THE SINGLE EUROPEAN FINANCIAL MARKET

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The regulators in our midst see the single European financial market as something that will happen as soon as they permit it but not before—all culminating in the *annus mirabilis* of 1992. But the causation of social processes is more complicated. Interests, personalities, technological conditions, institutions, and ideas contribute to the shaping of history, perhaps in that order in time and in the reverse order in importance.

The single European financial market now appears to be in the interest of most participants, but groups and individual personalities still want to control it for their own profit. The technology is irresistibly linking markets, despite institutional barriers. Institutions are being created that are ambiguous in their effects; also ambiguous are the ideas floated. On this count, the expectations ought to be uncertain.

But the die is cast. The single market is already here for many financial activities, and it will deepen and ripen unstoppably during the 1990s and into the next century. Why am I optimistic? I am sorry provisionally to have to give a Marxist (or should I say a Stiglerian) answer: The new information technologies will link Europe with the world financial markets, especially those of America, Oceania, and the Far East, and will make the European financial market part of a global financial market.

What Is Involved

It is not easy to give an idea of the size of the European financial market compared with the markets of the world, especially those

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of America and Japan. These markets involve not only the stock exchanges, which can be measured by capitalization, but also the contributions of banks, perhaps measurable by the netted sum of their balance sheets, the net transfers of the public sectors, and cash. The account is complicated by statistical incompleteness and the dangers of double counting. I will content myself with comparing the stock markets, GNPs, and populations (see Table 1).

There are many reasons for the discrepancies between Europe, the United States, and Japan. I do not doubt, however, that the trend will be for a relative increase of the GNP of Japan and in the size of *integrated* European stock markets. I emphasize "integrated" because the whole point of the exercise is to increase the amount and quality of financial services, however measured, by the creation of a single European financial market.

How far has this integration proceeded? If we start with the tip of the inverted financial pyramid, we see monetary arrangements are still rather compartmented. I do not mean by this that Europe has not yet reached monetary union, nor that the Delors Report is too far from being implemented, especially as regards the creation of a European central bank. Monetary integration for me does not mean regimentation nor "all power to the central bankers." By lack of integration, I understand that exchange controls still exist in many countries of the EEC and some of EFTA: Italy and France are a long way away from uncontrolled short-term money flows, Belgium inexplicably keeps the two-tier exchange system, Spain uses foreign transaction reporting for fiscal control, and Greece and Portugal resist attempts to make them give up smoking.

The situation regarding long-term capital investment is a little better. The recently arrived countries in the EEC retain some control on real estate. Spain has liberalized all exports of capital and all

TABLE 1

EUROPE IN THE GLOBAL ECONOMY, 1989

	Population[a]	GNP[b]	Stock Exchange Capitalization
Europe	409	4,979	1,860
United States	244	4,473	2,481
Japan	123	2,377	3,840

[a]In millions.
[b]Billions of U.S. dollars.
SOURCE: CCF, Iberagentes, *Marchés Européens*.

exports barring four key industries. A recent report of the Brussels Commission, *Creation of a European Financial Area* (May 1988), underlined the existence of indirect ways of affecting capital flows between countries, through tax breaks for buying local securities or regulatory restrictions, such as limiting the proportion of foreign securities to be purchased by insurers or other financial intermediaries.

As far as banks and savings banks are concerned, the competition in the market is making transnational banking a more tangible reality every day. The EEC's first and second directives on banking seem to be helping to even out the playing field between the different countries, but such intervention would not be necessary if the free right of establishment were completely recognized. The Tiebout principle would chastise governments that over-regulate their financial systems, and foreign banks would set up subsidiaries on the strength of their more profitable home head-houses. If, as I suspect, universal banks are not very adept at governing industries, then why bother limiting the amount of industrial shares that a bank can hold? Such a rule only angers the German and the Spanish.

Also, cross-border associations between banks are increasing: Banco Santander and Royal Bank of Scotland: Deutsche Bank acquires Morgan Grenfell; AMRO Bank cum Pierson G. P. work together with Sal Oppenheim: Hambro's, San Paolo, and BBV exchange minority portfolios; and everybody, especially the Spaniards, try to get into Portugal. These are only the arrangements I have been in touch with personally. There are many more.

The stock exchanges are competing and linking with one another. Again, the efforts of the EEC Commission are pathetic. A lot of weight is put on the Interbourse Data Information System, allegedly "to better the transparency of those markets, reduce costs, and improve settlements." They have not heard of Reuters, it appears. In any case, all the exchanges are going through mini-bangs; from what I have experienced in Spain, the customer benefits and the brokers grow white hair, which is as it should be.

The transformation may have some welfare costs, but some of the adduced ones are not attributable to the integration of markets. Thus, there are high and volatile interest rates. These are the companions of the currency serpent, and they would behave differently if the monetary arrangements were freer, both in the sense of freely floating exchanges and *full currency choice.*

The Regulators

As the integration proceeds, it will contribute both to a higher volume of financial transactions and to the productivity and welfare of Europe and the world. This much has even entered the head of the regulators, whether in the Commission or in the capitals of the EEC member nations. Let me put it more kindly, for I do not wish to make a straw man of the Brussels bureaucrat. Some of the regulations issued in directives have contributed to the furtherance of integration, that is, free trade (or in the traditional French phrase, laissez faire).

The application of Article 67 of the Treaty of Rome has been slow, but it took off again with the passage of the Single European Act. The proposed directive is admirable in its brevity:

1. The Member States will derogate the restrictions to the free movement of capital that takes place between persons resident in the Member States.
2. Transfers derived from capital movements will be carried out in the same conditions of foreign exchange as those in practice for the payment of current transactions.

When this is applied and if it is interpreted widely by the courts, the legal basis for a single European financial market will be there.

Some of the compromises arrived at recently are very wise. Thus, the increasingly applied criterion that domestic law is European law does away with the need to hammer out agreed single legal texts. Also commendable is the rule applied to banking by the first banking directive that "the control is that of the home country, the regulation that of the host country."

The Institutions

I have already criticized some of the sillier attempts at regulations, so only the EMS calls for particular treatment here. The best arrangement would be to have freely floating, freely competing national (and private?) currencies. A reverse Gresham Law would apply. Optimal currency areas would appear; optimal currency layers would appear as well, inasmuch as diverse currencies might be used by the same person for different purposes.

The second best arrangement would be immediate currency union, or European Monetary Union (EMU). If total unification is accompanied by free exchanges, free capital movements, and free contracting in any chosen currency (including the payment of taxes), then the situation might be acceptable. Obviously, the central bank of such a system should have to be reliable. (*Quis custodet custos?*)

The EMS halfway house is the third best alternative by far. It is even doubtful that it will lead to the EMU. Milton Friedman has noted the "ridiculous situation" in which adherence to the EMS has placed the European partners of West Germany. No less than 80 percent of the balance-of-trade surplus of the FRG is with other EEC nations. During the first three quarters of 1989, Spain's deficit with Germany was 20.9 percent of its total commercial deficit with the world. Meanwhile, the surplus of Germany with Japan and the United States is almost nil. It is clear what this means: The Deutsche mark is undervalued; it could become overvalued. Herr Pöhl is not perverse; he simply is pegged to other currencies at the wrong rate for political reasons. The justification for the EMS is political; namely, how to get money creation out of the clutches of profligate national governments. I could think of simpler ways to get there.

I am in favor of free competition in currencies, but not everyone is convinced. The main hurdle is the banking regulation and lender-of-last-resort functions of central banks. People are not convinced that a safe European Monetary System can exist without a European central bank. More work needs to be done here, and perhaps the analogy of the Euro-currencies markets might help.

Thought and the Events in Central Europe

I believe that interests are perceived by minds and technology grows out of science, which is in the mind first. I also believe that truth is useful and societies that do the right thing tend to survive. As I heard Gary Becker say recently, the ideologies of the East have crumbled because the capitalist system has been thought out in part and incrementally by many philosophers. If facts help them, it may mean that they were right.

The opening up of Central Europe is jeopardizing the Little Europeans in the train of M. Delors. A larger, freer Europe may be in the making. But the liberals thought of it first.