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The Eurozone: a monetary union without a capital market*

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Introduction

This Policy Brief calls our attention to the dire state of integration of capital markets within our monetary union, and questions in the conclusions whether this may represent an important factor in determining the ultimate viability of our common currency.

Capital Markets Union

Two themes blend and intermingle in the CMU Action Plan: one is capital markets reform, with the development of non-bank market segments that appear largely underdeveloped; the other is cross-border capital markets integration.

The CMU project has failed so far to attack the key impediments to market integration. Most of the initiatives undertaken under the CMU Action Plan to date have aimed at improving national markets to make it easier for companies to enter and raise capital on public markets, as an alternative to bank financing.

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The new prospectus regulation has distinctly failed to allow issuers to choose where to list their equities, due to national resistance to fuller capital market integration. Companies should be free to choose as Home Member State either the member state where the issuer has its registered office or the member state where securities are admitted to trading; this possibility is at present provided for only to issuers of certain non-equity securities.

The new market abuse regulation imposes new and heavy burdens on companies listed in MTFs, going against the goals of CMU to facilitate the raising of capital of SMEs on any trading venue. In this respect, the simplifications proposed in the SME listing package are negligible and limited to companies traded in a SME growth market. More in general, the two-fold notion of inside information – the same kind of information is the basis both for the prohibition of insider trading and for the obligation to disclose – generates a lot of legal uncertainty and risks facilitating market manipulation.

As to the SME listing package, the proposals are restricted to companies on SME Growth Markets; small and mid-cap listed in a regulated market cannot avail of less stringent regulatory requirements.

Cross-border company mobility

Article 63 TFEU provides for the full freedom of capital movements between member states and between them and third countries. However, in practice this freedom is ensured for portfolio investments, much less for real direct investment.

Cross-border company mobility – which rests on the freedom of establishment – is a key element for overcoming market fragmentation and economic nationalism. However, most member states hang to a 'real seat' legal doctrine entailing that the applicable corporate law would be that of the main centre of the company's commercial and financial operations. Under this doctrine, the legal seat and the main operations of a company must coincide, potentially limiting company mobility and freedom of establishment. The Treaty did not intervene to settle potential conflicts between national corporate laws; a Convention signed in 1968 by the (then six) member states "on the mutual recognition of companies and bodies corporate" never entered into force (owing to failed ratification by the Netherlands).

Over time the Court of Justice of the European Union (ECJ) has opened ever broader breaches into the closed walls of the real seat doctrine, de facto turning the European company law system into an 'incorporation' system whereby the applicable company law is determined by the place of legal incorporation.

Starting in 1999, with the landmark decision in the case Centros (1999) the ECJ progressively liberalized the choice of the place of incorporation of companies, thus fostering company mobility. With Cartesio (2008) and Vale (2012), the ECJ acknowledged the right of companies to convert into a company governed by the law of another member state. In the Polbud case (2017), the ECJ upheld the legitimacy of a cross-border conversion by way of a mere transfer of the legal seat without any activity in the country of arrival. However, these decisions do not amount to a full and transparent framework for company mobility, as significant legal uncertainty continues to surround cross-border conversions (i.e. change of legal seat and applicable law) and may require in each new case fresh action before the Court, as member states administrations and courts stick to divergent principles.

Following the 2005 Cross-Border Merger Directive, the cross-border transfer of seat may be achieved by merging the company to be transferred with a shell-company in the host member state. This operation, however, is more onerous and less efficient than a cross-border conversion. More importantly, since a cross-border conversion may be implemented through an alternative investment tool, it is difficult to understand why the EU should not adopt legislation directly covering the transfer of legal seat. Eventually, the European Commission has indeed proposed a legal framework for cross-border conversion with the Company Law Package published in 2018. The proposal goes in the right direction, but the procedures are encumbered by the overriding concern to prevent fraudulent utilization of the new legal tool to circumvent national tax, labour and corporate safeguards.

The European company statute

The European Company Statute (SE), originally conceived to allow companies to operate cross-border with common accounting and taxation rules (the latter never agreed upon), was approved in 2001 after more than 30 years of negotiations. A SE can only be created by transformation, merger and acquisition of pre-existing companies.

The regulation provides only for a few common rules (minimum capital, the option between a dual and a monistic governing board, procedure for the transfer of legal seat) and all other aspects of corporate governance are left to national rules, under a general regime of mutual recognition; it requires the legal seat to be placed in the location of the central administration and provide for rules on workers' involvement; in no case could the creation of a SE lead to a diminution of existing workers' rights within one of the companies involved. The long negotiations and the solution eventually agreed upon provide clear testimony of the paramount role played by labour market arrangements in limiting the cross-border integration of company operations.

The market for corporate control

Several factors still hinder effective integration of 'real' capital markets, that is the cross-border flows of direct investment going well beyond the sheer freedom of portfolio investment.

As to the European market for corporate control, there is still a strong national bias towards foreign driven acquisition. Although in principle the member states normally cannot legally block any transactions based on the acquirers' nationality, governments in continental Europe have used various legal and de-facto powers to create obstacles to foreign-driven transactions while supporting domestic transactions aimed at creating so-called 'national champions'.

A missed opportunity to change this scenario was the adoption of the Takeover Directive in 2004. The key provisions of the directive, the board neutrality and breakthrough rules, were maintained only as default rules, while the member states may leave companies the option not to abide by them. According to the principle of reciprocity, the two rules do not apply when they are not respected by the bidding company. This reciprocity provision is of course in direct contrast with the fundamental principles of the internal market.

In the 1980s and 1990s many governments accompanied the privatisation of state-owned companies with legal and statutory rules leaving them special rights – so-called golden shares – to block certain decisions and share transactions deemed in contrast with the public interest. The ECJ addressed the issue of the compatibility of golden shares and the privatisation laws of various member states with the freedom of capital movement in several decisions adopted in the early Noughties. Accordingly, the compliance of golden shares with European law should be assessed on the basis of a four-step test, whereby golden shares must be: (i) justified by overriding consideration in general interest; (ii) be non-discriminatory on the basis of nationality; (iii) be exercised on the basis of publicly known criteria established in advance; (iv) be proportionate, i.e. the objective which they pursue should be attained by least restrictive measures. Economic justifications are in general not recognised as legitimate. However, the application of these legal principles has been undermined by various decisions by member states limiting the freedom of capital flows and the right of establishment based on ill-defined grounds of public and strategic interest, that continue to give rise to legal controversies that are settled by ECJ decisions only with long delays.

Wanting supervisory convergence

A fundamental pillar of the European strategy for the integration of capital markets is the convergence of supervisory approaches, which play a paramount role in ensuring that the common rules are uniformly applied and that there is little room for an opportunistic use of discretionary powers by national authorities to protect national interests.

The convergence of supervisory practices entails a gradual build-up of institutional procedures and cultural attitudes, under the constraints imposed by the EU Treaties on delegated powers, as interpreted by the ECJ with its Meroni and Romano judgments.

An improved convergence of regulatory standards was expected to come from the transformation of CESR into the European Securities and Market Authority (ESMA), which was set up as Union body with legal personality and was entrusted with binding powers to develop common implementing standards of the Single Rulebook for capital markets. However, ESMA has continued to function as a network of national supervisory authorities, because of the composition of its governing bodies and its decision-making procedures, still based on the principle of national representation, and as a result has failed to dent national idiosyncratic implementation of European legislation.

Market fragmentation, risk sharing and the banking union

Market fragmentation is the persistent legacy of the sovereign debt crisis of 2010-12 in the eurozone, and it manifests itself in the wide spreads separating the yields demanded by investors on the sovereign paper of high-debt countries relative to the German bunds. In fragmented markets, banking and sovereign risks are closely correlated at national level. Thus, when the sovereign market in one country comes under stress, the doom loop between sovereign distress and the viability of the entire banking system comes back to haunt us. The losses on sovereign holdings cripple the banking system and generate expectations of a public bail out, which in turn weighs heavily on sovereign debt sustainability.

In June 2012, the European Council decided the creation of the banking union as an effective solution to breaking the doom loop, eradicating supervisory forbearance and moral hazard in banking, and restoring the integrity of the internal market. Thus, banking union was the instrument to effectively remove market fragmentation for bank funding and commercial lending.

However, banking union inevitably requires some sharing of banking risks across the member states, which some member states have been reluctant to accept until there has been enough reduction of legacy risks in some banking systems, still plagued by high non-performing loans (NPLs) and sovereign risks. As a result, banking union remains incomplete owing to the missing legs of a cross-border deposit insurance and adequate fiscal backstops for both the resolution fund and the deposit insurance fund, and the expected benefits of reduced market fragmentation have not materialised. This remains a formidable obstacle to effective integration of capital markets through equity and direct investment.

The paradox in the current situation is that, in a fragmented financial system, private risk-sharing through cross-border equity investments remains quite limited, and therefore the probability of necessitating a public bailout when one banking system is hit by a idiosyncratic shock is higher. In other words, far from protecting creditor countries from financial spillovers from debtor countries, lack of risk sharing may magnify those spillovers.

External imbalances and adjustment

As a monetary union based on a single currency, the eurozone was supposed to be immune from balance-of-payments crises as exchange-rate risks would vanish and payment disequilibria within the area would be smoothly offset by private capital flows. These expectations proved delusional: the sovereign debt crisis in the eurozone in 2010-12 started as a fully-fledged balance-of-payments crisis, prompted by the accumulation of large payment imbalances between its members, reflecting in turn persistent underlying divergences in prices and productivity.

This happened because monetary union did not eliminate market segmentation and nominal rigidities, while fiscal policies stayed national and continued to respond to national goals. Moreover, as long as exchange rates could be realigned, international capital flows worked to establish some symmetry in external adjustment obligations between surplus and deficit countries. No such mechanism has been at work within the eurozone, where domestic liquidity creation is under the control of an independent central bank – which in addition, as a rule, does not intervene in foreign exchange markets.

The only remaining external adjustment mechanism in the eurozone works through the markets for sovereign bonds: since lending of last resort for national sovereign debtors by the European Central Bank (ECB) is prohibited by the Treaties, financial investors will discipline national governments with unsustainable budgetary policies by selling their bonds. As a result, adjustment obligations work asymmetrically to discipline member states with government deficits, while there is little pressure for Germany to adjust its domestic policies in response to burgeoning external surpluses.

And, finally, intra-eurozone capital flows do not contribute much to the financing of external imbalances. In the early euro years, swelling imbalances between participating countries were financed mostly by intra-eurozone capital flows through the purchase of government and financial institution securities, including by private investors and cross-border interbank lending, with a substantial involvement of German financial institutions. During the euro debt crisis in 2010-12, private cross-border financing collapsed, and imbalances were curtailed; much of what was left was financed through the ECB by means of extraordinary lending operations. Afterwards, the music changed: Germany's outward financial flows were dominated by net portfolio investments, mostly outside the eurozone – which is a direct reflection of market segmentation, as has been described. Thus, Germany has contributed neither to real investments within the eurozone nor to sharing the risks implicit in an incomplete monetary union with divergent national fiscal policies.

In conclusion

Our monetary union is incomplete in various respects, including insufficient market integration for goods and services, extensive protection of incumbents in network services, divergent fiscal policies that help maintain divergent trends in prices and productivity. What I have argued with my presentation today is that insufficient integration of capital markets probably remains as a paramount weakness in its architecture because it hampers the free flow of capital, and notably direct investment, which is key to foster real economic integration and the convergence of productivity trends.

If one looks back at the heydays of the Bretton Woods and compares that system with our monetary union, one is struck by the fact that under post-World-War-Two arrangements the anchor country was offering open access to its domestic markets for the exports of the rest of the industrial world, with its growing external deficit providing a continuing stimulus to world growth. Its capital markets offered deep and liquid instruments to recycle payments imbalances and financed huge flows of direct investment to transfer technology and foster convergence in the rest of the industrial world.

Nothing could be more distant from the realities of our monetary union, where real economic integration is blocked by extensive protections and anticompetitive practices, the anchor country accumulates ever larger external payments imbalances and invests its proceeds out of the eurozone, and the common currency markets are by and large not able to offer adequate investment outlets to domestic and international investors in open and liquid markets for our debt and equity instruments – simply because we keep our capital markets closed and we are not willing to turn to debt to finance our huge shortfalls in productive and infrastructural capital.

Whether this is consistent with the continuing viability of the common currency remains an open question.