Comments on the future of EU capital markets

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The process that so many people are envisaging for EU capital markets may be summarised approximately as follows:

- The single currency will eliminate currency risk.
- This will encourage a diversification by investors based upon other risk considerations.
- This will lead to a tremendous growth in capital markets.
- In turn this will stimulate the EU economy because of the well-documented link between financial development and economic growth.

While not dismissing this logic, let me advance some doubts about the speed with which this may happen.

While there may well be an evolution towards more market-based financing over time, we are not about to see a sudden change as companies restructure their balance sheets.

Let us start by considering supply. Are we really going to see in Europe a large increase in the number of companies seeking access to markets either making initial public offerings (IPOs) or issuing securitised debt? Here we should distinguish between cross-border offerings by companies that are already listed somewhere, and previously unlisted companies. As shown by Colin Mayer's data for 1995-97, the former category, cross-border listings by already quoted companies, has been around for some years. Indeed, it is a phenomenon that is likely to diminish exactly because of EMU and the unification of financial markets. For example, the alliance between London and Frankfurt means that there will be a de-listing of German shares in London together with a de-listing of English shares in Frankfurt. However, this has very little effect on the overall size of the combined stock markets.

More importantly, it is not easy to find compelling reasons why the supply of listed stocks (or even of non-governmental bonds) should increase sizeably in Euroland merely because we have the single currency. Industry structure is important here. Consider the case of many countries where the economy is made up of relatively few very large companies and a large mass of smaller enterprises. This structure is not going to be changed by EMU. Now, the large corporations already have access to international capital markets. Smaller companies, on the other hand, will be discouraged from IPOs by other factors. Consider the case of countries like Italy. Listing and issuing securities involves disclosure, and there are fairly intuitive reasons why small and medium sized enterprises may not wish to open their books to competitors or to public scrutiny in general.

This means that while there may well be an evolution towards more market-based financing over time, we are not about to see a sudden change as companies restructure their balance sheets to take on board new (for them) forms of external finance.

Let me come to the demand-side. The argument is that the elimination of currency risk means that investors will pursue credit risks on a broader scale. Thus Martin argues that according to market

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surveys there will be a shift from currency to sector diversification. In general, this forecast is not confirmed by simulations made by using international CAPM models (as in Beltratti and Dumas) (1): the latter show that the elimination of currency risk would produce only minor modifications in the optimal portfolio composition.

In particular, to be justified a "sectoral" approach would imply that there is a high cross-country correlation of firms belonging to the same sector. However, the evidence shows that sectors have been closer substitutes than have countries. So, at least in the past, this means that countries have offered more scope for diversification than sectors. This is probably because shocks affect firms of a given sector differently in each country. Will this correlation pattern change rapidly under EMU? Given micro and institutional structural differences it is quite likely that country specific sectoral shocks will persist for some time, also as a result of the differential effects of a common policy reaction to symmetric macro-shocks.

Regulatory competition between jurisdictions could severly weaken investor protection.

A more convincing argument for an increase in cross-border flows is that the single currency will lower the home-market investor bias which is still very strong in Europe. Indeed, Graham Bishop has noted that a major group of investors - life insurance companies - have been prohibited from investing in instruments denominated in foreign currencies. If this happens, simulations show that diversification will tend to support larger markets, and Germany and France will be net recipients of funds. There will however, remain obstacles to complete diversification such as the persistence of tax and regulatory differences, together with other unknown factors in the international diversification puzzle.

This leads me to a last comment on the extent to which harmonisation within the EU is desirable. Colin Mayer is not convinced that regulatory harmonisation is a necessary precondition for the successful operation of financial markets. He refers to the difference across the States in the USA and argues that "there have been considerable benefits to corporations being able to select across a diverse range of systems". Competition between jurisdictions can, in his view, avoid excessive regulatory tendencies.

However, regulatory competition between jurisdictions in the financial sector could severely weaken investor protection as companies and intermediaries would naturally chose those jurisdictions with the most lax rule of conduct, or with permissive regulations with regard to price manipulation, etc. In this context we should remember that EU harmonisation is much more advanced in the banking sector than it is with securities markets, where co-operation is often of a voluntary nature. Imagine the case when European exchanges reach the stage where they provide a unified platform on which 300 EU blue chips are traded - the concept of home regulation will be almost impossible to apply.

We currently have an extremely fragmented situation, and one where more, rather than less, financial harmonisation is likely to be needed. So while agreeing that regulators should be "enabling" rather than "restrictive", I believe Colin Mayer's analysis may be more relevant for corporate regulation than for financial regulation.

1) See A. Beltratti, "The EURO; its effects on expected returns and asset allocation", and B. Dumas, "The effects of EMU on capital allocation: An equilibrium approach". Both papers were presented at the conference, Euro and Asset Management, held at the Universita' Bocconi, Milan, on October 2, 1998.