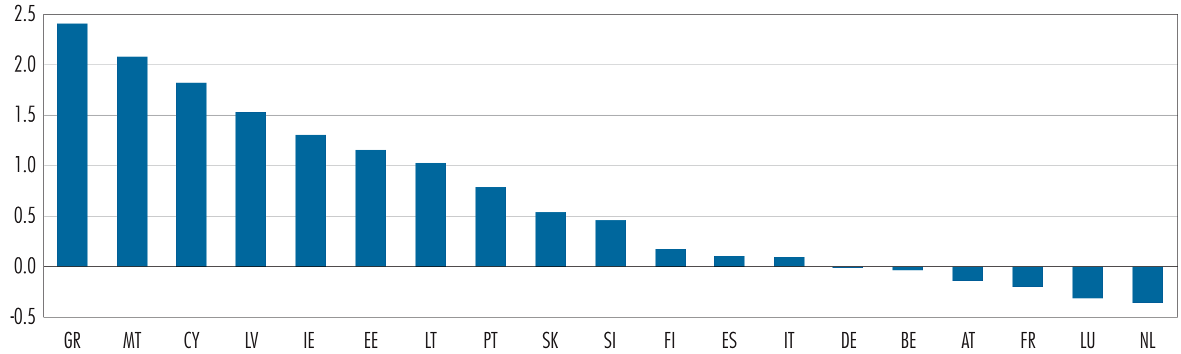
C5 Change in non-financial corporations' average cost of borrowing in the euro area (loans)



Source: ECB.

C6 Non-financial corporations' average cost of credit financing (July 2017-June 2020)

(gap from the average cost for the euro area, in percentage points)



Sources: ECB, authors' calculations.
Key: GR Greece; MT Malta; CY Cyprus; LV Latvia; IE Ireland; EE Estonia; LT Lithuania; PT Portugal; SK Slovakia; SI Slovenia; FI Finland; ES Spain; IT Italy; DE Germany; BE Belgium; AT Austria; FR France; LU Luxembourg; NL Netherlands.

Bank's (ECB) and Member States' implementation of credit support measures. For example, the financing constraint on SMEs in the euro area tightened between October 2019 and March 2020, and for the first time since March 2015, SMEs' demand for external financing in the euro area grew faster than funds became available.[3]

The financing constraint is more persistent in some countries and business categories than in others

Businesses' financing costs continue to be extremely variable across the euro area (see Chart 6), meaning that break-even points for investments are higher in certain countries in South and Eastern Europe.

There is thus a greater perception of barriers to investment due to the availability of finance among businesses in South European countries, which have been particularly affected by a decline in investment since the crisis began, and in CEECs, most of which joined the EU during its 2004 enlargement (see Table 1 below). However, a counterfactual analysis carried out by Ferrando and Ruggieri (2018) found that South European countries would be likely to achieve productivity gains of between 19% and 22% if they had full access to financing.[4]

Furthermore, this financing constraint also varies depending on firm size. As numerous studies have already shown (Artola and Genre, 2011; Siedschlag et al., 2014), the smaller the firm, the more likely it is to encounter a financing constraint. The findings of the EIB survey also confirm this (see Table 1 below).

Access to external financing thus appears to be a major constraint for business investment, particularly for small firms, and especially those in South and Eastern European countries. The Banking Union and the strengthening of the CMU would likely reduce these countries' constraint by bringing it down to that observed in the rest of the EU, and thus help push their NFC investment back up to pre-2008 levels, or even up to the highest levels observed in the EU.

3 See the ECB's SAFE survey of 8 May 2020, section 3. A negative financing gap indicates that the increase in external financing needs is outpaced by the improvement in the availability of funds. The financing gap became positive (2%) between October 2019 and March 2020 for SMEs in the euro area, after being negative (-4%) during the September-October 2019 SAFE survey.

4 According to this study's findings, there was an inverse correlation between labour productivity and financial constraint in a sample of euro area countries for the period from 1995 to 2011. This was particularly evident in the case of small firms and start-ups. The loss of productivity linked to financial constraint was found to be especially significant in Italy, Spain and Portugal.

T1 Proportion of businesses whose long-term investment decisions are affected by financial constraints

(%)

	All	Large	Small and mid-sized (SME)	*Medium*	*Very small and micro enterprises*
GIPS	60	53	64	*61*	*64*
CEEC	51	49	53	*52*	*54*
France	43	44	42	*33*	*47*
Germany and the Netherlands	35	36	35	*36*	*33*
Other EU 27	36	27	38	*36*	*38*
EU 27	43	41	45	*43*	*47*

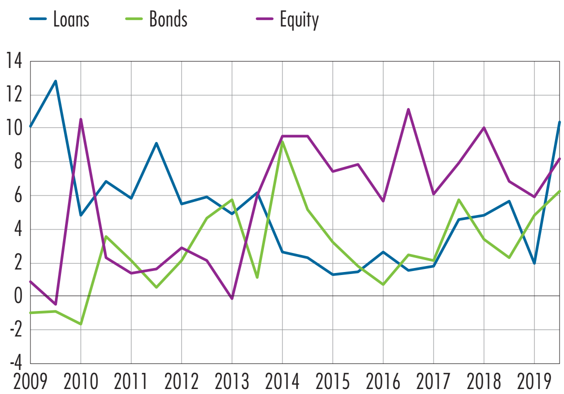
Source: European Investment Bank (EIBIS survey, 2019).
Scope: Businesses that reported that they faced obstacles to the external financing of their investments.
Notes: GIPS refers to Greece, Italy, Portugal and Spain.
CEEC (Central and Eastern European Countries) covers Bulgaria, Croatia, Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia.

An increase in reported equity financing needs

The European economy is still mainly financed by banks. This model is often contrasted to more financial market-based financing, which is more the preserve of Anglo-Saxon countries. For example, bank lending accounted for 80% of NFC debt in 2017, compared with only 30% in the United States (Villeroy de Galhau, 2018). However, an analysis of the surveys shows a major change in the most pressing equity financing needs over the past ten years (see Chart 7).

C7 Net financing needs of euro area businesses

(%)



Source: ECB (SAFE survey).
Scope: Net of businesses whose needs have increased; businesses with stable requirements excepted.

In 2009, at the height of the recession caused by the 2008 banking crisis and the subsequent credit crunch, the primary concern of European businesses was the net need for bank lending. Nevertheless, in the decade prior to the Covid-19 crisis, the need for bank loans reported in the surveys had decreased steadily. At the same time, the net need for equity financing increased significantly and has since consistently been the most sought after form of financing above loans or bonds.

The findings of the latest SAFE survey showed a sharp increase in the need for bank lending, which could be explained by businesses' short-term liquidity needs as a result of the Covid-19 crisis. However, demand for equity remains high and may increase further due to the lockdown period, especially if the liquidity crisis becomes a solvency crisis.

3 Better mobilising savings to reduce the financing constraint

Against this backdrop, the development of more integrated financial markets in the EU, through the Capital Markets Union project, offers significant advantages for the European economy by mobilising household savings towards more productive purposes, while easing the financing constraint for businesses and facilitating cross-border investment flows within the EU.

Mobilising household savings

EU private savings, the main source of domestic financing, grew by 1.7 percentage point of GDP[5] between 2007 and 2019. However, at the same time, the proportion of EU households' financial assets[6] held in shares, debt securities and investment funds fell sharply (down 8 percentage points in household portfolios) while the proportion of assets held in cash and life insurance rose significantly (up 8 percentage points).

European households thus show a preference for the least risky assets, which account for more than two-thirds of their portfolio. US households, on the other hand, tend to favour riskier assets: equities and investment fund shares/units account for nearly 50% of their portfolio, 20 percentage points more than in Europe (see Table 2).

Furthermore, EU household asset holdings measured as a proportion of GDP are half those of households in the United States (216% and 446%, respectively, in 2019). Furthermore, the proportion invested in shares and investment funds is three times lower in the EU than in the United States (63% and 217% of GDP, respectively). And yet, financial markets offer an investment opportunity for household savings; they may be riskier than bank deposits but they generate higher returns.

Several approaches would allow European savings to be better channelled towards businesses.

Measures to improve financial education and consumer protection are likely to enhance people's understanding of financial mechanisms and facilitate household investment in the markets. This was underlined in the reports of the Next CMU High-Level Group (2019) and the High-Level Forum on Capital Markets Union (2020), while Arrondel (2017), for example, demonstrates that share ownership in France as well as financial planning skills increase significantly with financial education.

Consumer information and protection also encourage a greater household presence in the financial markets. Campbell et al. (2011) point out that consumer protection reduces the undesirable effects of wealth distribution in financial markets between so-called "naïve" investors, incapable of optimising their financial situation, and informed investors. Thus, the CMU could help to standardise information on financial markets, and thereby strengthen consumer protection. The reform of the European Packaged Retail Investment and Insurance-based Products (PRIIPs) regulation, for example, is a step in this direction, as it aims to improve the readability and comparability of financial product information (particularly on performance and costs) offered to non-institutional investors.

T2 Composition of financial portfolios of households and NPISHs in 2019

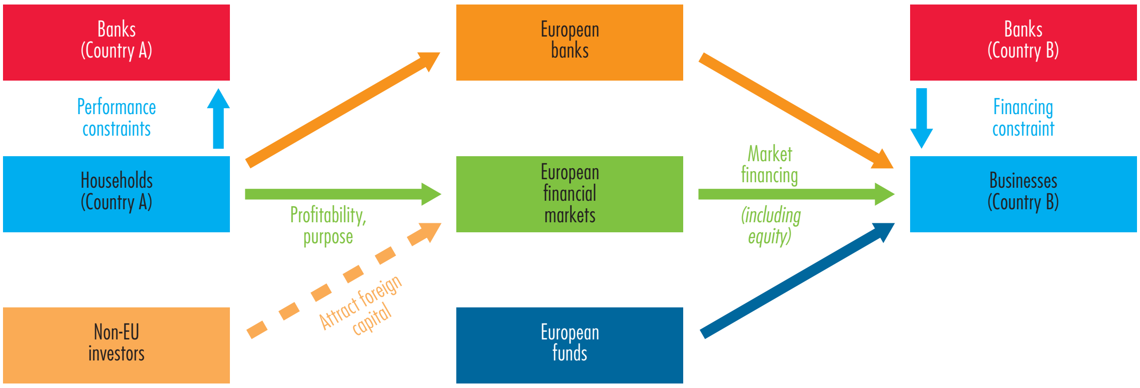
(%)

	Breakdown		Proportion of GDP	
	European Union	United States	European Union	United States
Total financial assets	**100**	**100**	**216**	**446**
Currency and deposits	32	12	69	53
Debt securities	2	6	5	26
Equity	20	36	44	162
Investment fund shares/units	9	12	19	55
Insurance, pension and standardised guarantee schemes	34	31	72	139
Loans and other assets	3	3	7	11

Sources: Eurostat, Federal Reserve.
Note: NPISHs are non-profit institutions serving households.

5 Excluding Croatia due to a lack of data.
6 Households and non-profit institutions serving households (NPISHs).

A Capital Markets Union to channel savings towards financially constrained businesses



Source: Banque de France (author's diagram).

Lastly, pan-European investment products could be developed, in the form of personal pension funds (see Regulation (EU) 2019/1238) or company savings plans, while ensuring a fair balance between risk taking and prudential supervision. Financial savings products destined for households could also target objectives that are attractive and relevant to them, such as supporting innovation, the ecological transition or SMEs. The increase in alternative sources of financing via the markets could also help businesses alleviate their bank financing constraints (see diagram).

Alleviating businesses' financial constraint

Reducing the administrative complexity involved in accessing capital markets. First, the European regulation[7] on SME growth markets aims to reduce the administrative complexity and compliance costs faced by SMEs when issuing securities on the financial markets, while ensuring that investors are well protected. Second, rolling out SME rating platforms across the EU should be encouraged, just as access to company information could be facilitated by banks' access to a Legal Entity Identifier (LEI) – allowing firms that belong to the same group to be identified – as well as to AnaCredit[8] data, in order to have a full picture of a firm's debt situation. Lastly, harmonised business financing conditions within the EU could be boosted by the expansion of cross-border mergers and acquisitions in the banking sector.

Reducing the bias towards debt financing. This bias may mean that firms are willing to pay a substantial premium for debt financing rather than equity financing (Brutscher and Hols, 2018) and can lead to excessive leverage. The proposed tax reforms in the Common Consolidated Corporate Tax Base (CCCTB) project are intended to address this bias.[9]

Facilitating intra-European capital flows

Differences between the insolvency regimes of the various EU Member States hamper the development of cross-border capital flows. Some countries struggle to ensure that debts are effectively recovered in the event of insolvency, with longer delays and lower recovery rates (see Chart 8, below). Improving the efficiency of the debt recovery of these regimes could facilitate cross-border investment and the development of financial markets[10] (La Porta et al., 1997).

7 This regulation, (EU) 2019/2115, also aims to reinforce the liquidity of shares issued by publicly listed SMEs to make the market more attractive for investors, and to simplify the registration of multilateral trading facilities as an SME growth market.

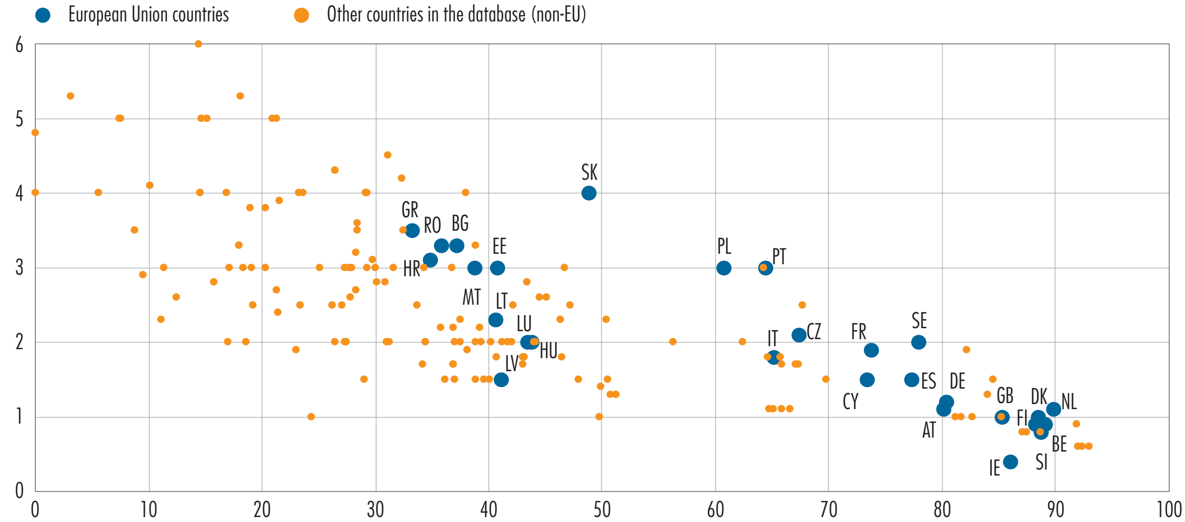
8 AnaCredit is a database created through an ECB initiative that provides details of bank loans in the euro area (*https://www.ecb.europa.eu/explainers/tell-me-more/html/anacredit.en.html*).

9 See pages 48 to 54 of the impact assessment accompanying the proposals for a Council Directive on the CCCTB project (European Commission, 2016), which considers that the different tax reform scenarios envisaged by the draft directive should lead to an equalisation between the cost of equity financing and the cost of debt financing in the EU.

10 The Report of the High-Level Forum on the Capital Markets Union proposes minimum harmonisation of targeted elements of NFC insolvency regimes, such as the creditors' ranking. The transposition into national laws of Directive (EU) 2019/1023 "on restructuring and insolvency" should contribute to this harmonisation process.

C8 Delays and recovery rates of non financial corporation insolvencies (2018)

(x-axis: recovery rate in %; y-axis: delay in years)



Source: World Bank, *Doing Business* report.
Key: AT Austria; BE Belgium; BG Bulgaria; CY Cyprus; CZ Czech Republic; DE Germany; DK Denmark; EE Estonia; ES Spain; FI Finland; FR France; GB United Kingdom; GR Greece; HR Croatia; HU Hungary; IE Ireland; IT Italy; LT Lithuania; LU Luxembourg; LV Latvia; MT Malta; NL Netherlands; PL Poland; PT Portugal; RO Romania; SE Sweden; SI Slovenia; SK Slovakia.

Furthermore, a recent European regulation (Regulation (EU) 2019/1156) aims to facilitate the cross-border marketing of investment funds by proposing the establishment of a single central point for information on all national fund-related regulations.

The European Commission has also proposed a single regulation for participatory financing, which aims to facilitate fund-raising via platforms in other Member States, as well as a regulation to introduce a pan-European pension product that should facilitate cross-border flows within the EU.

4 Developing equity financing and European green products to support innovation and the ecological transition

Equity financing is essential for R&D investments because of the risks inherent in innovation, which often involves intangible capital that cannot serve as collateral and significant uncertainty with regard to the outcome (Hall and Lerner, 2010). Venture capital funds play a central role in financing innovative firms at the various stages of their development (Parpaleix et al., 2019) and are the primary source of equity capital injections for small firms (Raposo and Lehmann, 2019). However, these funds are relatively poorly developed in Europe compared with the United States or South Korea. The 2017 European regulation to promote venture capital (EuVECA) by using public funds is thus an important step forward that could encourage financing of R&D expenditures by venture capital funds.

The ecological transition is another major challenge for the EU. The European Green Deal is a new European Commission initiative to respond to the environmental concerns of European citizens.

Indeed, green financial instruments are doubly attractive to people as they can invest their savings in ecologically responsible products while responding to a major economic challenge for the EU. Establishing a taxonomy that defines ecologically responsible activities is an essential first step towards developing environmentally friendly instruments, such as sovereign green bonds, and facilitating the emergence of genuine European green financial products that cannot be accused of greenwashing.[11] Moreover, the development of the

11 Greenwashing involves putting a virtuous spin on initiatives and products in order to exaggerate their environmentally friendly nature.

CMU and of European green products could help attract foreign investors who care about investing in an economic area that is playing a pioneering and standard-setting role in the ecological transition.

The Capital Markets Union project was launched in 2015 with the aim of facilitating SMEs' access to European savings through the financial markets and promoting cross-border financial flows within the EU. In the current context of the Covid-19 crisis, consolidating the CMU is essential in order to complement public-spending measures to support the economy, which may be reined in in the wake of the crisis. The CMU would thus make it possible to better mobilise European savings – by responding to a demand for yield and social relevance – while potentially alleviating the financing constraint on businesses and strengthening investment in innovation and the ecological transition.

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