Luxembourg Capital Markets Day: Why a Capital Markets Union?

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Speeches

Pierre Gramegna, ESM Managing Director
Luxembourg Capital Markets Day
Keynote speech
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Why a Capital Markets Union?

(Please check against delivery)

Dear Chairwoman, dear Julie,

Dear friends,

Ladies and gentlemen,

It is a pleasure for me to give the keynote speech at the occasion of this second edition of the Luxembourg Capital Markets Day.

I became the Managing Director of the European Stability Mechanism (ESM) on 1 December 2022. I already knew the institution well. As I was the Minister of Finance for Luxembourg for eight years, I was sitting on the ESM’s Board of Governors. I always recognised the added value of this institution to the financial architecture of the Economic and Monetary Union and I am proud to lead it today. It might be less well known that I also became the CEO of the European Financial Stability Facility (EFSF). As such, I am at the helm of two important issuers in the markets. In 2022, the funding programme of the EFSF and the ESM in bonds reached 27.5 billion euros. The ESM also has a bill programme, which provides it with liquidity and flexibility. The bill auctions in 2022 reached a total volume of €30.6 billion. In total, the EFSF and the ESM lent close to €300 billion to five beneficiary countries: Ireland, Greece, Spain, Cyprus, and Portugal.

Created in 2010 as a temporary structure, the EFSF does not provide any new loans anymore, as this task is now performed solely by the ESM, created two years later. However, the EFSF continues to operate because it needs to refinance the loans it provided, as the maturity of loans provided is longer than the maturity of bonds issued by the EFSF. The ESM needs to roll over its bonds for the same reason.

As the Managing Director and CEO of two important issuers, I go on roadshows to meet investors. I did my first roadshow in Japan in March. Investors and key market players are essential stakeholders for the ESM and the EFSF.

The sessions that will take place throughout the afternoon look very promising, and the topics addressed are quite specific in nature. I will take a more holistic view and speak about the advantages to make progress in creating a genuine capital markets union (CMU) at the European level.

Finance is the bloodline of our economies. Without it, we can’t trade, we can’t invest. Without it, there is no growth and no prosperous future. I used to say that I love banks. Let me add today that I also love markets.

But for finance to play its role effectively, certain prerequisites are needed. For instance, sources of finance need to be varied to cater to different needs and to diversify risks. Drawing on one source of financing puts you at risk when this source dries up. Also, for finance to be accessible under the best possible conditions, competition needs to be at play. To achieve the best possible results in this regard, financial integration at the European level is even more necessary.

This year, we are celebrating the 30th anniversary of the single market. It was established on 1 January 1993 for 12 EU countries, following the entry into force of the Single European Act. Today, there are 27 participating countries, and it benefits close to 450 million citizens.

The single market established four fundamental freedoms, namely the right for goods, services, people, and capital to move freely. Among these freedoms, capital should be free to move effectively across borders for financing and investment.

Unfortunately, the CMU project is lagging. The low-hanging fruits have been harvested, but a lot remains to be done. Despite repeated attempts since 2014, when the Juncker-led Commission launched the project, the EU capital markets remain largely segmented.

This proposal came in the wake of the great financial and the euro sovereign debt crises, which had a significant negative impact on banks' balance sheets. If bank lending stops flowing, who takes over to finance the private sector?

Alan Greenspan, the former Chairman of the Federal Reserve, once said that the lack of a spare tyre was of no concern if you do not get a flat. Today, in Europe, I would argue that the risks of having a flat have receded. European banks are in better shape than 10 to 15 years ago. The establishment of a single rulebook for banks and the inception of a banking union played a pivotal role in this respect. Better regulation forced banks to increase their capital and their liquidity buffers. Better supervision also helped keep balance sheets healthier. While banks had been part of the problem during the great financial crisis and the sovereign debt crisis, they were part of the solution during the pandemic. So, is there no need to develop capital markets anymore? No, on the contrary.

Businesses should be able to tap a deeply integrated capital market or have seamless access to cross-border bank lending instead of relying mainly on their domestic sources of financing. Depending on where the business is located, this fragmentation leads to higher funding costs and risks.

Investors need more investment opportunities, beyond their borders. An integrated market for capital is conducive to a better allocation of capital and attracts international investors.

Besides, the EU is at a turning point, looking with great ambition towards a more digital and greener future. In this respect, Next Generation EU has been an exceptional act of solidarity of about €800 billion to support EU Member States to invest in the dual transition; it will phase out in 2026. In terms of greening, the EU's net-zero objective is on the horizon for 2050. Public-sector financing can only complement private sector financing. This is especially true at this juncture, when the pandemic and the war in Ukraine have stretched public finances a lot and when high inflation has led to a tightening of monetary policy, making access to credit more difficult. A deep, liquid capital market is necessary today more than ever to finance innovation the EU needs. In the US, which is better at financing innovation than Europe, market capitalisation accounts for about 150% of GDP. In the euro area, it only accounts for about 60% of GDP.

Major institutional innovations have made the EU more crisis-proof over the last decade. These include the creation of the ESM, which is expected to add another layer of protection. Upon ratification of its amended Treaty, it will provide the backstop for the Single Resolution Fund, which ensures an orderly resolution of failing banks. As we have seen recently in the US and Switzerland, financial turbulences can occur unexpectedly. But public risk sharing needs to be complemented by private risk sharing, and this goes through financial integration.

However, progress has remained disappointing. As a result, the sources of funding and investment that capital markets can provide remain unavailable in full to European citizens and businesses.

The Euro Summit's recent decision to enhance CMU may provide new momentum. The Eurogroup approved a CMU process in May, and the Eurogroup President intends to update the Euro Summit in early 2024.

To move ahead, it will be important to focus on a clear set of priorities. I will mention five.

First, continuing to develop sustainable finance could be a major driver of CMU. The EU is already a world leader in bond issuance and the euro is the global currency of choice for sustainable finance, with nearly 50% of global sustainable debt capital markets denominated in euros, compared to the US dollar's 23%. However, when you look at the entire global debt market, it only represents a share of about 3%.

There is major room for growth. The EU taxonomy for sustainable activities, reporting obligations, or the green bond standard can have major catalytic effects in this regard. The Luxembourg Green Exchange is a good example of how to deploy efforts in that direction.

Second, it is imperative to put in place a single rulebook for capital markets. The establishment of a single rulebook for banks has proven very beneficial in strengthening banks. The parallel to banks inevitably also leads to the question of supervision. The Single Supervisory Mechanism (SSM) could be a concrete example to draw lessons from. While systemically important institutions are supervised at the central level by the European Central Bank, national competent authorities supervise all the other entities at the domestic level. Also, representatives from national authorities are part of the joint supervisory teams that supervise systemically important institutions. This interaction is important and has performed well judging by the resilience of the European banks in the last years.

As seen with the SSM, the harmonisation of rules and practices is key to enhancing integration while taking into account national specificities and prerogatives.

Third, it is important to revive the securitisation market. While securitisation was blamed for the subprime market crisis in 2007/8, a simple, transparent, and standardised securitisation, as proposed by the European Commission, will help banks offload risks from their balance sheets responsibly while offering new investment opportunities. This, by the way, illustrates well that banks and markets are not in competition but are, instead, complementary. Banks play an important role in capital markets, for instance by giving advice, structuring deals, and syndicating loans and bonds.

Fourth, small and medium-sized enterprises (SME) need alternative sources of financing. Earlier, I was talking about innovation. In the EU, a well-known issue is the lack of access to sufficient funding for the expansion of small, innovative businesses. Measures should be taken to boost SMEs and equity finance, i.e. forms of risk-taking in market financing that banks are not willing to provide.

Fifth, an integrated capital market would benefit from additional European safe assets. About €1 trillion European safe assets have been issued by the European Commission, the European Investment Bank, and the ESM/EFSF, mainly listed on the Luxembourg Stock Exchange. Following Brexit, Luxembourg law also plays a key role in this respect. The ESM moved from English to Luxembourg law, for example. More of these common European safe assets are bringing Europe's capital market to the next level.

Let me conclude. CMU is necessary to live up to the EU's ambitions to make our economies greener and more digital. But it is also imperative to increase risk sharing via private channels to make the EU and the euro area more resilient. In addition, it is essential to optimise the allocation of capital, without facing barriers. The objective is not to attain the same proportions of market-based finance to bank-based finance as in the US. Rather, we should aim for a better equilibrium.

The potential pertaining to CMU is enormous but untapped. The past has shown us that when Europe harmonises rules and regulates, it can translate into great success stories. The regulations going back to 1989 on Undertakings for Collective Investment and Transferable Securities – better known as UCITS – are a case in point. A new opportunity is emerging for progress on CMU, but Europe needs to act together. If you want to walk fast, walk alone. If you want to walk far, walk together.

Thank you.

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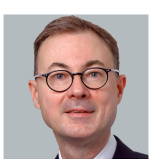

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