IMF Background Note on CMU for Eurogroup

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This note, drawing on the IMF paper, "A Capital Market Union for Europe", discusses the case for a capital market union (CMU) and compares the EU with the US on several metrics. Developing a CMU in the EU could boost funding for innovation and growth—including for the green transition—enhance resilience and cross-border risk sharing, reduce the cross-country dispersion in firms' financing costs, and increase returns on savings. Currently, EU capital markets are fragmented along national lines, with institutional investors exhibiting significant home bias in their portfolios, which limits the size of the pools of capital that can be deployed. Firms are overly dependent on loans and unlisted equity, leaving fast growing firms financing constrained, while households keep relatively large shares of their assets in low yielding bank deposits. This poses risks to the EU's competitiveness and growth prospects, as innovative firms often move to the US seeking risk capital.

The Case for a CMU

Developing a CMU is critical to boosting innovation and growth, including financing the green and digital transitions. Banks are generally less suited to financing innovative firms and significant infrastructure projects. Start-ups and smaller firms investing heavily in R&D are often risky and have few tangible assets to pledge as collateral, limiting their access to bank financing. The more fragmented and limited pools of capital in the EU mean fast growing firms seeking venture capital often look to the US for larger amounts of late-stage funding and listing. Spotify and BioNTech are two well-known examples. Infrastructure projects are often in large scale and long in duration, making their financing more suitable to long-term investors like insurers and pension funds.

Making it easier to invest across borders could help lower the dispersion in firms' financing costs, while greater retail participation in capital markets would increase returns on savings. Similar firms can face dramatically different financing costs depending on the country they are located in. Making it easier for them to tap capital markets and attract investors from other countries could help to reduce the dispersion in funding costs. Households would also benefit from greater participation in capital markets. Allocating more of their savings to tradable bonds and equities would boost returns over those received on relatively low yielding bank deposits.

A CMU would enhance resilience and private cross-border risk sharing. Investing only in domestic firms and banks leaves savers more exposed to domestic shocks. Investing in other countries can diversify risks and cushion shocks at home. Similarly, if foreign investors own shares in your country, part of the hit in a downturn is absorbed by them rather than domestic investors. Firms with only domestic financing options may also find themselves strapped for liquidity in a recession, especially if reliant on banks. Capital markets can help to diversify firms' financing options.

The Evidence

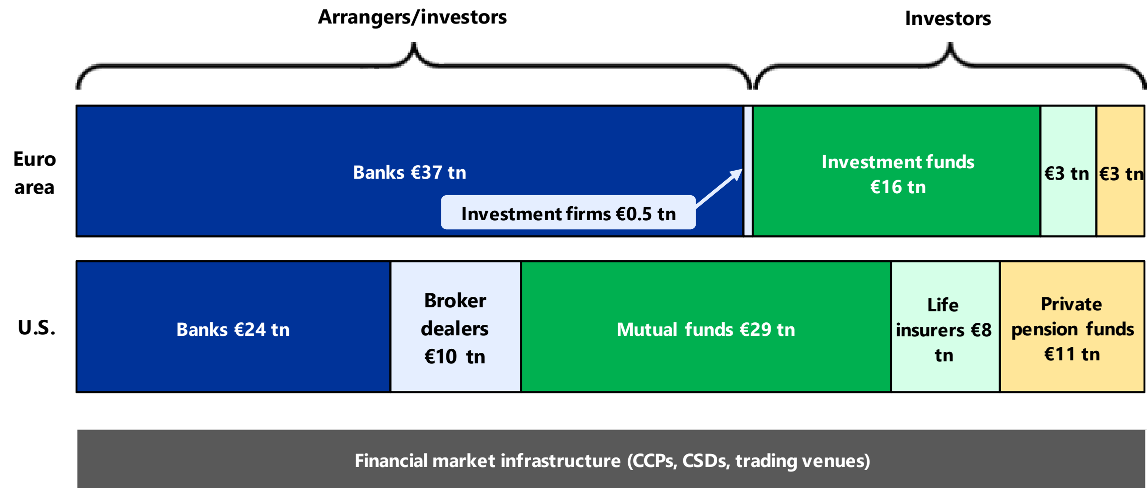
European capital markets are relatively small, resulting in a greater dependence on banks. Banks account for a much larger part of the financial system in Europe than in the US (Figure 1). A less generous public pension system in the US compared to Europe results in US households saving more in financial assets—including in equities, investment funds, and private pension schemes—increasing the size of the pools of capital available (Figure 2, left). Households in Europe also allocate more of their savings to bank deposits (over 30 percent) than in the US (just over 10 percent), limiting the availability of market funding further (Figure 2, right).

Capital markets in Europe are also more fragmented, with dispersion in firms funding costs across countries. Sophisticated long-term investors like insurers and private pension funds are an important source of capital markets financing. But they display a notable home bias in their portfolio allocations. The median insurer or pension fund invests nearly half of its equity portfolio in their own countries' equities. Debt portfolios of pension funds display even more home bias (Figure 3). This fragmentation is also reflected in the dispersion of funding costs for firms in different countries. An analysis conducted for the 2019 IMF paper showed that similar firms can pay substantially more for debt financing depending on where they are located.

As a result, firms rely less on capital market funding, with implications for growth and innovation. European firms rely much less on market sources of financing, with less than 30 percent of their funding coming from tradable equity and debt, compared to nearly 70 percent for US firms (Figure 4). And firms with fewer tangible assets to pledge as collateral are particularly constrained in a bank dominated system, which can impair their growth performance. Smaller pools of capital, more fragmented markets, and greater bank dependence particularly impact the prospects of start-ups and innovative firms. While venture capital (VC) financing increased substantially since the pandemic, even in the best performing EU countries, VC as share of GDP is less than half the level the US (Figure 5). There is also significant dispersion in VC financing across Europe, suggesting the best performers could hold lessons for other EU countries.

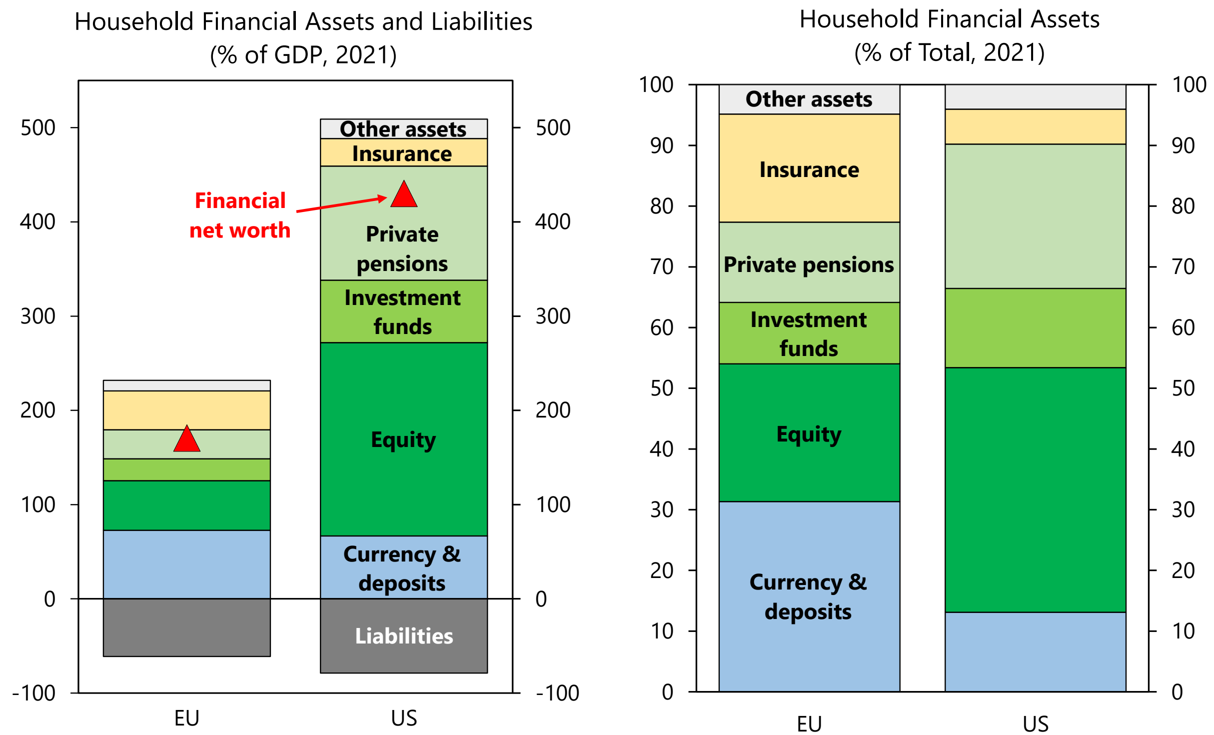
The smaller size of capital markets and their fragmentation along national lines impedes cross-border risk sharing and resilience to shocks. IMF staff's analysis has found that cross-border capital market integration can play an important role in smoothing domestic shocks. In the US, risk sharing between states through capital markets helps to smooth nearly half of the impact of a growth shock on consumption. In Europe the extent of consumption smoothing through capital markets is only around one-tenth (Figure 6).

Figure 1. Euro Area and US Market Structure, 2022:Q4



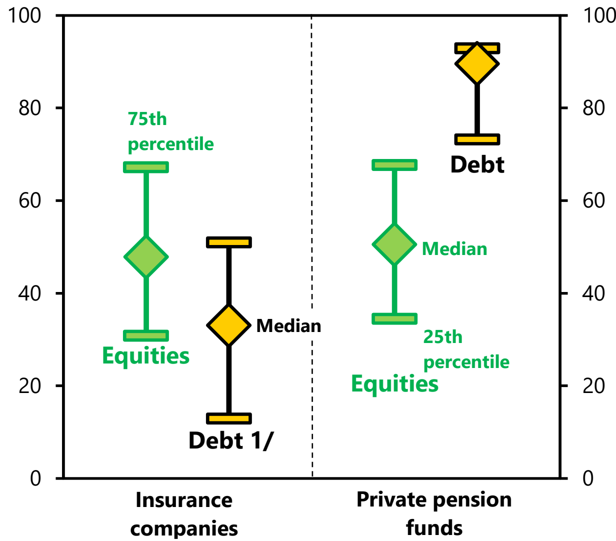
Source: ECB Flow of Funds; US Federal Reserve Flow of Funds; EBA (2015); ECB; and IMF staff calculations.
Notes: Euro area: 2022 Q4 data except for investment firms' assets which are based on EBA 2015 data, categories 1-4, 8, 10, 11. US data: 2022 Q4 data. Security brokers and dealers include holding companies, funding corporations. Mutual funds include real estate and investment trusts, exclude hedge and private equity funds.

Figure 2. Household Balance Sheets



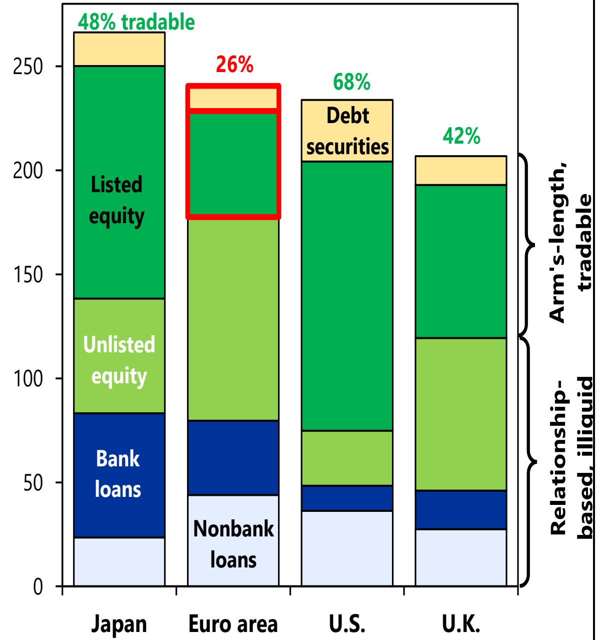
Source: OECD and IMF staff calculations.

Figure 3. Home-Country Securities in EU Investment Portfolios, 2020
(Percent share of total EU securities)



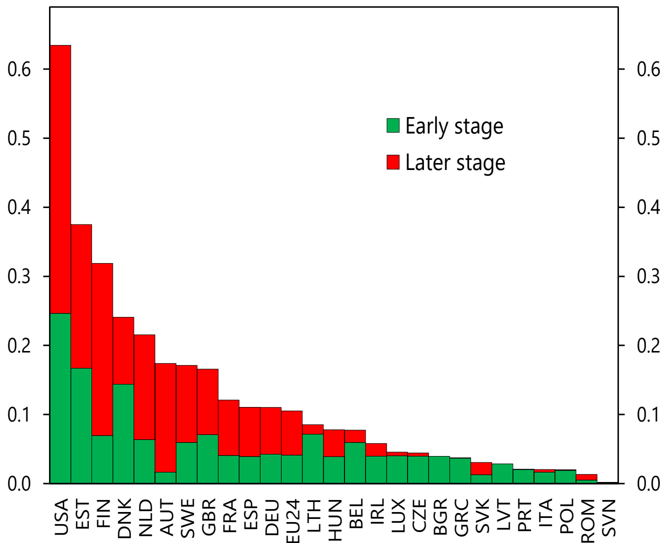
Sources: European Insurance and Occupational Pensions Authority; Mercer European Asset Allocation Survey; and IMF staff calculations.
1/ Excludes sovereign paper.

Figure 4. Non-Financial Corporations Funding Structure, 2022
(Percent of GDP)



Source: Haver Analytics and IMF staff calculations.

Figure 5. Venture Capital Investments
(Percent of GDP)



Source. OECD and IMF staff calculations.
Note. Latest available is 2021, except 2019 for the US.

Figure 6. Risk Sharing Channels
(Percent of growth shock)