How Capital Markets Union can bolster Monetary Union

Mr. Chairman, Your Excellency Minister of Finance, Jeroen Dijsselbloem, Commissioner Lord Hill, Esteemed ICMA-members and conference participants,

1. Thank you for this opportunity to share my views on the European Capital Markets Union.
   First, let me express my full support for the views expressed by his Excellency, the Minister of Finance.
   I, too, very much welcome the initiatives by the Commission geared at the further development and integration of European capital markets.
   I am confident that through the harmonization of regulation and the introduction of common standards we'll be able to unlock important new ways of finance; productive ways that will increase the resilience of the European economy, going beyond the traditional financing channels of banking.

2. It is true that in the euro area, small and medium-sized enterprises are still very much dependent on financing by banks. This implies that business investment in the euro area also depends on the availability of bank credit. And this creates vulnerabilities to the European economy. For example, when banks need to deleverage in order to strengthen their balance sheets.

3. The European bank-based financial system is often contrasted to the situation in the US, which is presumed to be more market-based.
   I should note that this difference is a bit more nuanced than is commonly acknowledged.
   For in the US as well, SMEs are similarly dependent on bank financing, in particular the smallest of firms. To the extent that smaller firms do access capital markets, this is mostly confined to specific sectors.
   A well-known example is the Silicon Valley industry, start-up tech-companies that are able to attract large sums of financing from venture-capitalists.

4. This refinement notwithstanding, in general it has been shown that well-developed access to market financing can complement bank financing.
And economic research confirms that this can improve economic performance.
The Minister has eloquently explained how this would apply specifically to the European economy and set out how the Capital Markets Union relates to the recently established European Banking Union.
In my address, I want to focus on yet another perspective.
I will give you my views on why the completion of a true European Capital Markets Union is beneficial from a monetary policy perspective, for there are several reasons why better developed and integrated capital markets can make the lives of European central bankers much simpler.

5. As you know, the Governing Council of the European Central Bank aims to maintain price stability in the euro area as a whole. To achieve this, the ECB conducts monetary policy.
Based on the outlook for inflation, we set our policy rates to steer overall financing conditions for households and firms in the euro area.
A homogeneous transmission of our monetary policy decisions throughout the financial system enhances the appropriateness of our policy decisions.
For the euro area as a whole, and for the participating Member States.
That is why monetary policy benefits from a level-playing field in financial markets across countries.

6. Note that I do not intend to suggest that all economic agents should be able to lend against the exact same conditions. Actual financing conditions for individual households and firms are to be determined by the market and not by the ECB. And these should appropriately reflect differences in earnings capacity and risk.

7. This is exactly what went wrong in the run-up to the crisis. Lending rates converged throughout the euro area, and no longer reflected actual underlying risks.

Several potential explanations have been put forward for this. One reason often mentioned is the search-for-yield as a consequence of the low interest-rate environment.

Or the fact that the no-bail out clause in the EU Treaty was perceived as not credible.

Yet another explanation is that gaps in banking regulation were the primary cause of the mispricing of risks in the run-up to the crisis. In my view, all three explanations have been relevant. In fact, these factors are likely to have reinforced each other.

8. In a similar way, I believe that a lack of harmonization in regulation and common standards in euro area capital markets can also be viewed as an aggravating factor.

   For heterogeneity and inconsistencies in regulation can obscure how losses will be distributed once financial risks materialize. And this can exacerbate the mispricing of risk in financial markets.

9. I think this is a key issue that the Commission agenda on Capital Markets Union should address. In my view, one of the obstacles to be tackled is the lack of harmonization in insolvency laws across countries.

   Unfortunately, in the Commission's early proposals initiatives to that effect do not feature very prominently, yet. I nevertheless believe it could be an effective way for Capital Markets Union to contribute to consistent pricing of risk across countries.

   For it will help ensure a homogeneous, but risk-consistent transmission of monetary policy decisions.

10. But Capital Markets Union can deliver on more than just that. It can also greatly increase the efficacy of monetary policy.

    Common to all monetary policy decisions is that their transmission to the real economy is sluggish and can sometimes be incomplete.

    For example, the extent to which banks are able to lower lending rates following a rate cut depends on many factors beyond the control of

monetary policymakers.
One can think of the level of competition in the banking sector, or the health of bank balance sheets.
A successful Capital Markets Union will open up entirely new channels for the transmission of monetary policy to the real economy, making central bankers much less dependent on a single sector for the transmission of its policy decisions.
In that sense, central banks can diversify the channels through which they can influence the economy, adding to its effectiveness.

11. Note that economic agents can benefit from Capital Markets Union in a very similar way.
Households and firms can diversify their dependency on financing, if alternative sources of finance are in abundance, making themselves less vulnerable to risks stemming from a single sector.
A well-diversified financial structure increases the resilience of the balance sheets of households and corporations to shocks. And the resilience of the economy as a whole.
And when an economy is better able to cope with external shocks, monetary policy will not get distracted from pursuing its primary remit: delivering price stability.

12. The latter is even more relevant for monetary policy in a monetary union. Structural differences between national economies imply that the euro area economy is prone to asymmetric shocks. Private sector risk-sharing across countries can greatly enhance a smooth transmission of such shocks.
This is what Capital Markets Union can accomplish, for an increase in the cross-border holdings of financial instruments will enhance risk-sharing across the euro area, thus improving the functioning of the monetary union.

13. However, Capital Markets Union is no silver bullet. Clearly, its introduction does not absolve us from pursuing prudent policies in other policy areas, too.

Moreover, it will take time before we can reap the full benefits of Capital Markets Union.
But there can be no doubt that it will prove an important complement to Banking Union in enhancing the functioning of our monetary union.

14. At the same time, Capital Markets Union will also bring new challenges and risks.
For example, as a result of the shift in the relative importance of the transmission channels of monetary policy. Interest-rate decisions may transmit to the real economy differently through markets than they do through the banking sector.
This calls for careful analysis. And possibly a reassessment of the effectiveness of our monetary policy instruments. These instruments are currently primarily geared at the banking sector.
However, to be able to influence financing conditions beyond the banking sector we may need to introduce new instruments.

15. Another possible consequence is that risks may shift to the shadow banking sector.
A sector that is currently less transparent and less regulated than the traditional banking sector. It is yet unclear what could be the financial stability implications if such a development were to occur.
In any case, it would warrant enhanced monitoring of developments in the sector.
One could even argue that a more formalized supervisory framework should be put in place.
Finally, it could be conceivable that macro-prudential policy measures would have to be applied beyond the banking sector.

16. As for the potential risks associated with developing capital markets, let me highlight one more issue. Some might worry that by developing financial markets we will again see the introduction of complex financial instruments.
The type of obscure instruments that according to many were the root

cause of the global financial crisis. Here, I would like to reiterate firmly that this is clearly not what I envisage.

Rather, the goal of Capital Markets Union is to create a level-playing field by introducing simple standards that improve transparency. Only then, can Capital Markets Union foster financing flows that support economic growth in a sustainable way.

Dear participants, let me wrap up my address.

17. I presented to you a central banker's view on Capital Markets Union, and why I think this a very important initiative.

Today, the discussion on Capital Markets Union is still at an early stage.

The agenda is being set as-we-speak.

Having an exchange of views on such an important topic with esteemed members of the capital markets community could not have come at a better time.

Therefore, I very much look forward to the discussions later today.

I'm confident that this conference will yield many interesting insights.

New ideas that will bring us closer to completing this important pillar of our Economic and Monetary Union.

Thank you for your attention.