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The Capital Markets Union —Big Opportunities, Many Unknowns

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The European Commission plans to integrate the capital market, which should increase the scale of investment in the EU. Public consultations on this issue run till 13 May 2015. Many details still remain open, but even now one can see its importance for Poland. The Capital Markets Union can facilitate the financing of innovative companies and help overcome the so-called middle income trap.

The Capital Markets Union is a project of the European Commission (EC), aimed at the integration of the EU's capital market. This project is subject to the economic growth and jobs agenda through the planned facilitation of financial transactions, and it is welcomed by non-governmental organisations and the financial market experts. The EC's preliminary plan lists five short term goals: facilitating access to financing from the (commercial) market, increasing the number of entities that invest in small and medium-sized enterprises (SMEs), regulating securitisation, completing the regulatory framework for long-term investment in infrastructure, and the development of private placement markets. The long-term solutions (from 2019) are not yet known, but It is expected that they will support diversification of the forms of financing for business, and improve access to capital for SMEs.

For countries with developed capital markets, a hot topic would be state supervision of the financial sector and freedom of cross-country investments to maximise profits. However, for the countries of Central and Eastern Europe, including Poland, a key issue is to finance young, innovative companies, to help these countries in building knowledge-based competitiveness.

A Development Opportunity for Central and Eastern Europe. The concept of an integrated financial market should be particularly attractive for Poland and other countries of Central and Eastern Europe. They are host countries for capital, either as foreign direct investment or in other forms, such as loans granted by subsidiaries and branches of foreign banks that dominate the domestic market. Their financial markets are shallow compared to other EU countries and, consequently, their economies are heavily dependent on the domestic banking sector, with branches of foreign banks being over-represented. Limited supply of capital is more perplexing there than in other EU countries. Therefore, the establishment of the common capital market and the facilitation of access to this for businesses will be a strong incentive for the development of Central and Eastern European economies.

The most important consequence of improving access to capital in the region is an opportunity to change the model of national competitiveness. CEE states are, for the time being, able to compete because of low labour costs (wages are approx. 30% of the average hourly rate in the EU), but this engine of growth is running down due to the high cost competition from non-EU countries. Poland and other countries in the region should, if they aspire to catch up with Western Europe, become more innovative. OECD studies show small and medium-sized companies, which account for a significant part of CEE economies, have a lot of potential for investment. Unfortunately, according to the European Commission this sector in Central and Eastern Europe slowed significantly during the crisis. Undoubtedly one of the reasons was the lack of external financing for these companies, which resulted in a reduction or cessation of business activity. Also, according to the World Economic Forum, one of the main barriers to economic activity in the region is inadequate access to capital and the inability to innovate.

For Poland, construction of a capital markets union will be important because of the development opportunities for the Warsaw stock exchange, weakened by the outflow of capital through national private pension funds. The stock exchange, thanks to the integration of the capital markets, would become more accessible to foreign investors who want to invest their capital in an area with relatively more prospects than the mature Western markets. It can also become a more attractive place to make initial public offerings, both for foreign entities from Central and Eastern Europe countries apart from Poland, as well as for domestic entities.

The Brakes in the Process. The expected results may, however, not occur if the reform and integration activities prove superficial. It is difficult to rule out such a risk, for the process of building an integrated capital market is undoubtedly a major challenge for the EU institutions and is associated with several problems. The largest is the harmonisation of national bankruptcy and restructuring laws, a process which is questioned by EU Member States. The same applies to the harmonisation of tax regulations that affect the framework for the functioning of capital markets. An example of the lack of consensus on the introduction of a pan-European financial transaction tax is indicated by possible minor concessions by the Member States to transfer fiscal competences to EU level. In addition, Member States are reluctant to give away powers in the area of finance, and maintain barriers to payment services, settlement and custody. Therefore, although the EU has introduced regulations unifying the European capital market since the 1990s, it still falls far short of full integration.

Another problem is the safety of forms of financing other than those offered by the banks. The banking sector is subject to prudential regulations (for example, the Basel III regulatory package, which regulates the risk management and capital requirements of banks), but also to the Banking Union framework, poses less risk to investors than do other financial institutions. On the one hand, financial shock resistance increases through diversification of funding sources, but on the other hand, the growing importance of financing that is less secure than that provided by banks in the EU increases the systemic risk. In addition, the emergence of an integrated capital market still raises the risk of asset bubbles, one of the causes of the current financial crisis in the Eurozone.

But even the creation of an integrated capital market would not mean a complete solution to the problem of the shortage of capital in the Central and Eastern Europe region, because the markets can simply evaluate the region as an unattractive place to invest due to, among other reasons, the currency risk. Moreover, the increased mobility of capital may also have negative consequences for the region. For example, the probable asset bubbles or increased outflow of speculative capital in times of increased uncertainty in the markets will pose a serious risk of destabilising the economies of countries struggling with a lack of capital.

Room for Manoeuvre. The early phase of work on the construction of the union of capital markets gives Poland a chance to influence the final shape of the project. Of particular importance, in addition to access to the funds, is the issue of transparency in the capital market and the maintenance of a minimum level of control over cash flows through national financial supervision. In terms of market transparency, Poland should safeguard a limitation to tax avoidance or tax fraud. In addition, the national supervisors should, within this framework, be able to prevent too rapid capital flight, as well as the formation of bubbles.

The Polish government should, however, pay attention to solutions facilitating the financing of small and medium-sized companies, as they make up 70% of GDP. They currently experience the biggest constraints in financing for business plans. This particularly applies to innovative companies, which are crucial for strengthening the construction of a new model of competitiveness. Poland has the potential for innovation growth due to a high level of education at technical universities, but this does not translate into the commercialisation of innovative technological solutions. For example, less than 1% of all patents filed at the European Patent Office come from Poland. A major barrier to the development of innovation is the lack of capital for young companies, which in consequence halts the commercialisation of innovations by such companies.

In this context, access to inexpensive venture capital is important. Currently, this market segment is underdeveloped, as evidenced by the negligible (0.5%) share of the Polish market in the European private equity/venture capital market. This comparison is even more unfavourable in relation to the United States. This translates into high costs and a small number of companies using this financing. Access to it through an integrated European market will provide a stimulus for the number of innovative companies to expand, and raise the competitiveness of prospective industries in the domestic market.