# KEY PRIORITY FOR THE INCOMING COMMISSION: DEEPENING INTEGRATION, BOOSTING GROWTH OR STRENGTHENING FINANCIAL STABILITY?

Despite the strengths of the EU (single market, abundant savings, level of education...), the implementation of Invest EU, the slight improvement of its fiscal position and lasting zero and even negative interest rates, Europe is still facing a low growth future. Corporate investment and productivity gains are notably much higher in the US and Asia than in EU Member States. Europe's investment gap is estimated at about € 700 bn per year of which € 180 bn per year represents the growing climate gap. To meet Europe's investment needs over the coming decade, something has to change both at the national and EU levels.

**Raising potential growth needs to be at the top of the agenda**

Monetary policy cannot do everything and cannot replace the domestic reforms needed for long-term growth and reduce unemployment. Productivity growth ultimately depends on the capacity to innovate and to improve business processes. The combination of sound fiscal policies, targeted structural reforms in key areas such as education, skills, innovation, pensions and quality of investments are therefore essential to ensure higher productivity and to improve the competitiveness of the European economy. These internal adjustments efforts are also fundamental for improving the functioning of the EMU and strengthening the international role of the euro. They become more urgent with the long term drag of ageing populations and higher projected pension expenditure. But Europe has also to do more.

**Improving the funding of innovative SMEs all along the financing chain**

Many European firms are very innovative, operating in niche high-tech areas. But the EU has not one high tech company in the top 15 in the world. One of the EU's weaknesses is the underfunding of innovative SMEs all along the financing chain. The European private investment/venture capital market is much less developed than in the US. For example, the amount of venture capital invested in EU startup companies is 6x less than in the US. Successful start-ups in Europe frequently exit European markets for U.S capital in a context where they are unable to access sufficient scale-up funding. Consequently, the EU must focus its efforts and boost its firepower: a quantum leap for private equity and venture capital in Europe is urgently needed.

Furthermore, Europe is adding an Artificial Intelligence (AI) gap to its digital gap. In 2016, European private investments in Artificial Intelligence (AI) amounted to approximately EUR 3.2 billion, compared to almost EUR 10 billion in Asia and EUR 18 billion in the US. In 2018, China attracted almost half of global investment in AI start-ups ahead of the US with 38%. In such a context, Europe must support more the critical emerging technologies that are key in maintaining Europe's leading role in innovation and global competition.

**Addressing financial fragmentation in the EU**

The banking industry is more resilient in the EU, but, astonishingly, banking and capital markets are more fragmented than 5 years before. The euro area has a savings surplus of more than €300 billion, or 3% of GDP in 2018, which is not being lent to the other euro-area countries but to the rest of the world. Cross-border Eurozone financing has indeed decreased since the financial crisis. Fragmentation in the single banking market has gone up despite the partial implementation of the Banking Union five years ago; the "sovereign-bank loop" has not disappeared and in certain countries has increased. European financial institutions are in a relatively weaker competitive position compared to their American competitors (which enjoy the benefits of a single market and the economies of scale that it brings), and the EUs' Capital Markets Union project has underwhelmed. The EU is falling increasingly far behind the US and China, risking, unless there are robust new policies put in place, having to accept a growing, probably irreversible loss of sovereignty and global influence.

Given the highly destructive financial crisis, in recent years financial stability has been the overall priority for EU legislators with international agreements (Basel 3) and EU regulations (Solvency II) etc. However, market trends have shown that not just is the EUs' prudential framework for long term investment penalizing, in addition, the implementation of national ring-fencing policies, under the presence of financial stability, have fragmented banking and financial markets further.

This highlights policy conflicts between different priorities and suggests that, until now, stability has trumped all others. It is also true that it is easier to achieve EU agreement on financial stability objectives rather than on growth or public risk-sharing objectives. Integration reduces the latitude of Member States to impose their own specific requirements to seek faster growth. What is really required are collective structural reforms and a more common EU economic policy.

**Improving the global competitiveness of the EU financial sector**

Sustained zero or even negative interest rates (and low growth) are weakening the profitability of the banking and the insurance sectors, blurring risk premia and encouraging preference for cash savings over bond and long-term investment products. At the same time improving the efficiency of the EUs' financial players is essential to be able to supply optimal financing conditions in terms of quality and cost at a time when technological innovation, the speed of change and increased competition (e.g. new entrants, third country competitors) require significant, constant investment.

In the meantime, most experts believe EU banks are made even less globally competitive by the Basle IV reforms. Consequently, EU legislators should make sure that the implementation of Basel III does not affect the financing capacity of EU banks. Moreover, initiatives like reviving good European securitization can help European banks adapt and improve their performance in the future.

**Correcting the current disequilibrium in the monetary union**

Finally, banking and capital market integration are dependent on further fiscal discipline and economic convergence at the EU level and by an EU industrial policy. Furthermore, Monetary Union cannot work without fiscal discipline. However, the enforcement of the Stability and Growth Pact has been too lenient since 2003. Fiscal rules need to be enforced more vigorously. This would help to rebuild buffers and ensure debt sustainability.

In the meantime, the symmetry of economic adjustments should be a priority focus. Within a monetary union, there must be a symmetrical adjustment mechanism to prevent a long-run excessive balance of payment surpluses or deficits. The euro area is suffering from not having any such system in place, which creates economic and political tensions. Since the deficit countries have embarked on the structural reforms needed to address their competitiveness gap, surplus countries, which are receiving a massive currency advantage, would be expected to accept some degree of higher relative unit labour costs through higher real wages. This is not a matter of fiscal redistribution or a "union of transfers", but of correcting a "fundamental imbalance" which jeopardises the survival of the euro if nothing is done to counteract it and threatens the functioning of the international financial system.

**Maintaining the status quo is no longer an option**

Europe must "step change' and redefine its long-term view of the key priorities in the financial services area. Europe should be equipped with a powerful financial sector capable of rivalling that of the US and China. This would involve addressing the concerns of host countries regarding the EU crisis management framework, improving equity financing, lifting barriers to the movement of capital and liquidity between EU countries, showing collective well managed European integration pays the best dividends economically, for all, and thereby overcome the tendency for Member States to look inward, rather than outward.

If we really want an equity-based financing ecosystem in Europe, the lack of powerful pension funds needs to be addressed by member states and regulation has to change. Solvency II today, for example, discourages equity investment by excessive capital charges. More generally the debt -equity fiscal bias in favor of the tax deductibility of interest on debt but not on equity is another serious structural handicap to the development of Capital Markets Union.

Up to now the political will to further integrate European banking and financial markets has been limited despite the evident economic benefits and the new, formidable challenges arising from digitalisation, cybersecurity and the likelihood of Brexit. In such a context, agreeing politically at the highest level on the key EU priorities and the subsequent policy measures for all financial sectors before the Institutions commit themselves to launching ad-hoc legislative proposals is certainly the right way forward. This would create political momentum and facilitate the improvement of the efficiency and the flexibility of the EU legislative process in line with rapidly changing financial markets. It is the right time to do so as a new political cycle is starting for 5 years.

**A highest level Tripartite political agreement is now needed**

This is the reason why the European Council, on the basis of Commission proposals, taking full account of the views of the European Parliament, should explicitly define the overall level of ambition and priorities and define a new, holistic approach to achieve dynamic and competitive banking and capital markets in the European Union. Selection of the measures must be on the basis of economic impacts, not whim.

There should be a Tripartite EU political agreement between the Commission, the European Parliament and the European Council on the overall plan and rigorous, monitored delivery - a process which will rekindle European belief and long-term dynamism.