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**European Monetary Union:  
between the stakeholder and the stockholder  
models of capitalism**

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**Abstract**

From the mid-1980s on a new attitude towards self-determination appeared in Western European integration. With the Maastricht Treaty of 1992 and, later, with the Amsterdam Treaty of 1997 the member countries of the European Community manifested their determination to be active players in the new international order. Accepting and instituting the single market and monetary union constituted, however, a challenge of compatibility between the traditional model of welfare European capitalism and the impositions coming from globalization under the neo-liberal model of Anglo-Saxon capitalism. This issue is examined here under two perspectives. The first reviews the implications which globalization has had on the European model of capitalism and the second the complications for monetary management as Europe moves from a nationally regulated to a union regulated financial structure

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## **Introduction**

The determination of the European Economic Community (EEC) member countries to strengthen their integration, from the mid-1980s on, presented a new perspective to the postwar world. The desire to reach beyond the limits of commercial interests opened the possibility of projecting themselves as a world superpower. The single market and the single currency programs are evidence of the changes needed to orient in that direction the process of integration but they are also evidence of the confrontation between the requirements of integration and the impositions of globalization. This confrontation appears from the challenge of raising the competitiveness of European firms without reducing the welfare of European citizens. The dilemma is that these forces of change threaten to unravel the cozy relations that have existed between governments, banks, companies, and unions that determine the national peculiarities of the European model of social market capitalism.

In this context, two general hypotheses are put forward in this paper. One is that monetary union (MU) constitutes a defensive response to the challenges resulting from the financial and monetary globalization imposed by shareholder capitalism. The other is that MU is a political settlement of the asymmetries in monetary policy decision-making imposed by the role of the Deutsche Bundesbank (DBB), the German central bank, in the European stakeholder model. From these ideas, this paper examines how monetary union constitutes a response to the failure of the regulation of money and finance at the national level in the context of a global economy and how this failure caused negative consequences at the macro level of integration and imposed the need for regulation at the supranational level. To do this I first review the implications of these two models of capitalism and the tendencies in the globalization of finance, and then present a view of financial globalization and social standards. From this perspective I then review the role of financial regulation in European integration with its effects on market efficiency, monetary policy, and asymmetric decision-making. Finally, there are some conclusions.

## **The scenario of change**

The dissolution of the Iron Curtain meant the disappearance of the economic, ideological, and political abyss that divided the European continent for nearly half a century; it also meant the disappearance of the certainties of that half century. Europe, restored to health under the shadow of the nuclear umbrella provided by the US during the cold war, hardly challenged the economic, political, and military order established by the balance of power between the United States and the Soviet Union. However, in 1985 with the onset of Glasnost and Perestroika in the Soviet Union, this balance began a transformation that resulted in the end of the certainties of the economic, political, and military postwar relations. With the disappearance of the need for the nuclear protection of the US, European self-assurance gave impetus to the need for self-determination in priorities and objectives. This European will, clearly manifested in the “Europe 92” and the “Monetary Union” programs, was consolidated with the Maastricht Treaty in 1992 and, later, in the Amsterdam Treaty of 1997.

Europeans set the scenario for a new world balance of power for the twenty-first century, but to make it happen they had to attain a maximum degree of cohesion and political unity. Monetary Union is evidence of this new assurance and self-determination. The single currency was not an original aspiration in the Treaty of Rome of 1957, but in the new world, in the end-of-century economic context, it became not only viable, but necessary. With the Werner Report, at the beginning of the 1970s, a single European currency was a desirable objective, though not a viable option. It should not be puzzling that twenty years later the Member States of the ECC had finally entered the stage of advancing in that direction. The evolution of economic events since the formal demise in 1971 of the fixed exchange arrangements of the Bretton Woods system, and the political transformations in Eastern Europe in the mid-1980s, made this option possible. With active financial markets, like those imposed by globalization, the underlying argument is that the direction in which the exchange rate ought to move is not known because global financial markets make it move in directions scarcely related to fundamentals. In an integrated area like the European Union, global finance with different national moneys created excessive volatility, which was inconvenient for an orderly instrumentation of monetary and exchange policy at the national level; therefore, the need to fix the exchange rates at the community level. This option obliged the member countries of the European Union to establish a supranational structure of regulation by having the money supply under one single authority. In practical terms, this meant moving to MU. As Europeans themselves affirmed, monetary union became a requisite for the consolidation of European integration.

Accepting and instituting the single market and the monetary union challenged the compatibility of the traditional model of welfare European capitalism, and the impositions coming from globalization under the neo-liberal model of Anglo-Saxon capitalism. It has meant advances in solving the polarization between the continental European stakeholder model of corporate governance and the stockholder model that prevails in the United States and the United Kingdom. Equally, it has meant defining the kind of socio-economic order that is to emerge from the confrontation between the forces of globalization and those of integration. To raise the competitiveness of firms was a fundamental objective of these changes, but without making the achieved degree of company success synonymous with the degree of citizens' welfare. It must not be forgotten that "keeping the firm in the family is more important to continental European entrepreneurs than getting rich." (*The Economist*, 1996, p. 16)

### **Models of capitalism**

The immediate purpose in strengthening European integration in the eighties, with the "Europe 92" program, was to overcome the "euroesclerosis" affecting the continent. The combination of slow growth and high unemployment that paralyzed the European economy had to be eradicated. (Rozo, 1993) It was necessary for Europe to regain the capacity for growth by improving competitiveness and by eliminating the technological and economic gap existing with the United States and Japan. A new integrative effort on these lines was congruent with the original objective in the creation of the European Economic Community: improving the efficiency of the economy and increasing the level of welfare and the level of social security of the peoples of Europe. In order to take

advantage of the economies of scale and the high technology content of the digital revolution, reforms were required favoring certain industrial sectors like data processing, office automation, precision instruments, and electrical and electronic instruments. Without these sectors, it is difficult to compete in the international economy (Krugman, 1980, 1983). The purpose and orientation of these reforms was to preserve the social market economy, validating the principles of equality and social welfare. After WWII, these same principles had insured the development of egalitarian societies, without disregard for the market.

In trade, it was indispensable to recover the lost share in international markets, but even more important was recovery of the lost share in the domestic market. In the period between 1979 and 1985, the EEC lost more than 4 percent of its domestic market and 13.5 percent of its external market to foreign competitors (*European Economy*, 1988). It was urgent to strengthen international competitive capacity and the way to do it was by strengthening the domestic competitive capacity. The single market program offered the opportunity to augment productivity in order to improve the levels of competitiveness, but not competitiveness as understood in a narrow and restricted sense, where independent and decontextualised companies, or whole countries, compete against each other. Rather, it was taken in the more comprehensive conception proposed by Cohen, Zysman, and Tyson:

A nation's competitiveness is the degree to which it can, under free and fair market conditions, produce goods and services that meet the test of international markets while simultaneously expanding the real incomes of its citizens. Competitiveness at the national level is based on superior productivity performance and the economy's ability to shift output to high productivity activities that in turn can generate high levels of real wages. Competitiveness is thus associated with rising living standards, expanding employment opportunities, and the ability of a nation to maintain international obligations. It is not just a measure of the nation's ability to sell abroad, and to maintain trade equilibrium.

The single market was thus the door to greater competitiveness and real convergence. The degree of nominal convergence obtained through the "convergence indicators" of the Maastricht Treaty does not speak of the difficulties in attaining real convergence. The struggle to reduce unemployment has had highs and lows; it is not promising and neither is its future perspective if it is accepted that this problem is not cyclical but structural. This struggle exemplifies the difficulty of real convergence. The success with nominal convergence has stimulated the search for a similar approach in achieving real convergence. Thus, the agreement to include the fight against unemployment in the Amsterdam Treaty, and to proclaim the search for a "Social Europe" by an agreement on social policy, become objectives of the new impulse in European integration. This brings to the fore the dilemma confronting the promoters of integration led by Jacques Delors in the mid-1980s: how to deal with the impositions of globalization of the neo-liberal ideology inherent in the stockholder model while at the same time preserving the social market economy prevalent in Europe's integration under the stakeholder model of capitalism.

This dilemma has to do with the way institutional subtleties affect the practices and functioning of firms and constitutes one of the principal differences between continental

European capitalism and Anglo-Saxon capitalism. The latter, the stockholder model, as a market-oriented system, promotes loosely defined relations between finance and corporate management, a predatory competitive behavior reinforced by the dynamics of the modern practices of mergers and acquisitions and the supremacy of shareholder control. These characteristics have their bases on the priority given to individual success and short-term financial profits. To the contrary, the stakeholder system gives preference to the network of interrelationships between management, workers, and banks that defines the functioning of the firm within a realm of collective and long-term interests and purposes. These elements are sustained by giving priority to collective achievement, consensus, and long-term results. These features define an all-inclusive generalization of different varieties of national economies that exist in continental Europe.

The central feature distinguishing these two models of capitalism is their typical approach to the type of environment in which firms develop: the relation between capital and labor. In the stakeholder model there is an explicit support towards productivity by means of high levels of training, education, research, and development; this is truer in the Germanic countries (Germany, Denmark, Holland, Belgium and Luxembourg). Also, in this system there is more security for labor given that there are more constraints on employers in their relationship with workers, especially in their ability to hire and to fire. Labor markets are thus less flexible than those generally found in the Anglo-Saxon model. Another determinant factor of differentiation in the structure of corporate governance is the weight assigned to shareholder interests. While shareholder interest is not a high priority in corporate governance in continental Europe, it is of core importance in the Anglo-Saxon model. The problem is that this priority militates against labor-management relations and affects the return to labor; the result in Anglo-Saxon countries is “employee remuneration as a proportion of net value added is much lower” (Rhodes and Van Apeldoorn, p. 7). An important challenge for the European model appears here insofar as globalization makes it contradictory to maintain higher levels of education and skills in inflexible labor markets. Globalization means abolishing long-term contractual relationships between capital and labor and implies conflict-free adjustment mechanisms, especially in these times of technological change and unemployment. It also means opting for short-run, quick-profit strategies, with high corporate dividends and high executive salaries. The possibility of external takeovers, and incentives created by performance-related compensation, provide pressure on poorly performing managers who can be replaced by the stockholders. The dynamism attributed to the stockholder model comes, precisely, from these features.

Performance of firms is, however, in contradiction with this postulate, especially in England. Profits are certainly higher in the Anglo-Saxon model, but companies’ long-term survival and corporate performance, especially in the British case, are poorer. When managers are simultaneously large shareholders, the pressure put on them by the market eases off. In the stakeholder system, the absence of external forces pressuring management is also negative because such forces do not contribute to correcting inefficiencies and management failures.

### **Contradictory tendencies in financial structure**

The dynamics of change brought about by European integration have been up against two contradictory tendencies in the evolution of globalization. One is the rapid and gigantic accumulation of monetary balances worldwide that feeds international capital flows and the rapid growth of the financial sector. Simultaneously, there is a deceleration in the rhythm of real production growth as expressed by the atony in the evolution of national rates of production and the low increase of productivity levels (Gordon, 1998, 1999). There is thus a “growth paradox” in the sense that financial markets, domestic and international, grow at relatively high rates while the real economy grows at very conservative rates (Rozo, 1987, 2000). The argument made by Drucker about the existence of a decoupling between financial and productive dynamics has been validated by these tendencies. He asserts in this respect “the emergence of a symbol economy — capital movements, exchange rates, and credit flow — as the flywheel of the world economy, in place of the real economy, the flow of goods and services. The two economies seem to be operating increasingly independently” (1986).

How these two tendencies contribute to define the financial structure constitutes a fundamental factor of differentiation between the two models of capitalism. The central feature of differentiation is the preference of one system for equity credit, and the preference of the other for bank credit. The degree of importance given to one or the other of these two forms of financial structure defines the degree of differentiation between the two models. In this context, the evolution of financial markets is caught between forces that maintain a national character, and forces that push it to become international. To the former category belongs retail banking with its complex network of interrelated local and regional services. To the latter category belongs corporate finance as a way of insertion in global bond and equity markets.

In the United States and Britain the model based on equity capital, with capital and money markets widely unregulated, has had a greater acceptance than in Germany and other European countries. In those countries, corporate financing has been dominated by bank lending. A fundamental element of the network-oriented European type of corporate governance comes from the long-term relationship between firms and the sources of finance: “Often with board representation (as in the German supervisory board system) banks will, at least in theory, be well informed about managerial behavior and performance and provide a more constructive form of control than the Anglo-Saxon market for corporate control — i.e., the threat of take over and dismissal” (Rhodes and van Apeldoorn, p. 8). Against this view, a common argument is that the insider role of banks creates an information gap for possible external investors. Likewise, this arrangement opens the door to what Rhodes and van Apeldoorn called a “degree of collusive complacency” that leads to inefficiencies and even corruption.

The creation of a single European market for capital, heralded by the largest European banks, especially the German ones, has provided more competition and efficiency. This move has obliged European banks to diversify their investments and to dispose of their industrial holdings in order to compete with other banks. European companies have been

drawn to engage in these practices through joint ventures, mergers, and acquisitions with other European or overseas multinationals.

These transformations in progress manifest the larger role of markets, especially in finance. National as well as continental markets have felt the new importance of short-term securities and cross-border equity trade that derive from financial innovations and from the emergence of institutional investors. Their appearance in the form of insurance companies, mutual investment funds, pension funds, or hedge funds impels trends in financial innovation that lead to the creation of derivative instruments such as options, futures, and swaps. These new tendencies are becoming part of the European landscape, promoted by programs to revitalize European integration by the introduction of a single capital market with new standards of capital adequacy, risk assessment, and transaction transparency. There is a surrender of traditional bank control in favor of financial markets and the disappearance of traditional practices such as insider trading, or gentleman's agreements of conduct, in favor of a renovated, modernized, and privatized role of stock exchange activities and of markets in general. The comfortable and convenient relationship between national central banks and their domestic financial structure has been diminished by competition across borders and by the influence of new actors and their practices with international capital flows (Dyson et al, 1995; Martin, 1998). A consequence of this new financial activism has been the drive to consolidate the idea of Germany as a financial center, "Finanzplatz Deutschland." (DBB, 1992)

These developments have induced changes in the traditional European structure of corporate governance; management is now increasingly subject to the influence of shareholder power, especially in France, Germany, and Italy, where companies tended to be rather secretive. Companies' greater reliance on equity markets and their interest in international alliances have made operations more transparent and management more responsive to shareholder sovereignty. Betts even talks of the "privatization of the Italian private sector." Management, particularly in Germany, is becoming more open to company restructuring and more aggressive towards market opportunities because managers are now more at ease with stock price behavior. There is even a degree of acceptance of new forms of executive remuneration: stock options tied to performance. Privatization is no longer viewed negatively, but as an instrument against traditional and privileged contractual relationships; yet it is not openly accepted because of its implications for denationalization. In France and Italy, for example, privatization has been secured from foreign takeovers.

The changes in management perceptions and corporate behavior have to do with key changes in the financial sphere of the relations between companies and banks. Certainly, the German universal bank has gained importance, but at the cost of reducing its power in company governance. Its stakes in company governance have been declining, while investment, pension, and hedge funds have gained degrees of action in channeling capital to corporations. The secretive and conservative ways of financial intermediaries have been modified in favor of more aggressive and transparent methods. Here European companies learn about mergers and acquisitions from foreign companies since U.S. firms are the main operators of this type of transaction in Europe.

A fundamental element in the trend of European transformation is taking place in contractual labor relations; there is an underlying weakening of labor union power plus a shareholder demand for a larger portion of the added net value that has traditionally gone to the workers. In this dispute, a central issue is the so-called “locational threat;” that is the way companies extract concessions from labor under the threat of moving to cheaper labor cost locations. Another issue is the change in the funding of pensions with consequences for the welfare of labor; demographic pressures aggravate the situation by rapidly changing the ratio of the retired to the employed population. The result is a diminution of organized labor as a social force, what Martin denominates as “the Americanization of the European labor market” (1998).

These are important features of the transformation occurring in Europe and, at the same time, evidence of the forcefulness of globalization of stockholder capitalism. These changes are significant, but they are not yet prevalent and widespread. Not all companies or all countries are being transformed. These changes have taken hold in Europe, but their speed and diffusion are far from supersonic, as exemplified by the lack of a vibrant public corporate-bond market. Certainly, the ways and objectives of the financial and credit structure have been modified towards a tendency to lose the “particularly stable and compassionate lending through cross-shareholdings between banks and industry.” (Rhodes and van Apeldoorn, p. 11) However, that cannot be taken as a total renunciation of the social market model. In fact, it could be argued that there is a “new social course” enclosed in the search for an option of development between the model of the United States and the more traditional European one. The central challenge in this design has been the correct placing of this inevitable transformation between two extremes. On one extreme there was the Anglo-Saxon type deregulation, with a perspective of short-run profitability that produces low unemployment, minimum social benefits, and job insecurity. On the other extreme was the preferred European option of greater official regulation with firms that make long-term planning a consequence of their attitude towards continuity, consensus, and the improvement of workers’ capacities, resulting in generous labor benefits and workers’ protection. It is my hypothesis that the step to implement monetary union goes in the direction of finding a point of convergence between the two models. In the latter example, monetary union facilitates common economic policies and is more conducive to the objectives of efficiency and stability needed for the economic and monetary development, in harmony and congruency with the social objectives postulated for Europe since the Treaty of Rome.

The challenge for Europeans is solving the unemployment problem without recurring to an extreme degree of flexibility in labor markets demanded by stockholder globalization standards. There is a degree of reluctance in accepting this as the only alternative. The initiative in the Cologne Summit of 3-4 June 1999 exemplifies this approach by the proposal to adopt voluntary job-creation targets and macroeconomic dialogue between companies, unions, governments, and the European Central Bank. This approach could be marked as a European answer to the negative effects that can be derived from globalization in the terms examined by Rodrik (1997). His argument is that the costs of free trade and of capital flows have been underestimated. Globalization, by inciting firms



to move their productive structure to foreign countries, contributes to increasing unemployment, fosters job insecurity, erodes working conditions, and undermines labor unions. Because of these negative consequences, globalization makes it more difficult for the state to provide the degree of social security needed.

### **Financial globalization and social standards**

The inflationary tendency in the mid-60s and the liberalization of interest rates and exchange rates in the early 1970s made unsustainable the differences in regulation between commercial and investment banking in the US. This fact put in motion the dynamics of deregulation and financial innovation responsible for the movement towards global markets. The adjustment of the US financial sector has been responsible for the imposition of the globalization of the stockholder model. Liberalization of interest rates in the 1970s and the foreign debt crisis of the 1980s brought the banking system, particularly in the United States, to the brink of collapse. In the United States, the events of the 1970s precipitated the catastrophe of the savings and loan institutional structure, while the foreign debt crises affected the commercial banks because of their high degree of overexposure to some of the indebted countries. Europeans were also affected, but in a much lesser degree due to their smaller involvement in the financing of developing countries. The turmoil created by these events pushed for the transformation of the financial structure. The traditional banking function of collecting short-term deposits to extend long-term loans was part of the problem because of the concentration of risk taking by commercial banks. It was necessary to modify the structure of risk taking. The entanglements of the external debt crises pushed the system towards structural changes. The result has been the transformation of the system from deposit based financial institutions to a money and capital market oriented system fed by national deregulation and global innovation.

This change, initiated in the United States in the 1970s and followed by the United Kingdom with its Big Bang liberalization of 1987, imposed significant challenges to the economic, financial, and social structure. The changes from regulated institutions to unregulated markets and from individual investors to institutional investors have been propelling forces. The immensity of the funds that in the 1980s transformed the US financial market has by its outflow been shifting the battleground to worldwide dimensions. The significance of this flow for the transformation of financial markets accounts for the fact that financial claims have grown faster than other sectors of the economy. These changes in continental Europe, however, lagged behind those in Anglo-Saxon countries. White is very clear when he asserts that “In Continental Europe, traditional bank lending is of significantly greater importance than in the English-speaking countries where the direct sale of securities to ultimate lenders is much more widespread. Moreover, this divergence has tended to be more noticeable as the quality of credit diminishes; junk bonds and equity issues by small and medium-size enterprises are almost unknown in Europe and the securitisation of credit is still relatively undeveloped” (1998, p. 2). As can be appreciated in table 1, bank’s assets as a percentage of bank and non-banks financial institutions is much higher in any continental European country, with an average of 74.1 percent, than in the United States where this ratio is just 26 percent. It

becomes clear that Europe has been built on debt rather than on equity. The fact is that equity based investment and geographical spread of portfolios has been slow to develop in most EU members, except the UK and the Netherlands.

Table 1: Assets of banks\*

Austria	85
France	70
Germany	76
Italy	77
Netherlands	57
Spain	75
Switzerland	79
Average	74.1
United Kingdom	53
United States	26

The challenges of financial transformation have concentrated on two areas. One is in the wholesale versus the retail markets and the other is bank intermediation versus market intermediation. All over Europe, corporate and retailing banking services have a very low degree of integration and it is likely to remain that way. Table 2 shows that cross-border business within Europe remains very limited, given that on average just 4.9 percent of loans had a cross-border destination in 1996. Even in the UK, this type of loan represents only 9.9 percent of all domestic credit in that year and its rate of growth for the 1996-1997 period was just 4.3 percent. Germany presented the largest rate at 28.6 percent while Italy had a negative rate of growth. Thus, the transformation imposed by globalization has had more to do with wholesale than with retail business. It concentrates more in the competitive innovation in financial assets that has pushed the development of market intermediation over more traditional bank lending.

In Europe, wholesale activity has some degree of development but varies widely among countries. Institutional investment and corporate finance, for example, are significant in the UK, Netherlands, and Switzerland and are becoming relevant in France. In other European countries these activities have low importance, which make these institutions function with a very low degree of portfolio diversification. The problem with non-diversified countries is that they find themselves in the middle when the diversified countries undergo processes of adjustment; thus, as these processes become more complex because of gains in size and liquidity, these countries find it more difficult to deal with the transformations taking place.

Mutual funds and pension investing are still underdeveloped in Europe. The fledgling mutual fund industry amounts to only 1.8 trillion US dollars or about 23 percent of GNP. In the US, it amounts to 51 percent of GNP. In most countries, limits have existed in how to use pension funds by currency and class of assets. These limits work in favor of domestic fixed interest rate securities though debt and equity flows occur across borders. Until recently, even Germany limited how to invest in these funds by ruling that only 5 percent of the amount could be invested in non-German assets and no more than 30 percent could be invested in equities. In Denmark 60 percent had to be invested in government and mortgage bonds. However, mutual funds have grown at a fast pace in

some countries: 160 percent in Italy and 60 percent in Spain.

The transformation in markets in futures, options, warrants, and swaps, with the implied assumption that risks can be managed, has been slow to take hold in Europe because of the difficulty of dealing in highly fragmented markets. Capital markets still have to be totally linked and companies are unwilling to be credit-rated to participate in commercial paper markets while small assets, such as home mortgages, have been difficult to bundle together because of jurisdictional differences. In the United States, there were 336.4 billion US dollars of asset-backed bonds announced in the domestic market and 64.7 billion US dollars in the international market in 1996. Meanwhile, in the domestic Continental European market there were announcements for just 16 billion US dollars, and those in the international market barely reached 9.1 billion US dollars (Jeanneau, 1996, p. 37). This creation of markets varies among countries. While London is considered as the foremost international financial center, the UK's domestic market lacks high penetration to the point that asset-backed bonds have never been issued in its domestic market. Spain, Italy, Portugal, and Greece have low levels of penetration and even Germany falls into this category. Still, in 1991 foreign banks' market share amounted to 4.1 percent (Hoschka, 1993, p. 23). Venture capital is another industry that has just started in Europe. With 22 billion US dollars in 1997, it doubles the previous year's volume, with more than half coming from Britain. Significantly, most of this goes to early-stage companies rather than to mature firms. To some this represents the increasing eagerness of Europeans to invest in equities, as indicated by the sizzling growth of stock markets: Easdaq index rose by 168 percent in 1997 and Euro.NM by 322 percent. This can also be due to government initiatives to promote the financing of new ventures. In Germany, the BioRegio initiative started in 1995 with 90 million dollars of official money to help develop the biotechnology industry. The EU Commission also helps by calling to remove barriers to venture capital, especially fiscal ones; but the main restriction in this field is the lack of an entrepreneurial culture like that which has occurred in the US.

These developments point to a strong resistance to let markets be totally free. In terms of investment, Europe is still far from a single market. Money managers may have single passports to operate in any country but each country keeps its own peculiarities in customs, taxes, and regulations. Most important of all, as pointed out by *The Economist*, is that "domestic banks dominate access to customers" and that "retail customers think locally" (1998, p. 78). However, a basic observation is that changes do not wait for deregulation to happen, as in the corporate bond market that has moved from national markets to the Eurobond market (Toporoswski, 1993, p. 77).

This slow pace of change has occurred because of implications on the evolution of the real economy. The difficulty runs deeper because of the implications that the changes have on the European social model of the economy with its relatively generous welfare benefits and high wages plus distrust with deregulation, privatization, and liberalization. These changes leave open the issue of the effect of the global financial structure on real resources; greater capital flow can imply an allocation of financial resources to enlarge banks' earnings by way of making markets. Kuczinski puts it very neatly by observing

that nowadays “market makers make markets in items which will be heavy-volume, which then turn out to be heavy-volume because a market is made in them” (1993-1994). This observation is of significant value because it points to the issue of market stability and the new role of capital not just as a factor of production but as a good in itself, as the concept of “securities industry” implies. Money’s function as a store of value has been given preference over its function as means of exchange. Thus, the transformations in the wholesale markets point to this fact by way of the uncoupling of monetary markets from real production and world trade. (Drucker, 1986).

The evidence is clear in the behavior of the foreign exchange market. In 1998, the foreign exchange daily market turnover was 1,490 billion US dollars, a 25 percent increment over the 1995 daily turnover, as reported by the Bank for International Settlements (BIS, 1996). Meanwhile, the world product in the same period had grown just 13 percent while the daily world exports of goods and services in 1997 needed 27 billion US dollars, which accounted for only 1.8 percent of the daily exchange market turnover. The speculative nature of the international movement of capital is evident in this market and is responsible for the volatility and misalignments of foreign exchange rates, which have nothing to do with the evolution of the real economy. However, the level of parities plays a central function in production because of their implications on international trade competitiveness. A rise in labor costs in a national currency for a country may be lower than in other countries, but if its currency is appreciated by capital flows, then comparative labor costs may be higher and consequently its production less competitive internationally. This is precisely the German case: from the mid-1970s to the mid-1990s labor costs in German marks increased considerably less than in other industrial countries, but the strong appreciation of the mark in this same period maintained labor costs at a high level in Special Drawing Rights (SDR). This situation is exemplified by the changes in unit labor costs between 1991 and 1998 as explained by the Dresdner Bank: “The weighted index shows that Germany’s competitive position has improved since 1991 with regard to unit labor costs. However, in between there were periods in which international competitiveness appeared weaker. It is evident that Germany’s position clearly worsened until the end of 1992 and start of 1993. It then more or less stabilized at this lower level in the subsequent years before improving markedly in the last two years” (Dresdner Bank, 1998, p. 21). Such volatility in competitiveness is, in good part, the result of fluctuations in the exchange rate of the German mark, but also of fluctuations of the dollar and other currencies. Unfortunately, these effects induce debates about competitiveness in which management blames labor and claims the need to reduce wage costs. That means that financial capital profits are at the expense of labor wages and living standards (Lafontaine and Müller, 1998). Ackerman and Alstott have left no doubt about this effect when they show that the recent economic success of the US economy has hardly touched most of its citizens. They point out that 97 percent of the increase in incomes experienced in the US between 1979 and 1998 has gone to the top 20 percent in the scale of income distribution. This tendency must account for the fact that in the last twenty-five years the share of wealth of the top one percent of families has increased from 27 to 40 percent of the total (1999). The implication is that the strengthening of the stockholder model implies a growing inequality of opportunity. The reservations of Europeans to fully change their model are intended to avoid these results.

### **The European Monetary System as a framework of regulation**

The decision to go beyond a single financial market into a monetary union is to be understood in terms of the consequences of deregulation caused by the process of globalization. By removing exchange controls and liberalizing capital markets, all EU members formally recognized the impositions of global finance. The removal of national controls by 1990 meant recognition that these were ineffective in the new structure that was emerging, and simultaneously that the new monetary agreements at Maastricht recognized that markets could not be left totally to themselves.

The imposition of direct controls over capital markets in Europe stemmed from the need to avoid a depletion of foreign exchange reserves and inflationary effects derived from monetary and fiscal policies of WWII. The difficulties of reconstruction and the demands imposed by the Bretton Woods system made authorities reluctant to dismantle these controls after the war. The positive acceptance of planning that was a result of "Keynesianism" also contributed to the mentality that markets must be controlled. Financial markets that caused so much turmoil before the war were especially vulnerable to this attitude. Nationalization of the banks, as in France, direct control of the credit system in other parts of the continent, and the DBB's monetary policy orientation, were consequences of this attitude. Nonetheless, this attitude subsisted into the 1970s, notwithstanding the fact that foreign exchange restrictions in current accounts had been formally relaxed in 1958.

This attitude also accounts for a banking tradition with a lesser degree of regulation in continental Europe than in Anglo-Saxon countries. The higher number of smaller and medium regional banks in Germany, Italy and even France, which serve the needs of similar firms, have generated less dissatisfaction with the banking system and therefore less demand for its regulation. It should not be forgotten that regulation in the US was intended to solve negative consequences of the crash of 1929. Structural and functional factors are responsible for a continental financial structure less regulated, but more protected and responsive to the commands of central banks, as in Germany. From a negative point of view, these factors contributed to an underdeveloped financial structure, a "puny financial industry" as *The Economist* (13 August 1994) called the German financial system.

The monetary upheavals that followed the introduction of flexible exchange rates at the beginning of the 1970s made EC countries reinforce their capital controls to defend financial markets and preserve monetary sovereignty. Countries had to avoid having to choose between high rates of interest and politically undesirable devaluations caused by speculative flows. Controls were deemed necessary in the EC to such an extent that only Germany, Britain, and the Netherlands imposed no such restrictions on international capital movements when the European Monetary System (EMS) started in 1979, and even these countries had only recently removed restrictions. The original objective of the EMS was to create a zone of price stability through a close degree of monetary cooperation and exchange rate management and coordination. This was complemented

by the agreement to give up fiscal activism and the move to adopt a single currency, the European Currency Unit (ECU).

In this context, monetary management in Europe was exercised with a multiple purpose objective:

- To stabilize domestic nominal interest rates in a regime of controlled floating
- To avoid speculative attacks justified or not by fundamental imbalance
- To escape large swings in foreign reserves

The logic of controls derived from the basic axiom in international economics that fixed exchange rates, national policy autonomy, and full capital mobility cannot function simultaneously. The high sensitivity of capital flows to rates of return differential and exchange rate expectations are central to this incompatibility. In this logic, a system based on flexible exchange rates among countries with inflation differentials would require a steady depreciation in high inflation countries against low inflation ones. This would occur at a pace that would be equal to the difference between interest and inflation rates, provided purchasing power parity determined the expected exchange rate.

On the contrary, the mechanism adopted in the EMS opted for relatively fixed exchange rates and policy autonomy, which made practically mandatory the implementation of controls on the movement of capital in order to restrain speculative attacks that could force parity realignments. (Padoa-Schiopa, 1987; Giavazzi, 1989; De Grauwe, 1989b&c). This could have been avoided if Mundell conditions on fiscal activism had been introduced, but for different national reasons the option of some flexibility in fiscal policy was rejected, in Germany because federalism has suppressed any tradition of centralized fiscal activism, in most other countries because of large public indebtedness.

The institutional constraint on exchange rates subject to periodic realignments imposed by the EMS left differentials in interest rates as the compensating variable that could check capital flows. The stability of interest rates derived from capital controls thus inhibited speculation. The capacity of these arrangements to restrain speculation postponed the need for exchange rate realignments, thus avoiding disorderly market conditions. It also constituted a central factor in forcing inflation convergence among the member states. In high inflation countries, these arrangements imposed a certain degree of discipline towards avoiding permanent realignments that had made the system a *de facto* crawling peg. Controls also allowed central banks to not rush to realignments in time of crisis. The main idea was that central bank intervention, by fighting erratic short-term fluctuations, forces equilibrium based on fundamentals. Controls served to evade the perverse effects of hot capital flows on the economy and the difficulties they create for a smooth management of macroeconomic policy. The absence of controls, on the contrary, would have forced continuous realignments to counter speculative capital movements. In this perspective, regulation and control of capital flows play a vital role in the functioning of the EMS. They enable domestic deviations in nominal interest rates “so that countries have been able to pursue more appropriate monetary policy than those which were implied by the strict EMS” (Walters, 1990, p. 127).

The problem in this context was that the EMS was not equipped with automatic correction mechanisms. It was easy to predict the direction of movements in exchange rates though not necessarily when they would occur. The result was a degree of uncertainty that allowed a disinflationary policy in inflation-prone countries and reaffirmed low inflation in strong countries. Thus, Walters was correct when he argued that it was a paradox that uncertainty kept the system functioning when originally it was argued that “The EMS was to be an island of stability and certainty”(Walters, 1990, p. 81). The EMS functioned as a fixed exchange rate mechanism with occasional periods of flexibility to allow for realignments. This was necessary and possible because exchange controls protected against speculation motivated by anticipation of realignments. Floating was definitely not a preferable option to Europeans because of the implications for common programs like the Common Agricultural Policy.

Under these conditions and in the context of movement to a single market, an agreement among EC member states to liberalize financial markets was reached and signed in 1986. (EC Commission, 1986). Eight countries agreed to eliminate all controls by July 1990, the rest: Spain, Ireland, Portugal, and Greece agreed to do so by the end of 1992 to coincide with the initiation of the single market. Portugal and Greece were to be given three more years if necessary (Tsoukalis, 1993, p.123). The removal of capital controls agreed in the Single European Act rendered infeasible all arrangements but a fixed exchange rate as proposed by the Delors Report. By removing national controls, the European Community was confronted with the choice between floating or single money. The relevant question is why the EC introduced this overt elimination of exchange controls that could cause speculative capital movements, therefore, hindering domestic stability.

### **Capital flows and deregulation**

Liquidity and size have become crucial characteristics of the financial structure since in the early 1970s restrictions on market activity, such as non-bank intermediation, wholesale intermediation, derivatives, and exchange controls were eliminated in order not to inhibit cross-border transactions.

Financial innovation and market deregulation have contributed to international capital transactions that have come to dominate the markets to such an extent that they “now dwarf transactions on current account” (BIS, 1994, p. 145). Annual gross capital flows within the main industrial countries (excluding official and short-term banking transactions) have grown from US \$100 billion in the first half of the 1980s to US \$500 billion between 1985-1992 to US \$800 billion in 1993 (BIS, 1994, p. 148). It is estimated that daily turnover in the world capital market, since the mid-1990s, is around one trillion US dollars. This huge flow of funds can be better appreciated by considering that cross-border flows of bonds and equity in the United States went from the equivalent of 4 percent of GNP to 213 per cent between 1975 and 1997. In Germany, the change went from 5 to 253 percent and in Italy, it moved from one to 672 percent (BIS, 1998, p. 100). In net terms, these flows are not as large, but they are not insignificant. More important is that their tendency is in an upward direction. In the years from 1986 to 1998, the total



international assets of the banks reporting to the BIS have gone from 3,221 billion US dollars to 11,189.8 billion US dollars, in itself an increment of around 250 percent (BIS, 1999). External assets and local assets in foreign currency make up the composition of these flows; an interesting point is the loss of relevance of the latter to the former. While at the beginning of this period local assets denominated in foreign currencies constituted 30 percent of the total, by the end of the 1990s they accounted for only 12 percent. These percentages demonstrate the greater importance of international assets over domestic ones and are an indicator of the obsolescence of local assets under liberalized markets.

This gigantic movement of capital has an additional meaning: it points to the fact that capital is not just a factor of production, but has become a good in itself, as the concept of "securities industry" implies. This is particularly clear in the foreign exchange market. In 1998, this market's daily turnover was 1,490 billion US dollars, a 25 percent increment over the 1995 turnover, while the average daily needs of world export of goods and services only needed 27 billion US dollars; accordingly, the world product had grown just 13 percent between 1995 and 1997. This speculative movement of capital generates volatility in exchange markets that has nothing to do with the real economy. Transnational monetary markets have become uncoupled from real production and world trade.

It was in this context that the European Commission argued that the program of "Europe 1992" made capital controls incompatible with and out of place in an integrated unified market. Apprehension about deregulation and the political pitfalls of the drive to legislate the integration of national markets contributed to this attitude toward change. The mutual recognition and home-versus-host approaches to deregulation had encountered difficulties. The problem with mutual recognition resides in the possibility that not all countries provide the same quality of supervision; the possibility of regulatory laxity by some of them could cause problems or disadvantages to the rest. The ideal, as O'Brien pointed out, was to exert "peer pressure on each other and on their various regulatory bodies to provide quality and to be alert for attempts to compete for business through regulatory laxity"(1992, p. 66). But this ideal fell short in practice.

The difficulty posed by the home-versus-host approach to regulation is that it divides regulatory and supervisory responsibilities on geographical bases. Financial institutions of one country are authorized to offer a full range of services in another country. Thus, they have to comply with the operative regulation of the host country, but the responsibility for regulation of this institution lies in the home country. The home country, where the firm is headquartered, is responsible for licensing, appropriate ownership structure, and capital adequacy while the country where it carries on its business, the host country, supervises the business behavior of the firm in the market place. Financially, the home country is responsible for solvency while the host country is responsible for liquidity. With global markets, these legally separated responsibilities become blurred; one reason is the possibility of cross-border expansion by firms. The non-nationality of capital further erases these distinctions because firms ignoring geographical borders will alter local customs and practices.

In this perspective, restrictions on capital movements and on capital markets made financial assets illiquid, thus, national controls contributed to higher costs of financial services and consequently became a source of lower profits and lower competitiveness. Their elimination had a positive impact on the costs of capital since prices could be reduced in banking services, insurance and securities transactions.

**Table 2. Cross-border banking penetration in Europe**

Countries	1996 loans to non-banks			1997 loans to non-banks	
	Domestic credit	Cross-border assets	Cross-border as % of assets	Cross-border assets	% change 1997/1996
Austria	225.6	6.0	2.3	7.2	20.0
Belgium	365.1	39.8	9.8	44.0	10.6
France	2074.1	72.6	3.4	85.1	17.2
Germany	3075.5	79.8	2.5	102.6	28.6
Italy	930.8	34.6	3.6	28.8	-16.8
Netherlands	476.6	30.3	6.1	31.3	3.3
Spain	661.6	10.7	1.6	11.5	7.5
Switzerland	492.2	25.7	4.9	28.4	10.5
United Kingdom	1324.3	145.1	9.9	151.4	4.3
Average	1069.5	49.4	4.9	54.5	9.5

Source: Williams, 1998, p. 25.

One optimistic, though highly controversial, notion has been that greater market volatility is positive and more of a benefit than a cost because it reflects changes in perceptions of economic agents about future developments that serve to prevent inconsistent government policies. In this perspective, coordination by the market is preferable to official coordination or regulation because it is flexible and continuous. Behind this notion is the idea that the markets can do no wrong. This idea nourishes the perfectly efficient market hypothesis, which states: prices reflect all available information and asset prices are tied to their fundamental values (Fama, 1970, 1991).

This hypothesis, however, when applied to financial markets, has lost much strength (Shiller, 1988; Wadwhani, 1987; McDonald & Taylor, 1992; Magil & Shafer, 1991). The Grossman-Stiglitz paradox, in particular, makes the point (Grossman and Stiglitz, 1980). Prices do not fully reflect all available information because there are informed and uninformed agents in the market. The informed ones make higher gross returns than the uninformed though net returns are equal for both (Wadwhani, 1987, p. 10). The cause of the problem is the existence of asymmetric information due to the costs incurred in becoming informed, considering the constraints of time and uncertainty. Under these conditions, resource allocation is not done in over-the-counter real markets, but in the interrelationship between real and financial markets in which bonds, equities, futures, swaps, and contracts among firms and between firms and workers become necessary.

This interaction between markets in goods and services, and financial markets with a need for money and nominal contracts leaves behind the theory of idealized general equilibrium to come to the realm of non-perfect equilibrium markets due to the need to function in nominal terms. In this New World the future ability to trade is limited by “the incompleteness of markets and by the unwillingness or inability of agents to make more than limited commitments into the future” (Magil and Shafer, 1991, p. 1524). This behavior characterizes firms that are risk averse, firms that diversified their risks partially. This short-run volatile behavior is particularly relevant in the foreign exchange markets because of the importance of panicky and herd instinct behaviors. This short-run perspective induces speculation, thus magnifying and multiplying capital flows, with a consequent effect on parity values and market volatility. In theoretical terms, efficiency seems to be more viable in exchange markets, but empirical evidence is not all in its favor. MacDonald and Taylor are very emphatic when they assert that the evidence on the efficiency market hypothesis “has been decisively rejected by foreign exchange markets” (1992, p. 33).

This result has a double effect. The first is greater instability in financial markets due to overshooting in exchange rates or interest rates, which induces wrong investment decisions and therefore, a misallocation of resources. The second is erosion in the scope for public policy to orient GNP growth or fight unemployment. Some lament that policy options to manage the economy are lost to the market, but others who think that money only affects prices, are satisfied since adjustment can only be propounded through real structural solutions. The highly controversial nature of these effects depends on basic considerations about the role of monetary policy in the working of the economy. In Europe, this is more so because of the central role that German monetary policy played in determining monetary policy for the entire community. The recognition of this inefficiency in exchange markets and the subsequent questioning of the virtues of independent floating has resulted in a change of attitudes (Allsop and Crystal, 1989).

To make matters worse, the spillover effect of the Single European Market (SEM) complicated the functioning of domestic exchange markets. The increase in commercial interdependence reduced the effect of currency rates in correcting balance of payments imbalances and in giving stability to national monetary policies. Thus, the single market made unsustainable the cost of managing different currencies because, by eliminating quantitative controls on credit, and removing restrictions on cross-border financial flows, interest arbitrage in the integrated financial market increases the potential for “universal arbitrage.” And as Bisignano asserts “The trend towards universal arbitrage has also meant that the ability of central banks to influence short-term interest rates directly, and other financial prices indirectly, through intervention in the short-term money market increasingly depends on their signaling capacity” (1996). This dependence is the ability to convey convincing and credible messages of their intentions about market conditions and proposed objectives. In an integrated area with different signaling capacities by each national central bank, as in the EEC, the potential for confusion and monetary policy inefficiency increases. Here lays the validity of single money to restore the ability of a single central bank to effectively control both financial quantities and prices after national central banks lose this capacity when markets become more efficient because of better

arbitrage. This is the case with monetary aggregates when they are taken as intermediate target variables due to the higher substitutability of short-term financial assets with bank deposits.

The greater efficiency in monetary policy must be perceived as the real gain of MU. It is the function of the central bank to make market expectations more efficient by way of reflecting all possible available information. This is more important and the benefits are larger than exchange cost reductions.

### **Constraints on policy and regulation**

The European Community evolved in the 1970s and 1980s in a permanent conflict between policies of growth and policies of stability that inhibited the movement towards MU. The shelving of the Werner Report, at the beginning of the 1970s, is an example of how this clash “prevented agreement on a coherent integrationist response in the form of monetary union” (Milward & Sorensen, 1993, p. 23). The issue of MU was avoided in the proposal and the negotiations of the single market and the Single European Act. The issue of establishing a single financial market had to be reopened immediately after the “Europe 1992” program was started. The Capital Movements Directive of 1988 set in motion the creation of a single financial market in which the Commission is responsible for eliminating national restrictions while member states retain responsibility for domestic market regulation. To this purpose, a system of mutual recognition was accepted that meant competition between national rules was the norm in the search for a single set of rules. The Second Banking Directive of 1989 established more clearly this new perspective of market regulation.

The Delors Commission was formed to resolve this elusive issue. France was the driving force behind this proposal, with strong support from Italy and Belgium, and some reservations from Spain (Tsoukalis, 1993, p. 208). Germany, seconded by Denmark, showed little interest in this course of action, and Britain openly questioned its desirability and feasibility.

The spectrum of preferences leaves no doubt as to the central role that immediate national interests played in the pursuit of two issues: one was the development of a liberalized single European financial market and the other the issue of asymmetries in the EMS. The first concern dealt with the feasibility and convenience of maintaining national monetary autonomy in the presence of a full commitment to free trade and free movement of capital. The second concern centered on the role of the Deutsche mark and the DBB in European monetary matters and the functionality of the EMS. For the solution of these concerns, it was necessary that central banks measure up to the changing world in which they implement their policies.

The first concern was the degree in which national financial markets were being transformed by deregulation, innovation, and liberalization and how, in the process, these markets become oriented to the pursuit of liquidity and inter-market arbitrage profits, and thus determine the efficiency of central banks to manage monetary policy. In

internationally integrated financial markets interest rates and asset prices become increasingly determined by international developments rather than merely by domestic factors, becoming a limitation to policy design and instrumentation. Additionally, financial innovation and deregulation impair the accuracy of aggregate money supply forecasts essential to monetary management (Andersen, 1997).

Simultaneously, financial liberalization inhibited the conventional transmission mechanisms of monetary policy by influencing the domestic demand for credit. In the short run, the impairment of stability policies occurs regardless of whether the exchange rate is fixed or flexible, given that fiscal policy, in the short run, is inflexible. In the fixed rate case, the burden of adjustment falls on the interest rate. In the case of flexible rates, the burden of adjustment falls on the exchange rate itself. A change in the interest rate affects the rate of return on assets that are held in different currencies, which leads to exchange rate effects. When the initial disturbance occurs in the exchange rate or in exchange rate expectations, it is the rates of return of holding foreign assets that is altered. Significant shifts in portfolio can occur that have a determinant influence on the functioning of the real sector, because financial liberalization increases the interest rate sensitivity of consumption. Globalization, by promoting liberalization, works by inhibiting monetary policy in the sense that changes in monetary policy do not affect the economy through the traditional monetary channel, but through the alternative credit channel. The use of this channel can induce situations of credit rationing and consequently, production constraints (Stiglitz and Weiss, 1981, 1992)

Domestic monetary policy adjustments, in consequence, come to depend more on evolution of international events than on domestic ones, and on the influence of the financial markets than on national priorities and objectives. This effect, of course, becomes particularly relevant for countries in an internationally integrated financial system because it may affect the means chosen to achieve domestic objectives for monetary policy, though not necessarily the objective itself. High mobility of capital makes variable-peg exchange rate regimes difficult to sustain as a way to import price stability. The pegging of some European currencies to an appreciating German mark during the 1990s evidenced the difficulties of this regime. Consequently, such a situation pushed in the direction of an immutable fixed regime or a managed float. In these conditions, the actions of single governments become diffuse in the financial system with the result that national monetary independence is curtailed by globalization. The stronger evidence of this curtailment of monetary independence seems to be in exchange rate policy since this price has less to do with trade and more with capital flows. Foreign exchange has become an end in itself, as Ohmae asserts, "It obeys rules of its own and displays its own distinctive forms of behavior" (1990, p. 157)

The dilemma with financial liberalization in Europe was that by weakening the instruments of national monetary policy it strengthened the asymmetries within the EMS. Even more important, these transformations imposed limits on the capacity of regulators to regulate at a national level. For global flows, a global solution was necessary. The system had to be transformed to strengthen economic policy from a Community perspective rather than from a national standpoint, given that national solutions left a rather negative experience in the 1970s. To regain some degree of efficiency the solution

had to be focused at EU level. MU was the response to this challenge. It seems to be a rather contradictory solution since what was demanded by national markets was deregulation, but what a union-wide solution required was more regulation. By joining MU, national governments renounced turning back to inflationary policies, but also accepted a commitment mechanism to give credibility to monetary policy by way of preserving the credibility of the Deutsche Bundesbank. This credibility is transferred when the statutes and objectives of the European Central Bank (ECB) resemble those of the DBB. It is also done by adopting for the ECB's operability the premises of strong independence from government, limitation of its responsibility to price stability, non-involvement in bank supervision and renunciation to be a lender of last resort.

### **EMU and asymmetric decision-making**

The second concern relates to how the EMS really operated. Adjustment in the EMS was postulated to operate symmetrically: countries with an appreciating currency would tend to expand while those with a depreciating currency would tend to contract. The Delors Report supported this conception of symmetry in the system. Success was the result of a conscious process of co-ordination, mutual surveillance, policy convergence, and central bank co-operation. This means that exchange rate realignments were the result of an institutional process of orderly multilateral negotiations. This interpretation of how the EMS worked, however, does not seem to be congruent with its practical experience, which leads to divergent interpretations on this topic, not only on theoretical grounds, but in practical terms as well.

The acceptance by all EMS member countries of the monetarist orthodoxy, validated by the Mitterrand government in 1983 and radically backed up by the DBB, led to a view of the system as a virtual monetary area of the German mark (Gross and Thygesen, 1992; DeGrauwe, 1994, 1989<sup>a</sup>; Melitz, 1989; Giavazzi and Giavaninni, 1989; Herz and Roger, 1992; Wyplosz, 1997). The DBB was the institution that virtually, if not formally, determined monetary policy within the EMS. Its credibility as a low-inflation institution and the international role of the DM imposed such a degree of discipline on the entire system that national economies had to move in the direction of convergence towards lower inflation.

Two central premises define this behavior. The first was that Germany set the standard for all when she established her own level of short-term interest rate in order to pursue her particular objective of maintaining discipline in the labor market (Martin, 1998). Other member countries played no role in these decisions. Germany thus pursued an independent monetary policy that other EC members followed. The second premise was that, by operating national mechanisms of control over domestic credit expansion, other countries would conform to the limits imposed on exchange rates volatility. This is the result of accepting the commitment to adjust interest rates to counterbalance exchange rate movements. The success of national authorities to counter play these variables would be a function of the credibility of the authority's commitment to stability to the financial market. In consequence, the system functioned asymmetrically in terms of decision-

making on interventionist adjustments and on the degree of influence in setting policy priorities. In this perspective, realignments were not simple technical decisions, but political compromises of give and take among the participating countries. The limits to this wrangling were set by the DBB's own policies.

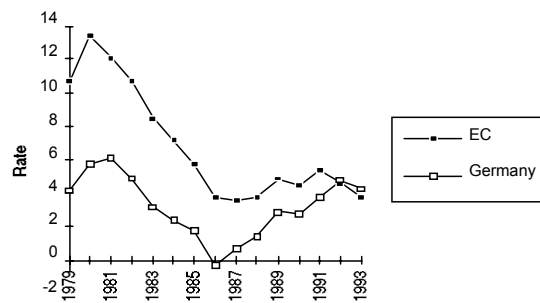
A palpable example of this mechanism is the EMS crisis of 1992. It is not that the DBB did not respond to the necessity of lower interest rates. In fact, its discount rate was reduced between September 1992 and July 1993 from 8.75 percent to 6.75 percent and the Lombard rate from 9.75 percent to 8.25 percent, plus the repurchase rate came down three percentage points. The DBB reasons that these measures were taken for external considerations and not just for Germany's own benefit. The problem was that these corrections were untimely since they came after the crisis had started to run its course. More important, these policy corrections cannot be disassociated from the fact that these cuts were possible because DM appreciation was protecting the anti-inflationary stance of the bank.

These issues of symmetry in decision-making and the role of national central banks in this process are presented by some as a central paradox of the EMS (Walters, 1990). Conceptually, to have symmetry all countries should be equal in their capacity of influencing policy. In reality, credibility of the DBB would falter and all countries would drift in a sea of inflation if that were to happen: credibility would be lost. There was an implicit assumption that some countries are decidedly inflationary under any circumstances. Consequently, there was a need to impose monetary discipline by the institution best fitted to do it.

The role of the DBB, as suggested by De Grauwe, has been over-emphasized. (1989a) His findings incline the balance in favor of a certain degree of symmetry in European interest rate determination. To Gros and Thygesen (1992) the experience since 1987 was that of a more symmetrical system since Germany found it increasingly difficult to keep demand for goods and services in check in order to curb inflationary tendencies. In their study on the tendency of inflation within the EMS, Artis and Nachene (1989) examined the relevance of German monetary policy to this end and concluded that there was a stabilizing tendency, but the evidence was not overwhelming.

A comparison of inflationary trends between the EC and Germany, chart 1, throws some light on this issue. It seems relatively safe to argue that up to 1986 the narrowing of the inflationary gap between EC members and Germany comes about by the movement of the EC trend towards the German level. Afterwards, a shift occurs in which the German level approaches that of the EC. This shows that, in fact, the asymmetrical nature of the system is not a rigid feature. Its nature as well as intensity varies over time, giving different degrees of asymmetry. A hard version of this asymmetry means that credibility is acquired by a strict pegging of the national currencies to the DM. This is Giavazzi and Pagano's "tying one's hands" argument in which the purpose is to reduce the output loss resulting from inflation (1988). A second, soft version of asymmetry derives from the external discipline that EMS imposes in the design of national monetary policies. The

Chart 1. Inflation tendency: EC vs. Germany



practical situation is not as clear-cut as this classification since the two versions were practiced simultaneously. It may be correct to assert that the German mark zone countries (Netherlands, Belgium, Luxembourg, and Denmark) practiced the hard version while the others moved between the two.

This functioning of the system could not be just an arrangement to preserve the DBB's independence. It has been presented as an argument of the utmost importance for the German economy to function well. Two factors are central to this argument. One is the fact that the EMS constituted an instrument to diffuse the pressure accumulated by the DM as a refuge currency. An expansionary German monetary policy can spread its costs more easily under a flexible than under a fixed ER system. The result is a less inflationary Germany (Fratianni & Von Hagen, 1990). A higher level of German inflation when exchange rates became practically fixed after 1986 lends credibility to this idea. No wonder the insistence of the Germans on exchange flexibility and their initial lack of enthusiasm for MU. There is, of course, the inverse position of its partners, traditionally high inflation countries for whom being tied to Germany was less attractive under a flexible than under a fixed exchange rate. This result comes from the effects that the international trade multiplier can have in distributing the flows of intra-European trade, which seem to have been to Germany's advantage. Price stability in strong currency countries with few parity adjustments causes these currencies to become undervalued giving them a competitive edge over countries with weak currencies. Surpluses accumulated, henceforth, in strong currency countries. Monetary union was a way to resolve these inconsistencies in the decision-making process. Its acceptance had to do with the general dissatisfaction with the fact that the EMS came to depend entirely on the exigencies of the anti-inflationary posture of the German central bank. The creation of a European central bank in which all Member States' interests are considered on equal ground played along national preferences. The dissatisfaction of the Member States with the dominance of the Deutsche Bundesbank within the EMS called for a curtailment of this influence (Milward and Sorensen, 1993; Artis, 1994; Tietmeyer, 1993). It became clear to all that a German influenced MU would be preferable to an EMS controlled by the DBB. In fact, MU could increase national sovereignty by allowing the Member States' central banks greater participation in decision-making through a European central bank. This option was impossible if each country maintained indivisible its monetary sovereignty.



## Conclusions

In the new framework of the post-Cold War era, economic supremacy has become the propelling factor of international relations. The greatness of nations is no longer primarily measured by their capacity to make war but rather by their capacity to increase market shares. In this context, the greatest challenge for an integrated Europe has been how to confront the unilateral hegemony assumed by the United States. The commercial disputes of the 1990s unambiguously testify to the existence of this confrontation. The new strength of European integration, in Jacques Delors' terms, means something more than a program of economic reconstruction; it constitutes a sketch for European political rebirth as a superpower, but on its own economic terms and conditions. Nevertheless, there is an implicit acceptance to achieve a higher degree of efficiency, as postulated by the stockholder model of globalization. It does not seem to mean, however, an utter renunciation of the European social market model of a mixed economy with generous welfare benefits and high minimum wages that makes possible an ordering of the market with freedom for wage negotiations, but without eliminating social legislation. Economic efficiency is a must, but under the premise that it does not become social dumping. In this context, the new labor market structure should stand in between present European inflexibility and the cheap labor without social security of the Anglo-Saxon model. The underlying premise is that the market functions when competition between firms is correctly regulated, thereby fostering both competitive business and social consensus. Without doubt, the transformation taking place implies a degree of convergence in corporate governance that necessarily brings a weakening in traditional relations, as is happening in the German consensual industrial relations system. Neither the stakeholder model nor the shareholder model can remain unscathed under the impetus of globalization.

The paradox of the dominant stockholder ideology is not that it pretends to minimize the presence of the state but that it does so within a more global perspective and with new instruments. MU represents, thus, the degree of compromise required among Member States to solve the dilemma on the proper role of the nation-state in deciding between domestic and community interest, which points to the fact that MU is not sustainable without political union. Nowhere is this more evident and necessary than in money matters. A more crucial aspect of the same problem is that regulation is no longer operative at the national level, but has to be applied on a global scale or at least at the regional level, as intended by MU.

In Europe MU confirms that the nation-state is reluctant to disappear, and therefore, capable of adapting to changing conditions. As Milward has demonstrated, integration has never been an end in itself (1984, Milward and Sorensen, 1993) but rather a means to strengthen national goals. In the 1950s, it became a way to deal with the German Problem and the Cold War; in the 1980s, it was a response to the incapacity of the individual nation-states to cope with their loss of market share, domestically and internationally. In the 1990s, it is my contention, integration responded to the need of reassurance against the negative effects of the globalization of money and finance. The overall inter-governmental character of the Maastricht Treaty reinforced by the Amsterdam Treaty

manifests that national realities have prevailed. In fact, a limited surrender of national sovereignty has taken place only in the economic pillar of the EU since, in the other two (i.e., the defense and internal affairs), the structure of decision-making maintains an intergovernmental character. Following Koehane and Hoffmann, I assert that what has taken place is just a pooling of national sovereignties (1991). The furtherance of strictly national interest led to a deeper step in integration: “The German decision to proceed to EMU was fundamentally political,” as Tsoukalis puts it (1993, p. 208). It was a bargain between Germany and France to secure their own national economic and political interest. Since the rest of the member states could hardly impede this agreement to proceed, they opted for bringing into the negotiations their own interests. Small countries linked EMU to substantial budgetary transfers in order to avoid a two-tiered Community. Britain secured its independence by opting out, with Denmark and Sweden emulating this step.

EMU added considerable mileage in the road of integration, showing the existence of a will to go forward in achieving political and economic union. However, this enterprise has also meant finding an alternative option between stockholder and stakeholder forms of capitalism.

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Chart 1. Inflation tendency: EC vs. Germany

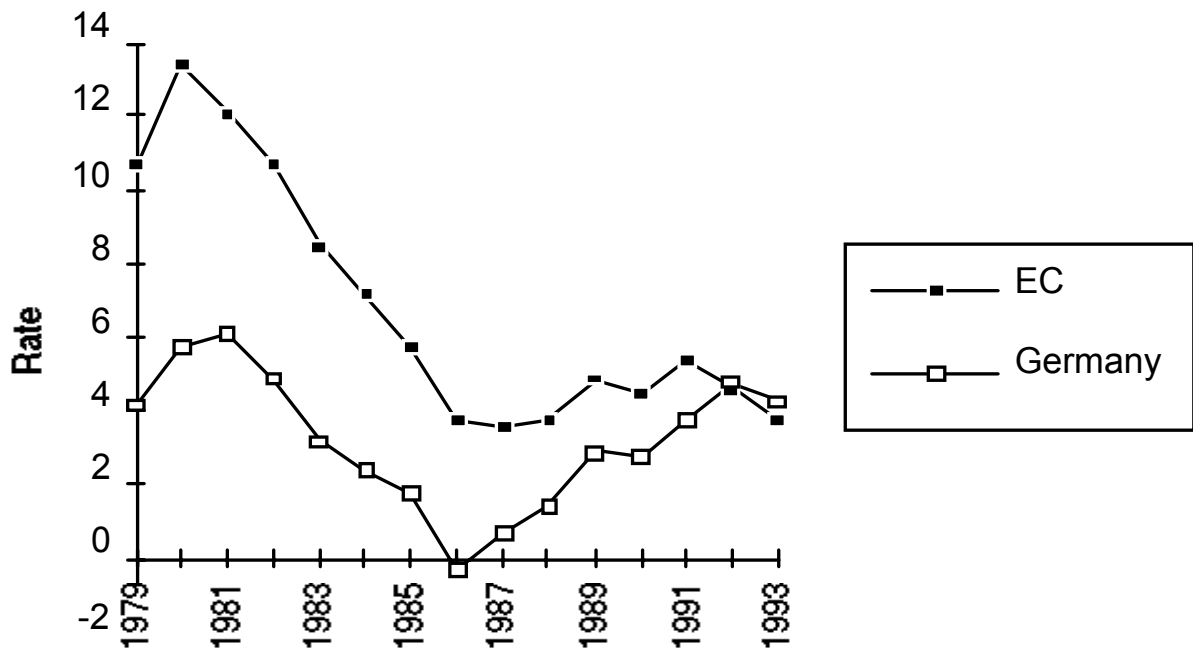


Table 2. Cross-border banking penetration in Europe

Countries	1996		1997		% change 1997/1996
	loans to non-banks Domestic credit	Cross- border assets	Cross-border as % of assets	loans to non-banks Cross- border assets	
Austria	225.6	6.0	2.3	7.2	20.0
Belgium	365.1	39.8	9.8	44.0	10.6
France	2074.1	72.6	3.4	85.1	17.2
Germany	3075.5	79.8	2.5	102.6	28.6
Italy	930.8	34.6	3.6	28.8	-16.8
Netherlands	476.6	30.3	6.1	31.3	3.3
Spain	661.6	10.7	1.6	11.5	7.5
Switzerland	492.2	25.7	4.9	28.4	10.5
United Kingdom	1324.3	145.1	9.9	151.4	4.3
Average	1069.5	49.4	4.9	54.5	9.5

Source: Williams,  
1998, p. 25.

Table 1. Assets of  
banks\*

Austria	85
France	70
Germany	76
Italy	77
Netherlands	57
Spain	75
Switzerland	79
Average	74.1
United Kingdom	53
United States	26