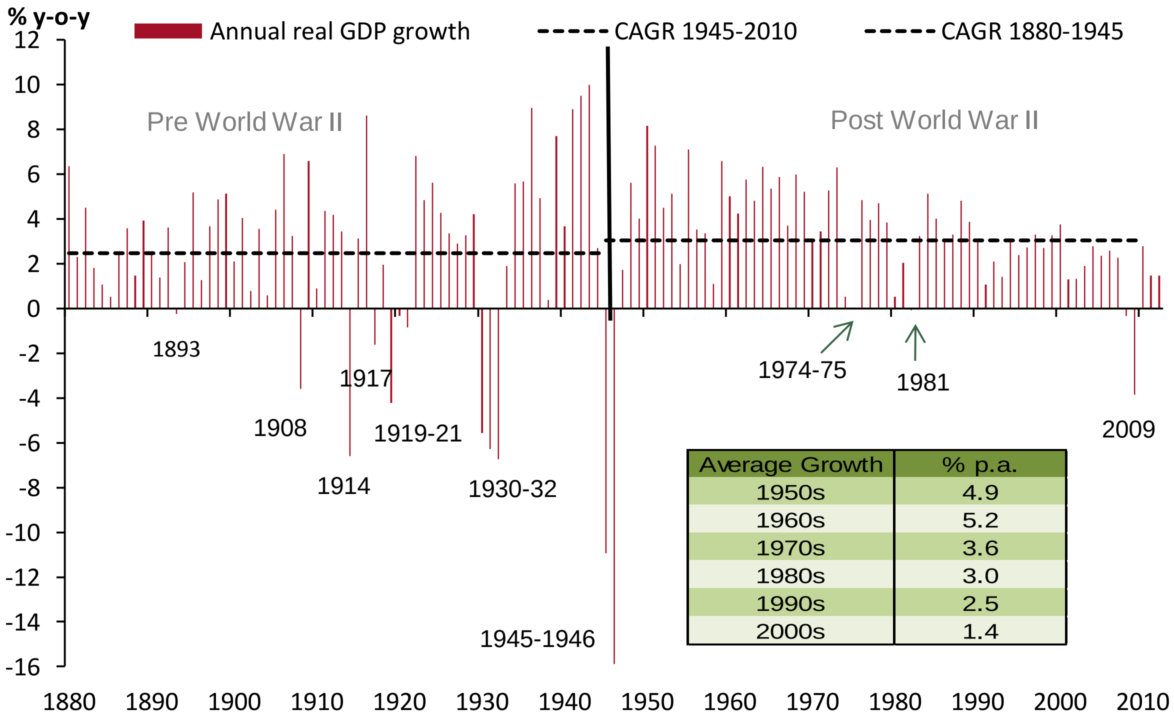
The EU and its Partners:

Defending Open Markets in Challenging Times

G7 GDP growth has trended down over the post-WWII period

This might have been expected to continue, even without the 2008 crisis

G7 real GDP growth, 1880-2012



Average Growth	% p.a.
1950s	4.9
1960s	5.2
1970s	3.6
1980s	3.0
1990s	2.5
2000s	1.4

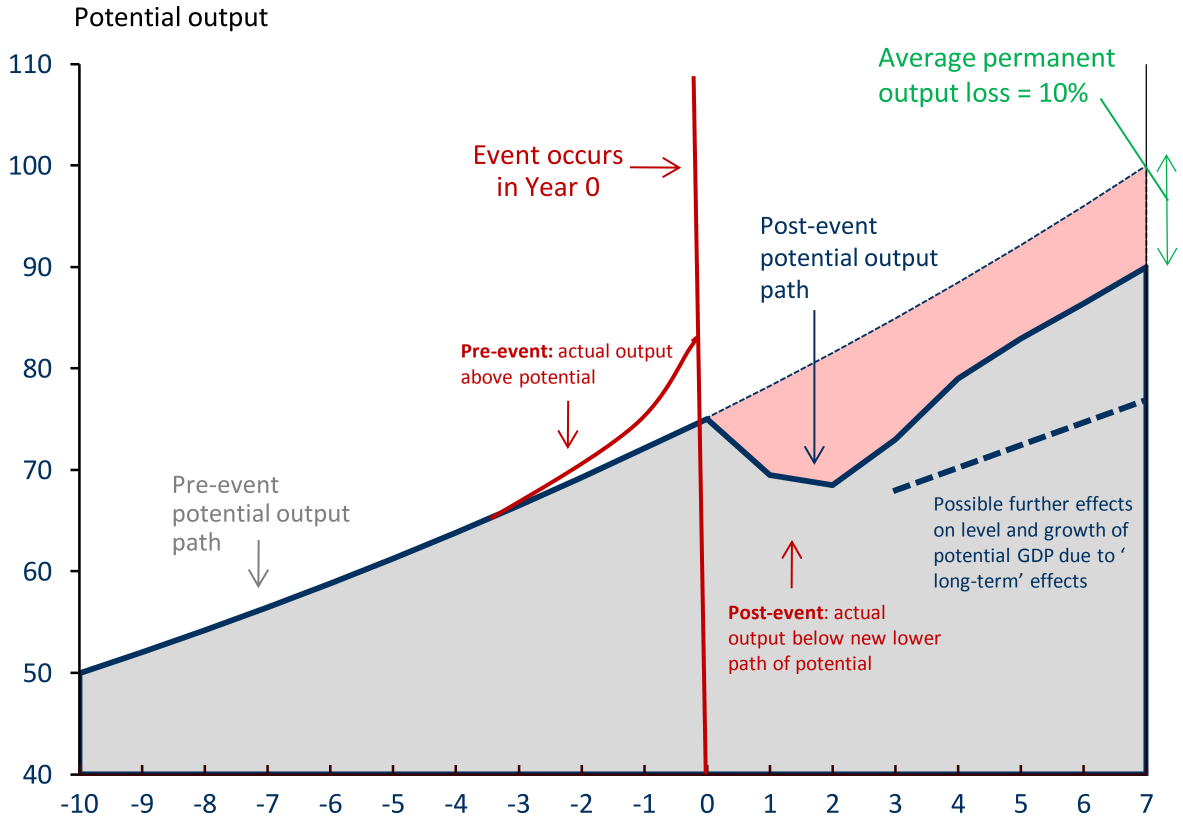
- Open markets and multilateral cooperation led to Europe’s peaceful and successful integration, and over many decades have contributed its economic development and its place in the global economy.
- Major financial crises generate enduring economic costs: these costs will be the smaller, the more tightly integrated such nations are into the global economy
- Along with jobs, the most conspicuous casualty is typically investment spending: investment from abroad therefore becomes even more than usually attractive and important
- Europe today needs more integration and multilateralism, not more fragmentation, to complete economic recovery, and sustain growth with consistently higher employment.
- The Capital Markets Union offers a unique opportunity to look beyond the EU-28 by maximizing the benefits from enhanced cooperation between the EU and key partner countries.

Source: Angus Maddison database and IMF World Economic Outlook database, April 2013

Financial crises are expensive, and the aftermath uncertain

The loss of output (relative to trend) is of the order of a year's worth of GDP

Stylised financial crisis: fall in potential output



Direct effects

- Typically, seven years or so after a financial crisis, GDP is some 10% below its pre-crisis (extrapolated) trend
- Much of the "lost" output owes to investment being 30% -odd below its trend level

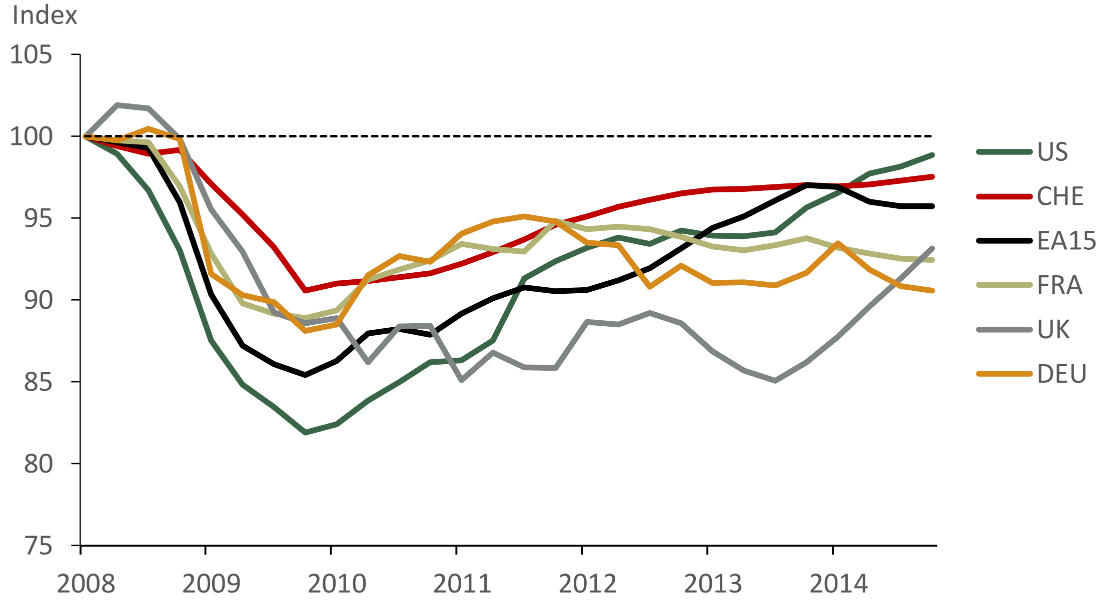
Indirect effects:

- Labour market (hysteresis) effects can further reduce productive potential
- If low investment persists and the labour force suffers continuing damage, growth of potential could slow further

The recovery in business investment has been relatively weak

This has been so right across Europe

Real business investment, % of real GDP, 2008q1=100



- Despite historically low interest rates, business investment spending remains below its previous peak throughout the major advanced economies
- This is particularly the case across Europe.
- The domestic investment shortfall reflects a number of considerations, including: Excessive debt, depressed 'animal spirits', banking sector dysfunction and few alternative sources of finance.
- Investment from abroad can serve as an important buffer in such times

Source: Macrobond and OECD
Note: data are quarterly private non-residential gross fixed capital formation, seasonally adjusted, in constant prices. UK and Switzerland quarterly data series have been smoothed using a four-quarter rolling average. Euro-area data for 2014 are estimated using growth rates for total gross fixed capital formation.

Europe: Challenges after seven years of crisis

- Weak GDP growth, with large divergences within the EU/Eurozone
- Subdued inflation, currently negative
- Excessive public and private sector debt, slow deleveraging
- Structurally high unemployment
- Growing support for anti-establishment parties:

  => Europe is facing economic, social, and political challenges

  => EU: Long-term economic and political success is at risk

  => Euro area: Integrity of monetary union is at risk

Banking Union – a major step forward

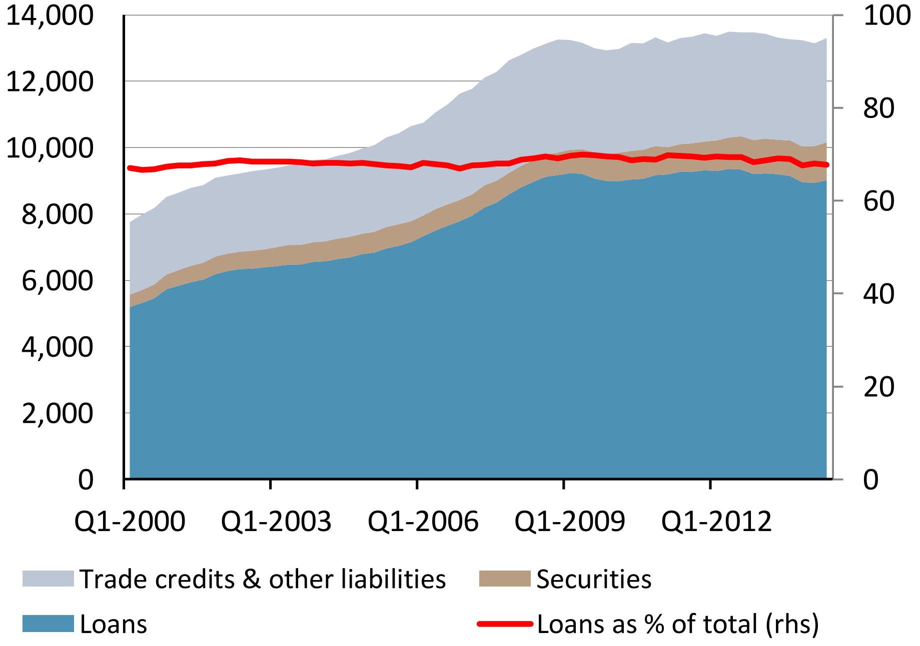
- Financial crisis & sovereign debt crisis have hit EU banking sector hard
- Weak banking sector has caused major damage to the economy
  - Banks are a key source of corporate funding in Europe (unlike the US)
  - SMEs, the backbone of the EU economy, have suffered particularly badly
- Banking Union to break the vicious circle between banks & sovereigns
- Asset Quality Review and Stress Test, followed by recapitalisation
- Single Supervisory Mechanism (4 November 2014)
- Resolution Mechanism and Resolution Fund to follow in 2016
- Major step towards healing of the Eurozone banking system

The next big thing: Capital Market Union

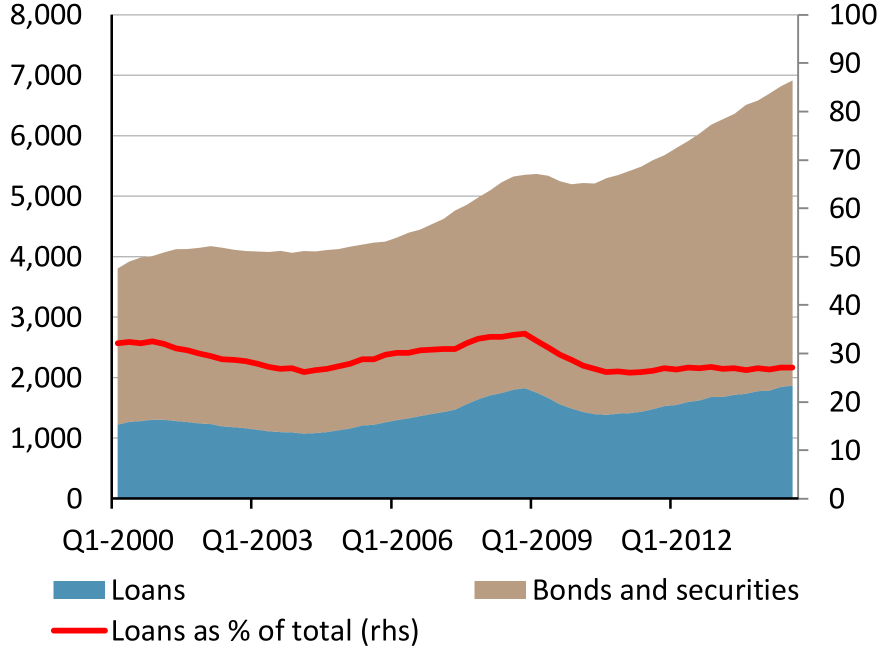
The aim of the Capital Markets Union (CMU)

1. Alternatives to bank funding, focus on <u>securities markets</u>
2. More efficient, growth-friendly and <u>fully integrated</u> financial system
   - European capital markets remain fragmented along national borders

Corporate borrowing in the Eurozone, €bn



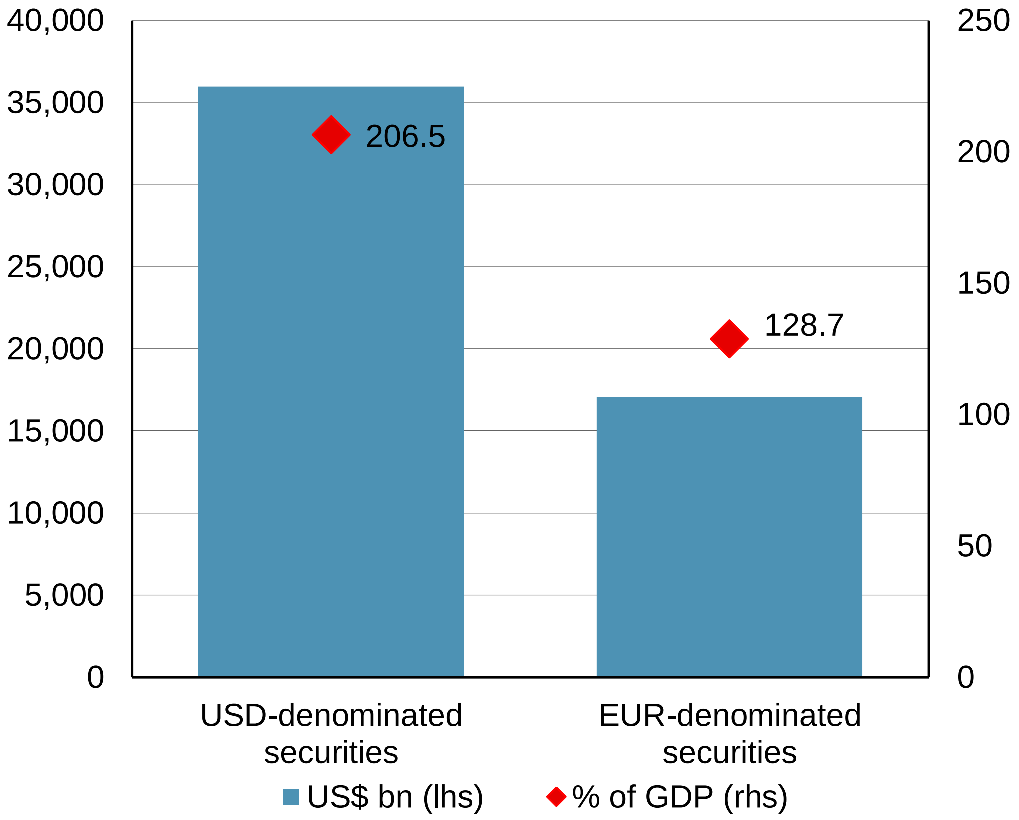
Corporate borrowing in the US, $bn



Source: Haver

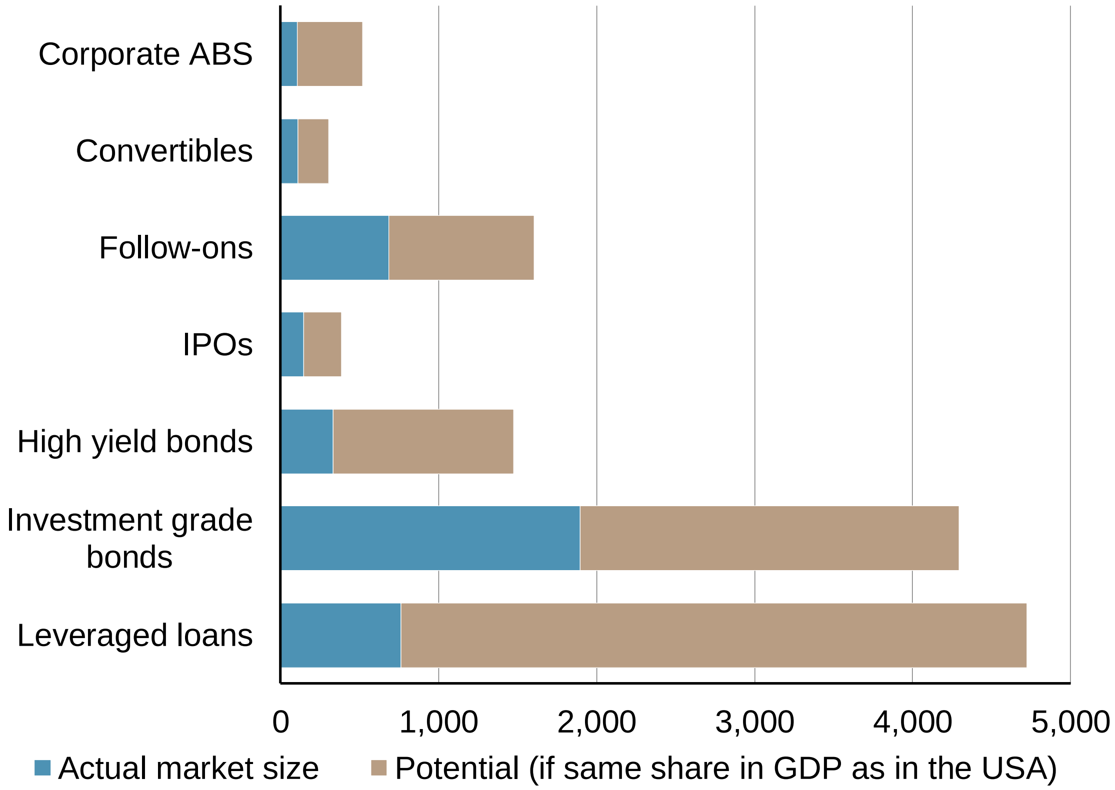
The upside of truly integrated capital markets

Securities markets are much bigger in the US than in Europe



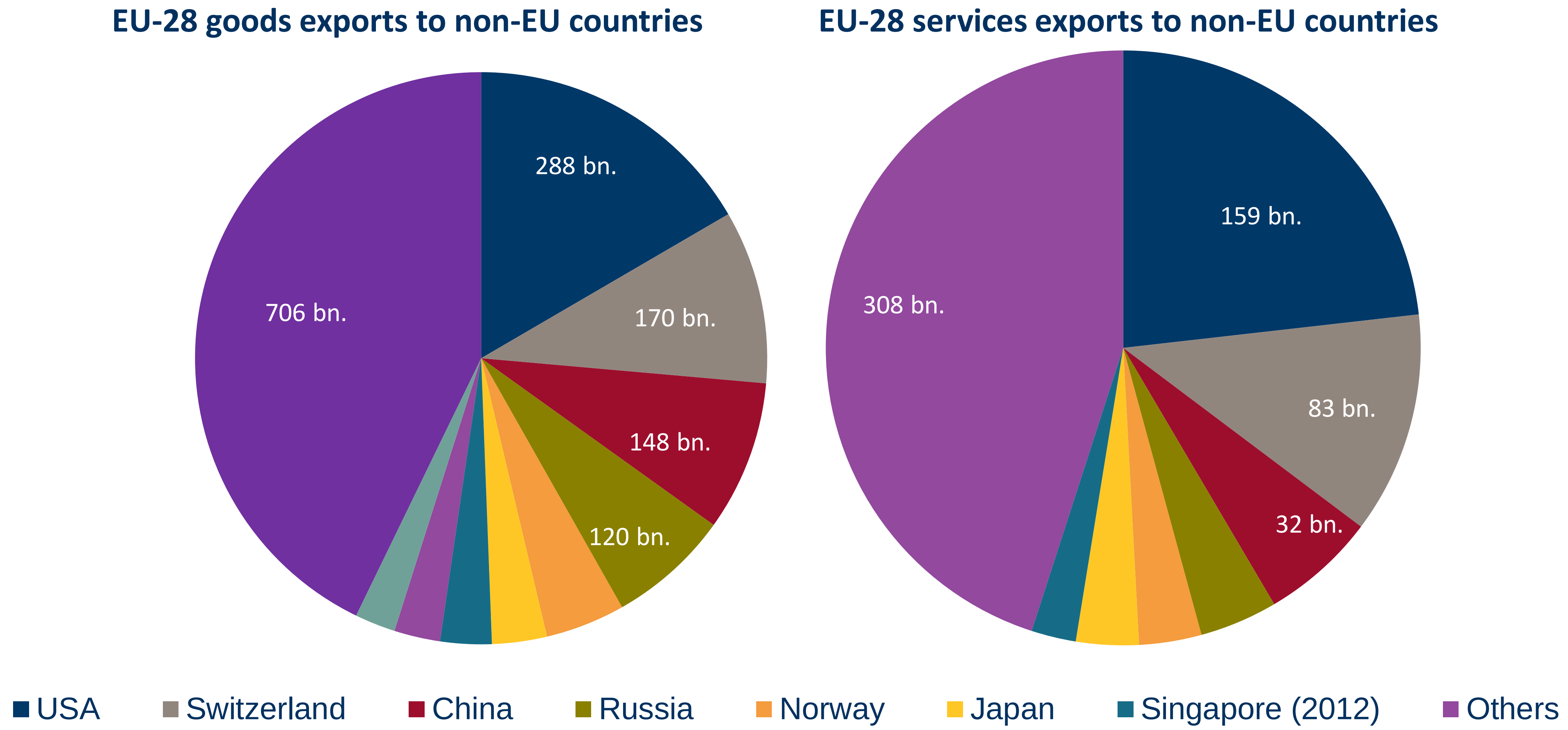
Source: Markit, iBoxx, SIFMA, SFC

European new issuance vs its potential (if same size relative to GDP as in the US) €bn*



Source: Wright, W. (2014), Dealogic, National Statistical Offices, SFC
* 2009-2014 Europe includes the EU, Switzerland, Norway and Iceland

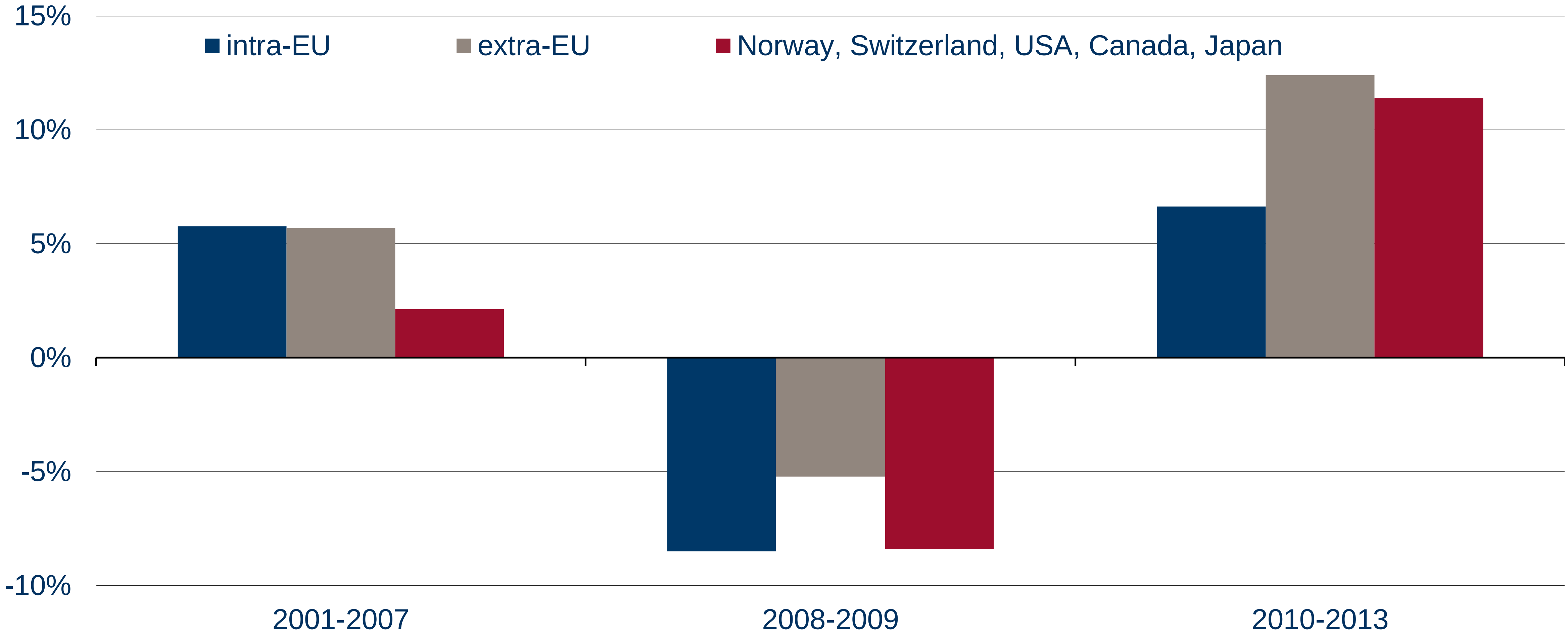
Trade with "external" partners



Source: Eurostat (2013)

External trade as an EU business cycle stabilizer

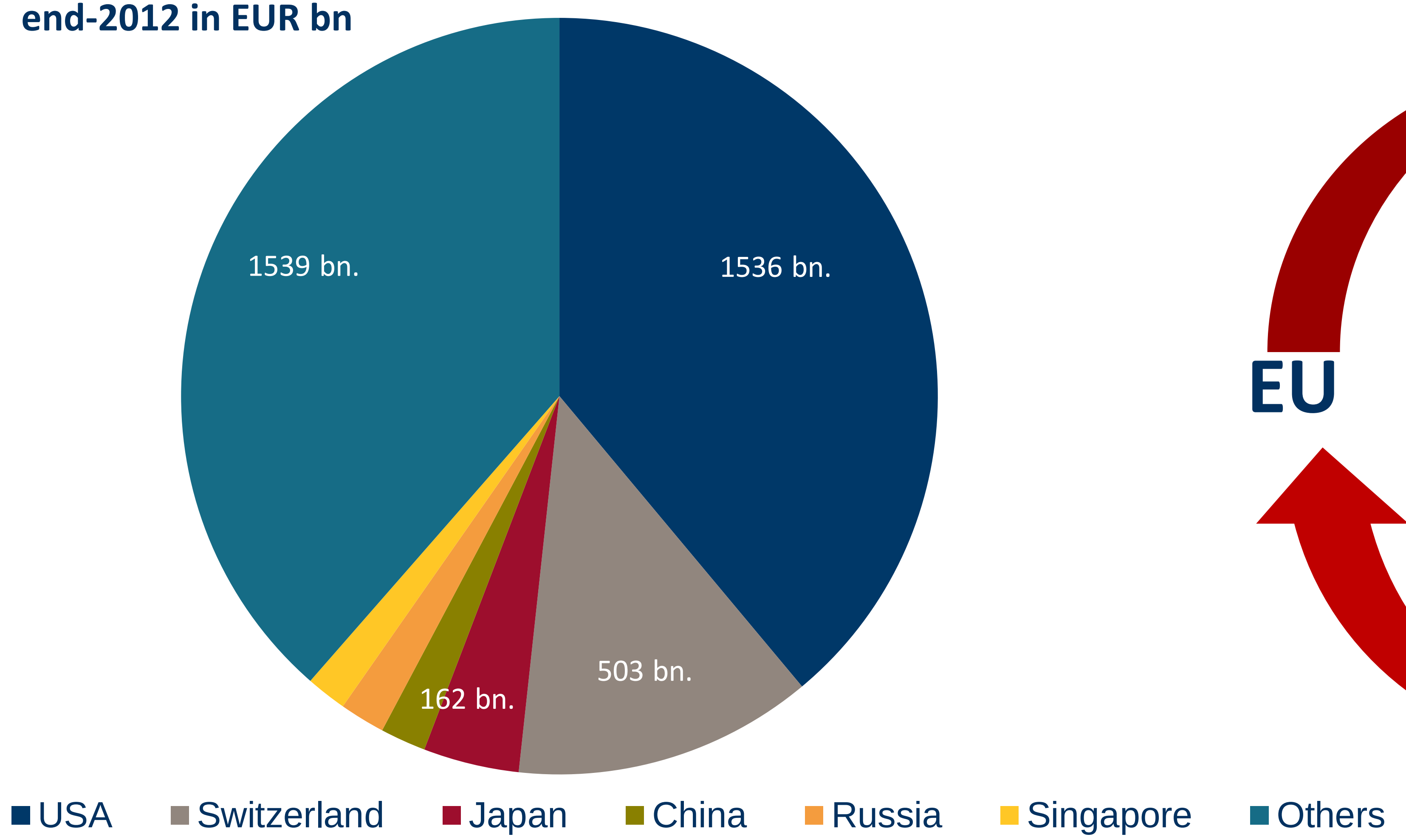
Growth of trade (exports) intra- and extra-EU, annual averages



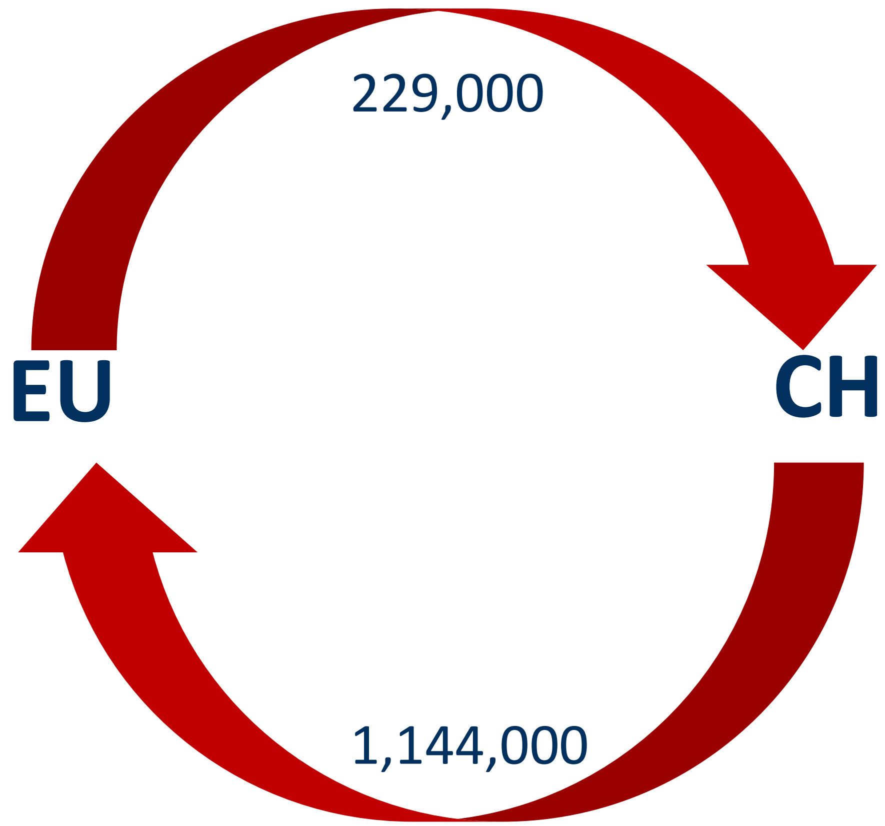
Source: Eurostat (2013)

Capital and labour links

Stock of non-EU foreign direct investment in EU-27, end-2012 in EUR bn



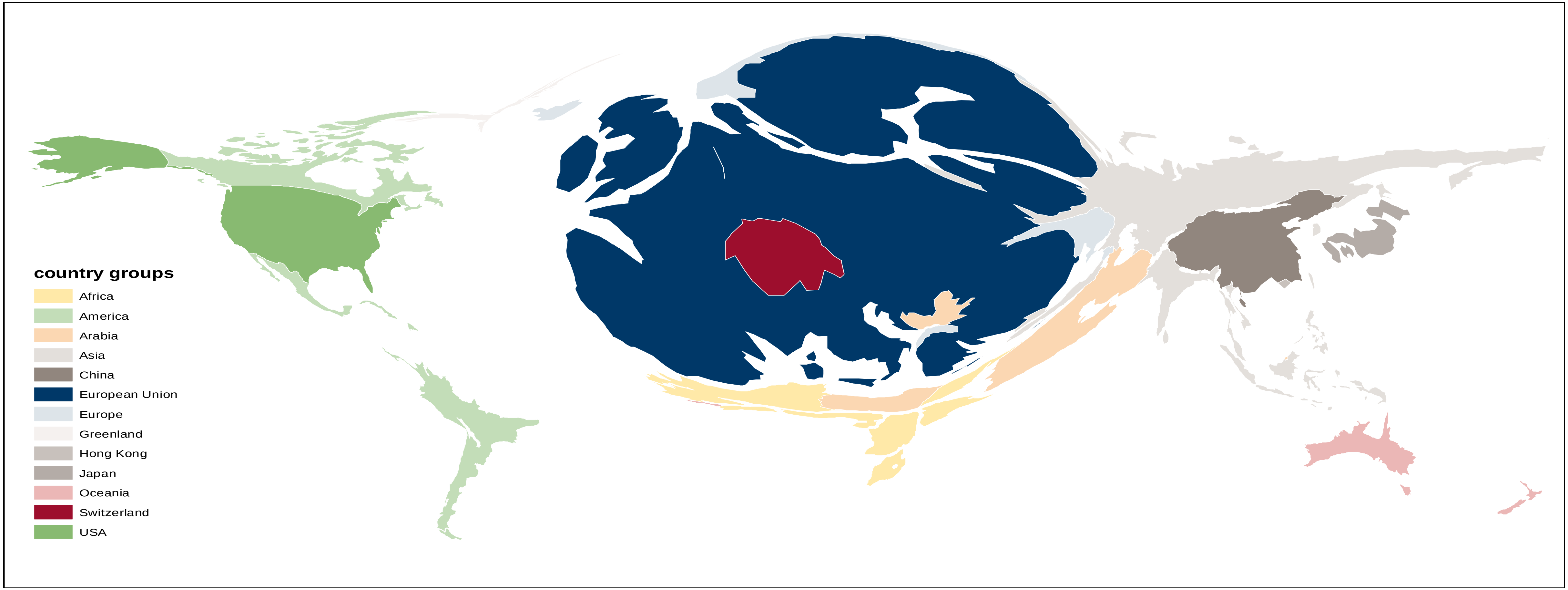
Workers employed in foreign-owned companies



Source: Eurostat (2012)

An EU trade-adjusted world map

Areas sized by EU exports to countries/regions



Source: Federal Customs Administration (2013), Credit Suisse

Non-EU partners can play a vital role in the region's recovery and development

- Efficient and robust markets, both within the EU and beyond, are needed for Europe's economy to thrive
  - The Banking Union (BU) will contribute importantly to this process as it develops into a common approach across the major economies
- Capital Markets Union (CMU) offers the opportunity to open up other, non-bank sources of saving, both to finance investment and thereby increase the region's resilience to shocks
  - It is best conceived, developed and implemented in conjunction with key partner economies
- Europe's external partners contribute significantly to EU economic activity and welfare, bringing both direct and indirect benefits through trade, finance and employment
- A small number of countries are disproportionately important
  - The top three non-EU destinations for EU goods and services are the USA, Switzerland, and China
  - One-third of EU countries' FDI comes from outside the EU, with Switzerland and the USA at the fore

Recommendation #1
Promote open and transparent markets!

➢ At EU level

- Complete the internal market
- Focus on effective and consistent implementation of single rule book by ESAs
- Assess impact of new regulations on capital market flows inside and outside the EU

➢ At international level

- Seek ambitious trade deals with key partners - especially with the US in the context of TTIP
- Encourage internationally recognized standards, implement them effectively and consistently as was the case for the OECD standard on Automatic Exchange of information in tax matters
- Support work by IOSCO, OECD and Basel Committee and stick to agreed standards

Recommendation #2
Policies should deliver both growth and stability!

➢ At EU level

- Minimize differences between Euro-zone and non Eurozone countries when implementing the Banking Union
- Adopt a cooperative approach, to avoid risk of fragmentation within the EU

➢ At international level

- Promote cross-border capital flows, collateral use and lending
- Promote regulatory coherence based on the lessons from EMIR & Dodd-Frank etc.
- When revising CRD, address discrepancies between EU rules and global standards

Recommendation #3
Capital Market Union can become a game changer!

➢ At EU level – focus on European debt and equity markets

- Encourage transparent securitisation, recalibrate ABS treatment in CRD & streamline existing reporting requirements; consider public guarantees to stimulate SME securitisation markets
- Review Solvency II could incentivise long-term investments into infrastructures projects
- Develop a Pan European MTF market for SMEs

➢ At international level - enable long-term investors to fund the economy

- Encourage international investment in private placement through harmonised EU framework
- Avoid geographical bias (i.e. EU focused only) when designing of funding vehicles
- Use European Fund for Strategic Investments to make international investments in infrastructures attractive

Recommendation #4
Cooperate with your main partner countries

➢ At EU level – cooperate with our main partners

- Involve partner countries' authorities in the discussions about CMU to ensure regulatory coherence
- Complete outstanding equivalence assessments and, if necessary, boost resources
- Help partner countries by perfecting the equivalence recognition process

➢ At international level – avoid additional cross-border obstacles

- Assess the impact of new laws on the ability of EU firms to access foreign markets and of foreign firms to access the internal market
- Encourage cooperation between ESAs and international supervisors based on MOUs and regular dialogue
- Explore opportunities to conclude financial services agreements with key partners