Europe's Role in International Financial Markets After Emu

Barry Eichengreen
International Monetary Fund[1]
October 1997

Emu, it is now fashionable to assert, will be the most important event in the evolution of the international monetary and financial system since the breakdown of Bretton Woods.[1] As the currency of the member states of the European Union, it will be the basis for transactions in an economic zone with a gross domestic product greater than that of both the United States and Japan. As it becomes the currency of denomination for foreign investment into and by the European Union and the invoicing currency for its international merchandise transactions, the euro will emerge as one of the world's leading reserve and vehicle currencies along with the dollar and the yen.

These developments will allow Europe, it is hoped, to rival and even surpass the United States as a financial center. Countries, or more precisely cities within countries, become financial centers when their markets in financial assets are deep, liquid, and stable. Status as a financial center, once acquired, thus tends to sustain itself. When a country succeeds in attracting a critical mass of transactions in the relevant securities, other investors bring their business there to take advantage of the liquidity and depth of the market. Incumbency is an advantage, and the United States is the leading incumbent financial center.

---

[1]Prepared for presentation to the DG Bank-Euromoney Conference on EMU, Frankfurt, 28-29 October 1997. The author is Senior Policy Advisor at the International Monetary Fund, on leave from the University of California, Berkeley. None of the opinions expressed are necessarily those of the IMF.

But Emu, it is hoped, might be a sufficient shock to the status quo to vault the EU into first place in this competition.

The obvious indicators of financial depth bode well for these aspirations.[2] The introduction of the euro has the potential to create the largest single financial market in the world. The market value of the bonds, equities and bank assets issued in EU countries amounted, at the end of 1995, to roughly $27 trillion; the comparable figure for the United States is $23 trillion. Were Emu to include only the "Baffling Countries" (Belgium, Austria, Finland, France, Ireland, Luxembourg, the Netherlands and Germany) plus the three "Club Med Countries" Portugal, Spain and Italy, it would still equal the size of the U.S. market. Were it to include only the Baffling Countries, it would be only two-thirds as large, but the market value of issues would still exceed that of Japan.

At the same time, there are important differences between Europe and the United States in the relative importance of bank and nonbank assets. At the end of 1995, bank assets comprised more than half of all outstanding financial assets in the 11 aforementioned EU countries, whereas in the United States they accounted for less than a quarter. The securities issued by the EU 11 (stock market capitalization plus public and private debt) amounted to a mere 50 per cent of those outstanding in the United States ($9 trillion versus $18 trillion). It is particularly unusual for European companies to issue the kind of short-term obligations that in the United States provide the basis for the highly-liquid commercial paper market (U.S. commercial paper accounting for more than half of the world's total).

These differences in asset composition mean that from the standpoint of creating a deep and liquid market in securities -- corporate securities in particular -- even a Europe with a single currency will start off behind the United States. And in contrast to markets in public

debt, which are integrated internationally, Europe's markets in corporate debt are still segmented nationally. All but the largest corporations borrow almost exclusively from domestic sources. The European market in corporate paper is decidedly less deep and integrated than that of the United States.

Of course, this is what Emu is supposed to change. By eliminating currency risk and reducing transactions costs, it will create a Europe-wide market in corporate debt. And the likelihood that the ECB will use repurchase agreements to implement its monetary policy will encourage the development of an Emu-wide repo market. I am not about to suggest that Europe's tradition of bank-based finance will be driven out of existence by the "Anglo-Saxon" alternative of securities markets, but in fact there has already been considerable movement in the direction of greater reliance on bond and equity finance in some Continental European countries, most notably France.[3] For optimists this bodes well for the emergence of the European Union as an international financial center.

So far so good. But the tale I have just told, which is familiar in its outlines, in fact misses the critical factors that will determine whether the EU becomes a financial center to rival the United States. Accounts emphasizing incumbency advantages are too mechanistic; incumbency may be helpful, but it is neither necessary nor sufficient for attaining financial-center status. And the size of the financial market that will be created by Emu, while a useful statistic, does not tell us whether the EU will succeed in using that market as a point of attack from which to seize the financial high ground.

Rather, the critical determinants will be the scope of the responsibilities assumed by the European Central Bank.[4] It is assumed that, in line with Bundesbank practice, the ECB will engage in relatively limited day-to-day liquidity management. Following the Bundesbank,

it will provide refinancing to the private sector perhaps once a week, using reverse transactions (repos). While such periodic transactions are appropriate for bank-based financial systems, in which the interbank market can be relied on to match financial institutions with excess demands and supplies of liquidity, securitized financial systems are characterized by more generalized excess supplies and demands. Preventing sharp spikes in interest rates requires continuous liquidity management by the central bank, not just periodic intervention. Admittedly, the ECB will possess other windows at which financial institutions can obtain overnight liquidity, notably a marginal lending window. But the fact that it will not use open market operations to suppress sharp spikes in liquidity means that rates on the relevant instruments will not exhibit the attractive stability of Anglo-Saxon markets. And the activities of the ECB will themselves contribute relatively little to the creation of a stable and active market in the relevant instruments.

A second point is that the depth, breadth and stability of the market will depend on the extent of last-resort lending by the central bank. The Maastricht Treaty does not make provision for last-resort lending and bank supervision by the ECB. It adopts the Continental European model in which the responsibility for bank supervision and support is typically separated from monetary policy and assigned to an agency under the control of the Ministry of Finance.

Actually, this is a bit strong; in nine of the 15 EU member states -- France, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and Britain -- the monetary authority is at least partially responsible for bank supervision.[5] But Germany is absent from this list, and German arrangements were clearly the model for the ECB. The Maastricht Treaty had the Bundesbank in mind when it made the ECB subordinate to the relevant

national supervisory authorities. To quote Article 25, "the ECB **may offer advice and be consulted by** the Council, the Commission, and the competent authorities of the EU countries on the scope and implementation of Community legislation relating to the prudential supervision of credit institutions and the stability of the financial system" (emphasis added). But while the ECB will propose, the national regulatory authorities will dispose. It is they who will make supervisory and regulatory policies and implement decisions.

In bank-based financial systems, there is a logic to separating monetary policy from bank supervision. Doing so insulates the central bank from lobbying by large, politically influential financial institutions. And where finance is bank based, there is less need for the central bank to inject liquidity to prevent financial markets from seizing up. To be sure, it may be necessary to prevent problems in a particular bank from leading to a system-wide banking panic, but there exists a variety of instruments for containing the impact of isolated banking problems, notably lifeboat operations by the banks themselves (which are feasible because of the relatively small number of major banks) and recapitalization by the fiscal or supervisory authority.

In contrast, in countries like the US and the UK with highly securitized and liquid financial markets, the central bank has repeatedly acted as lender of last resort. Recall the 1980 Penn Central bankruptcy, which caused a liquidity crisis in the U.S. commercial paper market, or the 1987 stock market crash. In 1987 the problem was that floor traders lacked the liquidity to keep up with the flood of sell orders. Unprecedented order imbalances in several large stocks delayed openings on Monday, October 19th for as much as two hours. And once trading in those securities opened at drastically reduced prices, investors found themselves

forced to sell out by margin calls. Traders who might have wanted to purchase securities whose prices had fallen lacked the liquidity to do so, and other investors, having purchased on margin, had no choice but to redouble their distress sales as the market continued to fall.

One can imagine how a total meltdown might have resulted. Fortunately, the Fed was quick to act. It provided liquidity to the banking system, which passed it through to its dealer/trader customers. Over the two subsequent weeks the Fed pumped up the monetary base at an annual rate of 40 per cent.

The lesson of this episode is general.[6] History shows that securitized financial systems, to be stable in the face of sudden movements in asset prices, need governmental authority with the ability to backstop the market. This is the case in the both U.S. and the UK, where securitized finance is well advanced. Indeed, the United States acquired its role as a major player in international financial markets only after the Federal Reserve System was established in 1913. To be sure, bank-based financial systems can experience contagious losses of confidence with systemic repercussions, but the scope for such problems increases exponentially with securitization.[7]

The Maastricht Treaty says little about the ECB's responsibilities in this connection. Admittedly, it does give the ECB responsibility for promoting the "smooth operation" of the payments system. But how will problems in that system be detected if the ECB has no supervisory responsibility? Will the ECB be prepared to provide liquidity to financial institutions if it lacks timely information on whether they are facing liquidity or solvency problems and it has no basis on which to value the collateral they offer?

Where does this leave us? I am not arguing that securitized financial markets will stagnate in Europe in the absence of continuous liquidity management and last-resort lending

by the ECB. Those markets will develop in response to the same advances in information- and risk-management technologies that have stimulated their growth in the United States. Still, it is unlikely that European securities markets will rival New York in the absence of a central bank which stands ready to backstop the market. Traders and dealers will not undertake business on the scale of their American competitors if they have to raise additional capital because they cannot rely on ample credit lines from their banks, who in turn cannot obtain them from the ECB. And if the asset-price volatility that will result threatens the stability of important financial institutions, regulators will be reluctant to permit securitized markets free rein.

European policymakers are aware of these issues. The question is whether, once Stage III commences, they will encourage the ECB to provide the requisite liquidity-management and backstopping functions. Will the ECB become more responsive to the needs of Europe's growing securities markets, in other words? One possible answer is yes -- that political imperatives to model the ECB's operating procedures on those of the Bundesbank will become less powerful once monetary union is a *fait accompli*. Once German participation in the monetary union is no longer at issue, it may be possible for central banks and officials to make known their preference for a different model.

But another possible answer is no, that the ECB will not move over time toward more active liquidity management and backstopping operations, because its initial approach to monetary policy and the initial structure of European financial markets will become locked in. The dominance of bank-based finance in Europe will encourage the ECB to cater to the needs of a bank-based financial system, which do not include the liquidity-management and backstopping functions required by securities markets. As a result, bank-based finance will

retain a comparative advantage relative to securitized finance, and the consequent persistence of the bank-based system will encourage the ECB to stick to its initial approach. We could have here a classic case of a positive feedback loop. If so, the convergence of the Anglo-American and Continental Europe financial systems could turn out to be much less dramatic than is commonly supposed.

Path dependence does not mean stasis. It does not take an oracle to foresee significant consolidation in the European banking industry. Even granting its disproportionate reliance on bank-based finance, Europe is overbanked. Population per branch is less than half that in the United States. Its banking industry has 50 per cent more employees than that of the United States. Measured on a per-employee basis, staff costs exceed American levels in Belgium, Luxembourg, Austria, Germany, France, Sweden, Denmark, Italy, and even Spain.

This cozy state of affairs is inherited from a past in which European banks were protected from international competition by barriers to entry. Some banks have received public subsidies, for example, German *Sparkassen*, which enjoy a capital guarantee from the municipalities whose residents they serve. Quite independent of monetary unification, European integration has now turned up the competitive heat. Subsidies like the aforementioned capital guarantees are under scrutiny by the EU's competition office. The Community's Second Banking Directive, implemented by the member states between 1991 and 1994, requires national supervisory authorities to accept the principle of mutual recognition of supervision, so that a single "passport" will allow a bank to operate throughout the EU.

Admittedly, barriers to intra-EU competition remain. Banks still find it hard to acquire the information needed to effectively offer the full range of banking services in countries other

than their own. In addition, not all regulatory restrictions have gone by the board. Greece still prohibits foreign banks from engaging in real estate lending. France permits only the Post Office and the *Caisse d'Epargne* to offer tax-exempt savings accounts. In countries with high firing costs, labor-market regulation discourages foreign banks from acquiring domestic financial institutions and downsizing their operations.

Notwithstanding these obstacles, cross-border banking in Europe is on the rise, especially wholesale and investment banking. European Commission estimates suggest a 60 per cent increase in cross-border branches between 1992 and 1995, with British, French and German banks showing the greatest propensity to branch abroad. Cross-border activity through subsidiaries, alliances and joint ventures has been rising as well, although data on its extent are incomplete.

Some of the consequences are already evident. Interest margins have declined, most dramatically in the traditionally inefficient banking systems of Spain, Portugal and Greece. The margin between loan rates and money market rates has fallen for all types of loans, but particularly for corporate customers and especially in Denmark, France, Greece, Ireland and Spain. Reflecting the stagnation of cost-to-income ratios, profits before tax have declined since the second half of the 1980s in Belgium, Finland, France, Germany, Italy, the Netherlands, Spain, Sweden and the UK. As in any industry, this decline in profitability presages exit and consolidation.

Emu will only intensify the pressure. It will make it easier for banks to offer mortgage loans abroad by rendering redundant restrictions which bar banks from denominating these in foreign currency. It will remove the teeth from regulations that prevent insurance companies from holding more than 20 per cent of their assets in foreign currency unless these are

matched by liabilities denominated in those same currencies. It will eliminate much of the revenue European banks derive from currency conversion and foreign exchange trading, activities which have traditionally accounted for 10 to 15 per cent of their profits. As explained above, Emu will intensify the competition banks feel from the securities markets. Insofar as investors find it easier to decipher firms' balance sheets when these are denominated in a single currency, they will have less need to use banks as delegated monitors.

Looking ahead, one should not underestimate the competition European banks will feel from institutions headquartered in other parts of the world. With the WTO pushing for the liberalization of services trade, US banks will find it easier to penetrate European markets. They will have a competitive advantage as a result of the America's head start in Internet-based banking. To be sure, European banks have not been oblivious to the applicability of information technology to retail banking. Their high labor costs have had at least one favorable effect, namely, encouraging reliance on cash machines and other labor-saving technologies. The Minitel system accustomed many French households to banking by computer even before the PC penetrated the American household.

With free trade in services, European banks will be able to purchase the same software as their American competitors. But there are undeniable advantages to be derived from proximity of software development to software application. And the U.S. has a head start in Internet-related software development, reflecting the efficiency of its venture-capital industry, the ease of small firm formation, the flexibility of its labor market, and the connections between its industry, government and universities (where, after all, the Internet originated). If new information technologies are developed first in the United States, they will be tailored to

the needs of American users, and American banks will be quicker to adopt them than their European counterparts.

With all these factors intensifying the pressure on European banks, their regulators will come under pressure to give them a hand. They may be pressed, for example, to offer more generous deposit-insurance protection without requiring the banks to help fund it. Nothing obvious will prevent them: the 1994 EU Directive on Deposit-Guarantee Schemes mandates minimum levels of coverage but does not specify a ceiling. In countries where banks have been restricted to narrow lines of business, regulators may come under pressure to let them branch into less familiar activities involving securities, insurance and real estate. Elsewhere, such liberalization has strained managerial capacity and set the stage for financial crises.[8] While one hopes that Europe will be different, there are grounds for concern.

The problem, at the deepest level, derives from introducing a single market and a single currency but not also a single regulator. As long as national authorities could use policy to construct barriers to entry by foreign banks and as long as separate national currencies endowed domestic banks with subtle competitive advantages in their home markets, the segmentation of banking permitted a certain segmentation of regulation. As the Single European Act and the Maastricht Treaty run their course this becomes less true. Now decentralization of bank supervision and regulation threatens competitive deregulation and confusion about the ultimate locus of responsibility. Here, clearly, is a case where subsidiarity should not be pushed too far.

1. See for example C. Fred Bergsten, “The Impact of the Euro on Exchange Rates and International Policy Cooperation,” in Paul Masson et al. (Eds), Emu and the International Monetary System, (Washington, D.C.: International Monetary Fund, 1997).

2. The discussion here draws on Alessandro Prati and Garry Schinasi, “European Monetary Union and International Capital Markets: Structural Implications and Risks,” IMF Working Paper 97/62, Washington, D.C.: IMF.

3. See Christian Boussieau and Jean Pisani-Ferry, “The Political Economy of French Economic Policy” in Barry Eichengreen and Jeffry Frieden (eds), Forging an Integrated Europe, Ann Arbor: University of Michigan Press (1997), pp.49-89.

4. In developing this argument I draw on the important work of David Folkerts-Landau and Peter Garber, “The European Central Bank: A Bank or a Monetary Policy Rule?” NBER Working Paper no. 4016 (1992).

5. See Charles Goodhart and Dirk Schoenmaker, “Monetary Policy and Banking Supervision,” Oxford Economic Papers 49, pp.539-560.

6. It follows from the 1929 stock market crash, when the Fed also generously injected liquidity to prevent the initial fall in prices from feeding on itself even more alarmingly. See Barry Eichengreen, “1929 and 1987 -- Parallels and Contrasts,” in Eugene White (ed.), Crashes and Panics: The Lessons From History, New York: Dow Jones-Irwin (1990), pp.244-247.

7. David Folkerts-Landau et al., International Capital Markets: Developments, Prospects and Key Policy Issues: Part II: Selected Issues, Washington, D.C.: International Monetary Fund (forthcoming 1997).

8. Barry Eichengreen, “Exchange Rate Stability and Financial Stability,” Institute for Business and Economic Research Working Paper no. C97-092, University of California, Berkeley (1997); Patrick Honohan, “Banking System Failures in Developing and Transition Countries: Diagnosis and Prediction,” unpublished manuscript, University College, Dublin; Morris Goldstein, The Case for an International Banking Standard, Washington, DC: Institute for International Economics, 1997.