EU CAPITAL MARKETS UNION AND IMPLICATIONS FOR THE SMALL MEMBER STATES – CASE OF CROATIA

EUROPSKA UNIJA TRŽIŠTA KAPITALA I IMPLIKACIJE ZA MANJE DRŽAVE ČLANICE – SLUČAJ REPUBLIKE HRVATSKE

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Abstract: *The purpose of this paper is to discuss the Capital Markets Union, newly proposed plan by the European Commission in February 2015 which aims to generate deeper and more connected European capital markets by unlocking non-banking funding for Europe's businesses. More specifically, the paper examines potential effects for the small Member States on the case study of Croatia. Following short introduction, the paper provides an overview of policies and attempts to create the Single market for capital before the 2007 financial crisis. The third part outlines the objectives and surroundings of the Capital Markets Union plan, while the fourth part explores potential impacts of such plan for the small Member States on the case study of Croatia. Section five summarizes the main conclusions.*

Keywords: *Capital Markets Union, European Single Market, European financial regulation, financial crisis, Croatia*

Sadržaj: *Svrha ovog rada je dati prikaz novostvorene Europske Unije tržišta kapitala i identificirati moguće implikacije za manje države članice EU. Unija tržišta kapitala ima za cilj stvaranje dubljeg i povezanijeg europskog tržišta kapitala radi olakšavanja pristupa izvorima financiranja za europska poduzeća i smanjivanju ovisnosti o bankama kao dominatnim izvorima financiranja. Provedbene mjere fokusirane su stoga na uklanjanje barijera koje onemogućuju prekogranična ulaganja u EU i poduzećima otežavaju pristup financiranju. Nakon kratkog uvoda, rad daje povijesni pregled politika i pokušaja da se stvori jedinstveno tržište kapitala u razdoblju prije financijske krize 2007. Treći dio opisuje proces nastanka Unije tržišta kapitala i njene glavne ciljeve, dok četvrti dio istražuje učinke takvih politika na manje države članice na studiji slučaja Republike Hrvatske. Peti dio sažima glavne zaključke.*

Ključne reči: *Unija tržišta kapitala, Jedinstveno tržište EU, europska financijska regulacija, financijska kriza, Republika Hrvatska*

1. INTRODUCTION

The free movement of capital was originally outlined in the Treaty of Rome signed in 1957. After more then fifty years the European policy makers are still working on achieving this goal. On the one hand, single market for capital offers greater diversification in the funding of the economy, better interconnectedness between investors, issuers and intermediaries across the Member States borders and therefore reduces cost of raising capital. On macroeconomic level this leads to greater (highly paid) employment and economic growth and is therefore an

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imperative for EU policy makers. On the other hand, the full integration of the European capital markets was in the past obstructed by various different reasons and obstacles, mostly economic and legal in nature and transformed to political opposition by the Member States governments. For decades, differences in legal systems, corporate governance and company law between Anglo-Saxon and Continental systems seemed too excessive to overcome. However, the strong forces of financial globalization and integration managed to direct the two systems towards convergence and the future looked promising until the beginning of the 2007 financial crisis…

2. EUROPEAN CAPITAL MARKETS BEFORE THE FINANCIAL CRISIS

The founding fathers of the European single market envisioned the place where specialized supply meets sophisticated demand. Free movement of capital represents one of the four freedoms of the European Union crafted with the goal of creating single European market with the smooth flow of goods, services, capital and people. Single European currency and unified regulatory framework were designed to encourage businesses in their cross-border activities on the territory of the EU in order to benefit from the larger economies of scale and consequently improve efficiency of the allocation of resources.

Uniformed business conditions provide reduced operating costs for the European companies while the European Commission continuously promotes competition policy in order to boost competitiveness of the European market and its players. Simultaneously, consumers benefit through greater quality, price and availability of the products and services. Finally, the Single European market aims to create synergistic effect of increased productivity of economic activities for greater potential for growth, employment and prosperity of the national economies and the EU as a whole.

Ivana Bajakić was born in Zagreb in 1975. She graduated from Faculty of Economics University of Zagreb in 1998 and finished her Masters in 2000 at the Faculty of Law University of Lund, Sweden. Since 2000, Ivana Bajakić worked in several different institutions as researcher or advisor: the Economic Institute at the Lund University, the Ministry of Foreign Affairs and European Integration of the Republic of Croatia and the National Competitiveness Council. Since 2007, she works at the Faculty of Law University of Zagreb where she finished her PhD in 2009. She is currently teaching Political Economy and Management and is active in researching and publishing in the area of political economy and securities markets regulation.

There have been numerous empirical research studies on correlation between financial development and economic growth. They showed that efficient and integrated financial markets reduce the costs of funding for issuers of capital and provide higher yields for investors while on the macro level they have positive effect on the economic growth and development (Levine, 1997; Demirgüç-Kunt and Levine 1999; Beck and Levine, 2002; Carlin and Mayer, 1999, 2003). European Commission (2015: 4) observes that despite all the efforts put in by the European policy makers and national government administrations, capital markets throughout the EU remain fragmented and national oriented. The process of European financial integration that was rapidly taking place from the late 1990s was abruptly stopped and took the downturn since the global financial crisis 2007 with banks and investors moving back to the home market (European Central Bank, 2009; European Commission, 2009, 2015).

The starting position back in the 1960's was somewhat similar but for other reasons. For over the twenty years European financial market was synchronized only through principles of mutual recognition, minimum technical standards and home country control (Ferran, 2004: 1-7; Moloney 2008: 11-16). Number of conducted research was devoted to differences between bank-based and market based financial systems as explanatory factor for national governments resistance and opposition for harmonisation at the EU level (Story and Walter in Quaglia 2009: 5). Ferran (in Ferran, Moloney, Hill and Coffee 2012: 17-37) offers an overview of different political, legal and economic theories to explain what she calls "*deep-rooted fundamental preferences*" that disabled harmonisation process from taking place in the European financial markets.

During 1990s, financial globalisation promoted convergence of the two financial systems in the period of relatively stable macroeconomic environment. Technological innovations have led to new, sophisticated financial products and services (e.g. e-commerce, securitization) in the atmosphere of deregulation and liberalization, while development of financial sector and institutions accelerated the process of consolidation and integration of financial markets (HM Treasury, 2008).

The EU competitiveness position, which was getting worse in comparison to Japan and the U.S., has set the political ground for changes (European Commission 2008: 1). The EU policy makers embraced the academic thesis on the relationship between financial development and economic growth and called for wide range of reforms, among which the full integration of financial markets within the EU (Cardiff European Council, 1998: 9).

European Commission (1998: 1) emphasized the benefits of the Single market in financial services: further employment in highly paid jobs, optimal allocation of capital, new business opportunities in wide range of financial services (e.g. mortgages, pensions and insurance), development of small and medium sized enterprises through better funding opportunities and finally economic growth. Quantitative indicators suggested many positive macroeconomic benefits for the EU economy: the level of EU-wide real GDP raised by 1.1%, or €130 billion in 2002 prices, in the long-run, higher total employment by 0.5%, almost 6.0% higher total business investment and 0.8% higher private consumption (London Economics, 2002: 123-124).

The result was a massive financial regulatory reform called Financial Services Action Plan (FSAP) which has been conducted in the period between 1999 and 2005. The FSAP covered four major target areas: (i) finalizing the wholesale market for institutional investors, (ii) developing open and secure markets for the retail investors, (iii) ensuring quality of financial regulation and supervision, (iv) other objectives for the optimization of a single financial market (e.g. reducing the difference in tax treatment between Member States, efficient and transparent systems of corporate governance, European Commission, 1999).

In accordance with the EU's *better regulation* principle, numbers of studies were produced to analyze the impacts of the FSAP process (European Commission, 2005, 2009a; European Economics, 2007; Committee of European Securities Regulators, 2009). Generally, positive effect of the FSAP is that it has created unified regulatory framework, benefiting financial conglomerates with numerous cross-border activities on the territory of the EU. It has however caused regulatory overload at all levels, especially for the national regulatory agencies in charge of the whole implementation process. The introduction of the competition at the securities markets caused some negative effects, such as the fragmentation of the market and liquidity, as well as market trading data, disproportionate level playing field for the financial service providers (stock exchanges, multilateral trading platforms) and in the short term failure to reduce the cost of trading for the investors, caused mainly by enormous investments in advanced technology for high-frequency algorithmic trading (ibid.).

The 2007 financial crisis put an end to one era of conducting business at the securities markets. Predictably, it caused shrinkage of the liquidity and depth of securities markets, spilling-over to the real economy and causing recession in the countries worldwide. World leaders at the G-20 level agreed on the new sets of rules and principles, burrowing previously praised system of self-regulation and introducing new cycle of more regulation and stricter supervision. As some commentators put it: "*it's a shame to waist a good crisis*" (Lannoo, 2009; Coffee in Ferran *et al.* 2012).

3. CAPITAL MARKETS UNION

The EU adopted "De Larosière Report" in 2009 and introduced the new European System of Financial Supervision (ESFS). The ESFS provides micro and macro-prudential supervision and its goal is timely assessment of financial stability offering early warnings of possible systemic risk (European Commission, 2009b). On micro level, three European regulatory agencies (ERAs) were established for different financial areas: ESMA (The European Securities and Markets Authority), EBA (The European Banking Authority) and EIOPA (The European Insurance and Occupational Pensions Authority).

Unlike the U.S., that has passed one regulation (Wall Street Reform and Consumer Protection Act) in 2010, with a goal to unlock "too big to fail" problem, protect consumers and maintain stability of financial system (Coffee in Ferran *et al.* 2012: 334-367), the EU opted for set of legislation and is still undergoing big regulatory reform (Moloney in Ferran *et al.* 2012: 111-202). The jury is still out with regard to effects of the new set of regulation and supervision infrastructure centralised at the EU level, however influential Financial Times described the new set up as "*regulation and institutions on steroids*" (Jeremy Grant in Financial Times, 2010, 2010a).

The new European Commission leadership appointed for the period 2014-2019, under the president Juncker, introduced new term – the Capital Markets Union (CMU). It represents policy for more integrated capital markets with a goal to lower the cost of raising capital and dependence on the bank funding, especially for the small and medium sized enterprises (SMEs) and providing attractive environment for the investors with an aim to boost the real economy sector and EU economic growth (Juncker, 2014: 7).

The European Commission (2015: 2) calculated that EU could have profited from around 90 billion € of extra liquidity available to Europe's businesses in period between 2008 and 2013 if EU venture capital markets were as deep as the U.S. Capital markets in the EU have been expanding during past decades, reaching 85% of GDP in 2007, but have been decreasing since the beginning of the global financial crisis to about 65% of GDP in 2013. The situation across Member States varies greatly in the area of stock market capitalisation from 121-125% for the U.K. and Luxembourg to 4-10% of GDP for the Baltic countries. Europe's businesses have traditionally been more reliant on bank financing, with inadequate availability of credit information for the SMEs which are also in inequitable position in comparison to larger companies (Ibid., p. 7-9).

"*Capital Markets Union is about unlocking liquidity that is abundant, but currently frozen, and putting it to work in support of Europe's businesses, and particularly SMEs"* (EU Commissioner Hill in EC Press Release 2015: 1). In other words, the goal is to improve the investment chain at the EU venture capital markets by easing up the access to funding for Europe's businesses through decreasing reliance of bank funding. Stronger capital markets as sources of financing can have positive effect on the stability of the financial system as whole, attract more investment into the EU and supply more investments for Europe's businesses. The upcoming measures will therefore be focused on removing the obstacles and barriers that are blocking cross-border investments in the EU (European Commission, 2015).

The European Commission is currently conducting public consultations with all stakeholders and interested parties in order to adopt the Action Plan in summer 2015 with measures and timeline for successfully accomplishing the Capital Markets Union within next four years. Short term measures include the following actions: (i) developing proposals for "high-quality" securitisation, (ii) Prospectus Directive review, (iii) standardise and improve credit information on SMEs, (iv) the implementation of pan European private placement regime and (v) support investment in infrastructure projects (ibid., p. 2-3).

The European Commission policy actions could be interpreted as an ongoing promotion of the market oriented system introduced during the FSAP regulatory reform. The proposed measures are intended to encourage stronger development of the capital markets, targeting mainly Continental Europe, as a counterbalance to a strong bank system existing there and dominating the financial markets. Paradoxically, the dominant market oriented system, with its high tech financial innovations of products and services (securitisation, short-selling, credit default swaps, etc.) and, in all honesty, together with few other simultaneous occurrences such as inadequate supervision, self-regulation, asymmetry information, monetary policy, moral hazard, etc. led to the global financial crisis. In the end, it seems that the poison which has caused the disease will take its share in curing it as well.

4. IMPLICATIONS FOR SMALL MEMBER STATES – CASE OF CROATIA

European continental economies, including Croatia, are considered to have bank-based financial system, with dominant role of banks in mobilising capital and promoting economic activities (Demirgüç-Kunt and Levine 1999; Dalić, 2002). The Capital Markets Union continues to promote the market oriented system as efficient engine for growth introduced during the FSAP reform and recently stressed by the Commissioner Juncker – it aims to further decrease reliance of Europe's businesses on bank-funding.

The total loan outstanding of the Croatian credit institutions at the and of 2014 amounted to 280,1 billion HRK out of which 92 billions were loans to companies (29,2 billion HRK denominated + 62,8 foreign currency denominated loans, in Croatian National Bank, 2015:

39). The equity value of all 904 joint stock companies registered in the Central Depository and Clearing Company is estimated at the level of 271 billion HRK (Central Depository and Clearing Company, 2015: 1). Out of this amount, 46,5% of the total joint stock companies are listed and traded at the Zagreb Stock Exchange, which amounts to 126 billion HRK at the end of 2014 (Zagreb Stock Exchange, 2015: 4-8). These companies are able to attract new capital in the regular process of secondary public offering without cumbersome procedure of introducing itself at the stock exchange.

Although the statistics for aggregate value of limited liability companies' equity is scarce, the statistics from the above mentioned sources points to leverage ratio of 25,3% (i.e. for each 3 HRK of capital 1 HRK of debt is used to finance companies). This calculation does not take into a consideration a total capital of limited liability companies which would decrease the leverage statistics. This indicates that the Croatian joint stock companies are not highly leveraged and that a banking sector in Croatia has a lot of potential to grow its lending business. Still, at the end of the first quarter of 2015 the total of 6-8 billions HRK of banking sector available assets is presently being unused in the non-bearing interest account at the Croatian National Bank (CNB, 2015a, slide: 24).

The overall profit of all Croatian companies in 2014 was estimated at 14 billion HRK, which makes it 200% higher than in 2013 (The Croatian Financial Agency, 2015). However, the major problem of Croatian economy is low profitability of undergoing investments. This raises a question of how could the Capital Markets Union project help the Croatian economy?

Currently in Croatia, the SMEs segment equity financing is very narrow. It consists only from the entrepreneurs' contribution with negligible contribution from the private venture funds or other sources of alternative investments. There are only seven venture capital funds with negligible 743 millions HRK under management (The Croatian Financial Services Supervisory Agency, 2015, tables: 38, 39). As mentioned earlier, The European Commission calculated that EU could have profited from around 90 billion € of extra liquidity available to Europe's businesses in period between 2008 and 2013 if EU venture capital markets were as deep as the U.S. The deepening of the liquidity for the SME's via introduction of cross border venture capital incentives should be one of the most beneficial factors for the small Member States.

The European Union recognizes the lack of equity financing for the SMEs in the small Member States. Therefore it encouraged through different measures - grants and subsidies as a form of quasi-equity for the SME sector. In Croatia, soft financing is covered through different ministries and agencies: the Ministry of Entrepreneurship and Crafts through its entrepreneurship impulse which was in 2012 at 166 mil HRK (CEPOR, 2013: 53), the Croatian Employment Agency through its subsidies for new employment, Ministry of Tourism with its co financing project for tourism, Ministry of Regional Development and EU funds with its funds for regional development, Ministry of Agriculture and Agency for payments in agriculture with number of subsidy programs as well as other ministries and agencies (HAMAG BICRO, 2015).

In 2012, the total subsidies for the SMEs amounted to 938 mil HRK including 234 mil HRK de minimis subsidies (the Croatian Competition Agency, 2013: 43). In addition to subsidised loan programs through the Croatian Bank for Reconstruction and Development, a guarantee program of 946 mil HRK through Agency for SMEs increased total investments in SMEs at above 3 billion HRK in the period 2012-2014 (Ministry of Entrepreneurship and Crafts, 2015:

7). In the period 2014-2020, Croatia is entitled to receive up to 79 bn HRK from the European structural investment funds out of which 64 bn is to be used for the economic growth and employment. The total amount in the period 2014-2020 which will be used for the SME development is estimated to 7,4 bn HRK through the Competitiveness and Cohesion Program (ibid., p. 8).

The overall picture for the small EU Member States is that it will increase soft subsidies as a form of equity financing for the SME sector. The Commission's intention to increase possibilities for the equity financing for SMEs through the Capital Markets Union will benefit SMEs in the small EU states, but most likely will not surpass the existing form of financing. The major financing will come in the form of subsidised loans and grants (as mentioned around € 1bn in the period 2014-2020) and less through the capital markets infrastructure. However, the privatization of state held companies and fiscal accommodation for the capital markets could further develop capital markets form of financing the SMEs in the long run.

The European Commission short term measures (securitisation, Prospectus Directive, etc.) are not likely to contribute significantly to the Croatian situation. The Croatian financial system is already highly liquid with between 6-8 bn HRK available for profitable company financing. The problem is that companies do not have enough profitable projects to satisfy this credit supply. The securitisation of current business would only increase already high liquidity in the banking sector. If the Prospectus Directive decrease requests for SMEs in order for them to get easier access to capital markets, there will still be an open question if investment opportunities will be able to attract already available capital.

As regard to improvement in credit information for the SMEs, the Croatian National Bank imposed rules to credit institutions to publish effective interest rate in order to allow debtors to compare offers from the credit institutions. However, this rate is in practice misused by the credit institutions due to other factors which are not calculated in the formula (e.g. exchange rate for loans and foreign currencies). In Croatia, private placements are already covered by the high net worth individuals (e.g. "business angles" and institutional investors). Overall, the liquidity in the Croatian market assists all good investments to be financed. The open space remains for Croatian investors to start investing abroad via European private placement markets. The transparency and the language represent main obstacles for implementation of this type of projects.

5. CONCLUSION

The Capital Markets Union intends to foster opening up of national markets for investors, issuers and intermediaries by encouraging free movement of capital and providing best practices know-how of the EU Member States. Furthermore, the objectives of the Capital Markets Union include: improving access to financing for Europe's businesses, especially SMEs and infrastructural investment projects, increasing and diversifying the sources of funding from investors in the EU and the rest of the world and finally, improving stability and resilience of the financial system.

In the small Member States such as Croatia, the majority of financing is still coming through subsidy loans and grants and less through the capital markets infrastructure. Therefore, on the one hand, the European Commission's measures such as securitisation and Prospectus Directive do not match Croatian economy's needs at the moment, however, the implementation of some measures could guide Croatian financial system towards more transboundary economic activities and European financial integration.

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