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Working Paper

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SAFE White Paper, No. 102

Provided in Cooperation with:

Leibniz Institute for Financial Research SAFE

Suggested Citation: Heider, Florian et al. (2024) : The geopolitical case for CMU and two different pathways toward capital market integration, SAFE White Paper, No. 102, Leibniz Institute for Financial Research SAFE, Frankfurt a. M.,
<https://nbn-resolving.de/urn:nbn:de:hebis:30:3-700108>

This Version is available at:

<https://hdl.handle.net/10419/294828>

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SAFE White Paper No. 102 | April 2024

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The Geopolitical Case for CMU and Two Different Pathways Toward Capital Market Integration*

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April 2024

Abstract

Almost ten years after the European Commission action plan on building a capital markets union (CMU) and despite incremental progress, e.g. in the form of the EU Listing Act, the picture looks dire. Stock exchanges, securities markets, and supervisory authorities remain largely national, and, in many cases, European companies have decided to exclusively list overseas. Notwithstanding the economic and financial benefits of market integration, CMU has become a geopolitical necessity. A unified capital market can bolster resilience, strategic autonomy, and economic sovereignty, reduce dependence on external funding, and may foster economic cooperation between member states.

The reason for the persistent stand-still in Europe's CMU development is not so much the conflict between market- and state-based integration, but rather the hesitancy of national regulatory and supervisory bodies to relinquish powers. If EU member states wanted to get real about CMU (as they say, and as they should), they need to openly accept the loss of sovereignty that follows from a true unified capital market. Building on economic as well as historical evidence, the paper offers viable proposals on how to design competent institutions within the current European framework.

This note outlines the case for speedy capital market integration and for the adoption of a common regulatory framework and single supervisory authority from a political economy perspective. We also show the alternative case for harmonization and centralization via regulatory competition, elaborating how competition between EU jurisdictions by way of full mutual recognition may lead to a (cost-)efficient and standardized legal framework for capital markets. Lastly, the note addresses the political economy conflict that underpins the implementation of both models for integrating capital markets. We point out that, in both cases, national authorities experience a loss of legislative and jurisdictional

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competence at the national level. We predict that any plan to foster a stronger capital market union, following an institution based or a market-based strategy, will face opposition from powerful national stakeholders.

I. Capital Markets Union at 10

Ten years after then Commission presidential candidate Jean-Claude Juncker announced the plan to develop a Capital Markets Union (CMU), the picture looks dire. Despite small advances in the harmonization of capital markets regulation¹ the main challenges identified in the CMU Action Plans (European Commission, 2015; 2020) remain unsolved: corporates, esp. SMEs, rely predominantly on bank-funding, and financial market fragmentation persists across 27 jurisdictions.² This lack of a single European capital market has significant negative welfare effects. European companies have decided to list at US exchanges where conditions to attract capital are better. Superior funding opportunities do not only attract tech start-ups such as Biontech, Curevac, or Spotify, but also household names of the old economy like shoe manufacturer Birkenstock, chemical company Linde, and car manufacturer Ferrari (for a more detailed discussion of this development, see Langenbucher, 2024).³

On the eve of the European election, European policy makers have expressed their revived commitment to the project and overcoming the logjam.⁴ In this White Paper, we (1) highlight why a functioning CMU is particularly valuable in a world with rising geopolitical tensions. We (2) then sketch two avenues for achieving a deeper capital market integration, and (3) identify the ultimate roadblock that has delayed any significant progress towards a true CMU in the past.

Bottom-up approaches are, at the same time, blamed for the failure of CMU (Lagarde, 2023) and presented as viable options to kick-start the project (BMF, 2023). This White Paper argues that the

¹ E.g. the [European Single Access Point](#) Regulation (entry into force in January 2024), the [Listing Act](#) (provisional agreement reached in February 2024), or the [Retail Investment Strategy](#) whose legislative components are at the stage of inter-institutional negotiations.

² This perspective is not shared in the official communication by the European Commission. The 2020 Action Plan noted that 12 of 13 legislative initiatives proposed in 2015 had been accomplished, yet it is reflected in Enrico Letta's recent report on the future of the single market: "The attempt to create the Capital Markets Union over the past decade has not been successful, among other causes, because it has been perceived as an end in itself. True integration of financial markets in Europe will not be realized until European citizens and policymakers recognize that such integration is not merely beneficial for finance itself but is crucial for achieving overarching goals that are otherwise unattainable, such as the fair, green, and digital transition." (Letta, 2024, p. 12)

³ These developments conflict with earlier assessments that European companies did not list on stock exchanges because they could borrow money cheaply from banks due to historically low interest rates (Oxera, 2020, pp. 116-117).

⁴ Following a Financial Times article by French and German ministers of Finance Bruno Le Maire and Christian Lindner (Le Maire and Lindner, 2023) and a slightly more detailed Franco-German roadmap towards CMU (BMF, 2023), European finance ministers published a policy statement on priorities and intended measures in March 2024 (Eurogroup, 2024). Earlier, ECB President Christine Lagarde had also advocated restarting the CMU agenda (Lagarde, 2023).

main challenge for advancing CMU does not hinge on following a bottom-up or a top-down approach towards capital market integration. Instead, it follows from the ubiquitous need to remove a massive institutional roadblock in Europe: Overcoming vested national interests that benefit from the status quo and are likely to lose out, if a deeper CMU is established. To make real progress, EU member states must be willing to relinquish sovereign competences for market design and oversight, either to a supranational authority or to other national jurisdictions in a competitive setting. Before making this argument in more detail, we motivate the urgency of our approach by delineating the CMU project's significance in a world with rising geopolitical tensions.

II. CMU: Why we need it now more than ever

The arguments in favour of capital market integration are paramount. They are prominently placed in the Commission communications on CMU and in statements by various stakeholders. Beyond the efficiency gains market integration yields through economies of scale (de Guindos et al., 2020; Duruflé et al., 2017; Li and Marinc, 2017; Noyer et al., 2024; Ringe, 2018; Véron and Wolff, 2016) and the essential role deep and liquid capital markets could play in financing the EU's twin transition towards a green and digital economy (Battiston et al., 2019; Born et al., 2021; ECB, 2022)⁵, we see capital market integration as a geopolitical necessity. Plainly put: It is an essential means to pursue strategic goals in other policy areas in a global order structured by power dynamics (Herranz-Surrallés et al., 2024). A unified and robust capital market enhances the EU's resilience and strategic autonomy in the face of global geopolitical shifts and uncertainties. By reducing the dependence on external sources of funding and fostering intra-EU investment, European securities markets bolster economic sovereignty, while reducing vulnerabilities to external pressures and potential disruptions in global financial markets.

Moreover, a CMU strengthens the EU's geopolitical influence by promoting the euro as an international reserve currency. As geopolitical rivalries intensify, particularly among global powers, integrated capital markets would strengthen Europe's position as a cohesive economic bloc, capable of asserting its interests and values on the international stage. Market integration would also foster even closer economic ties among EU member states, promote stability, and reinforce the EU's role as a global economic powerhouse. There must be one (and only one) counterpart in regulatory negotiations representing the EU and its market power, irrespective of where it is located. The multiple crises (Covid-19, Russia-Ukraine war) and their global economic impact have revealed the EU's weakness vis

⁵ This argument features particularly prominent in supportive opinion pieces and public speeches by central bankers, governments, and international organizations (see e.g., BMF, 2023; Lagarde, 2021; Letta, 2024; Georgieva, 2023; Villeroy de Galhau and Nagel, 2022)

à vis economic blocs such as China or the USA. The cost of non-Europe is obvious in the EU's inability to create efficient and robust capital markets.

III. Two avenues for achieving one goal

The political objective to achieve CMU must be to move from the current state of fragmentation to an integrated capital market with a level playing field for all market participants, including a single supervisor. Incremental advances in harmonizing the regulatory framework for capital markets will remain insufficient, as long as the “law in action” varies, because 27 national supervisors implement the common rules and standards differently in their domestic supervisory practice. Relying on a single supervisor would allow issuers, investors, and other market participants to trust in the uniform and impartial implementation of the regulatory framework, thereby enhancing legal certainty and the predictability of transactional outcomes. These features of a fully integrated European capital market are attractive for global investors and local would-be issuers alike.

Two distinct models describe the trajectories for creating the integrated regulatory and supervisory framework we envision as the robust backbone for CMU: Integration through institutions and institutions through markets (Figure 1 and below III.2 and III.3). Arguably, the results differ in detail: Regulatory competition will likely produce a more efficient regulatory framework, although some market fragmentation would prevail. It can be understood as a separating equilibrium more attuned to the specific needs of individual market participants. In contrast, a centralized European rulebook and supervisory framework would be universal but might exhibit inefficiencies caused by a one-size-fits-all overregulation for some market participants.

Figure 1: Two integration models for capital markets

	Integration via institutions	Integration via markets
Principle of order	State	Market
Necessary political action	Creation of a European supervisory authority for capital markets	Mutual, unfettered recognition of all financial market products and services originating in any EU jurisdiction
Integration mechanism	Top-Down (institution-building)	Bottom-up (competition)
Historical model	United States Securities and Exchange Commission (SEC)	Delaware charter mongering
Harmonization of supervisory and regulatory framework	De jure (sole EU competence)	De facto (natural monopoly)

However, regardless of which approach to achieving CMU EU co-legislators will ultimately pursue, their efforts will face the same roadblock: Member states must consent to seizing sovereign powers, either at the supranational level by empowering a single European supervisor, or through mutual recognition of some foreign regulatory and supervisory regime. In both settings, national politics loses the power to impose a regulatory regime on listed firms. While this is obvious if co-legislators opt for a full-fledged supra-nationalisation of market regulation and supervision, it also is true if they chose a market-based solution. The integrative power of regulatory competition hinges on an unfettered mutual recognition which in turn requires the political will to accept outcomes on foreign markets with foreign regulatory environments and supervisory practices. Therefore, both approaches will attract opposition from public and private actors who currently exercise or benefit from the proximity to local authorities. Ultimately, it is a political rather than an economic question which approach will dominate.

1. Market integration through institution-building

Integration through institutions achieves capital market integration through the creation of a common market supervisory authority and one supervisory rulebook on European level. Shifting power upwards has been proposed as a suitable solution for implementing CMU more than once, relying on different institutional approaches:

1. Building a new institution, a European Securities and Exchange Commission (E-SEC) (Krahnen and Pelizzon 2020, Lagarde 2023),
2. Upgrading an existing institution, by giving ESMA full supervisory authority and allowing it to bypass national authorities: “ESMA 2.0” (Noyer et al., 2024; Sapir, Véron and Wolff 2018; Véron 2024)
3. Adding a new responsibility to the ECB as a competent authority (Friedrich and Thiemann 2017).

Irrespective of the specific institutional implementation, the new capital market supervisor would fulfil a similar task as the ECB’s Single Supervisory Mechanism (SSM) in the banking union, as it would take responsibility for the recognition of financial products, would monitor trading and enforce a single rulebook across all EU member states.⁶ The current national supervisory authorities would be either absorbed into this supranational authority or would continue to perform subordinate activities. In case of the latter, they would be re-orientated from national administrative hierarchies to subordinate branches of the European supervisor, akin to SEC regional offices in the US. The SEC serves as the positive case study has created a comprehensive regulatory rule book plus a supervisory practice that is applied uniformly across US states.

As with the ECB and the SSM, the new institution would be governed by multinational expert teams which would impede biases. So-called national champions would find it more difficult to receive preferential treatment at home to protect their franchise value. For example, a centralized supervisor would lower the incentives for conflicts of interest and inefficient competition between national stock exchanges: As long as all stock exchanges can effectively lobby their national governments for protection, they will find it easier to dominate national markets, largely without respect of the quality of their services. Centralization of supervision would alternatively increase incentives for cross-border cooperation between stock exchanges which would now engage in real competition on a level playing field.

Peer review culture and joint supervisory teams make for better enforcement. A centralized supervisor will almost automatically generate a massive concentration of expert observers, analysts, consumer advocates, corporate lawyers, institutional investors, activists, and regulators – shaping market development in view of a large public audience across the continent. Arguably, there is a higher chance that fraudulent behaviour and other illegal activities will be uncovered, increasing trust in markets.

⁶ We are aware of the discussion on the constitutionality of each these proposals, yet decided not to comment on these as they deviate from the aim of this paper. While legal arguments certainly have merit, they are too often used to conceal political and economic interests.

Currently, European capital markets lack such an ecosystem which does not only provide clarity and transparency for market participants but would also stipulate innovation and growth.

2. Market integration through regulatory competition

At its core, the CMU seeks to foster a more unified and efficient financial market landscape, where capital can flow seamlessly across borders, facilitating investment, growth, and innovation. The traditional approach to implementing this vision has been a top-down, planned order that relies on sweeping legislative and regulatory interventions on the supranational level. However, there is a substantial risk in building a new supranational regulatory framework and respective institutions: These might not replace existing institutions but add an additional regulatory layer. An alternative approach would rely on market participants' decentralized decision making, precipitating market integration as a spontaneous order. Essential to this approach is the concept of regulatory competition, wherein member states compete to attract market participants by offering favourable regulatory environments. This competition is anticipated to drive improvements in governance, efficiency, and investor protection, ultimately enhancing the attractiveness of European financial markets on a global scale (Enriques and Tröger, 2008; Romano, 1998; but see also Fox, 1999).

A historical case study that underscores the potential and limits of regulatory competition within the CMU framework is Delaware's charter mongering practice in the United States. Delaware's business-friendly corporate laws and flexible regulatory environment have made it the jurisdiction of choice for numerous corporations, despite many being headquartered elsewhere. However, research has also shown that market outcomes may be suboptimal from a social perspective (Bebchuk, 1992; but see also Romano, 1993) and additional safeguards are required to achieve optimal results. Arguably, European minimum standards for contractual activities, consumer protection etc. may already fulfil these requirements.

Within the EU, full mutual recognition of all financial products across member states could catalyse a similar dynamic, where market participants opt for jurisdictions offering desirable features such as robust investor protection, efficient courts, low market entry costs, and adept supervisory authorities. The passporting regime available for some disclosure documents under current EU capital market regulation (e.g., under the prospectus regime) is a far cry from such an unfettered mutual recognition, because it does not set aside domestic enforcement powers once the financial product has entered the host market and therefore does not prevent fragmentation. However, the success of regulatory competition within the CMU hinges on striking a delicate balance. While market participants may gravitate towards jurisdictions offering favourable regulatory conditions, the risk of regulatory arbitrage must be carefully managed. To be sure, market forces already serve as a bulwark against a

potential race to the bottom within the CMU, because regulatory frameworks that unilaterally favour one side of capital market transactions are not a sustainable choice in equilibrium and capital markets thrive if the institutional framework credibly promotes joint surplus (Black, 2001; La Porta et al., 2006). Where markets fail to provide optimal results due to informational asymmetries (Bebchuk, 1992), network effects (Klausner 1995) or other forms of market failure, targeted interventions to erect guardrails for regulatory competition are required – and this is where a central power is needed to keep national competitors in check (Roe 2003).

Under these assumptions, the level playing field in the EU would not emerge as a result of far reaching, supranational harmonizations of the regulatory framework and the creation of additional European institutions, but in a guarded market process that remains responsive and hospitable to transacting parties' needs and to regulatory innovation. Such a CMU can foster a dynamic and resilient financial ecosystem that benefits investors, businesses, and economies across Europe.

The successful implementation of such a vision for CMU, just like the option of a central supervisor explored above, necessitates EU member states to relinquish sovereign powers in regulating and supervising financial markets. Embracing a collective commitment to honouring the choices of other member states and accepting that their domestic market may not succeed in a winner-takes-all competition is unavoidable. Against the background of mutual recognition and cooperation among all EU members, competition will without doubt create winners and losers among issuers, marketplaces, and supervisory bodies. Yet, the notion of “winners” and “losers” becomes obsolete in light of the expected welfare gains for all European citizens and corporates. The overarching objective is to foster a level playing field that allows for welfare gains of all participants in the single market for financial services and the economy at large. By fostering a regulatory environment that encourages healthy competition while mitigating arbitrage risks, the CMU promises to realize a more integrated, resilient, and dynamic European capital market ecosystem to the benefit of all European citizens.

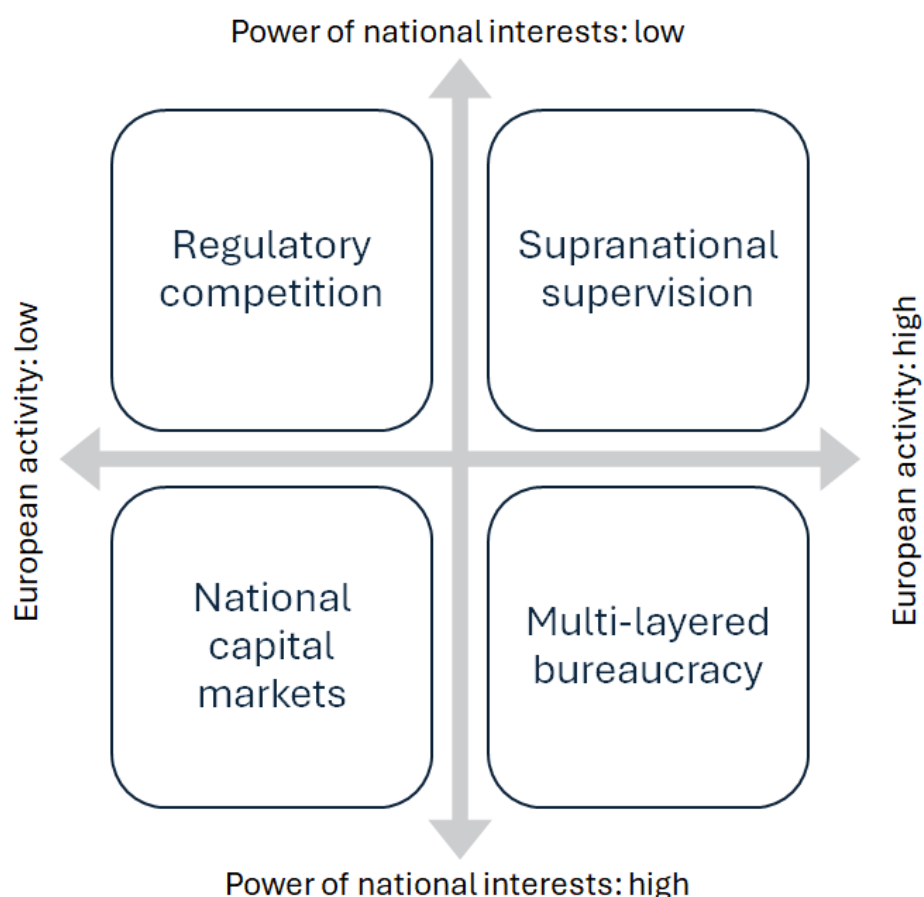
3. Addressing the real challenge: National interests

Both models for capital markets integration, centralized supervision, and regulatory competition, face political opposition because they entail the loss of national sovereignty: Centralization would transfer political and regulatory power to the European level and regulatory competition, if taken seriously, would disempower national authorities and stock exchanges due to the principle of mutual recognition. We argue that both avenues are functionally equivalent in conjuring up political opposition because member states would always have to surrender some of their rule-setting autonomy – be it to a central agency, or to the rule setting agency of a competing, recognized EU member state. CMU advocates must tackle the challenge head-on, regardless of which avenue they

ultimately pursue: Up to now, CMU has primarily failed because several member states want to retain sovereignty and protect national interest groups with lobbying power. Our optimistic view is that the geopolitical tensions introduce a novel argument to the decades-old CMU struggle, promising a reorientation. However, without immediate and decisive action, we will instead see a relapse to national protectionism.

Figure 2 graphically highlights the indispensable preconditions for successful market integration that must be present regardless of whether policy makers opt for a top-down or bottom-up approach. Desirable capital market integration is only achievable in the upper half of the graph if and only if the legislative process attenuates the power of vested national interests, and the influence of incumbents. To achieve such a design of the legislative process, European co-legislators may carefully choose whether the EU activity should be high (upper-right quadrant) or low (upper-left quadrant).

Figure 2: Four scenarios for capital market integration in the EU



In our opinion, the real threat relates to the bottom quadrants of the graph, shifting from national capital markets to multi-layered bureaucracy, a status, in which national interest groups preserve their power and lobbying influence, and the EU simultaneously increases their policymaking and institutional activity (bottom-right corner), effectively moving from one bad equilibrium to another.

National institutions would continue to exist, and the EU would extend its activities via harmonization and convergence efforts. The latter would occur in supranational bodies staffed by an extended bureaucracy with officers dispatched or seconded by national institutions. Such an approach towards CMU would not produce a single integrated capital market with one rulebook and one supervisory authority. It would only increase the regulatory burden and the cost of doing business in Europe. Similarly, incomplete mutual recognition would keep the inroads for national interest groups' influence open if member states could supplement passported foreign regulatory requirements with domestic add-ons and procedures, leading again to sustained fragmentation.

IV. Conclusion and policy recommendations

There is much to gain from integrating capital markets: The EU will need private finance to address its multiple challenges, such as the green and digital transition or the reconstruction effort in Ukraine (Carletti et al., 2024). The increasing geopolitical competition between economic blocs (USA, China) means that the EU must speak with one voice in international negotiations on financial issues. The logic of competition between economic blocs and the nexus of economic policies and global power dynamics were visible during the pandemic and since the full-scale Russian invasion of Ukraine in February 2022: Shortages in critical materials and products and the disruption of energy supply underscore the importance for the EU to reassure and consolidate its role as a global economic powerhouse – capable of asserting its interests and values on the international stage. In overcoming the fragmentation of capital markets, the EU would reduce its vulnerabilities to external sources of funding and global disruptions while boosting its profile as a strong, stable, and secure union.

Yet, while the EU and its citizens would benefit from CMU, it will also produce losers, namely national supervisory authorities, stock exchanges, and, in the short run, small and medium-sized enterprises from countries that have not had a strong capital markets tradition. Naturally, these actors have successfully lobbied for protection from competition and the transfer of power and will continue to do so. Policymakers in Brussels and European capitals must be aware that any meaningful steps towards capital market integration will put them in conflict with interest groups at home. We argue that any attempts to improve the current situation without speaking truth to power cannot produce positive results but will at the worst lead to a situation where capital markets remain fragmented, the European bureaucracy increases, and the geopolitical challenges remain unanswered.

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