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Three Elements of European Integration that Matter to Markets

French President Emmanuel Macron recently announced that Europe stood 'at the edge of a precipice'. He was trying to reinvigorate efforts by the European Union (EU) to take charge of its destiny and to leverage its economic power on a global stage. The backlash against his thoughts was intense. However, it highlighted the pressure the EU finds itself under to achieve progress on issues such as security, the environment, migration and trade. From December 1st the new EU government has a fresh Commission, EU Parliament and ECB President. The Merkel-era is quickly drawing a close. The EU electorate is demanding new strategies driven by fresh thinking. There is even, in typical EU fashion, a Conference on the Future of Europe. Grassroots participation is encouraged rather than top-down blue skies-thinking of an earlier era.

In this article, we look at three specific areas which we believe will play a role in determining the capacity for, and potential success of, further Eurozone integration in the next decade.

01 Banking union

02 Capital markets union

03 Fiscal union

Completion of these projects, we feel, is necessary, if not sufficient, in maintaining the EU as a global economic super-power. Fiscal union is essential to drive region-wide infrastructure projects that benefit all member states. The measures would take the region in the direction of a federated government - something that might be achieved by the end of the next decade.

European Banking Union

Ever since the sovereign debt crisis, policymakers have aimed to establish a banking union that is resilient to external and internal shocks. The crisis highlighted the need for policymakers to reinforce confidence in bank balance sheets, and reduce the risk of capital flight and liquidity squeezes. In particular, there was a clear need to address the 'death loop' of the over-reliance on local sovereign debt in banks' capital bases.

Banking integration so far has taken three forms.

1. The establishment of a single supervisor (the ECB) with a clear mandate to intervene and establish adequate reporting standards;

2. The creation and application of a single resolution mechanism for failing banks.

3. The inception of an EU-wide deposit insurance scheme which ultimately brought progress to a virtual standstill.

National governments have been hugely resistant to bailing-in senior debt holders in failing institutions and instead have sought to include participation by depositors. The wealthier northern European members are wary of seeing contingent claims on their banking systems should they fully insure the depositors of banks in peripheral economies who have had a reputation for poor quality lending.

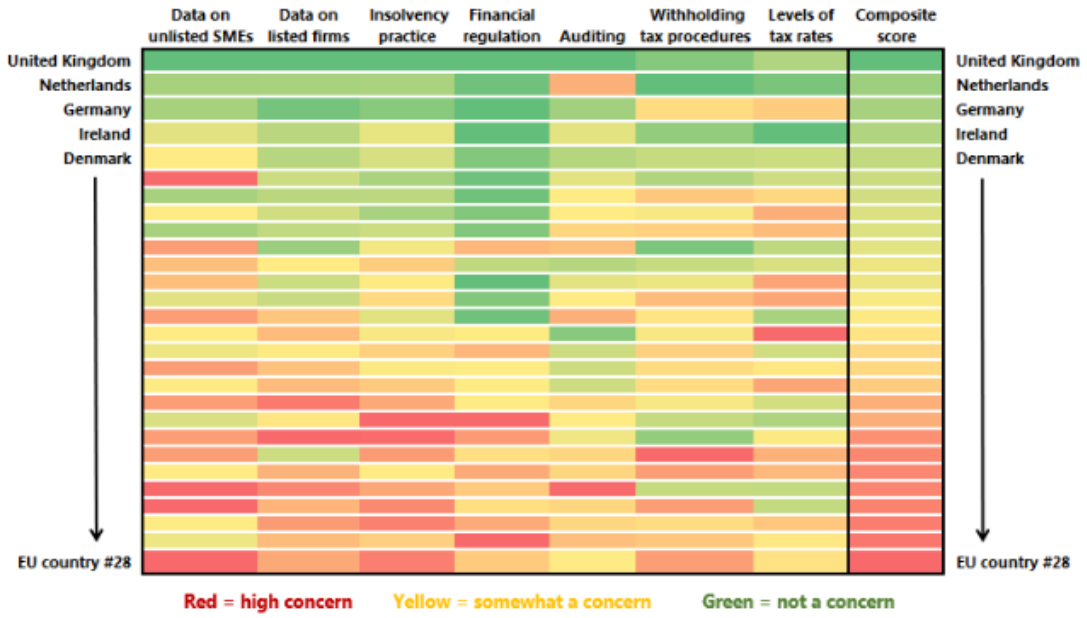
If financial markets, depositors and EU policymakers can have confidence that measures of the quality of a bank loan book and its reserves are accurate, then it will encourage mutualisation of risk. It will require root and branch reform that will undoubtedly be lengthy and painful. There is the no small matter of ensuring that individual country bank regulators are fully independent and informed. Likewise, there is a need to embed a consistent process around bad debt recognition. Decent audit standards are particularly important. None of these will be arrived at overnight, but they are essential if an EU banking system is fit for future purpose.

Capital Markets Union

The capital markets union aims to dissolve the significant barriers to cross border investment across the EU. A project has been in place for almost a decade but has been given new urgency by global trade tensions and a stagnating regional economy.

Success to date has been limited. Companies are still very dependent on their domestic banking sources. An IMF report* in September 2019 highlighted how ***"firms in, say, Greece, pay a 2.5 per cent higher rate of interest on their debt than similar firms in the same industry in France; Italian firms pay 0.8 per cent higher interest on debt than comparable firms in Belgium.... there is no level playing field".*** The report highlighted deficiencies in capital markets regulation and insolvency regimes as just some examples of what might lead to companies disadvantage in accessing competitive funding across the region. It recommends a focus in areas such as transparency much as we mentioned under banking union with a genuine independent stance by European markets' regulator in working to contain systemic risk. Measures proposed include large central clearinghouses and robust settlement systems.

Results of the IMF's Capital Market Union Survey
Some countries are more attractive destinations for capital than others.



Source: IMF survey of investors and EU regulatory agencies.
Note: The composite score is a simple average of underlying scores for the seven areas for each country; the colors for the composite score column are arranged by relative grades across the countries.

Fiscal Union

Six years ago, after the EU debt crisis, there was a greater focus on enforcing the well-known Maastricht criteria that are still the basis of the euro currency club. The Maastricht criteria set out targets for borrowing through an economic cycle as well as capping total outstanding debt alongside restrictions on borrowings for current spending purposes. As a way of ensuring a more cohesive approach to economic management, there has been much discussion in the interim about how the EU could take a path to fiscal union.

By 2019, the context has changed markedly as the notion of a fiscal union is now seen as the framework for an integrated EU budget with spending directed at specific sectors that have union-wide relevance. At present, the EU budget is no more than 1% of combined GDP. Efforts to expand its reach and to attach a dedicated revenue stream to the budget (e.g. VAT receipts) has run into staunch resistance, especially from creditor Eurozone members. They see any concession requiring establishing a vigilant oversight from an EU Treasury or Budget Department.

Yet there is clearly a political need to provide a visible return to economies that have suffered as part of the adjustment to Eurozone membership mainly in the case of hardship linked to cyclical downturns. Support for automatic stabilisers such as unemployment benefits is one example. Yet increasingly, long term thinking is focused around a European Infrastructure Fund that would focus on projects that offer benefits to the union as a whole rather than individual economies. Examples include green or environmental investment or support for the digital economy and its connectivity. The added important aspect is that euro-bonds issued to finance such outlays, by carrying the guarantee of the union, would offer a 'safe-asset' to the regions banking system. It would also provide a means by which the ECB might provide monetary financing at times of stress in the eurozone economy.

By Bill O'Neill

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