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Finance for Europe

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The importance of equity markets for Europe's economy

Association for Financial Markets in Europe
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Introduction

Growth in the European economy remains subdued and unemployment rates high. In order to return economic growth to a strong and stable footing, European companies need to make full use of all available funding options.

Equity and equity markets represent a key funding option, which is not being used to its full potential in Europe. Equity capital complements funding sources like bank and non-bank loans and alternative sources such as bond financing, invoice financing and export finance through its ability to support different business risks. It comes from various sources such as family and friends, venture capital and private equity providers, business angels, crowdfunding platforms or public markets in the form of private placements or public offerings. Equities and equity markets can fund the growth of European businesses and create jobs.

Europe needs healthy equity markets. They provide the region's companies with long-term capital for growth, leading to higher levels of economic activity, greater wealth and more jobs. Equity capital is particularly important for funding companies in high-growth sectors such as technology, communications and energy. Yet equity markets remain under-developed, weakening the region's economic potential.

Turning to savings, it is important to stress that equities have historically generated higher returns than other asset classes.

Several important regulatory proposals are currently being developed that will influence the role of equity markets in the future. The most notable of these is the European Commission's initiative for a Capital Markets Union. It provides an ideal opportunity to help ensure that equity fulfils its potential as a crucial source of capital.

The importance of equity markets

- Equity markets play an important social and economic role. Complementing bank finance as a source of capital, they foster Europe's economic development and employment, especially in high-growth sectors such as technology, communications and energy. Healthy, sufficiently large equity markets are essential for economic competitiveness, wealth creation and employment growth.

- Companies can gain access to the long-term capital they need for innovation, value creation and growth from equity markets. Equity markets channel capital directly from investors to companies, accessing sources of capital not open to banks. Moreover, equity investment is more suited to taking the risks necessary to grow businesses.

- Equity markets also provide an essential asset for saving. Over the long-term, equity markets have delivered the highest returns of all conventional, liquid asset classes. Having diverse, liquid equity markets provides greater opportunity for investors such as pension funds. This is important at a time when Europe – like other developed economies – faces a challenge funding retirement.

- A comparison with the US shows the possibility for Europe to increase the size of its equity markets, improving the balance between equity and debt funding. In 2015, US equity market capitalisation represented 159% of GDP, whereas Europe's was just 73.3%. If Europe's market capitalisation-to-GDP ratio were to rise to 100%, more than €3.5 trillion in additional equity capital could be deployed in European companies.

- The European Commission's initiative to develop a Capital Markets Union presents an opportunity to increase the role of equity markets in funding the region's economy.

Funding growth, creating jobs

Europe's equity markets give businesses access to the capital they need for innovation, value creation and growth. Each year, companies raise billions of euros of equity capital that complements the debt in their capital structures. Because it is long-term capital, equity allows companies to take a longer-term approach to the pursuit of growth. As businesses grow, they contribute wealth to the broader economy.

Equity capital encourages companies to grow. Unlike bank loans or bonds, equity capital never has to be repaid. It is permanently in place, giving managers the confidence to design and execute long-term plans. It encourages long-term investment in research, development, intellectual property, human capital, machinery etc, which will have a long-term positive impact on jobs, consumption and tax collection.

Equity markets are, arguably, more important than ever for Europe's economy. In spite of improving economic data, unemployment remains high across the region. Furthermore, equity capital is critical for funding the high-growth, high-risk companies that are major job creators.

A healthy equity market helps to create jobs. Businesses have tended to grow far more quickly after raising capital on equity exchanges, with corresponding expansions in their workforces. For Europe to tackle its jobs crisis, small-and-medium sized companies must have access to equity funding. Often, SMEs are the fastest growing companies and create the most new jobs. Several stock exchanges in Europe exist solely to fund these young companies.

Delivering investment returns

Equities are a vital asset class for investment. They have tended to deliver higher long-term investment returns than other asset classes, such as bonds or cash. At a time when Europe faces a challenge funding the retirement of its growing population, equities' typically superior returns are an invaluable part of the investment mix for pension funds.

The strong long-term returns of equities are well documented. Over the past 50 years, for example, European equities have delivered an average 6.0% return each year, compared with 4.9% for bonds and 0.9% for cash (in US dollars, after discounting inflation). This performance makes equities a suitable investment for pension funds, which have long-term liabilities.

With Europe facing a 'pensions time bomb', the potentially superior returns of equities have a particularly important part to play. Ageing populations are putting Europe's state and corporate pension systems under pressure. As the post-war baby-boomer generation starts to retire and the working population shrinks, Europe's state pension systems will struggle to maintain payments, while people aren't saving enough to supplement them.

Saving more, and maximising the returns on those savings, is clearly an important part of the solution.

Secondary markets

Equity markets are venues that match buyers and sellers. They set prices for companies' shares and provide a liquid market. Ideally, confidence in the market leads to a virtuous circle developing, in which liquidity grows and prices become more accurate.

Equity markets take the form of either stock exchanges, MTFs or over-the-counter markets. The equity market is one of the most vital components of a free-market economy, as it provides companies with access to capital in exchange for giving investors a slice of ownership in the company.

Smaller companies in particular rely on the support of brokers in the form of market making and research. Research distributed by brokers helps to inform investors about a company's progress and prospects, again helping liquidity.
Europe's stock exchanges have set up a number of growth markets dedicated to financing and promoting small and mid-sized stocks. These include London's AIM market, AIM Italia, NYSE Euronext's Enternext, the Frankfurt Stock Exchange's Entry market, Nasdaq's First North serving the Nordic markets and Spain's Alternative Stock Market.

For a more comprehensive analysis, please read AFME's publication "*Why equity markets – The heart of Europe's economy*" (December 2015).

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