

Presidency Issues Note for Working Session I: **FINANCING EUROPE'S FUTURE GROWTH**

Introduction

In the past 15 years, the EU has dealt with several crises such as the global financial crisis, the sovereign debt crisis, the COVID-19 pandemic, and the Russian invasion of Ukraine. At the same time, it is important to maintain a focus on elements underpinning our long-term prosperity, in particular the green and digital transitions and our international competitiveness. To be successful, we need to ensure that innovation in the EU thrives. In the context of the capital market, this means ensuring that our less established innovative companies have access to sufficient private capital to develop into internationally competitive companies.

Financing innovation

Although there are innovative companies of all sizes, this discussion will focus on the less established innovative companies that have fewer financing options. From the investor's perspective, these companies entail higher risk but often a higher potential return. In the early phases, such companies can rely on angel and venture capital as well as bank venture lending. As they grow, they increasingly rely on regular bank loans and non-venture equity capital. Established companies can rely on direct borrowing through corporate bonds or public listings.

The availability of pre-IPO capital¹ has increased in the EU over the past decade. In particular, venture capital activity increased by 305 per cent between 2014 and 2021.² The improvement partly stems from reforms over the years, at both EU and national level.³ While this

¹ Pre-IPO risk capital refers to the sum of equity crowdfunding, business angel, venture capital (VC) and private equity (PE) investments.

² Source: *The politics of EU capital markets*, New Financial (2022).

³ At EU level, reform initiatives have focused on both strengthening the financing of early stages of company development (e.g. improving crowdfunding) and more general reforms to strengthen the capital market (e.g. listing act).

development is positive, pre-IPO capital to GDP invested in the EU in 2021 only represents around 7 per cent of investments made in the United States.⁴ Furthermore, capital availability is still highly fragmented in the EU. In 2021, six Member States accounted for 86 per cent of pre-IPO risk capital.⁵

In the EU and its Member States, a number of publicly funded institutions, such as the European Investment Fund, provide capital and mobilise private capital to innovative companies. These institutions have a role to play, especially regarding the financing of deep-tech companies,⁶ which entails higher risk-taking and longer investment horizons. However, experiences from the US market show that these investments can also be made by the private market.

The EU's capital market(s)

The overall size and structure of the capital market are also relevant for less established innovative companies. For instance, increases in the number of IPOs and use of corporate bonds free up resources in earlier financing phases, such as bank borrowing and private equity. The good news is that the EU's capital market has increased in size and depth over the years. Its depth has increased by 29 per cent since 2014, the year the Capital Markets Union (CMU) was first announced.

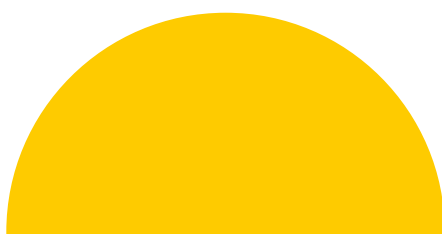
However, despite the many reforms in the CMU, the EU still clearly lags behind other jurisdictions with the UK capital market being nearly twice as deep and the US capital market a full four times deeper.⁷ Reforms that can help increase the size and depth of the EU's capital market are therefore still much needed. In terms of structure, the EU is highly dependent on bank lending, and less reliant on listed equity and corporate bonds than other jurisdictions. This dependence is especially problematic when banks are under pressure. However, it also

⁴ Source: *Time to re-energize the EU's capital markets*, CEPS (2022).

⁵ Source: *Time to re-energize the EU's capital markets*, CEPS (2022).

⁶ Deep tech generally refers to startups with the objective of providing technology solutions based on scientific or engineering challenges. This requires lengthy research and development, and large capital investment before commercialization.

⁷ Source: *The politics of EU capital markets*, New Financial (2022). Here, depth is measured as value of activity as a percentage of GDP. A frequently used measure is the market's ability to absorb relatively large market orders without significantly impacting the price.



underlines the EU's significant potential to increase diversification in the funding of firms. The EU's capital markets are highly fragmented, with large differences in size to GDP and depth. The fragmentation underlines the need to continue CMU reforms, but also for Member States to continue to strengthen their national capital markets.

New economic reality

We have now departed from more than a decade of low, at times even negative, policy rates and quantitative easing. During this period of 'cheap money', investments have surged and the willingness to take on risk in the search for return has been strong. The rapid increase in inflation has triggered central banks to increase policy rates substantially. This has sent company valuations tumbling, substantially increased the cost of financing for companies and reduced the willingness to take on risk. The question now is, when will policy rates decrease again, and to what level? Many argue that we will not see a return to the near-zero policy rates; this will have implications for the availability and price of financing.

Questions for discussion:

- Is the last decade's growth of the EU's capital markets mainly due to structural reforms or accommodative monetary policies? What are the financing prospects for our less established innovative companies given rising interest rates and recent financial turmoil?
- To ensure that the EU catches up in ensuring private capital to less established innovative companies to drive growth and jobs, where should we focus our efforts in strengthening the EU's capital markets?
- What can the EU do to attract global capital to enhance our future growth? How should this be balanced with the need to ensure a level of strategic autonomy in an open economy?

