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*In this number :
Advancing financial integration*

BACKGROUND PAPER

1. INTRODUCTION AND SUMMARY

The Community started in the mid eighties to put emphasis on the creation of a single financial market, to integrate the different national financial markets and create a more efficient and stable single financial market.

Steps accomplished in this process were:

- 1. The liberalization of capital movements within the Community. Capital movements have been essentially fully liberalized since 1 July 1990 by virtue of Council Directive 88/361/EEC. The freedom of capital movements has been reinforced by the Treaty on European Union: Its Article G(14) replaces Articles 67 to 73 by the new Articles 73b to 73h. These new Articles, in force since 1 January 1994, enshrine the directly applicable freedom of capital movements within the EU, and also with some reservations, with third countries, in the Treaty. As from 16 May 1994, the derogation for Greece, and thus all country specific derogations, ceased to exist.*

The Commission issued on 19 July 1997 a Communication on "Certain legal aspects on Intra-EU investment" (OJ C 220 of 19/7/1997, p. 15 ff.), clarifying the conditions under which discriminatory and non-discriminatory measures as regards investment are compatible with Art. 52 and 73b of the EC Treaty.

- 2. The freedom of cross-border financial services has been accomplished in the banking sector, by a series of directives, notably the 2nd Banking Directive 89/646/EEC. It establishes the freedom of cross-border services under the principle of a single license and control by the home country under the regime of common rules on admission and supervision. The insurance market was equally opened up to cross-border services from 1 July 1994 on, when the 3rd life and non-life directives entered into force. The opening of securities markets for cross-border services within the Community complemented and completed the opening of financial services from 1 January 1996 with the entering into force of Directive 93/22/EEC.*

The aim was to allow, by removing administrative obstacles, the creation of a single financial market structure in the Community¹. Such a single financial market should in particular

- increase cross-border competition on EU financial markets and thereby enhance development and efficiency of financial markets and financial institutions;
- reduce the volatility in and failure risk of the financial system by creating a larger and more stable market sphere;
- thereby strengthen its main allocative function, the channelling of savings into productive resources with the highest return to capital.

Although first evidence suggests that progress has been made on all these targets, there remain doubts if this development has gone sufficiently far.

Assessing the Community economy on the basis of the Commission "White Paper"², the European Council (10/11 December 1993, Brussels) concluded, among other items, that "the capital market must be made more efficient in order to encourage a flow of savings into productive job-creating investments"³.

The present study deals with some of the issues identified as significant for an assessment of the result of the programme of financial integration of EU financial markets. It is neither exhaustive nor does it give definite answers, but is rather a starting point for further more detailed analysis on this matter, concentrating on a few main issues:

- the general level and development of financial markets' activity over the past 10 years;
- the degree of assimilation and integration of financial markets of Member States over the past 10 years;
- the development of the efficiency of financial markets and financial integration in the Community;
- the eventual costs of financial integration and liberalization over the past years;
- remaining obstacles to further integration of the EU financial markets in the field of market structure and regulation

In order to reach such conclusions the paper starts with a succinct assessment of the main features of the financial sector in the European Union. This assessment concentrates on the main sectors of financial markets and institutions and casts some light on the specific features of the EU as compared to other major financial markets, but also remaining differences, as regards the structure or the degree of development, within the European Union.

The first results nevertheless give a few indications about the general situation and areas of concern:

- Although the volume of private domestic savings appears relatively satisfactory, it reached 22% of GDP in 1995, the available pool of savings for private sector investment could be further enhanced by a greater consolidation of public deficits. Institutional investors, such as insurance companies or pension funds, are now playing an increasingly crucial role in channelling savings into investment. On an EU level, around 30% of private savings are collected by these institutions.
- Cross-border capital movements between Member States play a growing and positive role in investment in the Union and in a more efficient allocation of savings. However this process is still in its early stages and the Member States' financial markets are only to some degree integrated.
- Company financing relies mainly on direct bank lending. This reflects, amongst other factors, an on average high efficiency of EC banking. However, in a few Member States the efficiency of the domestic banking system lags behind the Community average.
- Furthermore, securities markets, both as an alternative and a complement to bank lending in financing investment, are inefficient in some areas or non-existent in some Member States. This factor weighs more heavily on smaller companies and, generally, on companies in smaller countries, where the limited size of domestic capital markets makes it more difficult to obtain investment financing at competitive terms. The development of specialist markets seems to have had, so far, an overall positive impact on the efficiency and stability of the securities markets.
- Some obstacles remain to reaping the full benefits of the Internal financial market in the European Union. A minimum harmonization in the field of the taxation of savings and in taxation of corporate profits could improve the functioning of the internal market. The adoption of a Community minimum withholding tax on interest income would be an important step towards that goal.

¹ See therefore in detail: Commission of the European Communities, Directorate-General for Economic and Financial Affairs: "Creation of a European financial area"; European Economy, No 36, May 1988.

² Growth, Competitiveness, Employment.- The Challenges and Ways Forward into the 21st Century"; Brussels 1993.

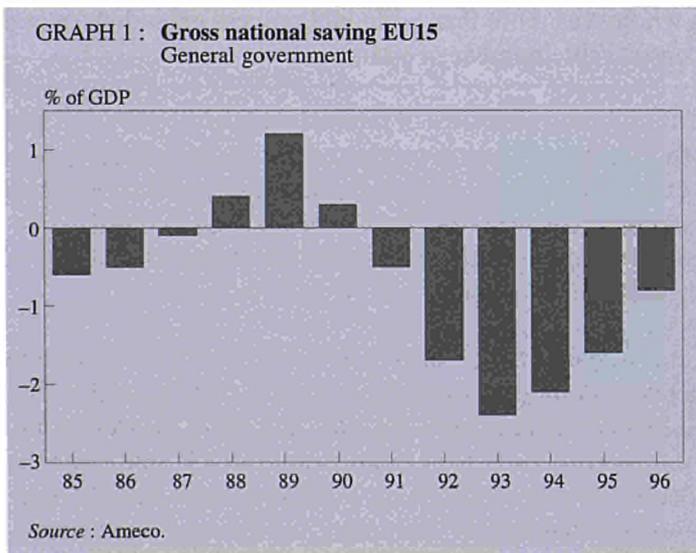
³ Presidency conclusions - Brussels, 10 and 11 December 1993 (SN 373/93).

2. VOLUME AND STRUCTURE OF SAVINGS AND CAPITAL FLOWS

2.1 Domestic savings

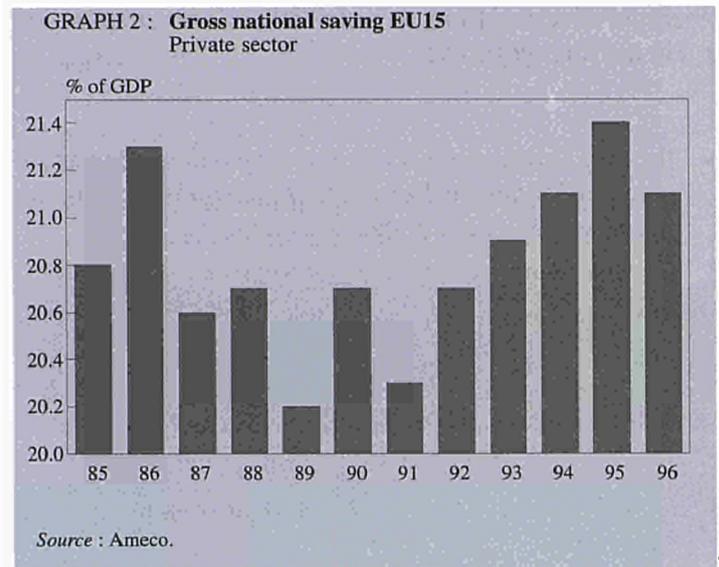
The savings structure of domestic sectors in the EU has in the past 10 years been subject to a cyclical pattern, but apart from this component been relatively stable: households had in 1995 saving rates of between 18% in Belgium to 7% in Portugal. In most Member States household savings were slightly declining between 1985 and 1989. The early eighties and late eighties, under a situation of recession and recovery respectively have seen higher and lower savings contributions by the household sector. In the same period corporate savings were up, which led to an overall stable rate of private savings of around 22% in 1995, slightly up from 21% in 1985. These rates were relatively strongly rising in Belgium, Austria, Finland and Sweden, and significantly declining in Greece, Ireland and Italy.

Together with a relatively stable net borrowing requirement of the public sector of 4–4.5% (with higher and lower values in recession and recovery times) this allowed the corporate sector to maintain a borrowing requirement of nearly 2% in 1990/91, about the same as in the early eighties, and clearly above the much lower borrowing requirement of companies in the mid and late eighties.



This situation compares to the one in Japan, where a private savings contribution of almost double the relative size fuelled company borrowing from 5 to 7 % and even more than 10 in 1990/91, a situation of exceptional circumstances. The US on the other hand has built on much lower private savings over the past 10 years. Considerable foreign capital inflow has nevertheless not allowed the US corporate sector to borrow on the capital markets at an equal level than in the EU, or even in Japan.

Although the volume of private domestic savings appears relatively satisfactory, the available pool of savings for private sector investment could be further enhanced by a future consolidation policy of public borrowers and by an



creasing private funding of old age retirement systems, due to the demographic change the Community will undergo within the next decades.

The structure of household savings still varies considerably among Member States (see table 1). However, in most Member States the bulk of household savings is directed towards bank deposits. Available figures for 1995 show a share of deposits in total household savings between 33.4% (Italy) and 53.7% (Spain). However in all Member States, for which data are available, the share of savings at institutional investors, and to a minor degree, of securities, is increasing in household portfolios of financial assets. This is particularly pronounced in Netherlands and France, where more than half of household savings are already channelled through insurance or pension plans. Thus the role of the banking industry is on this level slowly eroding.

TABLE 1 : Structure of household savings
(in % of total claims, year end 1995)

| | cash and deposits | long-term securities | pension fund and life insurance equity | others |
|-----------------|-------------------|----------------------|--|--------|
| D | 43.6 | 28.7 | 24.5 | 3.2 |
| E | 53.7 | 25.7 | 10.4 | 10.2 |
| F | 36.0 | 42.3 | 16.5 | 5.2 |
| I | 33.4 | 39.1 | 10.2 | 17.3 |
| S (1993) | 41.6 | 22.0 | 15.9 | 20.5 |

Source : OECD, own calculations.

2.2 Savings and financial liberalization

In some countries outside the European Union it had to be noted in particular during the past decade that financial liberalization led in some instants to an, at least temporary, significant decrease in private savings in the respective country. Such a development was attributed to two distinct development:

- the reallocation of financial assets which were before the liberalization to artificially large degrees held in the country. Such a reallocation resulted in respective capital outflows, not sufficiently matched by increased in-

flows of capital from abroad and therefore in a reduction in net foreign savings.

- the liberalization of borrowing and lending led to an increase of lending to the privates sector and therefore to a net reduction of net domestic savings.

The Community has been mostly able to avoid such problems when advancing its internal liberalization. Nevertheless the Community also experienced major swings in real asset prices over that period. Prices of commercial real estate, more so than prices for residential property, were rising in the Community, as in many other parts of the world in the eighties, before peaking in the late eighties. Since then real estate prices have strongly dropped also in the Community, by around 40 – 50% which is in line with developments on major markets outside the Community. However these changes have not led to the strains in the financial industry as in other markets.

2.3 International capital flows

2.3.1 Capital movements and financial integration

The availability of funds for domestic capital accumulation is increasingly influenced by cross-border capital movements. Such transactions are growing considerably faster than cross-border merchandise trade or trade in services, and thus the fastest growing type of cross-border transactions. Capital movements are essentially liberalized within the Community since 1 July 1990⁴.

In many Member States, however they have been liberalized well before that date. Therefore the effective transition to full freedom of capital movements for the Community as a whole was more than a gradual process extending over a considerable number of years.

The common measures of interest rate parities suggest that after the liberalization capital can now move fairly freely between Member States⁵, that is the criterion of covered interest rate parity holds. They have allowed a continued decoupling of domestic investment from domestic saving in the EU Member States.

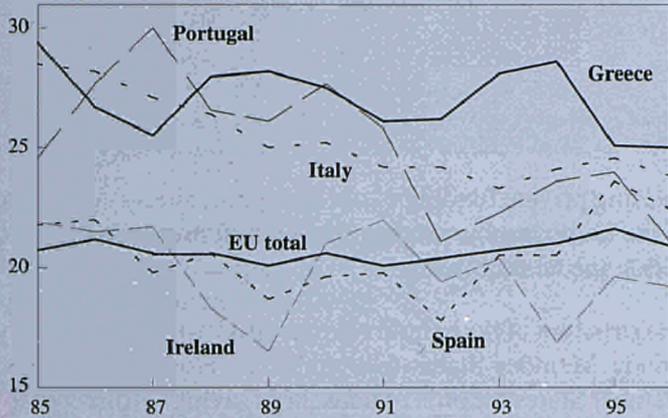
Chart 4 shows the gradual development of the relationship between domestic savings and domestic investment within EU Member States between 1985 and 1994: in an economy completely closed for capital flows the 45° line, thus the identity of domestic savings and investment, should hold. However the gradual "flattening" of the regression line reflects the growing independence of domestic investment from the available pool of domestic savings, thanks to foreign capital⁶.

⁴ With some countries enjoying a transitory period in which they could maintain some forms of capital movements. All these transition periods ended in May 1994 (with the full liberalization by Greece) at the latest.

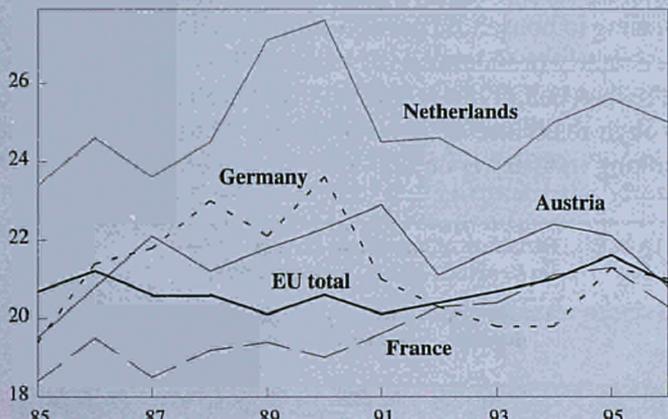
⁵ Lemmen, Jan, Eijfinger, Sylvester; "The Price Approach to Financial Integration: Decomposing European Money Market Interest Rate Differentials"; Tilburg University Center Discussion paper, January 1994. This finding suggests that perfect "covered interest rate parity" now prevails, imperfectly only for the case of Greece and Portugal (those countries which maintained capital controls the longest). Uncovered interest rate parity however is much less established, to be found only between Germany and the Netherlands.

⁶ Even under perfect capital mobility the correlation between the investment and savings ratios of different countries is not necessarily zero. In particular in case of immobile labour, external shocks, such as new specific technologies, might equally affect domestic investment and savings. See e. g. M. Obstfeld, Capital Mobility in the World Economy: Theory and Measurement", Carnegie-Rochester Conference Series on Public Policy 24 (Spring 1986) pp. 55-103.

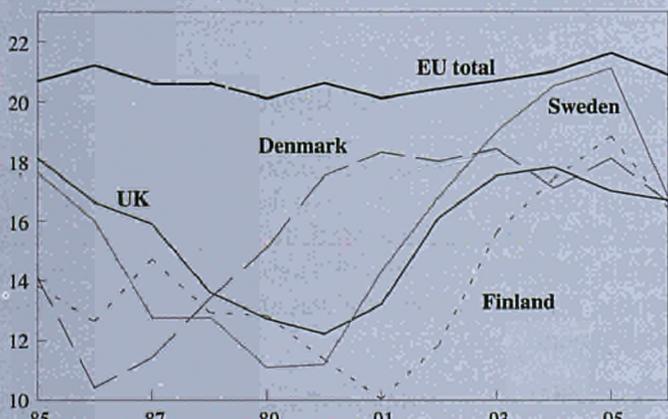
GRAPH 3a : Savings rates
Gross saving of private sector in percent of GDP



GRAPH 3b : Savings rates
Gross saving of private sector in percent of GDP



GRAPH 3c : Savings rates
Gross saving of private sector in percent of GDP



Source : European Commission.

Box 1: The Feldstein–Horioka condition for capital mobility

The Feldstein–Horioka condition¹ for perfect capital mobility, namely that due to freely flowing international capital flows, domestic savings and investment plans are uncorrelated, delivers weak, but positive evidence that the EU as a whole has been more open to the rest of the world as regards capital movements. Therefore the link between domestic savings and investment plans has become weaker.

If the regression equation $I/Y = \alpha + \beta S/Y + u$, where S/Y is the share of national savings at GDP, I/Y the share of investment at GDP, α and β parameters and u an error term is estimated², the following estimates occur, depending on the sample period:

Feldstein–Horioka equation: estimates for EU (15)

a) absolute values

| sample period | α | β | R |
|---------------|----------|---------|------|
| 1971 – 89 | 1.65 | 0.93 | 0.93 |
| 1990 – 95 | -1.8 | 1.18 | 0.82 |

The regression equation $\Delta(I/Y) = \alpha + \beta \Delta(S/Y) + u$, where $\Delta(S/Y)$ is the change in the share of national savings at GDP over the previous year and $\Delta(I/Y)$ the change in share of investment at GDP, α and β parameters and u an error term, gives the following estimates, depending on the sample period:

b) changes over previous year

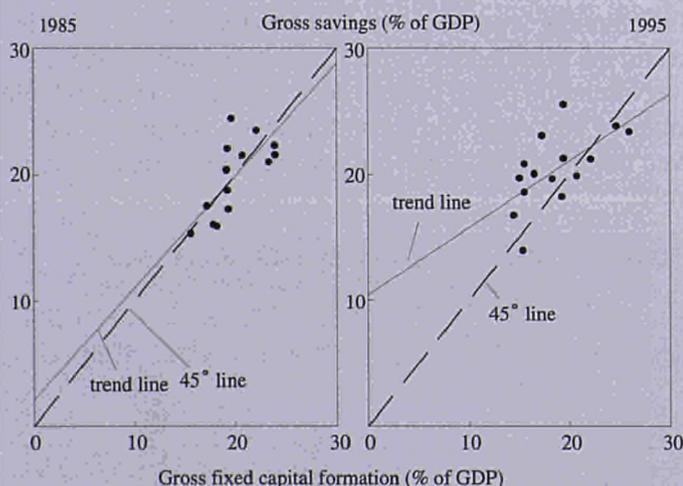
| sample period | α | β | R |
|---------------|----------|---------|------|
| 1971 – 89 | 0.05 | 1.0 | 0.76 |
| 1990 – 95 | -0.18 | 0.81 | 0.74 |

According to these estimates, the more recent period of 1990–1995 which essential reflects the period after the full abolition of capital controls, shows a weaker dependence between investment and savings plans within the Community. However, it is widely accepted that this measure would be affected by external shocks both affecting savings and investment and therefore distorting the estimate results.

¹ Feldstein M.; Horioka, C. (1980), "Domestic saving and international capital flows", Economic Journal, No. 358, pp. 314–29; see also Obstfeld, M. (1994) "International capital mobility in the 1990's", CEPR Discussion paper, No. 902 for an explicit use of this criterion on time series rather than cross-sectional data, the original approach by the former authors.

² Ordinary least squares (OLS).

GRAPH 4 : Gross fixed capital formation growth versus gross savings – EU15 (as % of GDP)



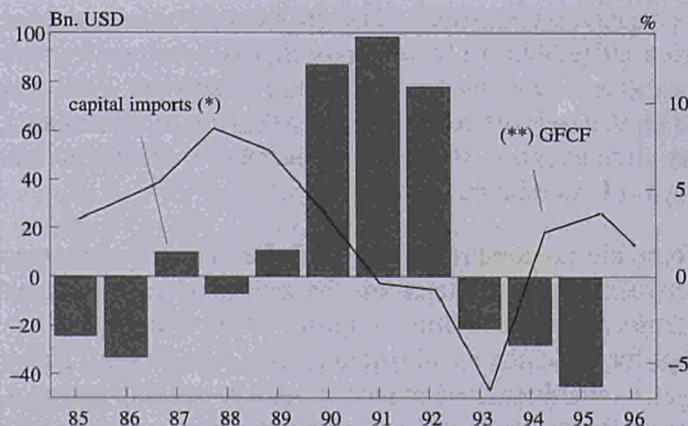
Source : Ameco.

The effects of capital liberalization and market integration in the Community have been both direct, being reflected in changes in the cross-border flow of funds, as well as indirect, taking the form of structural changes in financial markets and in the prices of financial services. Although capital mobility is certainly the initiating force and a prerequisite for these changes, both direct and indirect effects can be considered as the result of interaction of capital lib-

eralization, government reforms and market induced innovations.

There is an apparent high correlation between domestic and foreign investment by Community investors. As foreign investment in the Community is less cyclical, net capital inflows into the Community are negatively correlated to the business cycle.

GRAPH 5 : EU net capital imports* and domestic investment**



(*) Capital and financial account excl. reserve assets, use of fund credit, except. financing, & liabilities const. foreign authorities' reserves.

(**) GFCF, constant (1990) prices, annual growth rate.

Source : IMF, European Commission, own calculations.

2.3.2 Community developments and global trends

There was, in recent years a spectacular growth of international capital movements. This development was, however, more pronounced in the Community. The main features of this development are as follows:

- sharp growth of all categories of capital, in particular direct and portfolio investment;
- increased attractiveness of Community for direct investment capital;
- the emergence of Japan and more recently other countries in South East Asia as major sources of direct investment capital.

The main recent developments in the movement of direct and portfolio investment are shown in table 2.

TABLE 2 : Capital flows (Bn ECU)

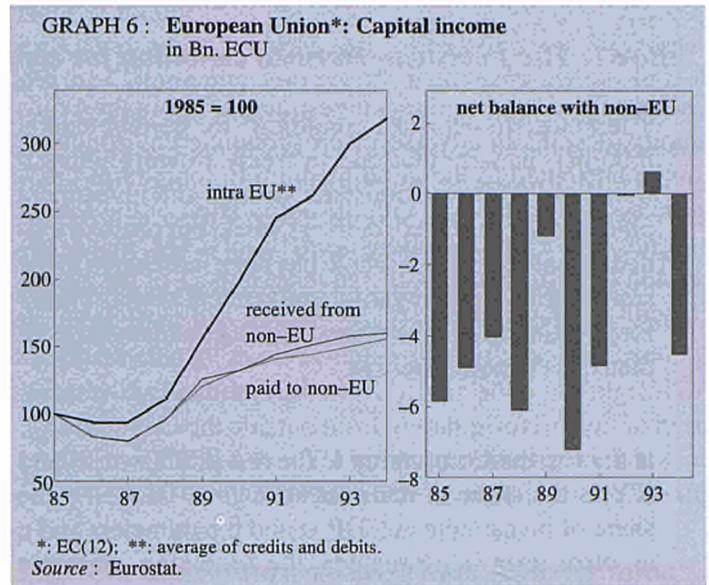
| | Direct Investment | | Portfolio Investment | | Other Investment | |
|-----------------|-------------------|-------|----------------------|---------|------------------|---------|
| | 1994 | 1995 | 1994 | 1995 | 1994 | 1995 |
| Outflows | | | | | | |
| EU* | 93.1 | 109.5 | 107.3 | 98.4** | 19.6 | 258.5** |
| USA | 46.6 | 72.8 | 50.8 | 75.2 | 33.6 | 79.6 |
| Japan | 15.3 | 17.2 | 75.9 | 65.7 | 29.6 | 78.4 |
| Inflows | | | | | | |
| EU* | 60.0 | 91.6 | 64.9 | 151.7** | 101.3 | 222.1** |
| USA | 40.8 | 46.0 | 116.4 | 180.3 | 83.0 | 97.7 |
| Japan | 0.8 | 0 | 56.6 | 38.6 | -9.1 | 73.6 |

*EU 15, including intra EU flows. ** without BLEU.
Source : Eurostat.

Growth in international capital movements peaked in 1989-90. Since then, there was a contraction of capital flows world-wide, a phenomenon linked to the beginning recession and increased uncertainty about asset price developments.

However, the recent contraction of direct investment flows has been much less pronounced in the Community compared to that witnessed in the USA or Japan, while flows of portfolio capital continued to grow in contrast to the above-mentioned global trend. The growth of portfolio capital from and to Member States has been most spectacular in the past years, growing by almost 300% between 1990 and 1993. A good part of the 1993 growth is due to withholding tax circumvention strategies of German residents, investing via Luxembourg.

There are no comprehensible data for capital movements between Member States on the one hand and between Member States and third countries on the other hand, except for the category of foreign direct investment. However, available indirect evidence, such as banking statistics or data for income from foreign capital, seem to suggest that overall intra-EU flows have risen much more strongly than capital flows with third countries. This would reflect the complete liberalization of capital movements and financial

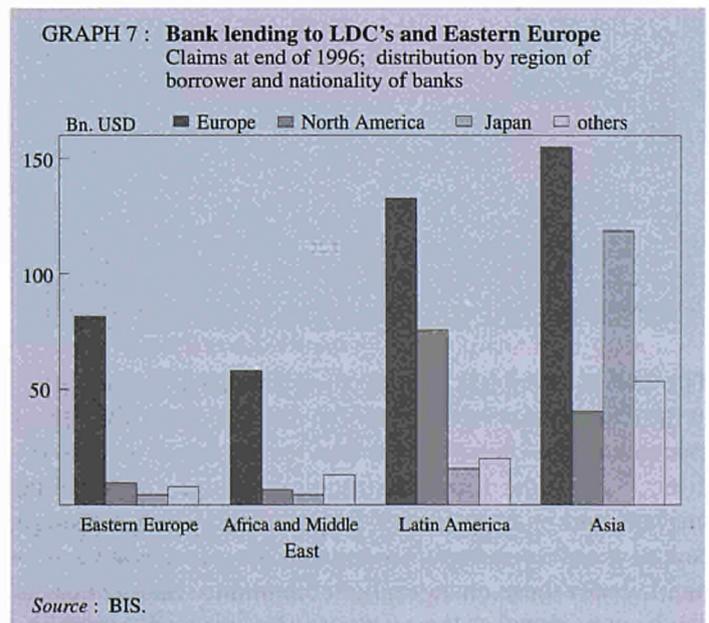


services within the EU and the indirect effects of the general single market programme.

Nevertheless capital movements with third countries have also risen strongly over the past decade, reflecting the ongoing integration of the EC financial markets into global markets.

It seems that, as compared to other major countries, such as the US or Japan, this growth of capital movements with third countries was particularly strong in the field of portfolio and debt flows, and less in the field of foreign direct investment.

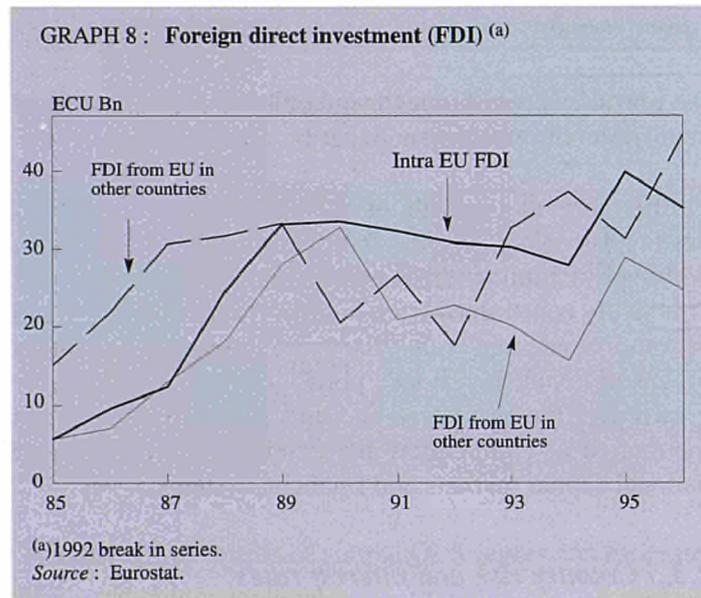
The EU financial markets and institutions play a major role in the debt financing of less developed countries and countries in transition. European banks hold around 60% of all debt to such countries, far ahead of the US and Japan. Bank lending is particularly strong to Eastern Europe Africa and the Middle East, where European banks finance the overwhelming par of foreign debt. However, even in Latin America and Asia, European banks are the main lenders, even before North American and Japanese banks, respectively.



2.3.3 Direct investment

The sustained level of direct investment flows in the Community, despite an adverse macroeconomic environment, can be attributed to the good medium to long-term prospects associated mainly with the completion of the Single Market. These considerations seem to outweigh, in the perception of entrepreneurs, the adverse impact of the recent difficult cyclical phase.

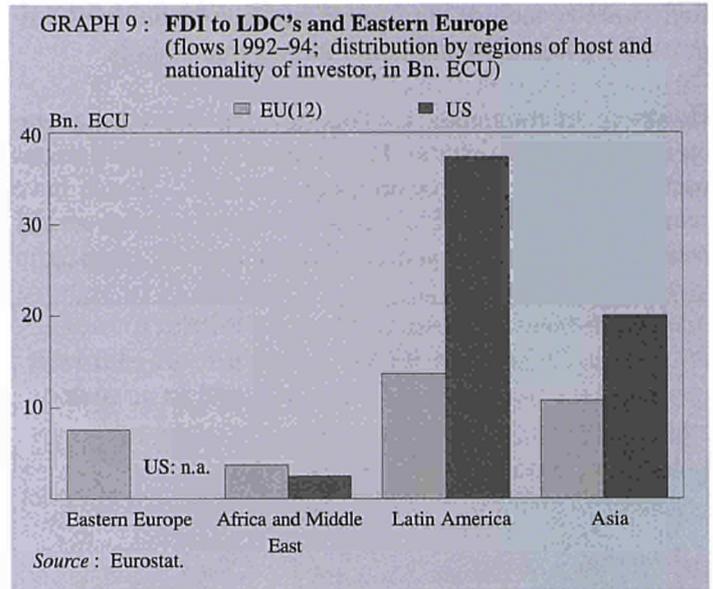
An insight might be gained from the comparative examination of inward (originating from outside the Community), outward (from the Community to the rest of the world) and intra-Community direct investment.



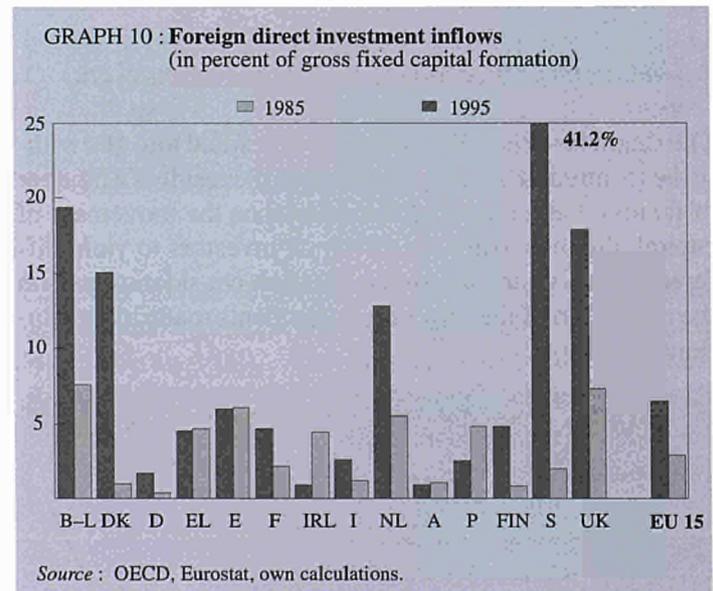
Inward direct investments grew at a much higher rate than outward direct investment over until 1990, although the absolute amounts of the latter remained also significant. Specifically the ratio inward/outward direct investment rose to about 0.80 in 1991 up from 0.35 in 1984, a development indicating the increasing attractiveness of the Community for foreign investors. Inward direct investment started to moderately decline after 1990, its level remain significant and, as noted above, contracted much less than the world-wide trend of direct investment flows. Foreign direct investment by EU investors in third countries have strongly grown since 1992, and in 1996 they clearly exceeded the level of intra-EU investment, as regularly until 1988.

EU FDI in developing countries is, compared to industrial countries, relatively low. Furthermore, it is concentrated on a relatively few number of countries. As compared to the US, and unlike in bank lending, the EU has a very clear deficit in FDI both in Latin America and in Asia. Only in Africa and the Middle East EU investors are more strongly represented than their US counterparts.

Also, noteworthy was the development of intra-Community direct investment as a percentage of total direct investment in the Community. Intra-Community direct investment rose to 60% of the total in 1991 compared to 40% in



1984. This development indicates that although inward direct investment grew sharply, intra-Community direct investment grew even faster. This development can be attributed to the "Single Market" effect, i. e. the aim of European companies to strengthen their presence and establish strategic alliances and to benefit from the Single Market.



The contribution of foreign direct investment to the productive potential of Member States has been significant. Overall the share of FDI (including intra-EU flows) in total gross fixed capital formation rose from 2.9% in 1985 to 6.5% in 1995. In certain cases the share of direct investment in gross fixed capital formation rose by several magnitudes, while in almost all Member States this share rose significantly. For example, in B/L this share rose by twelve from 7.5% in 1985 to 19.5% in 1995, in the UK from 7.4% to 17.8% and in Denmark from 1% to 15%.

Following the recent contraction of direct investment flows mentioned above, the share of direct investment in gross fixed capital formation declined from the peak levels of 1990-91. Beyond its significant quantitative contribution, foreign direct investment constitutes a qualitative input to the productive potential of the recipient economies. Identi-

fied benefits include the use of modern technology, improved organization and better management skills.

However international competition for capital has increased in the past years. The increase in competition has partly stemmed from developing countries. These have seen a dramatic rise in FDI inflows, after years of generally being deprived of this source of financing (see table 3).

TABLE 3: Direct investment : Inflows
(Bn \$, annual averages)

| | 1986-90 | 1991-95 | 1996 |
|---------------------------------|---------|---------|-------|
| Total | 147.6 | 193.9 | |
| Industrial countries | 124.1 | 161.0 | |
| of which: United States | 53.1 | 38.9 | 83.9 |
| Japan | 0.3 | 1.8 | 0.2 |
| Western Europe | 60.5 | 96.1 | 87.9* |
| Less developed countries | 23.5 | 32.8 | |
| of which: Asia | 13.7 | 20.2 | |
| Eastern Europe | 0.2 | 0.6 | |
| Latin America | 5.8 | 6.8 | |

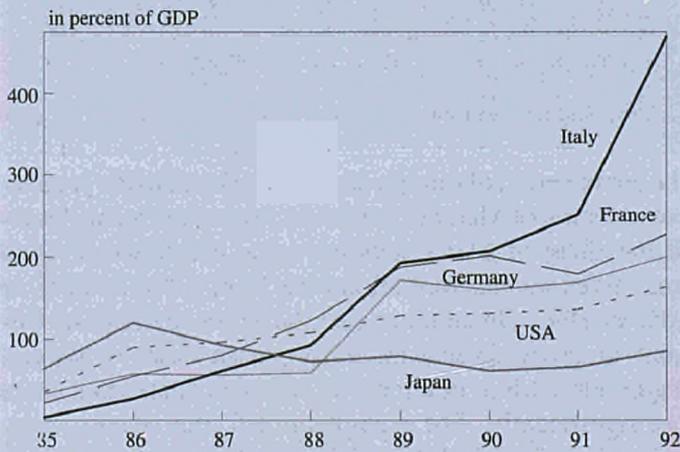
Source : BIS, OECD.
* partly estimated.

The European Union has now to compete for this resource in an increasingly competitive international environment.

2.3.4 Portfolio investment and financial markets

The steep rise in the flows of portfolio capital into and within the Community in recent years was the result of a number of factors: the removal of restrictions on the movement of capital, the increasing sensitivity of investors to yield differentials and portfolio diversification considerations and the relaxation of the limits on investments made by institutional investors.

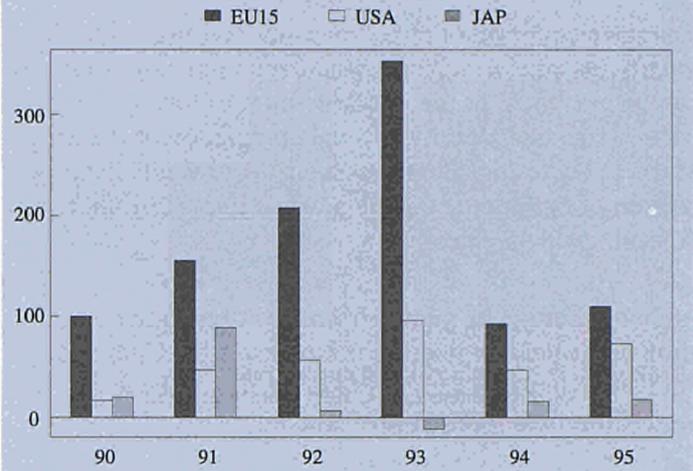
GRAPH 11 : Cross-border transactions in bonds and equities



Source : BIS.

The growth of portfolio investment capital reflects also the increasing sophistication and attractiveness of national equity and bond markets, notably government bond markets. It indicates at the same time the enhanced possibilities offered to Treasuries to tap the huge Community pool of savings. Existing data show that a substantial share of

GRAPH 12 : Portfolio investment inflows (Bn. ECU)



Source : Eurostat.

the portfolio capital investment reflects indeed increased acquisition of government paper by non-residents.

Furthermore the growth of mentioned institutional investors has enhanced cross-border securities' investment. Although institutions are in many countries (see below) still effectively constrained from investing abroad on the basis of some "prudential" rules, the overall internationalization of institutional investors' portfolios has considerably grown over the past years, and thus substantially affected the degree of competition and of efficiency of different national capital markets and financial systems.

2.3.5 Country risk and interest rates

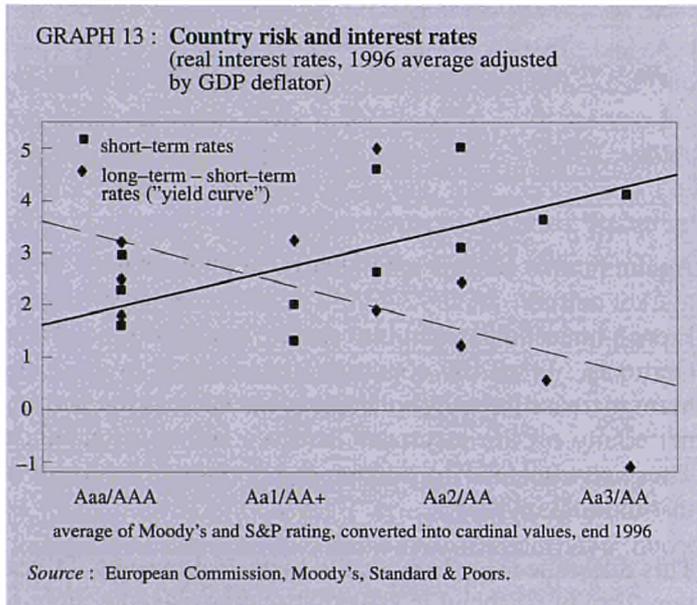
Some of the persistent differences in real interest rates are explained by different risk levels associated to the respective countries by foreign potential investors. For the Community some differences in this perceived risk remain. The country risks attributed by the large two rating agencies might indicate this situation (see table 4).

TABLE 4: Risk ratings for EU Member States
(long term debt in foreign currency)

| | Moody's | S&P |
|------------|---------|-----|
| B | Aa1 | AA+ |
| DK | Aa1 | AA+ |
| D | Aaa | AAA |
| EL | Baa1 | |
| E | Aa2 | AA |
| F | Aaa | AAA |
| IRL | Aa2 | AA |
| I | Aa3 | AA |
| L | Aaa | AAA |
| NL | Aaa | AAA |
| A | Aaa | AAA |
| P | A1 | AA- |
| FIN | Aa1 | AA |
| S | Aa3 | AA+ |
| UK | Aaa | AAA |

Source : Moody's, Standard & Poors; 2/1997.

For the past years there has been a continued correlation between interest rates and the perceived country risk. This relationship has not always been stable, but nevertheless significant. It shows that international mobility of capital is high enough to lead to a fairly efficient allocation of capital. It furthermore underlines the importance of such ratings obtained by rating agencies for the pricing of sovereign debt and thus the general interest level of the country. The following chart, on the basis of the above given country risk ratings by the two major rating agencies (ratings translated into cardinal numbers)



The respective results of simple OLS regression estimates are

$$\hat{r}^s = 1.24 + 0.76 cr; \quad r^2 = 0.47$$

$$\hat{r}^l = \begin{matrix} (0.57) & (0.25) \\ 5.25 & - 0.06 cr; \end{matrix} \quad r^2 = 0.003$$

(0.85) (0.36)

standard errors in brackets;

\hat{r}^s and \hat{r}^l : (1996) short-term and long-term interest rates, adjusted by the change in the GDP deflator;

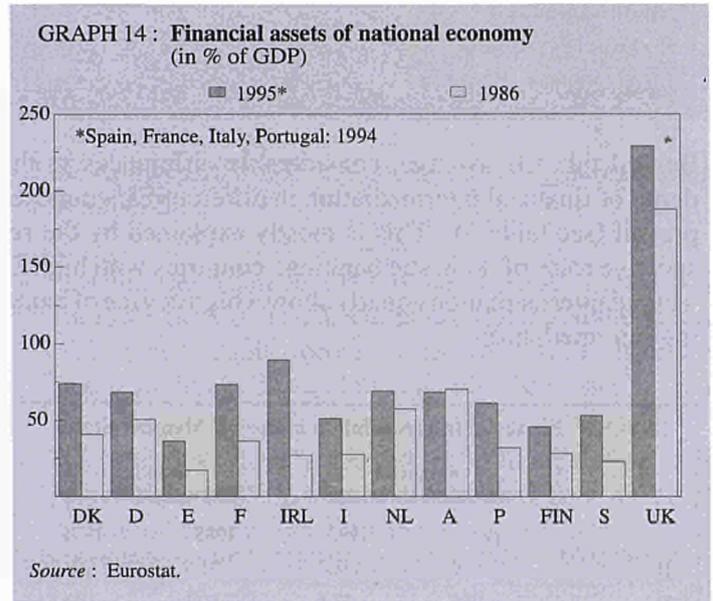
cr: country risk variable, at the end of 1996, average of Moody's and Standard & Poors risk rating for foreign currency debt.

Whereas the relationship between country risk and real short-term rates seems to be significant, the corresponding impact on real long-term rates seems much weaker. This result might, however, also be the effect of a misspecification of real long-term rates, where inflation expectations and actual inflation might more considerably differ, than on a short period.

3. FINANCIAL MARKETS STRUCTURE

3.1 Volume of financial markets

The role of financial markets in Europe is continually increasing. Financial assets have continued to increase strongly in all Member States, also (with the exception of Austria) in relation to the Gross Domestic Product. This underlines the increasing role of financial markets in the functioning of Member States' economies.

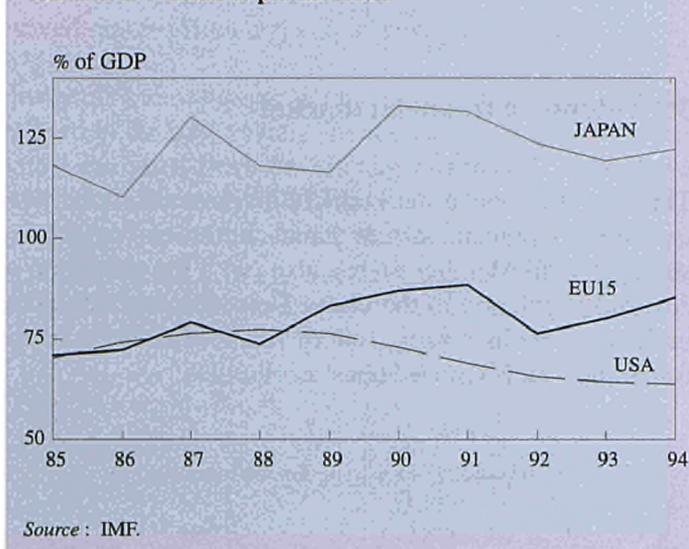


Loans to private sector borrowers at the end of 1995 reached more than 80% in percentage of GDP, up from less than 60% in 1980. The increase has been particularly strong in the period from 1987 to 1992, whereas in the US and Japan private sector borrowing has been relatively constant or even declining in the past three years.

Two factors explain this different pattern of the late eighties and early nineties of Europe: the economic downturn came later than in the other large economic areas, and, secondly, European banks were not plagued by lack of own capital as was the case with rival banks in North America and Japan. Intra-EU differences are large: particularly high are these figures for Luxembourg (152% in 1992) and the UK (115%). However, these two countries serve as international financial centres, thus these figures, as regards domestic intermediation are biased upwards. For the other countries, this ratio varies between about 100% (D and F) and 30 to 45% (B, DK, I, IRL).

In the same period, relative disintermediation continued, the securities markets increased their share even more strongly. From 1987 to 1992 the value of outstanding bonds increased strongly to about 60% at the end of 1992.

GRAPH 15 : Loans to private sector



Behind this EU average, considerable differences in the depth of financial intermediation in different EU countries prevail (see table 5). This is mostly explained by the respective roles of domestic banking: countries with high financial intermediation equally show a high degree of banking intermediation.

TABLE 5 : Financial Intermediation in the EU Member States

| | Financial intermediation rate ¹ | | Banking intermediation rate ² | |
|---|--|-------------------|--|-------------------|
| | 1985 | 1995 | 1985 | 1995 |
| B | 47.6 | 58.5 | 91.8 | 90.2 |
| D | 49.6 | 52.8 | 80.1 | 80.3 |
| E | 47.6 | 51.2 ⁴ | 75.0 | 70.8 ⁴ |
| F | 48.9 | 42.4 | 82.8 | 73.8 |
| I | n.a. | 39.9 | n.a. | 70.3 |
| F | 52.7 | 52.8 ³ | 61.9 | 62.0 ³ |
| S | 46.5 ⁴ | 49.6 | 40.9 | 33.2 ⁴ |

¹ Financial assets of financial institutions in percent of total financial assets.

² Financial assets of banks in percent of financial assets of financial sector.

³ 1993.

⁴ 1994.

Source : OECD, own calculations.

3.2 Structure of financial intermediation

The data which exist (OECD, not fully harmonized, financial accounts statistics) show particularly vast differences in the use of loans vs. shares (see table 6). Loan financing is particularly important in Spain and Germany, as it is in Scandinavia or Japan. Overall bank credit amounted, end of 1992, to 89% of indebtedness of non-financial companies in Germany, 82% in France, 68% in Italy, and only 63% in the UK. Financing by shares are relatively significant in the UK, France and Italy. A striking phenomenon all over Europe seems to be the absence of company bond issues (unlike the USA, where bonds play a major role in company finance).

On the other side, household saving (see chapter 2), similar differences in financial allocation behaviour exist within the Community compared to other countries.

TABLE 6 : Balance sheet of non-financial enterprises (in percent of total liabilities)

| | 1985 | 1994 | 1985 | 1994 | 1985 | 1994 |
|-----|--------|--------|------------------|------------------|-----------------|-----------------|
| | equity | equity | short-term liab. | short-term liab. | long-term liab. | long-term liab. |
| B | 34.3 | 40.9 | 42 | 38.8 | 23.8 | 20.4 |
| D | 39.5 | 39.9 | 42.9 | 44.9 | 17.6 | 15.3 |
| DK | 42.3 | 46.5 | 42.2 | 37.2 | 15.5 | 16.3 |
| E | | 39.8 | | 38.2 | | 22.1 |
| F | | 38.8 | | 37.7 | | 23.5 |
| I | 24.4 | 23.5 | 48.2 | 52.2 | 27.4 | 24.2 |
| NL | 40.8 | 43.8* | 35.8 | 29.5* | 23.5 | 26.8* |
| A | 38.2 | 46.5 | 45.5 | 37.6 | 16.3 | 15.9 |
| FIN | 27.8 | 35.5* | 39.4 | 25.7* | 32.8 | 38.8* |
| S | 34.8 | 33.8* | 40 | 39.5* | 25.2 | 26.7* |
| UK | 68.9* | 68.3* | 31.1 | 31.7 | ** | ** |

Source : OECD, Financial accounts of OECD countries.

Again France shows a relatively high degree of stock market culture. In 1992 43.6% of all financial savings of French households went into shares, compared to 0.2% in Germany. In all EU countries, for which data exist, the main increase in household assets has been in the form of net equity on life insurance reserves and pension funds. Thus household saving undergoes a pooling in the hands of institutional investors.

This difference is mainly due to historical reasons. A certain form of financial intermediation has played a more or less prominent role; this relative structure has been mutually supported by financing decisions of households and companies and enforced by the development of those financial institutions with the respective expertise. Thus, a high degree of loan financing, and thus low securitization, normally coincides with the universal banking type system.

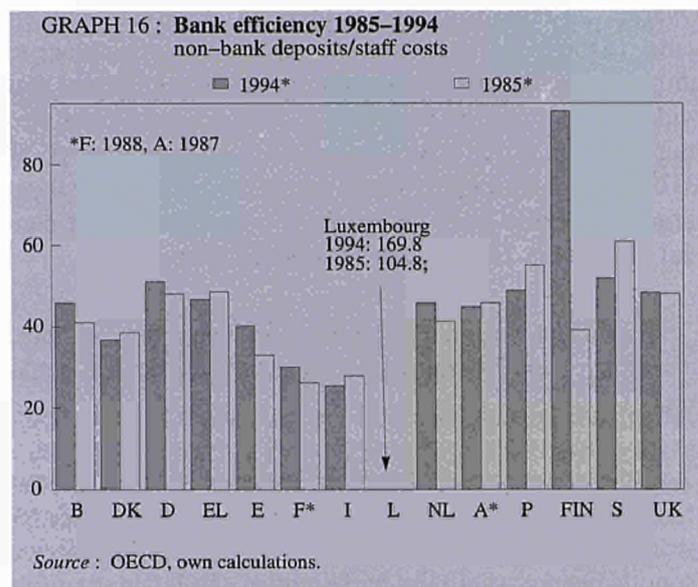
In all European countries all the major segments of financial markets are developed to some extent, but to a very different degree. Some market segments, particularly playing a role in the financing of companies, do not exist in some Member States. Commercial paper instruments have for a long time played a prominent role in the US as an alternative source of company finance to direct loans, although the relative difference to loans has been almost wiped out by the strong involvement of banks in the placing of such paper, by opening its client base to such issues and by guaranteeing the placement of such paper (Revolving Underwriting Facilities). Commercial paper markets exist in six EU countries (B, D, E, F, NL, UK). But only in France and Spain does Commercial Paper play a sizeable role.

3.3 Banking industry

3.3.1 Loans and deposit taking

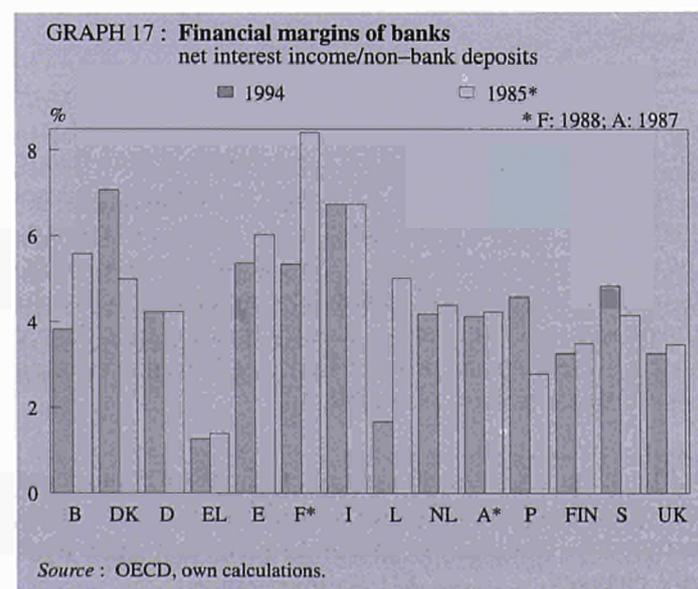
Classical banking intermediation by deposit taking and loans is still, as noted, the main channel of saving and investment financing in the Community. All EU Member States have a well developed banking sector active in this market.

The efficiency of the respective domestic banking sectors improved slightly in the eighties⁷. However large cross-country differences remain. Various different measures of efficiency can be applied: staff costs per deposit, which give information on the cost side of intermediation; or net interest income per deposit, which also takes into account a possible lack of competition within the banking sector, and thus adds information on the efficiency of the industry structure. The most efficient banking sectors, under both criteria, are to be found in Germany and the Netherlands (apart from the special situation in Luxembourg). The industries in the other EU countries are in an intermediate group (although no data is available for Greece or Portugal), whereas in Italy the lowest, by far, cost efficiency prevails. The situation is more complex as regards the other criterion on interest rate margins; apart from the two efficient countries mentioned, other countries show very different results. The UK, Belgium, and Denmark follow, with a certain margin between each of these. Relatively poor figures emerge for Spain, France, and Italy (see table 7).



These results partly reflect the state of banking deregulation in Member States:

- in countries where regulation was not extensive already in 1985, such as the UK, Germany, and the Netherlands, financial margins decreased (as structural restrictions were gradually lifted), but at a rather low rate;
- in countries where some efforts in deregulation took place since 1985, in particular regarding fees and commissions, the decline in financial margins is steeper (F, B, L);
- among those Member States which have started deregulating later, Spain, which has undertaken the most significant deregulation mainly after 1985 – 1987, enjoyed declining margins. In Portugal and Greece margins were equally declining, but only since 1991. Finally, in Italy, where some structural deregulation was undertaken, margins are still rising and show a high discrepancy with the rest of Europe in terms of regulation.



| labour costs interest spread | low | medium | high |
|------------------------------|----------|--------|------|
| low | D, NL, L | UK | |
| medium | | B, DK | |
| high | | E, F | I |

Source : Jordi Gual, D. Neven: Banking; in: European Economy; Reports and Studies 1993(3).

3.3.2 Banking profitability

The overall development in the *cost structure* of EU banks has improved over the past decade. In particular, staff expenses have, in relation to the average balance sheet decreased in most countries. The only notable exception to this increase in labour productivity has been Italy, where relative personnel expenses have even been slightly higher than in the early eighties. This exceptional development coincides with an above average development in the operating margin and net provisions of Italian banks: Unlike in other large EU banking markets, Italian banking did not experience at the same time a squeeze of its operating margin, nor the need for large provisions for outstanding loans. Thus, it seems that the pressure for efficiency gains had been lower in Italy.

Banks' *financial margins*, as measured as the ratio between net interest income and non-bank deposits, overall declined from 1985 to 1993 in the Community (EC-15). In Denmark, Portugal and Greece, financial margins in 1993 were larger than in 1985, however a decreasing trend has been observed already since 1991. On the contrary, in Italy and Sweden the trend in financial margins from 1985 and 1993 has been steadily increasing.

⁷ See: Gual, Jordi, Neven, Damien ; Banking; Annex to European Economy – Social Europe; No. 3, 1993; pp. 151 ff.

Overall, as regards financial margins, a certain convergence in the recent years among EC countries took place as compared to the 1980s where the variety of regulations was wider. The margins of banks in some highly regulated markets were at that time substantially above average (F, E, B) compared with unregulated markets whereas now these large differences have decreased (on average, high financial margins in 1993 do not go beyond 5%).

Consolidation within the banking industry has, in most countries of the EU increased concentration within banking.

Over the same period, financial margins in the US have steadily increased from 4.2% in 1985 to 5.2% in 1993, reflecting the recovery of the banking sector in this period from its deep crisis in the mid eighties. In Japan, margins are much lower than in the US and have overall remained at the same level around 1.6%.

3.3.3 Stability and consolidation

Over the period from 1985 to present, concentration has overall only little changed (see table 8). Whereas in some, formerly more regulated and state-owned markets, concentration fell over the period (Greece, France, Portugal), it increased in particular in Denmark, Spain and the UK. Concentration levels are naturally, given the very different market sizes, quite dispersed. The market share of the five largest banks amounted in 1994 in the Netherlands to 84%, Belgium, Spain and Greece around 60%, UK, France and Italy around 45%. It was relatively low in Germany (28%) and in particular, given the specific nature of its market, Luxembourg (19%).

| level 1994 change 85-94 | low | medium | high |
|----------------------------|------|----------|------|
| decrease | | EL, F, P | |
| little / no change | D, L | I | NL |
| increase | | B, E, UK | DK |

Source : Economic Research Europe Ltd.

Most of the changes in market concentration were due to external corporate growth by means of mergers and acquisitions of and between banks in the respective country. The overall volume and time profile of M&A in the different countries is quite different, following more specific circumstances in the respective country (profitability, degree of state ownership and privatization, ...) than an overriding pan-European pattern (see table 9).

Unlike in the US in the 80's or in Scandinavian countries at the beginning of the 90's, the EU banking system has demonstrated its resilience to external shocks and rapid asset price changes.

TABLE 9 : Mergers and acquisition in banking
(in percent of M&A in all industries)

| | 1989-90 | 1991-92 | 1993-94 | 1995-96 |
|-------|---------|---------|---------|---------|
| B | 0.2 | 14.1 | 7.0 | 7.9 |
| D | 4.5 | 6.5 | 7.6 | 3.5 |
| E | 18.5 | 13.5 | 21.5 | 34.1 |
| F | 5.1 | 4.3 | 1.0 | 10.4 |
| I | 22.7 | 15.6 | 17.7 | 19.7 |
| NL | 56.3 | 0.2 | 0.5 | 9.5 |
| FIN | 13.9 | 22.3 | 21.7 | 11.3 |
| S | 8.8 | 3.8 | 2.0 | 0.4 |
| UK | 2.6 | 6.5 | 3.4 | 12.4 |
| USA | 7.3 | 18.7 | 9.0 | 13.5 |
| Japan | 71.8 | 0.3 | 18.8 | 77.0 |

Source : BIS, Annual Report 1996.

Essentially only very few banking failures took place since 1985:

- the *Bank of Commerce and Credit International* (BCCI), the largest bank in Luxembourg, collapsed in July 1991. It was closed down by regulators;
- the Spanish *Banesto* had an acute liquidity crisis in 1994. It was saved by the Spanish deposit insurance scheme, and later sold to another Spanish bank.
- the UK bank *Baring's* collapsed in February 1995 over uncovered losses in stock options traded in Singapore; it was subsequently taken over by the Dutch ING.

None of these failures had any serious repercussion on other financial institutions. Thus the feared systemic risk inherent in the banking sector, did not materialize even in these few large banking failures in the Community over the past few years.

To this result contributed a number of factors, among which the overall stability of the general economies, the efficient prudential supervision, the quality of banking management and the improved capital base which has increased over the last decade. In international standards, though, the EU banks' capital base is not exceptionally high. Whereas, as regards the largest 500 banks world-wide, EU banks accounted for 43% of all assets, they only accounted for 37% of tier one capital⁸.

3.3.4 Payments system

Tremendous efforts have been made over the past decade to enhance the domestic payments systems. Efficiency has been strengthened by switching gradually from paper-based to paperless means of payments. The value of paperless transactions (credit transfers or direct debits) in the EU amounted in 1995 to around 60% of total transactions, up from 34% in 1988. However, there are still considerable differences among Member States. Belgium, Ireland, and Portugal rely still to a large degree on paperbased transactions. In many other Member States, the value of paper-

⁸ See: The Banker, July 1997.

based transactions has fallen below 10% and is falling further.

The stability of the payments system has been enhanced by the progress in the introduction of Real-time gross settlement systems (RTGS). Such systems allow the reduction and virtual elimination of time lag between a payment order and the final settlement of the order, and thus an important source of possible credit risk which might spread over, affecting other institutions participating in the payments system⁹. Most Member States have now such a system in operation, whereas in 1985 only the UK, with its CHAPS system, had such a system. Recent introductions took place in Belgium in 1996, the ELLIPS system, or Italy, the BIREG system in 1997.

Furthermore Member States decided that all Member States such have such a system, and that these systems should be linked by the TARGET system. Such Community-wide introduction of that type of system, and the linking of these systems will additionally reduce the systemic risk in the payment system of Member States.

3.4 Securities markets

3.4.1 Stock markets

Total market capitalization of EU stock markets amounts to 22% of total international stock market capitalization. As an EU average this amounts to 32% of total GDP, as compared to 68% in the US and 65% in Japan.

However, within the Community differences are considerable (see table 10): the largest stock market by far, measured in terms of market capitalization, in absolute and relative terms, is the UK, followed by, in relative terms, the Netherlands. Relatively small are the market capitalization in Greece, Italy and Austria. Differences in trading vol

| | market capitalization in % of GDP | trading volume in % of market capitalization | trading volume in % of GDP |
|------------|-----------------------------------|--|----------------------------|
| B | 45.9 | 18.6 | 8.6 |
| DK | 41.8 | 50.8 | 21.2 |
| D | 29.6 | 112.3 | 33.3 |
| EL | 19.7 | 34.3 | 6.7 |
| E | 42.3 | 97.9 | 41.4 |
| F | 38.9 | 163.4 | 63.5 |
| IRL | 49.7 | 17.0 | 8.5 |
| I | 21.7 | 39.9 | 8.6 |
| L | 193.4 | 2.3 | 4.5 |
| NL | 97.8 | 49.4 | 48.3 |
| A | 14.3 | 32.1 | 4.6 |
| P | 23.7 | 28.7 | 6.8 |
| FIN | 50.7 | 35.5 | 18.0 |
| S | 97.2 | 53.5 | 52.0 |
| UK | 149.9 | 44.1 | 66.1 |
| EU | 53.0 | 72.6 | 38.5 |

Source : Federation of European Stock Exchanges, own calculations.

umes are even larger among Member States. Whereas the markets in Luxembourg, Ireland, Belgium and Portugal have shown a turnover in 1996 of less than 30% of the domestic market capitalization. On the other end, German, French and Spanish markets have proven to be highly liquid.

Within the last 5 years, stock markets have, measured in capitalization and number of quoted companies, increased their role in the Netherlands, France, and Greece, and decreased in Belgium and the UK. However, liquidity in these markets very often differs sharply from the size of tradable assets. In 1996 the German and UK exchanges accounted for more than 76% of all equity market turnover in domestic companies in the Community. Within the last 5 years an increase in trading activity of about 50% took place in the Community. However in the same period for Belgium, Ireland, and Italy this number dropped whereas in other markets (Germany, Greece, Denmark, Portugal, France) the increase was above the EU average.

However, to a large extent, stock markets do not serve as an alternative to financial intermediation but just as a supplement, as it is to a certain degree financial services companies which tap the stock markets (e. g. as a percentage of total capitalization in Portugal 73%, and in Italy 67%). There is a negative correlation between the size of the overall stock market and the share of financial firms. In other words, the absolute figures even underestimate the different degrees of stock market financing of non-financial companies.

Member States' organized stock markets mostly trade domestic equity only. Financial integration has not changed this type of segmentation. Only London has a sizeable amount of trading in foreign shares (around 2/3 of total trading in London, around 95% of total EU trading in foreign shares), far ahead of German (where a very large number of foreign shares is listed but in which trading is quite thin) and French markets.

Apart from the London SEAQ, most EU stock markets still basically trade domestic securities. Nevertheless, financial integration has over the past years translated into a closer interrelation of national stock markets. Cross-border securities transactions have very strongly increased and portfolios in particular of institutional investors have become more international.

This closer integration has translated into a higher correlation of national stock market prices. As table 11 shows, a simple comparison of the period 1991-1996 with 1985-1990 shows the increasing correlation between EU markets. For example, the correlation between the German

⁹ See the report of the BIS: Real Time Gross Settlement Systems, 1997.

TABLE 11: Change in correlation of share prices
(correlation of monthly values of national share price indices, change in period 1991-96 over period 1985-90 in % points)

| | B | DK | D | E | I | NL | FIN | S | UK | USA |
|-----|-------|------|------|-------|-------|------|------|-------|-------|-----|
| B | 0 | | | | | | | | | |
| DK | 0.35 | 0 | | | | | | | | |
| D | 0.42 | 0.23 | 0 | | | | | | | |
| E | 0.01 | 0.58 | 0.62 | 0 | | | | | | |
| I | -0.02 | 0.3 | 0.02 | 0.11 | 0 | | | | | |
| NL | 0.13 | 0.19 | 0.13 | 0.20 | -0.13 | 0 | | | | |
| FIN | 0.01 | 0.5 | 0.75 | -0.06 | 0.35 | 0.33 | 0 | | | |
| S | -0.02 | 0.24 | 0.37 | 0.03 | 0.04 | 0.11 | 0.10 | 0 | | |
| UK | 0 | 0.34 | 0.36 | -0.04 | -0.08 | 0.13 | 0.11 | 0.03 | 0 | |
| USA | -0.05 | 0.23 | 0.17 | -0.10 | -0.32 | 0.08 | 0.05 | -0.03 | -0.03 | 0 |

Source : Eurostat; own calculations.

and Dutch markets has increased by 0.13 points. Overall, the correlation has increased over this period within the EU, whereas the corresponding correlation of Member States' markets with major third markets, such as the US, has virtually remained the same in these two periods (see table 11).

3.4.2 Bond markets

EU bond markets account for about 32% of all outstanding bonds world-wide¹⁰. However within the Community there are large differences in the absolute and relative size of the respective bond markets (see table 12).

The largest EU bond markets are by far the German and Italian ones with together nearly half of all EU outstanding

TABLE 12 : Bond markets' size
(all domestic fixed income securities, 1996)

| | Bn. ECU | | | % of GDP | | |
|-----|----------------|---------------|---------|----------------|---------------|-------|
| | private sector | public sector | total | private sector | public sector | total |
| B | 165.3 | 348.4 | 514.2 | 49.3 | 103.7 | 153.0 |
| DK | 222.3 | 143.2 | 365.6 | 100.4 | 64.7 | 165.1 |
| D | 1301.0 | 1083.9 | 2384.8 | 43.5 | 36.3 | 79.8 |
| EL | 1.0 | 125.3 | 126.3 | 0.7 | 80.3 | 81.0 |
| E | 54.7 | 377.8 | 432.5 | 7.3 | 50.6 | 58.0 |
| F | 697.7 | 875.9 | 1573.6 | 35.6 | 44.6 | 80.2 |
| IRL | 2.0 | 36.8 | 38.9 | 2.3 | 41.3 | 43.6 |
| I | 520.6 | 1622.5 | 2143.1 | 33.8 | 105.2 | 139.0 |
| L | 13.7 | 1.3 | 15.0 | 61.6 | 5.7 | 67.3 |
| NL | 85.2 | 253.1 | 338.3 | 17.1 | 50.8 | 67.8 |
| A | 89.3 | 93.3 | 182.6 | 31.9 | 33.3 | 65.2 |
| P | 23.6 | 57.8 | 81.4 | 17.9 | 43.8 | 61.7 |
| FIN | 41.8 | 64.9 | 106.7 | 26.7 | 41.4 | 68.1 |
| S | 199.9 | 181.2 | 381.1 | 62.9 | 57.0 | 119.1 |
| UK | 328.4 | 593.4 | 921.7 | 22.6 | 40.8 | 63.4 |
| EU | 3747.0 | 5858.6 | 9605.6 | 34.4 | 53.7 | 88.1 |
| US | 5730.3 | 9017.7 | 14748.1 | 62.1 | 97.8 | 159.9 |
| JAP | 1865.4 | 4188.9 | 6054.3 | 32.0 | 71.9 | 103.9 |

Source : BIS, own calculations.

bonds. As regards bond markets for private issuers, in most of the EU Member States bond markets do not provide a feasible alternative for company funding. Germany has, in absolute numbers, the largest private sector bond market, mostly driven by mortgage-backed or other bank bonds. As compared to the size of the economy, Denmark, Sweden and Germany have relatively large market. The main issuers on the markets are either governments or financial institutions. Other corporate bonds are, with the exception of France, the Netherlands and Spain, almost non-existent. Public sector bond markets are, in relative terms, particularly dominating in Italy, Belgium and Greece.

Certain instruments on the bond markets are not yet developed. This applies in particular to indexed bonds¹¹.

Government bond markets, as the largest and most liquid segment, have become the main target for cross-border acquisitions of securities, in particular reinforced by the increased activity of institutional investors. Table 13 might give an indication of the state of this trend.

Two cases, Italy and Portugal clearly buck the trend, as they show either a continuously very low level of foreign in-

TABLE 13 : Gross general government debt held by non-residents
(% of outstanding debt at year end)

| | 1987 | 1993 | change |
|-----|------|------|--------|
| B | 16 | 20 | ↗ |
| DK | 36 | 51 | ↗ |
| D | 21 | 34 | ↗ |
| EL | 34 | 26 | ↘ |
| E | 3 | 20 | ↗ |
| F | 3 | 31 | ↗ |
| IRL | 48 | 56 | ↗ |
| I | 4 | 2 | ↘ |
| NL | 9 | 16 | ↗ |
| P | 23 | 15 | ↘ |
| UK | 13 | 15 | ↗ |

Source : EMI Public Finance Report, 5/1994.

¹⁰ Salomon Brothers; "How big is the World Bond Market?"; September 1993.

¹¹ See e. g. for the discussion of these instruments: Viard, Alan; The Welfare Gain from the Introduction of Indexed Bonds; JMCB; Vol. 25(3); p. 613-29.

volvement or a significantly dropping foreign ownership. Both cases can be mostly explained by the respective tax system, which imposes or imposed withholding taxes on the bond yields of these securities also to non-residents, and thus had a structural competitive disadvantage as compared to most other markets where such a taxation on non-residents does not exist (see the chapter on tax issues related to capital movements).

3.4.3 Derivatives markets

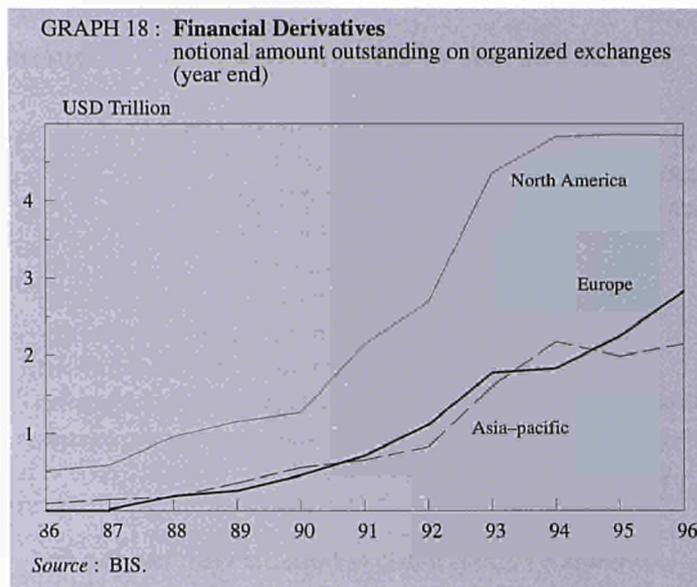
One of the major features of European fixed-income markets is the high and increasing presence of institutional investors and their interest in easily hedging their bond portfolio against interest rate changes. Thus, the attractiveness of a bond market is increasingly linked to the existence of an efficient market for interest rate derivatives. Consequently, organized derivatives' markets are mainly driven by contracts on fixed-income claims (see table 14).

TABLE 14 : Derivative financial instruments traded on organized markets
Notional principal amount outstanding (Bn. USD, 31/31997)

| | total | of which in Europe |
|-----------------------|--------|--------------------|
| Interest rate futures | 6529.1 | 182 |
| Interest rate options | 3776.9 | 111 |
| Currency futures | 50.7 | 0.8 |
| Currency options | 52.3 | 1.1 |
| Equity index futures | 214.7 | 61. |
| Equity index options | 422.7 | 134 |

Source : BIS.

At present liquid interest derivatives markets exist for the currencies of several Member States (Germany, Spain, France, UK). In the case of DM contracts two major markets (LIFFE, DTB) compete for business; whereas in the other cases one, domestic, market only exists. For a few other currencies (ITL, HFL, BEF) derivatives are traded, but the volume is relatively minor. For currencies closely linked to DM the DM derivatives market serves as the more liquid alternative for derivatives transactions, leaving just a relatively minor risk of unparalleled movements between the two different interest rates (base risk) All these markets have been started within the last 5 years at most, thus significantly later than the US markets where financial futures were first introduced in the late seventies. Initially long-term contracts were developed and introduced; more recently short-term contracts (typically three-months-contracts) were launched and are in large demand. LIFFE is the largest derivatives exchange in the Community, and the only one with significant business in derivatives on foreign securities or indices. In 1996 around 168 Mio. contracts were traded on its floor (after just 39 Mio. contracts in 1991), of which around 53% were in DM interest rate contracts.



Thus growth of financial derivatives has been in the past few years particularly strong in Europe (see chart 18), where for a long time the development was considerably lagging behind the US. However this gap is about to be closed.

The *systemic risk* associated with these markets has proven to be small, as efficient clearing houses guarantee settlement and delivery on all these markets.

No increase in the interest rate *volatility* following the introduction of such markets within the EU could be discovered. Nor do those bond markets with liquid derivatives markets exhibit higher interest rate volatilities than those without. History teaches, if at all; the reverse causality: high interest rate volatility, caused by monetary policy or external economic shocks, created the demand for derivatives, in order to allow economic agents to hedge against sudden interest rate changes, or to take speculative positions. Stock market derivatives play, as compared to interest rate products, a minor role on the derivatives exchanges.

The weight of exchange rate derivatives is even smaller, as the major market activity in this field is confined to the unorganized interbank market. Trades on this market are not reported on a regular basis; only a survey carried out by the BIS in 1992 casts some light on the size and structure of this market.

No trading supervision, as for regular exchanges, exists for these interbank exchange market. The only supervisory rules apply to capital adequacy standards in relation to open currency positions. As there is no central clearing institution acting on this market, open positions between the participating commercial banks are not netted against each other. Thus possible repercussions from the failure of one bank to meet its obligations subsequently on other banks (systemic risk) is amplified.

Box 2: The role of derivatives in financial intermediation

Initially, financial derivatives markets were a market-driven answer to volatility in interest rates stemming from increased inflationary expectations and "volatile" monetary policy in some major Western economies. They were conceived, basically, as a hedging instrument for long term investors. A consequence of this situation is that at present the major financial derivatives products are interest rate related products in order to allow big institutional investors to hedge the interest rate risk of their portfolios, who are to a large extent concentrated in bonds.

In today's capital markets both the cash and the derivatives markets form a single entity. Both are different methods of dealing with the same financial instrument and, thus, they move together in the same direction. This result is assured by arbitrageurs, which equalize prices between both markets.

At the beginning of their development, derivatives markets followed cash markets in their movements, as the former were simply hedging tools. However, nowadays, derivatives markets tend to become the primary market place where the "discovery price" activity is carried out, sending messages to cash markets, which tend to follow.

Several competitive advantages of derivatives markets over cash markets have contributed to this role reversal:

1. Some of the products, traded on the derivatives markets, are "ideal-type" of assets, such as certain notional bonds or stock indices. These assets allow asset managers to precisely adjust their portfolios to their specific needs. Cash markets provide only approximations to these contracts.
2. Transaction costs are lower, as the delivery and settlement of the security as such is not necessary.

3. They allow investors to leverage their positions very flexibly without having to borrow from credit institutions.
4. They are a flexible tool for investors to quickly reallocate their funds between different financial instruments within their portfolios.

Because of these factors "marginal" transactions are basically made in the derivatives markets, which form the critical mass in the process of price formation. The facilities given to investors by derivatives markets for a quick and efficient reallocation in their portfolios and in taking fresh positions, coupled with their linkage with the underlying cash markets, have the effect of improving the transmission and discounting of any piece of news into market prices and, thus the efficiency of markets to incorporate all information available.

Derivatives markets have also an important impact in improving the liquidity of underlying cash markets, not only via arbitrage activities, but also by the fact that derivatives markets allow investors to hedge their positions in the underlying markets and, thus, the possibility of reducing market risks, which is a powerful incentive for big institutional investors. Highly liquid markets have a positive impact on funding costs in the underlying markets, since the risk premium tends to be lower than in markets with lower liquidity.

Finally, evidence shows that derivatives markets do not increase the price volatility in the underlying cash markets. Volatility in those financial centres with relatively well developed derivatives markets does not seem to have substantially increased over recent years and, what is more important, it is lower than in other markets with no significant derivatives markets activity.

3.4.4 Foreign exchange markets

Foreign exchange markets have world-wide grown very rapidly in the past few years, and are mostly in the form of interbank over-the-counter markets. According to the last triennial BIS survey on this issue, the total daily volume amounted in April 1995 to around 1136 Bn USD.

During that period EU markets amounted to around 50% of global markets, up from 48.6% in 1992 (see table 15). The UK is the dominant market place for foreign exchange turnover, with around 29.5% of the global and 58.6% of total

EU foreign exchange business, far ahead of Germany and France. The US dollar remains the most heavily traded currency on these international markets, far ahead of Germany and France within the EU.

The USD has remained the main traded currencies, representing around 83% of total volume of 200% for both sides. EU, including the ECU, amounted to 69%. Thus, the predominance of EU markets for foreign exchange trading does not necessarily translate in a similar dominance of EU currencies in international trading. Here the USD has maintained its position, amounting to more than all EU currencies combined.

TABLE 15 : Foreign exchange turnover; April 1995

| Countries | % of total | Currencies | % of total |
|-----------|------------|-----------------|------------|
| B | 1.8 | DM | 36.1 |
| DK | 1.9 | FF | 7.9 |
| D | 4.9 | GBP | 9.4 |
| EL | 0.2 | other EMS curr. | 13.5 |
| E | 1.2 | ECU | 2.2 |
| F | 3.7 | total EU curr. | 69.1 |
| IRL | 0.3 | USD | 83.3 |
| I | 1.5 | Yen | 24.11 |
| L | 1.2 | total | 200* |
| NL | 1.6 | | |
| A | 0.9 | | |
| P | 0.2 | | |
| FIN | 0.3 | | |
| S | 1.3 | | |
| UK | 29.5 | | |
| EU | 50.4 | | |
| US | 15.5 | | |
| Japan | 10.3 | | |
| total | 100 | | |

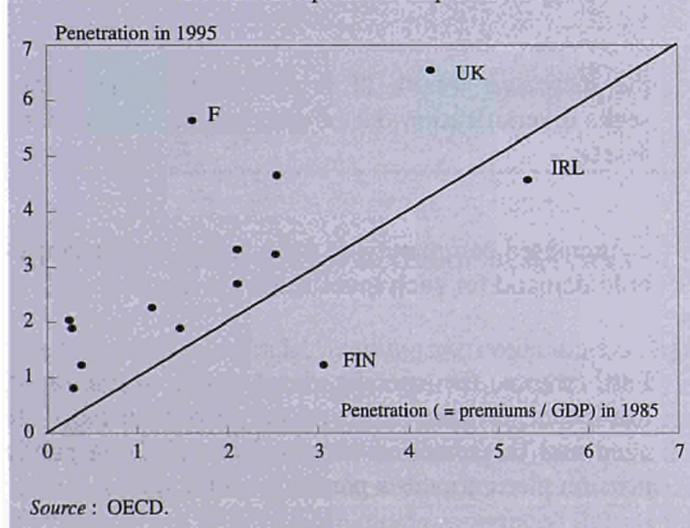
*the total is 200% due to the double counting.
Source : BIS, own calculations.

3.5 Insurance industry

Financial intermediation via insurance has steadily increased over the past decade. The growth has been particularly remarkable in the field of life insurance, and there particularly in countries which were still lagging behind the Community average in 1985.

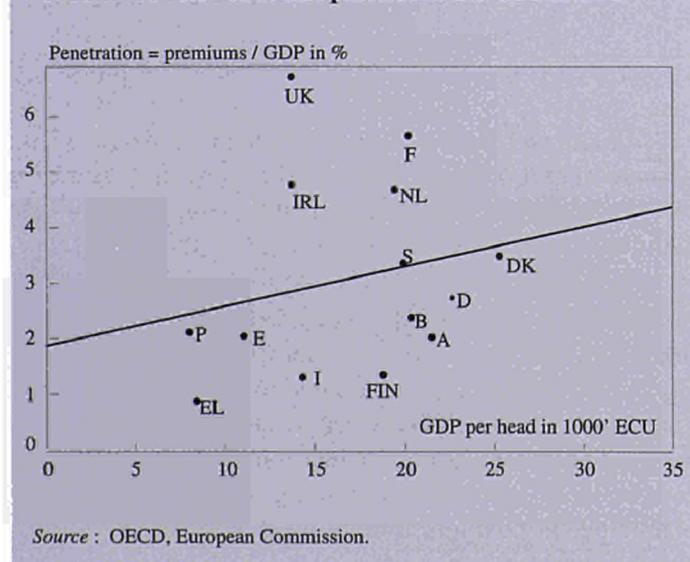
The impact of life insurance on financial intermediation typically depends on the general level of GDP in the respective country. However, the correlation between the ratio of premiums over GDP, and GDP per capita steadily weakened over the period 1985–1994. In 1985 a rather strong correlation can be observed between the two variables (R^2 of 0.65), disregarding the cases of the UK and Ireland which have a very different pattern compared with the rest of the countries under analysis. In 1993 (see graph) the correlation has strongly diminished (R^2 of 0.14). This shows that in a more deregulated environment life insurance depends more strongly upon other factors than the GDP.

GRAPH 19a : Life insurance penetration 1985 – 1995
life insurance premiums in percent of GDP



The penetration ratios (premiums over GDP) of life and non-life insurance generally increased across Europe (the majority of dots are above the dividing 45° line), except for Finland which has experienced a deep fall in its premium income from 1990 to 1993, and Ireland which has however more or less remained at its 1985 level in the case of life insurance. This means that overall the relative importance of the insurance industry in the domestic GDP has increased in Europe between 1985 and 1993.

GRAPH 19b : Life insurance penetration and GDP in 1995



Greece, Portugal, Spain and Italy show a relatively low penetration and therefore a below average development of the insurance sector, whereas in the UK and Ireland, insurance plays a much larger role than in Community average.

Life insurance penetration has increased most between 1985 and 1993 in the UK, France, the Netherlands, Spain, and Portugal. For non-life the same countries, except France, are equally the ones with the most dynamic development in this period.

In US and Japan, the picture is similar. In US, the penetration of life insurance remained the same from 1985 to 1993 (around 3.9 – 4%), whereas the penetration of non-life insurance increased by 75% (from 3.6% in 1985 to 6.2% in 1994). In Japan, penetration in life insurance increased by 33% from 1985 to 1994 (from 4.9% to 6.5%) and penetration in non-life insurance by more than 50% (from 1.4% to 2.17%).

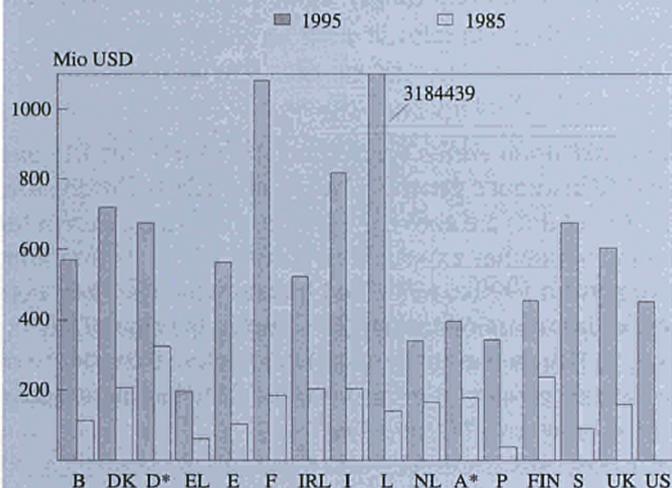
Productivity in the insurance sector, as measured as the ratio of total gross premiums over the number of employees of the insurance companies, increased across Europe from 1989 to 1995 by around 30%. This increase has been particularly strong in Germany, Belgium and France, whereas in particular Ireland and Spain have not registered any significant increase over that period. Over a longer period, starting from 1985, the overall nominal increase was slightly lower than the one in Japan but much higher than in the US. France, Italy and Spain have experienced a major rise in productivity, followed by the UK, Denmark, Luxembourg, Belgium, and Ireland. Only the Finnish insurance sector productivity has diminished from 1985 to 1994 (due to the sharp fall of GDP in the 1990s). In this period productivity levels among Member States showed a trend of further divergence; in 1985, the productivity levels were much more similar than in 1993.

TABLE 16 : **Gross Profitability of the insurance sector**
(in percent of total premiums)

| | Gross benefits | Gross operating costs | Profits |
|-----|----------------|-----------------------|---------|
| B | 64.4 | 40.0 | -4.4 |
| DK | 73.4 | 20.0 | 6.6 |
| D | 69.1 | 21.3 | 9.6 |
| E | 69.0 | 31.0 | 0.1 |
| F | 74.5 | 33.2 | -7.7 |
| IRL | 81.0 | 17.9 | 1.1 |
| I | 80.2 | 18.9 | 0.9 |
| L | 70.6 | 17.2 | 12.2 |
| NL | 73.6 | 23.1 | 3.8 |
| A | 67.6 | 27.4 | 5.0 |
| P | 69.1 | 26.7 | 4.3 |
| FIN | 80.9 | 19.0 | 0.1 |
| S | 85.1 | 26.4 | -11.4 |

Source : Eurostat; no data available for Greece and the UK.

GRAPH 20 : **Insurance sector productivity**
direct total gross premiums/number of employees
in insurance sector



* The first available figure for A and D is 1987 instead of 1985.
Source : OECD.

3.6 The role of institutional investors

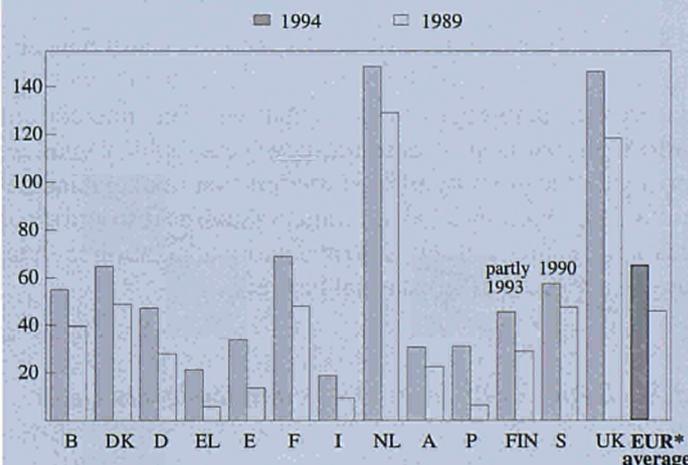
One major trend on the European financial markets is the growing importance of institutional investors (insurance, mutual funds, pension funds). Their increasing role is fuelled by several factors:

- the increased wealth of private households, which seeks diversification out of the classical saving book assets;
- an increased complexity on the markets creates household demand for such investment via institutions.
- Furthermore, the specific demographic situation in Europe, in particular, the expected sharp increase of the aged and the resulting expected shortfalls in public pension plans creates a particular demand.

Overall, EU Member States with the highest productivity in 1985 were Finland, Denmark, Ireland, and Italy; in 1994 France and Italy. The lowest productivity in 1985 was registered in Portugal, whereas in 1994 Greece was at the bottom of this list.

Productivity does not necessarily translate into corresponding profitability. Relative wages for insurance employees and other costs lead to above average costs in France and Belgium. Benefit payments are particularly high in Sweden, Ireland, Finland and Italy. Therefore, gross profits (without investment income) were negative in Sweden, France, and Belgium, and very high in Luxembourg and Germany (see table 16).

GRAPH 21 : **Financial assets of institutional investors**
(in % of GDP)



* EU without IRL, L.
Source : OECD, own calculations.

In some countries institutional saving has reached a very high proportion of household financial assets. In the Netherlands, for example, such institutional savings have reached around 94% of total household saving in 1994, up from 87% in 1985.

Most of the very large institutional investors in the Community are either banks, mutual funds, or life insurance companies from the big Member States (see table 17). Among Member States, pension funds play a significant role only in the UK, the Netherlands and Ireland (as it is the case in the US). This is partly due to the predominance in other Member States of pay as you go statutory systems or supplementary schemes, or of book reserve schemes such as those prevalent in Germany.

TABLE 17 : Largest EU institutional investors
(Assets under management in Bn. US-\$, end 1995)

| Institution | home country | assets |
|------------------------------------|--------------|--------|
| 1. BZW Asset Management | UK | 844.3 |
| 2. Groupe Axa | F | 275.0 |
| 3. Deutsche Bank | D | 212.1 |
| 4. Dresdner Bank | D | 178.5 |
| 5. Allianz | D | 171.2 |
| 6. Groupe Caisse des Dépôts | F | 166.3 |
| 7. Algem. Burgelijk Pensioensfonds | NL | 141.0 |
| 8. Union des Assurances de Paris | F | 136.0 |
| 9. ING Group | NL | 129.9 |
| 10. Mercury Asset Management | UK | 119.0 |

Source : Euromoney

3.7 Cross-border access to financial services

Trade barriers faced in EU banking and credit markets have been largely reduced since the completion of the SMP, although various restrictions still persist. The corporate customer market has witnessed the most significant reduction in barriers relative to the retail sector. Reductions in barriers appear to have been most pronounced in Italy and Portugal.

There is a broad consensus across member states concerning the relative importance of the barriers that respondents face when operating in other EU markets. The financial and informational cost of entering new geographical markets are by far the most significant barriers that financial institutions face. Various legal hindrances (such as restrictions on marketing financial services) and national taxation regimes are also viewed as substantial barriers.

3.7.1 Deposit and loan prices and fee levels

Competition intensified in all EU banking and credit markets in the post-SMP period and this has been reflected

by a decrease in financial service prices in various market segments across countries. Case study and questionnaire evidence suggested that the SMP has been largely responsible for reported loan and deposit price reductions in Greece, Italy and Spain, whereas in other EU systems the internal market integration programme has had a smaller influence.

The price of corporate loans to both small and large firms in all countries fell slightly, except in Ireland, France and Spain where relatively large decreases were reported. Banks in Greece and Denmark also indicated relatively large price decreases for corporate loans to large firms. The price of retail loans and mortgages also fell slightly across the EU, although the price falls were smaller than in the corporate sector.

Deposit prices in the retail and corporate sectors decreased slightly during the post-SMP period and some 14% of respondents attributed this decline largely to the SMP while two thirds claimed the SMP was slightly responsible for the decrease.

Fee levels have fallen by a very small amount during the post-SMP period. Banks in Spain, Portugal and Greece attribute relatively large proportions of this fall to the SMP.

In a replication of the price differential analysis found in the Cecchini report, significant price differences are found to remain across countries. Credit card prices, however, have fallen (by comparison with Cecchini) across all EU systems and the range of prices has narrowed by about 30 per cent. The range of mortgage prices between member states has also narrowed, although as the price of mortgages has not decreased across-the-board it is not possible to say whether this convergence is towards a lower average price.

For commercial loans, current cheque accounts and personal equity transaction costs, substantial price differences across countries persist. Moreover, in 1994 differences of over 100 per cent remained for the cost to consumers of cross-border payment transfers.

3.7.2 The impact of the SMP on consumers

There is no strong evidence that, in response to the SMP, banks have changed their strategies in ways that threaten the stability of banking systems in the EU. This partly reflects the need for banks in a number of EU countries to meet more demanding prudential requirements, but also reflects increased concern by banks to earn an adequate return on equity. Consumers are benefiting from a wider range of financial products and services as a result of SMP and new channels of delivery have opened up (direct banking) as in-

creased competition puts pressure on banks to contain and reduce costs.

3.7.3 Internationalization of financial services

Trade in financial services had increased across a range of financial markets post-SMP. The greatest increases were in off-balance sheet activities, investment management and in the corporate loan segments. Trade at the retail end of the market increased only slightly.

Cross-border provision of financial services, liberalized between 1989 and 1996 has strongly increased since the mid eighties. Overall intra-EU trade in financial services has outpaced the corresponding trade relations with third countries, reflecting the establishment of the single financial market over that period. The intra-EU trade in banking was in 1995 more than 2.5 times higher than in 1986 and more than twice the amount in insurance.

Trade in financial services with third countries has been marked, both in banking and in insurance, by a much stronger increase in imports over that period than exports to third countries. This reflects both the attractiveness of the single market for foreign financial undertakings, as well as continuing regulatory barriers to cross-border trade in services in other countries, whereas the EU is practically open to third country service providers. However, the EU maintained its net export position in financial services. Whereas in insurance, this net position fell over the respective period, and was even for one year negative, the according values for banking and other financial services show an even further increase of the EU net exports to third countries.

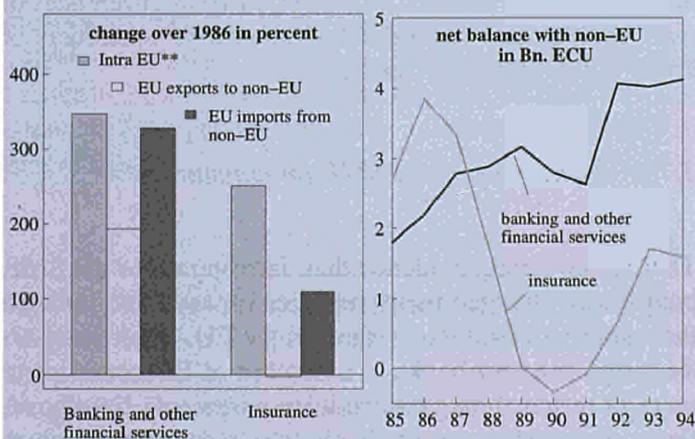
The SMP also appears to have had a marked impact on the establishment of cross-border branches, as illustrated by a 58% increase in such activity in the three years after 1992. In addition, the Commission has received from 11 EU member states 43 notifications of establishment or acquisition of subsidiaries as credit institutions (from third countries) during the first three years of the internal market.

Cross-border acquisitions increased sharply in the second half of the 1980s and there is a strong presumption that the SMP was the major influence. In addition cross-border joint ventures and strategic alliances also increased sharply over the period. In terms of absolute numbers of mergers and acquisitions non-domestic deals the main bidding countries are France, the United Kingdom and Italy, with the main target countries being France, Italy and Spain, confirming predictions (at least for F and E) for countries where deregulation has occurred on a relatively large scale. Approximately 70% of acquisitions are of an intra-industry nature with banks acquiring other financial intermediaries.

Financial markets and financial services in the Member States have after the abolition of legal obstacles, emphasized integration and gaining cross-border access. The cross-border merger and acquisition strategy in the financial sector (including insurance) activity has, in the mid to late eighties, soared to very high levels. Although such activities between Community institutions and those of third countries have also grown sharply since then, it was mostly intra-EU activity which expanded most. This activity should, although only gradually, have a major impact on the efficiency of Member States' financial institutions and financial markets.

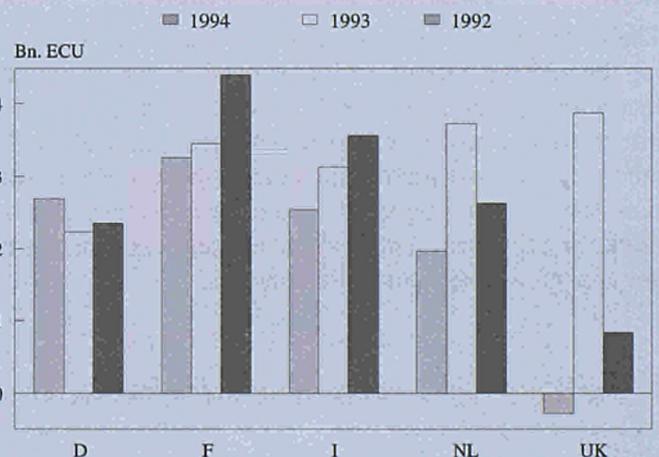
Looking at the profitability of the sector, the decline in interest margins has not been compensated for by efforts to boost non-interest income or reduce costs, with the result that even though profitability has not declined in absolute value over the 1980s, it has not benefited from the general recovery of returns observed in European non-financial institutions. Accordingly returns in banking to invested capi-

GRAPH 22 : EU* trade financial services



*: EU (12); **: average of values for credit and debit.
Source : Eurostat.

GRAPH 23 : FDI in banking and insurance (by country of origin)



Source : Eurostat.

tal have converged to economy-wide returns. These developments suggest that even in advance of the internal market, the benefits, in terms of lower financing costs of investment have been feeding through to European industry.

As regards the insurance sector, the supply of insurance within Europe had traditionally been dominated by domestically owned insurance companies. One reason for this is that many insurance contracts are comparatively standardized products, particularly non-life insurance, and so the opportunity for product differentiation is difficult. Moreover, regulation in some EU countries has tended to slow down product innovation. There have been efforts since the mid-1980s for a change in the situation for introducing new information technologies and for the entry of foreign insurance companies into local markets, but their share has remained rather low. Charts 24 and 25 show the development between 1985 and 1995 which shows a decline of market share of foreign branches all over Europe.

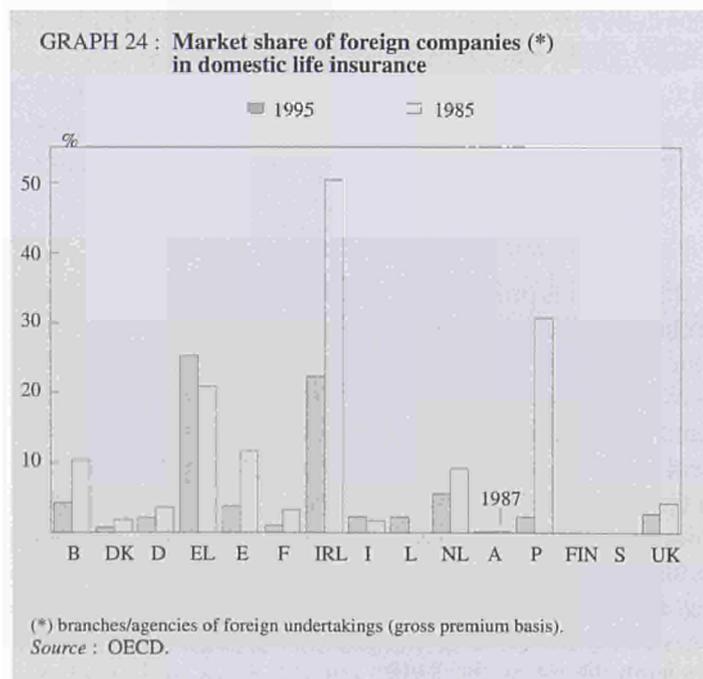
However, it should be noted, that these figures do not include market shares of domestic, but foreign-controlled insurance companies. If these were included the combined market share would be much larger. For only few countries figures for this "total" foreign market share exist. They range, for 1995 in life insurance, between 35% (Austria), and 22% (Netherlands) down to 9% (Germany). In non-life insurance, these "total" foreign shares are, in those countries for which data exist, in most cases even higher. Furthermore, these total figures remained relatively constant over the 1985-1995 period. It can therefore be assumed that some of the former branches or agencies were in that period transformed into domestically incorporated companies, thereby "reducing" the market share of foreign branches or agencies.

Probably either the market shares of foreign companies decreased or there was a merger/acquisition with a domestic insurance firm implying that foreign shares became domestic. During the last decade there has been a significant reduction in the number of independently controlled companies in the insurance market. Experience in many insurance markets shows that internal growth of companies does not change much market shares over time. Therefore an insurance company can significantly raise its market share only by means of acquisition of other insurance companies.

In life insurance, in Ireland, Portugal and Spain market shares of foreign branches and agencies in the life insurance market fell particularly strongly, whereas Greece and Austria are the only countries with rising foreign share over the same period. Greece, Ireland and Portugal were in 1995 countries with relatively high foreign presence, whereas Austria, Italy, Denmark and France were considerably below average.

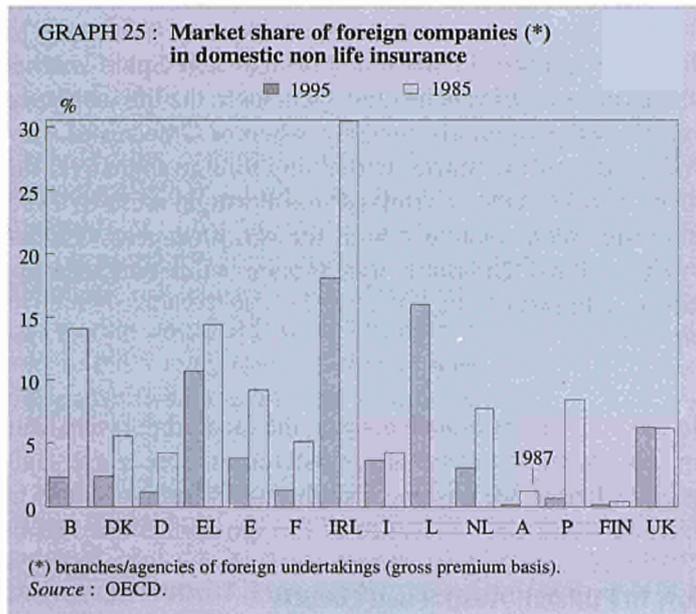
In the non-life insurance market, the most impressive falls in foreign market share are registered in Greece and Belgium, whereas we observe a slight rise in foreign shares in Denmark and UK. Presence of foreign companies was in 1995 relatively high in Ireland and Portugal and relatively low in Finland, Austria and Greece.

In US, between 1988 (first figure available) and 1995, the insurance sector has registered a fall of foreign shares in the life segment (from 1.62% to 1.2%) and a slight decrease in the non-life segment (from 1.2% to 1.1%). In Japan, between 1985 and 1995, in the life insurance sector foreign share increased from 1.1% to 2.3%, and in the non-life sector the foreign share decreased from 3.15% to 3.0%.



The Commission has adopted on 15 October 1997 a draft communication setting out how it proposes to interpret the concepts of "freedom to provide services" and "the general good" as applied to the insurance sector. These concepts are interpreted differently from one Member to another, a situation detrimental to the proper functioning of the internal market in insurance. The draft communication enumerates the circumstances in which a Member may invoke the general good in order to justify a set of national rules (requiring, for example, prior notification of policy conditions, certain rating systems, or compulsory excesses in insurance contracts) and the criteria on which a line can be drawn between business transacted by an insurance company under the freedom to provide services and that transacted through a branch. The draft communication will serve as a basis for a wide-ranging debate between interested parties, the European and Member States. In the light of its findings, the Commission will adopt the final version of the interpretative communication.

Cross-border mergers and acquisitions in the financial sector followed in the past years a certain regional pattern¹². The country of the targeted company tended to be more often than suggested by the size of their market, Spain, Italy, and Portugal. These companies were consequently also much more often acquired by another EU company than the reverse, that companies of these countries expanded into other EU Member States. France, Germany, and the Netherlands, on the other hand, were the countries from which mainly such takeover targets originated.



3.7.4 Internal market integration, market structure and concentration

The SMP has reduced entry barriers enabling banks to compete with a broader range of financial and non-financial firms as well as markets. The implementation of the universal banking model under the Second Banking Directive has led to the breakdown in demarcation lines between business area and institutions helping to promote bancassurance/*allfinanz* strategies. Competition on both sides of the balance sheet, as well as off-balance sheet, has intensified and industry restructuring has led, on average, to increased levels of market concentration. In the majority of EU systems, the level of employment in the banking and credit sector has fallen post-SMP, reflecting the increased competitive environment.

3.7.5 Economies of scale and costs

There is a preponderance of scale economies across a broad range of bank output in the European banking market. This is an important result of the analysis in that it demonstrates a

potential for cost reductions through increased market size that might be brought about by the SMP. However, these scale economies appear to be soon exhausted through cyclical changes in bank output. There is also evidence from the postal survey and case studies that the SMP has extended the relevant market size particularly at the wholesale end of the market (off-balance sheet activities, fund management, investment services and large corporate loans). Given these findings it appears that the SMP has led to further realization of economies of scale in these particular market segments. The econometric results indicate that the greatest potential for exploiting scale economies is for smaller banks particularly those in Germany and France.

The SMP has resulted in a decrease in the costs of supplying cross-border services with the greatest impact occurring in Greece, Portugal and Belgium. However, in all cases the impact of the SMP has been small. Bank staff costs per unit of output have fallen steadily throughout the 1980s and early 1990s but there is no strong evidence of an SMP impact. An SMP effect is equally elusive in the case of non-staff costs.

Scope economies are found across the majority of EU banking markets for only two size categories of banks: those with assets size in the range ECU 1 to 10 billion and banks larger than ECU 50 billion. Although there is a presumption that the impact of the SMP will be to increase economies of scope, there is no clear evidence from the econometric estimates to indicate that this has occurred for the largest banks across Europe. However, because there is evidence that the SMP programme has encouraged product innovation and diversification by banking and credit organizations, the identification of economies of scope establishes a strong presumption of an SMP impact. In addition, the move towards a universal banking model brought about by the SMP further reinforces the view that there has been greater opportunities for exploiting economies of scope across EU banking markets.

3.7.6 Revenues and returns

Although it is problematic to disentangle SMP effects from other cyclical, deregulatory and structural developments the analysis in this section points to the impact changes in cost efficiency and price effects had on the overall revenue and return characteristics of EU banking markets. Different systems witnessed a broad range of experiences but the cost and performance indicators overall, point towards a more competitive EU banking environment. Evidence provided from the case study and questionnaire responses, again, reinforce the notion of a heightened competitive environment resulting from the reduction of entry barriers brought about by the SMP.

¹² "Cross-border alliances in banking and financial services in the single market"; Bank of England Quarterly Bulletin, August 1993, pp. 372 - 378.

3.7.7 Strategic reactions of the SMP

The perception and strategic focus of the European banking sector altered rapidly as a consequence of the Single European Act in 1986 and the rapid moves to a single EU banking market. The Second Banking Directive (1989) and the attendant Own Funds and Solvency Ratio Directives gave a further impetus to these developments with the latter regarded as particularly important by banks. In addition the domestic deregulation of interest rate restrictions, capital controls, branching restrictions and so on also had the impact of changing the strategic focus of the industry.

The generalized impact of the SMP forces intensified banking competition and shifted the strategic focus of banks towards greater competition. Both domestic and cross-border acquisition business accelerated as did trade in banking and credit services.

Markets became more international and foreign operators established a significant presence in certain systems, especially at the wholesale end of the corporate banking market. As domestic regulations were relaxed or/and abolished, and as EC legislation was implemented, demarcation lines between particular business areas were broken down. The universal banking model increased its role across EU markets, facilitating the development of bancassurance business as well as capital markets and other non-mainstream banking activities.

The increasingly competitive environment brought about by these developments resulted in both defensive and/or offensive reactions by banks. Banks in the previously more protected markets, such as in Italy, Spain and Portugal, witnessed domestic mergers between large banks in a strategic attempt to protect market share from possible foreign competitors. The same can perhaps be said of banks operating in the smaller more concentrated EU markets, such as in the Netherlands.

Market positioning, product diversification and innovation, improved efficiency and increased size have all been strategically prioritized in the new, more pro-competitive banking environment facilitated by the SMP. Profitability and efficiency appear to be more important strategically than size alone.

There now exists a much more competitive and market driven EU banking system with a greater focus on cost and profit efficiency. Banking markets have become more international and the traditional banking franchise has broadened so much that, in most countries, it is now unrecognisable from what existed in the mid-1980s.

3.7.8 The effectiveness of the SMP

The legislation of the SMP is now largely implemented. However, despite the success in removing many of the obstacles that existed prior to the SMP and creating a new competitive dynamic across EU banking markets, there still remain a number of barriers that continue to constrain the exploitation of the full benefits of the Single Market. These remaining barriers are quite diverse and vary from one EU country to the next. Various legal and fiscal (tax) treatment barriers still remain. Important barriers also remain relating to restrictions on marketing activities and the range of products that banks can offer outside their territory. In areas relating to housing mortgages, access to capital markets, differences in the treatment of withholding tax and varying subsidy arrangements continue to hinder the creation of a true Single European Market. Finally, there is also some evidence that the 'general good provision', because of the uncertainty which it gives rise to, can create barriers to cross-border activity.

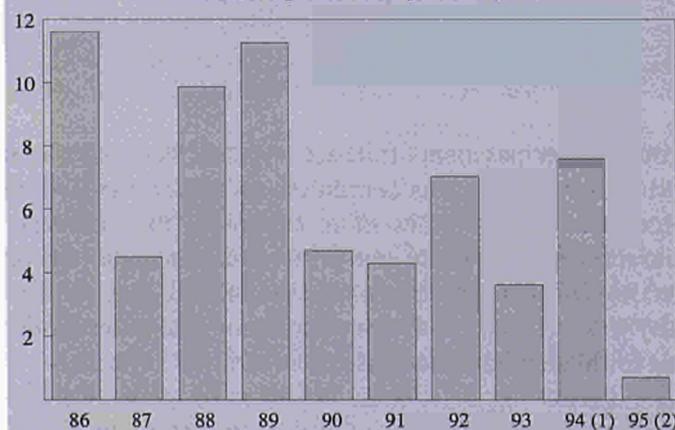
4. FINANCIAL MARKETS' PERFORMANCE

4.1 Employment, cost of financial intermediation and profitability

4.1.1 Size of financial intermediation

The financial markets of the Community increased their total transaction volume and outstanding assets considerably and to a larger degree than GDP. With it the cost of financial intermediation also grew. From 1985 to 1995 in most EU Member States the share of value added in the financial sector increased. However, this relative growth

GRAPH 26 : Growth of financial services in the EU
(gross value added of banking and insurance; nominal values in ECU; change in percent over previous year)



¹ without E.P.
² without D, E, IRL, P.
Source : Eurostat.

took mainly place in the 80s. The strong growth of credit and other financial services then lowered the cost of intermediation subsequently, without fully compensating for the cost increases of the first part of the last decade.

In most of the EU countries financial services amount to 5 to 5.5% of domestic value added (see chart 27). The very high figure for Luxembourg reflects the particular role of this country on the Euromarkets. The high and increasing figure for Portugal is noteworthy. It might reflect efficiency problems following the abolition of credit controls and the deregulation of the financial sector in the mid eighties, which has not yet led to a major consolidation.

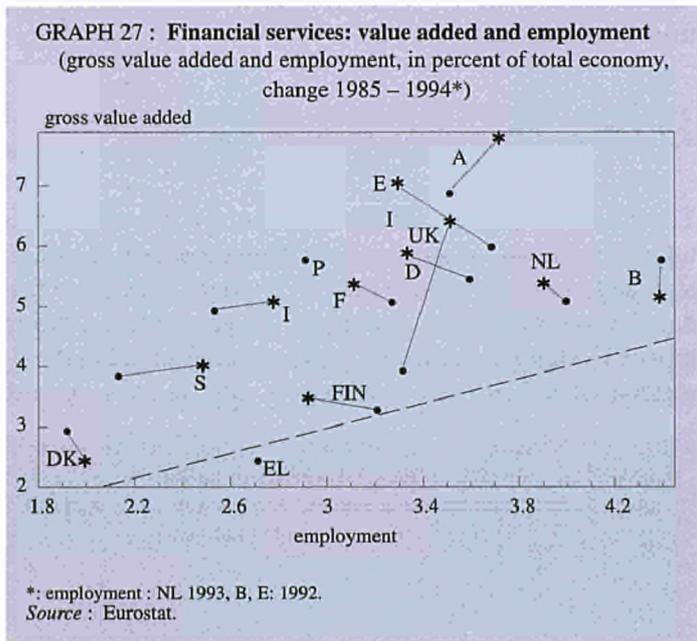
These figures have to be interpreted carefully, as they partly reflect only the change in the yield curve which does not necessarily reflect the underlying true costs of financial intermediation. They also overlook the increasing export and import of financial services. Finally, an increasing part of intermediation happens outside the banking sector. Non-banks, such as large institutional investors or cash-rich corporations, directly channel funds into the market, either securitized or not, but in both cases by-passing core financial institutions.

Financial markets. Securities markets are normally organized in the respective domestic financial centres. Foreign investors have to place their orders via their intermediaries, which in turn place the order via domestic brokers. Furthermore, settlement and delivery is equally bound to national markets. Cross-border delivery is expensive.

International foreign exchange markets, unorganized inter-bank markets, do not face high direct costs. However, in this field, the counterparty risk, the possibility that the counterparty of a mostly forward transaction fails to meet its obligation, are relatively high. This is a major difference to organized futures and options markets (for interest rate or stock market futures and options), where normally a clearing house nets the mutual positions and guarantees settlement and delivery.

In the field of securities transactions, private organizations have started to organize cross-border securities settlement, mainly due to the development of the Euromarkets, in a comprehensive and efficient way, such as Euroclear or CEDEL. National settlement systems, in the past sometimes hampered by national legislation imposing limitations on these institutions, have begun to play a role in cross-border settlement, often by cooperating with Euroclear and CEDEL by means of direct links with these organizations. National settlement systems are still, to some degree, supported by respective national regulations and government debt management.

The share of financial services in the total economy has, in terms of gross value added, increased over the 1985-1994 period in most Member States, quite strongly in the UK and Spain, weaker in many other countries and even slightly decreased in some Member States (see chart). In employment terms, in the same period there has been a trend towards similar relative levels, in countries with previously high shares of employment in financial services there has been a decrease and vice versa. In most member states the respective share has now attained levels of around 3 to 4 %.



Cross-border payments transactions still face major cost obstacles, which makes certain cross-border transactions sometimes several times more expensive than domestic transactions. This extra cost has two dimensions: the direct, higher, transaction cost, and the often higher counterparty risk, which constitutes an indirect, and more hidden cost to financial intermediation.

For cross-border payments equally the appropriate systems are missing, apart from certain private sector networks, such as SWIFT or the international credit card organizations. Payment systems are mostly organized on a national level by the respective Central Banks, and although very efficient, are completely unlinked. The expensive and slow method of correspondence banking is still the most frequent means of cross-border payments.

The reason for these higher costs lies in non-integrated markets and settlements for certain instruments on the fi-

There is no clear evidence that company profitability and thus willingness to invest would have suffered from a finan-

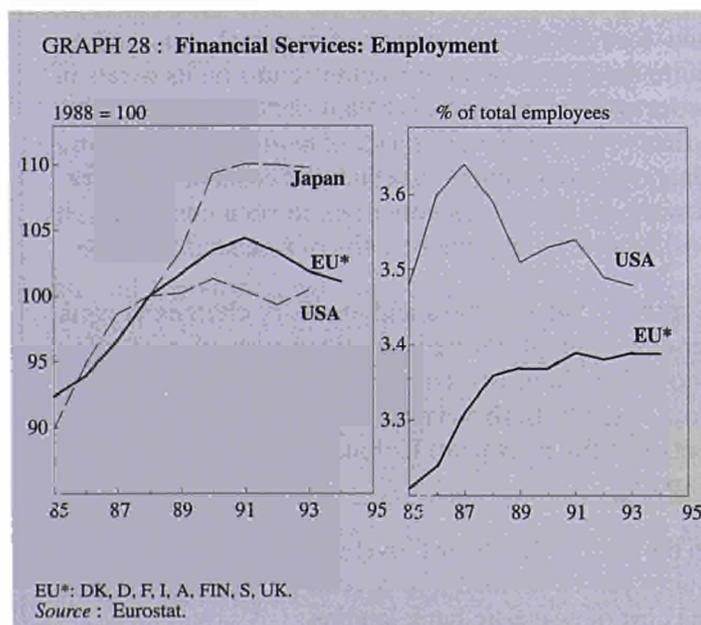
cial markets' cost squeeze. Net profitability of capital has been over the last 10 years sufficiently higher than real long-term interest rates. Furthermore overall company indebtedness, in the manufacturing sector, has decreased over the 1982 - 1991 period, thus reducing the leverage of companies and reducing the potential profit squeeze by financial market trends.

However, the situation in the different Member States seems to have followed different paths. Profitability problems seem to have arisen in particular in Italy and Ireland. In both countries the measured real interest rate increased to levels of more than 6 %. In both countries there are no sufficient other alternatives for company financing, such as liquid stock markets, corporate bond markets or commercial paper markets.

A recent study in the European Economy¹³ corroborates the correlation between credit market imperfections and company profits. The development of company profits between 1982 and 1991 was significantly influenced by the rate of company debt, the amount of financial charges and industry specific interest rate mark-ups.

4.1.2 Employment

Available data show a rather weak, correlation between the share of employment in financial services in total economy on the one hand and the share of value added in financial services in the total economy. This rather counterintuitive result might, apart from inherent problems of measuring value added in the banking sector, point to very large efficiency differences in the financial sectors of the different Member States.



Employment in the financial services industry has grown until the early nineties, but has since then slightly fallen. The picture is very mixed in different Member States. In Denmark, Italy, Austria, Sweden and the UK, overall employment grew between 1985 and 1994 whereas in most other countries financial services employment fell over that period. The general decline in employment from 1991 on coincided with a slow down in growth or fall in employment in the total economy which was even more pronounced than in financial services. Thus, the share of financial services in total industry has further grown, unlike in the US, and has reached a value of nearly 3.4 % as compared to nearly 3.5 % in the US.

TABLE 18 : Wages in financial services
(wages per employee in financial services sector, relative to wages in total economy)

| | year | ratio | change over 1985 |
|------------|------|-------|------------------|
| B | 1992 | 1.42 | -0.05 |
| DK | 1994 | 1.17 | 0.1 |
| D | 1993 | 1.35 | 0.08 |
| E | 1992 | 2.02 | 0.22 |
| F | 1991 | 1.38 | 0.03 |
| IRL | 1991 | 1.73 | -0.02 |
| I | 1994 | 2.21 | -0.03 |
| L | 1991 | 1.6 | -0.02 |
| NL | 1993 | 1.27 | 0.08 |
| A | 1994 | 1.01 | -0.02 |
| P | 1991 | 2.37 | 0.19 |
| S | 1992 | 1.28 | n.a. |
| UK | 1994 | 1.59 | 0.17 |
| USA | 1993 | 1.17 | n.a. |

Source : Eurostat; own calculations.

At the same time, casual evidence seems to point to a shift in financial services towards more highly qualified jobs, reflecting the changing structure of financial services and in particular the strong impact of advancing information technology, causing a shift from more simple clerical work to more highly qualified jobs in client consulting and management and trading. The wage structure might give some additional indications to this extent.

Average wages in the financial services sector are significantly higher than on average in the total economy (see table 18). In some countries they are more than double the amount in the general economy (Spain, Portugal), in most cases they are between 20% and 60% higher. Only in Austria, they are more or less in line with the level in the general economy. In most Member States, this gap between wages in financial services and in the rest of the economy has further increased since 1985, particularly in the UK, in Spain and in Portugal, countries, where change and modernization have particularly fast developed over the past 10 years.

¹³ Financial Situation of Industrial Supplement A - January 1994.

TABLE 19 : Financing structure of EU companies
(values in percent of total balance sheets (end 1995), and change over 1985 values)

| | Creditors : value | <= 1 year change | of which : value | from banks change | Creditors : value | > 1 year change | Provisions value | change | Capital and value | reserves change |
|-------------------------------|----------------------|---------------------|---------------------|----------------------|----------------------|--------------------|---------------------|--------|----------------------|--------------------|
| small companies | | | | | | | | | | |
| Austria | 38.6 | -16.3 | 13.3 | -6 | 16.2 | -2.3 | 6.6 | -4.1 | 38.7 | 22.6 |
| Spain | 41 | -1.8 | 12.2 | -3.7 | 13.1 | 2.3 | 1.1 | 0.5 | 44.6 | 0.5 |
| France | 44.5 | -12.2 | 5.1 | -4.4 | 18.6 | 2.2 | 2 | -0.5 | 34.4 | 10.3 |
| Italy | 51.8 | -1.9 | 20.2 | 1.9 | 16.4 | 4 | 6 | 1.7 | 24.6 | -2.6 |
| Netherlands | 33.5 | -2.3 | 4.7 | -3.1 | 28.5 | 8.5 | 5.8 | -0.5 | 32.1 | -5.8 |
| Portugal | 44.1 | | 10 | | 21.4 | | 0.3 | | 27.1 | |
| Sweden | 30.7 | | 1.6 | | 26.9 | | 6.5 | | 29.9 | |
| average* | 43.8 | -6.5 | 10.4 | -1.8 | 18.6 | 2.9 | 3.7 | 0.1 | 32.8 | 3.9 |
| medium-sized companies | | | | | | | | | | |
| Austria | 42.2 | -6.9 | 14.7 | -2.1 | 18.3 | 2.2 | 11.8 | -2.7 | 27.7 | 7.5 |
| Spain | 36 | -1.1 | 11.2 | -3.6 | 11.2 | -3 | 2.2 | 1.3 | 50.3 | 4.3 |
| France | 47.7 | 10 | 6 | -0.2 | 14.9 | -21 | 2.5 | -5.4 | 34.1 | 17 |
| Italy | 58.5 | 4.5 | 19.8 | 1.8 | 11.2 | 0 | 6.1 | 0.2 | 23 | -3.3 |
| Netherlands | 30.2 | -8 | 7.7 | -2.4 | 26 | 4.7 | 5.7 | -0.2 | 38.1 | 3.5 |
| Portugal | 34.1 | | 10.8 | | 20.5 | | 0.6 | | 39.2 | |
| Sweden | 32.2 | | 4.5 | | 25.4 | | 11.9 | | 24.3 | |
| average* | 45.8 | 4.4 | 11 | 0.2 | 33 | -7.8 | 4.7 | -2.3 | 15.4 | 6.4 |
| large companies | | | | | | | | | | |
| Austria | 31.6 | -4.4 | 8.2 | 0.3 | 18.4 | -5.1 | 18.9 | -1.9 | 31.1 | 11.4 |
| Spain | 28.9 | 4 | 5.4 | -3.2 | 23.9 | -11.6 | 6.2 | 5.1 | 40.7 | 4.2 |
| France | 30.1 | | 3.5 | | 30.3 | | 14 | | 23.9 | 23.9 |
| Italy | 41.8 | 0.8 | 10.5 | -0.3 | 18.1 | -5 | 9.1 | 1.9 | 30.1 | 3.6 |
| Netherlands | 30.4 | -5.1 | 5.7 | -1.5 | 21.4 | 1.6 | 6.4 | 0 | 41.8 | 3.6 |
| Portugal | 19.9 | | 5.1 | | 27.6 | | 3.4 | | 41.1 | |
| Sweden | 28.1 | | 2.8 | | 18.5 | | 18.1 | | 29.7 | |
| average* | 32.8 | -0.5 | 6.1 | -0.2 | 24 | -1.7 | 11.1 | 0.5 | 30.7 | 2.1 |

* weighted with respective GDP.
Source : European Commission (BACH, own calculations).

Box 3: SME's competitiveness and cost of capital

To be competitive, companies as a whole and, in particular, small and medium enterprises need a financial structure healthy enough to overcome periods of crisis. Furthermore, profits should remunerate the capital invested as well as the risks taken in order to obtain funds for financing the renewal or expansion of its equipment.

Since 1988 in Europe two facts have hampered adequate financial development of the productive sector:

- a recourse to higher indebtedness in order to finance investments;
- a tightening of interest rates and consequently of the cost of credit up to 1993.

Bank loan costs affect a company's competitiveness in various ways. They have a direct impact on its profit-

and-loss account, in the form of financial costs, and require the firm to acquire a better return on its assets in order to offset the costs of its bank debt. This means that a firm will have a better chance of being competitive in a financial environment in which the costs of bank borrowing are not excessively high; in such conditions, it will be able to reap the benefits of financial leverage.

Studies of interest rates and ancillary charges in bank lending to small and medium-sized enterprises (SMEs) show that **there are considerable differences in the cost of credit both between the Member States and between the European Union, the United States and Japan.**

In the light of the studies' overall findings, the Member States can be divided into several groups according to the cost of domestic bank lending.

Box 3 (continued)

In an intermediate group Spain, Italy, and Ireland are above average and France and Belgium below average. The Netherlands, Germany and the UK are, in that order, the Member States in which banks generally charge firms the lowest rates of interest, fees and commissions.

These differences cannot be attributed to the effect of inflation, which reduces the cost of borrowing only moderately: interest rate differentials between EC Member States are more pronounced than the corresponding inflation differentials. In its turn, the cost of borrowing in the United States and Japan are, by far, much lower than in the European Union.

The wide disparity between the interest rates charged by banks in the EC and the rates at which firms in Japan and the United States can obtain funds on their own domestic markets gives cause for concern also in view of its effects on the **competitiveness of European SMEs**. If European SMEs are in future to compete on more favourable terms with their Japanese and North American counterparts, their financing costs must be brought down to those borne by firms in countries where rates are lowest.

One of the objectives of the integration of financial markets is to ensure that EC firms enjoy the same opportunities for borrowing and lending, and can do so under the same terms, thus removing restrictions to free competition. This means that there should be competition between financial institutions, and this should encourage them to offer better, more efficient services at lower costs to their customers.

The findings of these studies lead to the conclusion that EC financial markets are not fully integrated since considerable differences remain between the cost of credit in the various Member States.

SMEs have so far seldom had access to the financial markets of other Member States, either for want of information enabling them to choose the best terms or because of the reluctance of financial institutions to grant loans to non resident firms or individuals.

The most likely development that will enable SMEs to have recourse to foreign financial markets is the establishment of subsidiaries of financial institutions in other Member States.

The financial institutions concerned will have to overcome the obstacles that make it difficult for them to enter these new markets and the problems involved in the mobility of loans.

The former obstacles appear to be on the decrease, chiefly owing to the development of information technology.

Other impediments remain, such as fees and commissions charged by banks when a firm wishes to pay off a loan in order to arrange another loan with a different bank make such transactions unprofitable for the firm concerned. As a result, it is more difficult to stimulate competition between financial institutions as part of the drive towards financial integration.

Furthermore, banks operating abroad often do so as secondary banks, offering their services to firms as a "second" bank, because they are not in a position to offer a full range of financial services.

As a conclusion it can be noted that SMEs have not yet reaped their share, in the form of cheaper bank finance, of the benefits expected from financial integration. Such integration is as yet incomplete, and there is little competition between banks in different Member States as regards lending to SMEs.

4.1.3 Financing of SME's

Small and medium-sized companies have to rely much more heavily on short-term external financing, by banks or other sources, than larger companies. Creditors of one year or less amounted, for those countries for which harmonized data are available (see table 19), to 31% for Sweden up to 52% for Italy. In all those countries the respective share is lower for large companies. Large companies can rely to a larger extent on long-term debt and own capital. And, although over the years 1985 to 1995 most companies made progress in securing more own capital, larger companies extended this gap towards smaller companies even further. Thus the split in financing between small and large companies in Europe has been deepening.

Small and medium-sized companies lack the access to capital markets as large companies in the EU do. This is true both for share capital and for fixed-income securities. The reasons are manifold¹⁴, among them the potential lock of control by the owner over the company and the impact on potential transparency and disclosure rules following a n exchange listing.

In the past year two alternative systems of stock exchanges for smaller European companies has been started. Easdaq started in September 1996 and has, in the first year of its life, attracted around 15 companies with a capitalization of around 3 Bn. ECU. In spring 1997 7 companies with a market capitalization of 1.2 Bn ECU were listed. The

¹⁴ See the Commission Communication: The European capital markets for small and medium-sized enterprises: perspectives and potential obstacles to their progress (COM(97) 187 final of 5 May 1997).

Euro-NM (new market) is a European Economic Interest Grouping, founded by the Paris, Brussels, Amsterdam and Frankfurt "New Markets" (NM). These markets started between February 1996 (Paris) and March 1997 (Frankfurt). The Paris market has attracted until summer 1997 31 companies with a combined capitalization of around 1.6 Bn. ECU. The other markets are even younger than the Paris-segment. Therefore, they have attracted even less listings. Together these four "New Market" segments had a market capitalization of around 3.8 Bn. ECU in Summer 1997. Turnover, and thus liquidity, are still extremely thin on these markets, and it will to be seen if these initiatives will succeed in provide a measurable alternative for the financing of SME's. The UK AIM has been more successful and has already a more sizeable listing (around 300 companies) and trading activities.

This relatively small volume of market capitalization and trading activity contrasts sharply with the US. There the "National Association of Securities Dealers Automatic Quotation System" (NASDAQ) serves as a quasi -exchange for shares in smaller companies which do not qualify for the listing on the larger national exchanges (NYSE, ASE) or which for other reasons remain on the NASDAQ system. More than 5700 companies (in the "small cap" or the "national market" segment) are presently traded on this exchange. This fully automated system creates considerable transparency and liquidity for the trading in shares of SME's, thus encouraging the funding of these companies by share capital.

4.2 Financial markets' behaviour

4.2.1 Present market environment

The improvement in standards of living and the subsequent increase in the resources of economic agents in Western economies over the last decades, coupled with a higher degree and extensive financial culture among them, has become an important motor in the enormous increase registered in the amounts of funds invested by them in different financial instruments. Moreover ageing populations, sophistication of financial markets and information and transactions costs are other elements that have contributed to a large extent to the so-called institutionalization of savings. Thus, today's financial markets are dominated by institutional investors (pension funds, insurance companies, investment funds, banks, etc. ...).

Another important element comes from the major advance in financial innovation registered during the 80's. The relatively cozy 60's were replaced by the bumpy 70's which brought unexpected levels and volatilities in both inflation and interest rates. This major change in the financial and

economic environment, coupled with important technological advances, paved the way for impressive innovations in the financial markets, ranging from new financial instruments to the creation of new segments in the capital markets. Derivatives markets, Euro-commercial paper market, swaps and many other financial innovations were born and now form an integral part of today's capital markets.

The liberalization of capital movements is another important element which has granted institutional and retail investors the opportunity to base their respective portfolio strategies on global considerations as cross-border transactions are available to any investor.

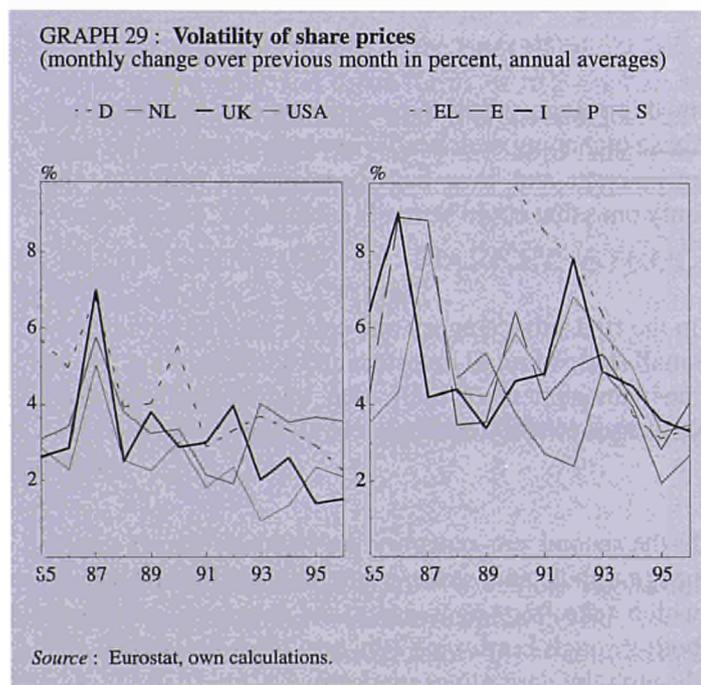
Thus, the present financial environment is radically different from the one prevailing only ten years ago. Technological advances which allow information to be disseminated globally on a real-time basis and transactions to be executed very quickly, financial innovation which allows investors to design any kind of portfolio investment strategy, liberalization of capital movements which allows capital to flow freely across frontiers and markets and the institutionalization of savings which increase portfolio management skills and capabilities for quick reactions to changes in expectations, form the back bone of today's capital markets. All these factors make financial markets much more efficient and reactive to any piece of information so that news is quickly discounted and incorporated into the prices of financial instruments.

The question then must be whether this new environment has rendered financial markets more volatile. A first analysis does not allow us to conclude that this is the case in either bond or equity markets. On the contrary, volatility of returns in both cases has remained relatively stable over recent years if exception is made for the 1987 equity market crash and the 1989 crisis where major corrections in equity prices occurred (program trading techniques played an important role in the first).

Market behaviour has overall shown an increasing stability after the gradual liberalization and integration. Although free cross-border capital flows and services and more powerful information technology allow a more rapid entry and leaving of markets, market prices have nevertheless been decreasingly volatile and have therefore contributed to the overall stability and efficiency of the financial sector. Higher liquidity and better hedging possibilities as well as a more stable general economic framework might have contributed to that result.

Chart 29 depicts, as an example, the volatility of share prices, measured in monthly relative changes (in absolute terms), on an annual average basis. The very large difference between the US, and also the UK, on the one hand, and other EU markets has gradually decreased over the past decade. Nowadays EU markets are not significantly more volatile than the large and liquid US market, although naturally some differences remain which are to a large degree explained by the respective size of the markets. In particular, smaller Community stock markets have seen a considerable reduction of their volatility, although they are still significantly more volatile than the larger markets in the EU or elsewhere.

Smaller stock markets with narrower liquidity show, as expected, a significantly higher volatility in stock prices than larger ones.



Financial integration gradually leads to a higher correlation of prices on European Union stock markets¹⁵. Therefore country specific factors for the explanation of share price movements are gradually losing their influence and are progressively replaced by industry specific factors.

4.2.2 Volatility, capital movements, and transaction taxes

Most of the legal obstacles to cross-border capital movements which still existed 20 years ago have been success-

fully dismantled. Furthermore, for certain forms of capital movements, no economic or technical obstacles to efficient cross-border position taking exists. This is particularly true for interbank markets in currencies and organized derivatives markets.

The simultaneous observance of free capital movements, independent monetary policy and fixed exchange rates has been proved increasingly inconsistent. Particularly the EMS turmoils in 1992 and 1993 had been attributed to unchecked speculative currency flows; particularly by offshore based so-called hedge funds. These hedge funds are pools of financial assets which are typically highly leveraged, in a double way: They borrow a considerable amount of money to be added to their own assets; and they typically invest in forward currency contracts which are themselves normally leveraged tenfold. Thus, certain forms of reintroduction of capital movement restrictions have been under discussion.

Generally, as for any market, interference via the price mechanism is less distortive than quantitative restrictions. Therefore, for the international capital markets, rather than outright capital controls, taxes on certain transactions in financial assets, such as securities or foreign exchange transaction taxes, as means to increase transaction costs, continue to attract attention from those who look to reduce the volume of transactions on these markets.

Such taxes play in practice a small and decreasing role. Most European countries have opted for the abolition of such a tax. The main motive behind this was the experience that such a levy would drive underlying business abroad. With the increased availability of information technology, the mobility of such business has further increased. Thus, there is no doubt, that such a tax, it is hardly enforceable¹⁶. Furthermore, the introduction of a transaction tax on foreign exchange transactions is also from the view of EC legislation on the freedom of capital movements (Art. 73b) very questionable.

However, most fundamentally, it seems clear that capital controls of any form are nowadays not only very difficult to enforce, as the possibility of circumvention has increased in parallel with the integration of the national economies and the advances of information technology, but are also not a tool to fight currency turmoil but could rather cause it¹⁷.

¹⁶ The Swedish experience with such a tax in the 1980-87 period is clearly described in Umlauf, Steven; Transaction Taxes and Stock Market Behaviour: The Swedish Experience; IFA Working Paper 150-91; 1991.

¹⁷ See Dellas, H., Stockman, A.; "Self-fulfilling Expectations, Speculative Attack, and Capital Controls"; JMCB; Vol. 25(4); 1993; p. 721-30.

¹⁵ See Beckers S., Connor, G., Curds, R.; "National versus Global Factors in Equity Returns", June 1995.

Box 4: Typology of investor behaviour

Investors placing their funds into financial instruments demonstrate different behaviour which has a direct impact on their portfolio strategy and management and on the markets in which they are active. Three major categories can be outlined for a better understanding of their behaviour and their impact on capital markets:

long term investors:

Traditional institutional investors such as pension funds or insurance companies, together with corporate treasuries and a big part of retail investors form the bulk of these kind of investors. They are the dominant force and ultimate trend-setters on financial markets. Investment decisions are mainly based on long-term fundamental considerations and often maintained for a long period of time. Thus changes in their portfolio strategies are relatively infrequent and normally based on changes in economic fundamentals.

However, given the importance of the size of these portfolios, even small changes in their expectations and investment strategies (for example a reduction of 5% in the equity holdings part of their portfolio in favour of fixed-income securities) can have an important impact on financial markets.

The investment decisions are typically based on the discounting of future expected cash-flows of different financial instruments, within a given risk-return framework. Thus, such investors tend to choose those financial assets with the highest expected rates of return for a given risk.

These investors operate normally in the cash markets and use derivatives either for hedging purposes or for transforming part of the upward price potential of the instrument into an additional return on the asset (by covered short operations thereby selling put options on instruments they are in possession of).

This kind of risk-averse behaviour from the major players in financial markets assures that in the long term riskier assets should offer higher returns and vice versa. Thus, normally short term fixed income securities offer the lowest real return, followed by long term fixed income securities and by equities, which represent, a priori, the inverted order of risk. This fact has been

demonstrated in several studies on the major markets. This result could not be otherwise, except for short term periods of time when financial markets suffer corrections due to changes in participants' expectations.

short term investors and speculators:

These kind of investors base their investment decisions on fundamental, chartist and some other less conventional analysis. They operate actively in the cash and derivatives markets and realize profits (or losses) quickly then moving on to the next objective. They carry out a very active management of their respective portfolios and take and undo their positions within short periods of time, ranging from hours to a few months.

In this category two subcategories can be identified: those managing their portfolios without any major kind of leverage and those heavily leveraged which are the only ones that could be really labelled as "speculators".

In the first sub-category one could include a relatively small share of retail investors and some banks active in the management of their own trading portfolio (so-called proprietary trading).

In the second sub-category are typically the so-called hedge funds and some other non-traditional funds, which take very aggressive and leveraged positions both through borrowing (via securities collateral) and through the derivatives markets.

The amount managed by this type of investors is relatively small as compared to the former. Nevertheless, the leverage of their positions and the velocity of their movements can have a relatively major impact in some segments of the financial markets at some specific moment. In this sense, they "speculate" on future movements in financial instruments and, thus, they can provoke some kind of overshooting in the markets in some cases.

However, with the support of traditional institutional investors, which have the necessary strength, financial markets correct the situation adequately to market participants' expectations based on economic and financial fundamentals.

Box 4 (continued)

The "dangers" of these short term investors and speculators are limited, since for them to have a major impact on financial markets a clear majority of them has to take the same-way bet at the same moment, which is improbable. It should also be noted that while the profits of speculative investors are often highlighted, their losses are not often the subject of the same publicity.

Short term trading has a major beneficial by-product: the increase in liquidity it supplies to secondary markets.

This is important for the functioning of financial markets, since a highly liquid secondary market is a basic condition for the existence of a primary market.

Only the proper functioning of the latter allows the issuing of new equity and other forms of risk-capital, as well as fixed-income securities. Moreover, liquid secondary markets reduce the price risk of any financial in-

vestment and, thus, reduce the premium demanded on it, lowering the relative costs involved. **arbitrageurs and some other forms of professional activism:**

These investors take advantage of differences between prices of the same or similar financial instruments quoted simultaneously in different markets. One of the most lucrative arbitrage activities is that between derivatives markets and the underlying cash market, by which market operators correct excessive differences in prices of the same instrument, for example the cash market index and a futures contract on the same index.

This activity is under normal circumstances risk free, but demands the use of advanced technology and management skills. Hence, banks and securities houses are normally the only market participants. It increases the efficiency of financial markets, since it assures uniformity of prices, integration of different financial centres and adds liquidity to markets.

5. INEFFICIENCIES IN MARKET STRUCTURE AND REGULATION

5.1 Lack of sufficiently large and efficient financial markets

The overall situation shows relatively well developed and complete financial market structures within the EU. However, very often these markets are relatively small, and thus not operational. This applies for example to many stock markets (particularly in the Southern and smaller countries) and several bond markets. Also the banking system is, although in every country present with a full range of core banking business, of very different quality and, particularly in the smaller countries, highly concentrated.

Overall, as compared to other large capital markets, such as the US, all European capital markets lack some size advantages and a certain degree of deepness and sophistication.

The findings show a wide spread of available instruments, markets, and institutions among the EU countries. Disadvantages in one sector are normally not compensated for by other advantages. Particularly in several countries, such as Greece or Portugal, a relatively inefficient banking sector is aggravated by the lack of alternatives for company finance on the capital markets.

It has to be assumed that in all countries a further integration of financial markets would benefit the efficiency of the financial system. And particularly in those countries with a cumulation of disadvantageous financial markets' structures, even the development of the domestic financial market should exhibit high efficiency returns.

Cross-border capital movements and cross-border provision of financial services are the basic instruments to enhance the efficiency on European capital markets by creating one large market. Several factors, indicated below, hinder the European capital markets however in fully reaping the benefit of its potentially combined volume, degree of development, and intensity of competition.

5.2 Financial markets and accounting standards

Financial statements are one of the most important tools that enable investors to assess the economic performance of companies, and accounting standards are the basis upon which financial statements are prepared. When accounting standards vary from country to country, it becomes difficult and more expensive to assess the comparative value and performance of enterprises.

The harmonisation of accounting standards thus contributes significantly to the integration of financial markets.

The EU's accounting directives¹⁸ provide the basis for the mutual recognition of company accounts for the purpose of obtaining listings on the Community's principal stock markets and help to enhance financial transparency for the more efficient functioning of the financial markets.

The Community securities Directives, however, do not prevent stock exchanges in the EU from requiring or permitting the presentation of accounts for companies seeking a listing to follow standards other than those resulting from the accounting directives, including US General Accepted Accounting Standards. Moreover, compared to the US, enforcement of financial reporting standards in Europe is not as strong as it could be.

At the international level, the exponential development of financial markets and their globalisation has resulted in an increased demand for highly developed accounting information. This led to the International Organisation of Securities Commissions (IOSCO) and the International Accounting Standards Committee (IASC) agreeing to establish a core set of accounting standards which would satisfy the information needs of the most sophisticated securities markets, by 1998.

Increasingly European companies are finding that they can only meet their capital requirement by requesting listings on international financial markets outside Europe. Such companies are at a disadvantage if they are obliged to prepare two sets of accounts, one to satisfy European requirements and the other to meet the requirements of specific financial markets or IAS. In order to avoid this drawback, the European Commission adopted Accounting Harmonisation: a New Strategy vis-à-vis International Harmonisation (COM 95 (508)) in 1995, with the basic objective of associating the EU with the joint IASC-IOSCO project. The Commission is committed to ensuring that IAS are compatible with the accounting directives, first by ensuring a more influential expression of the European view in the IASC and secondly, if necessary, by proposing changes to the Directives.

Financial information is only of use in so far as it is credible. To have confidence in financial information, financial markets must have assurance about the bases on which the information has been prepared. Therefore it is necessary for financial statements to be audited by qualified professionals in accordance with generally accepted auditing standards. There is not yet an agreement in the EU on a common set of standards for auditors. An important step

towards improving audit quality will be the adoption by the Commission later this year of a specific Communication on statutory auditing, which follows on from the 1996 Green Paper and Conference on "the role, the position and the liability of the statutory auditor within the European Union".

5.3 Information and Rating Agencies

One of the main conditions for an efficient capital market is the availability of information to investors and savers¹⁹. Equally, one of the remaining obstacles to an effective integration of European financial markets and thus to access of EU companies to cross-border financing is the given lack of information among investors about capital markets and borrowers other than the respective home market.

One of the necessary devices to spread information particularly in the securities market sector are rating agencies. Ratings on the European capital markets so far play mainly a role on markets for debt instruments (bonds; money market papers, medium-term notes), mainly for financial institutions and supranationals.

The market in this segment is very developed in the US, and rather weak in Europe. However, also in Europe it is dominated by the two large US agencies, *Standard & Poors* (owned by *McGraw-Hill*) and *Moody's* (owned by *Dun & Bradstreet Corp.*). These two companies form an oligopolistic market, each protected by the US Securities Exchange Commission (SEC) recognition as "nationally recognized statistical rating organization" (NRSRO).

The exclusive status of these two rating agencies give them a very unique power in the pricing of financial markets, including the interest levels in the different national markets (by rating changes for the respective sovereign debt in the country, recent example: downgrading of Sweden). However it seems that the SEC increasingly imposes rules on the business behaviour of such NRSRO's, thus partly depriving them from their independence. This trend might eventually lead to a situation where US regulatory authorities have a decisive say on the international financial markets' pricing behaviour and thus interest rates.

Market entry barriers for newcomers on the rating agency market are considerable, as it is difficult to convince poten-

¹⁸ Fourth Council Directive (78/660/EEC) of 25 July 1978 on the annual accounts of certain types of companies, O.J. No. L 222 of 14.8.78; Seventh Council Directive (83/349/EEC) of 13 June 1983 on consolidated accounts, O.J. No. L 193 of 18.7.83.

¹⁹ See also: Gordon, Roger, Bovenberg A. L.; Why is capital so immobile internationally? Possible Explanations and implications for capital income taxation; in: American Economic Review, December 1996, Vol. 86(5), p. 1057 ff.

tially rated companies of the marginal benefits of a third or fourth rating.

There exist only three European rating agencies at the moment: the relatively small Portuguese *Companhia Portuguesa de Rating Sociedade Anonima* (founded in 1988), which is active only on its domestic market, *Italrating*, founded recently in Italy, and *IBCA*, a French owned company, and. The latter is the largest European rating agency, has grown from an agency more or less specialized on banking assessment into a full scale rating agency, active in several countries, in particular the British industrial sector. Furthermore, after *IBCA UK* has been taken over by a French agency and been merged, *IBCA* is the largest and, apart from a small Portuguese one, the only European controlled rating agency, and in Europe behind the two large US agencies (S&P, Moody's) the third largest one. Efforts in Germany to establish a national rating agency (in particular pushed by Deutsche Bank) have been abandoned.

Rating plays a prominent role in the United Kingdom, where all the three large agencies compile ratings for around 60 to 90 companies. The second most developed country is France with 30 to 50 ratings. In all the other EU countries, company debt rating is just in its infancy and normally confined to internationally active banks.

In order to develop direct company funding on the European debt markets, rating would have to be considerably extended. On the other hand, a relatively low exposure on these markets prevents these companies from actively looking for such ratings.

In the US the development of rating agencies as a device for information transfer has been driven by rules on the investment policy of institutional investors. Such rules force them to distinguish between rated and unrated companies; with limits being stricter on investment in the latter companies. Thus for companies an incentive exists to obtain a rating, which bears two costs, the direct cost of rating (which is rather small) and the cost associated with the risk of getting a poor rating or being downgraded at a later stage. With increasing institutionalization of financial markets, the incentive to obtain a rating is constantly growing. Further factors in favour of US rating agencies has been the large number of US banks, artificially inflated by the prohibition of interstate banking.

The development and setting up of rating agencies is a private sector task. Thus potential Community action is very limited. In other markets, notably the US, where rating agencies have traditionally played an important role in pro-

viding market efficiency, the role of rating agencies has been nevertheless fostered by different measures:

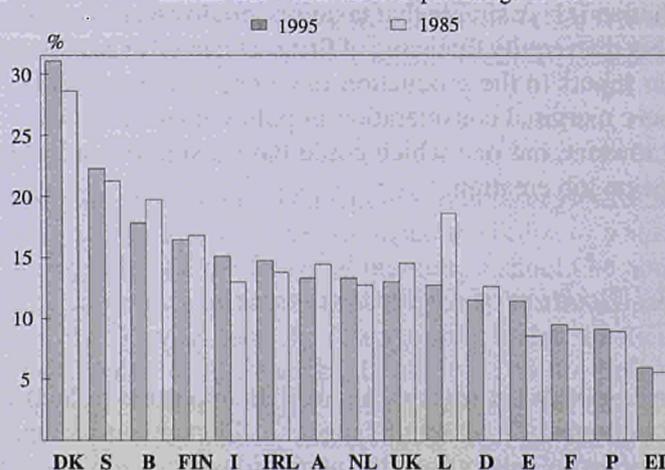
1. National and subfederal borrowers actively ask for ratings of at least one nationally controlled rating agencies.
2. Obliging institutional investors to invest certain parts of their portfolios in investment grade debt (highly rated securities) or even oblige certain issuers to obtain a rating²⁰.
3. The US SEC issues common minimum rules for the recognition of a rating agency in the respective market.

5.4 Income and corporate taxes

The globalization of financial markets and the abolition of exchange controls has made it more difficult to monitor systems of residence based taxation. Additionally, in countries with bank secrecy, it is difficult to enforce interest income taxation, even on domestic income.

These considerations, among others, have led to significant changes in taxation rates and policies over the recent past which have tended to result in rates on internationally mobile factors of production being set low, even those such as capital which is in fixed supply and thus a good candidate for taxation at a global level, with a shifting of taxation on to immobile factors (see table 20).

GRAPH 30 : Income taxes
Income and wealth taxes as percentage of GDP

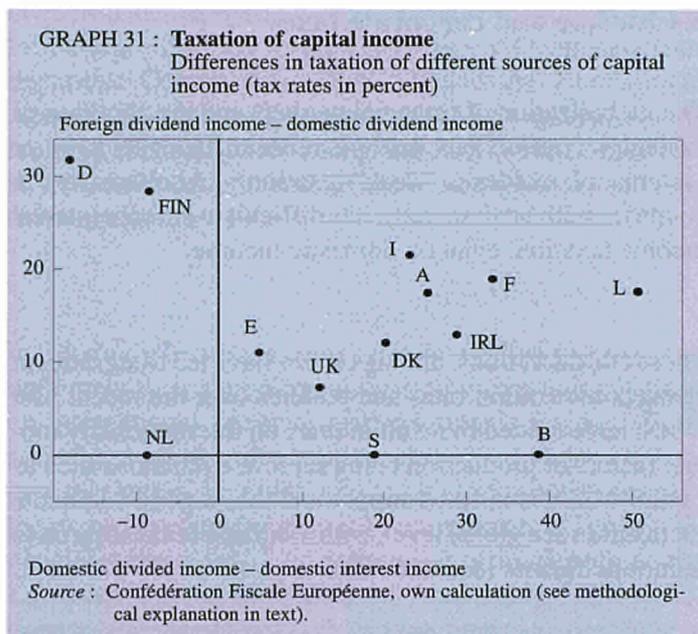


Source : Commission services calculations.

²⁰ Some elements of such an approach are already contained in the Capital Adequacy Directive.

To a large extent these changes have been a reaction to difficulties that have become apparent in enforcing domestic taxation rather than part of a coherent plan to draw up a rational and efficient tax system at international or regional level satisfying the traditional benchmarks of capital export and import neutrality used to evaluate the taxation of international capital flows, or to take a broader view of the desirable mix of taxation on capital and labour.

Even at the Community level, for instance, proposals for a common minimum withholding tax on interest income, although representing a significant step, if adopted, towards a more level playing field and a floor to unbridled tax competition for non-residents' deposits, do little to solve the differential treatment of taxation of income from equity and debt instruments. However since the latter are more mobile, they attract more policy interest because of the evident diminution of taxable capacity.



Whether it is desirable that taxation should encourage debt rather than equity financing of firms, or capital as against labour inputs in the production function, would seem to be amore marginal consideration in policy-makers decision-parameters, but one which could have a significant influence on job creation.

5.4.1 Taxation of corporate income

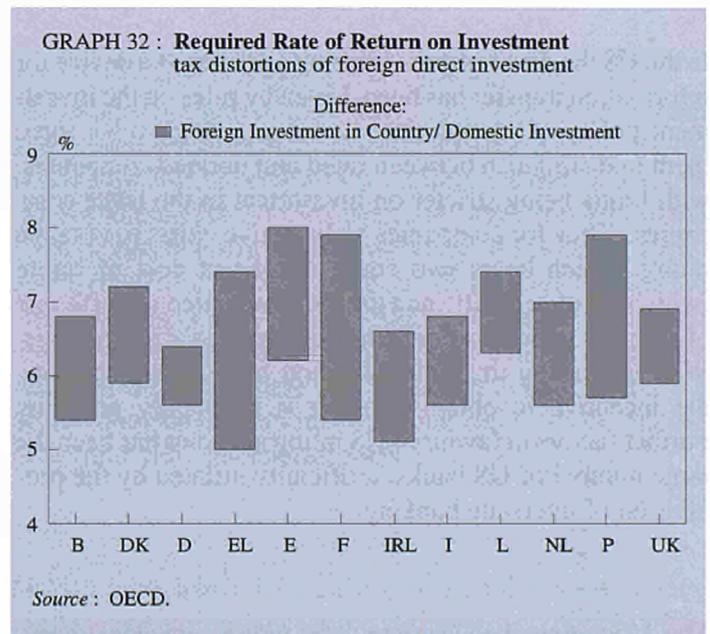
The corporate tax regime can exert an important influence on a company's competitiveness²¹. Changes in national corporate tax rules affect the international competitiveness of domestic firms in ways that do not necessarily reflect underlying fundamentals.

National differences in the tax rate and the definition of the tax base violate the principle of locational neutrality, stipulating that tax regimes ought not to influence the choice of jurisdiction in which to invest. From the viewpoint of theory such fiscally induced competitive distortions should be eliminated for the sake of allocative optimality in the EU, especially in the context of the internal market which, by eliminating other market barriers, increases the leverage of fiscal distortions.

The elimination of such fiscal distortions, by improving allocative efficiency, would encourage the flow of Community savings into the most productive pre-tax investment projects and could accordingly be expected to boost job creation.

The marginal effective tax rate has been determined to be a prime determinant of savings and investment in an economy. It measures the wedge between the pre-tax rate of return on a marginal investment project and the post-tax rate of return on that project for the eventual investor, be it an individual or a firm. Various academic studies and surveys by international institutions²² have computed for individual countries a very large number of marginal effective corporate tax rates.

These turn out to vary substantially (sometimes by more than 200%) among different industrial sectors, mode of finance, and among different categories of original investors. These large differences are observed when making cross-country comparisons, documenting the strong locational non-neutrality for individual investment projects and investors. The divergences are attributable, in descending order of importance, to the following three sets of factors:



²¹ See for example a recent study: Hines, James; Altered states: Taxes and the location of foreign direct investment in America; in: American Economic Review, December 1996, Vol. 86(5), p. 1076 ff.

²² See for example King and Fullerton (1984), McKee, Visser and Saunders (1986), Alworth (1987), OECD (1991), OECD (1993), IMF (1993).

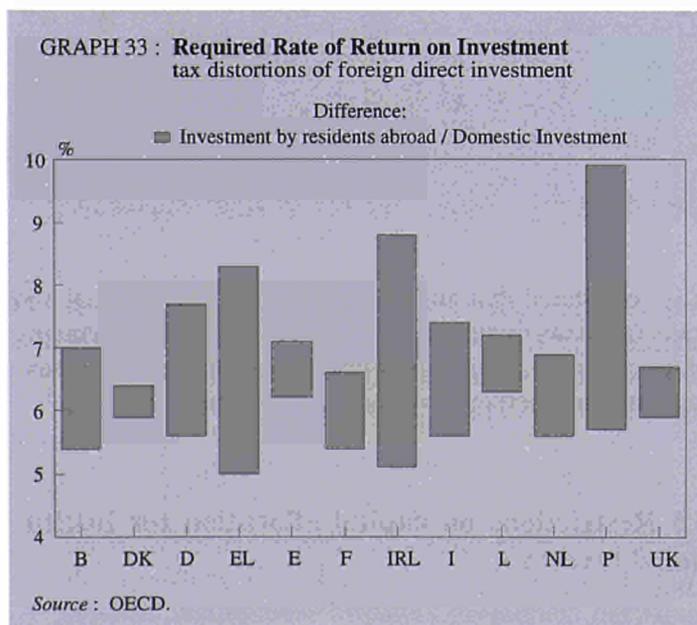
TABLE 20 : Implicit tax rates on production factors (1994)

| | level | change over 1985 | deviation from EU average | level 1994 | change over 1985 | deviation from EU average |
|------------|--------|------------------|---------------------------|--------------------------|------------------|---------------------------|
| | labour | | | other production factors | | |
| B | 45.8 | 1.5 | 5.3 | 38 | -2.5 | 2.8 |
| DK | 46.6 | 2 | 6.1 | 31.9 | -5.1 | -3.3 |
| D | 42.7 | 3.2 | 2.2 | 40.9 | -7.1 | 5.7 |
| EL | 39.8 | | -1.7 | 8.7 | -6.3 | -26.5 |
| E | 38 | 6.1 | -2.5 | 26.6 | 6.7 | -8.6 |
| F | 44.4 | 4 | 3.9 | 44.9 | -6.6 | 9.7 |
| IRL | 31.6 | 1.4 | -8.9 | 29.2 | 3.6 | -6 |
| I | 42.9 | 6.3 | 2.4 | 34.8 | 7.9 | -0.4 |
| L | 29.5 | -3.1 | -11 | 49.3 | 16.4 | 14.1 |
| NL | 51 | 0.1 | 10.5 | 37.3 | 6.8 | 2.1 |
| A | 43.4 | 2.5 | 2.9 | 37.1 | -3.8 | 1.9 |
| P | 35.8 | 14.4 | -4.7 | 16.3 | -8.2 | -18.9 |
| FIN | 55 | 12.1 | 14.5 | 21.3 | 5.4 | -13.9 |
| S | 52.6 | -0.1 | 12.1 | 34.7 | 0.9 | -0.5 |
| UK | 26.2 | 0 | -14.3 | 32.4 | -30.1 | -2.8 |
| EU average | 40.5 | 3.1 | | 35.2 | -8.1 | |

Source : European Commission.

- differences in the definition of the tax base (allowances for losses, inflation accounting, the tax treatment of foreign investment, depreciation allowances, etc.);
- differences in corporate tax rates and in investment incentives;
- differences in personal income tax and wealth tax (i. e. in some countries corporate taxes are linked to capital income taxes, whereas in others they are not).

It would therefore seem desirable that Community priorities in the area of corporate taxation should be set²³ according to the magnitude of efficiency gains to be achieved.



The Council adopted on 1 December 1997 a Code of Conduct for Business Taxation. This code identifies tax measures which are potentially harmful and provides a framework within which Member States can commit themselves to follow the principles of fair competition.

5.4.2 Taxation of savings

As suggested above the tax treatment of savings in the Community gives rise to a number of efficiency concerns.

The different treatment of interest income received by residents and non-residents (see table 21) has contributed to a massive tax-driven reallocation of savings capital in the Union. Cross-border bank deposits have risen considerably within the European Union. Main centres attracting these funds are the UK, Germany and Luxembourg. Cross-border non-bank depositors are mainly German, Dutch and UK residents.

While the differential treatment afforded through taxation to capital vis-à-vis labour is outside the scope of a study concentrating on the financial markets, it should be noted that it must have an important impact on the employment intensity of investment. To a large extent, national policies in this area are conditioned by the ability to tax the more internationally mobile factors of production, the desire to avoid significant leakages abroad and, perversely, to attract resources from partner countries.

The problems are primarily concentrated in the area of interest income from debt instrument (bank accounts and bonds) which generally are subject to much lower rates of taxation than direct participation in companies (dividend

²³ See for example Rädler, Albert; Einheitlicher europäischer Kapitalmarkt und Besteuerung; in: Festschrift für Karl Beusch; Berlin, New York, 1993.

TABLE 21 : Withholding tax on interest on bank deposits

| | residents | non-residents |
|------------|-----------|---------------|
| B | 15** | 0 |
| DK | * | 0 |
| D | 30 | 0 |
| EL | 15 | 10 |
| E | 25 | 0 |
| F | 20.9 | 0 |
| IRL | 27 | 0 |
| I | 30 | 0-30 |
| L | 0 | 0 |
| NL | * | 0 |
| A | 25** | 0 |
| P | 25 | 15-20 |
| FIN | 28** | 0 |
| S | 30** | 0 |
| UK | 25 | 0 |

* reporting system. **) final tax.

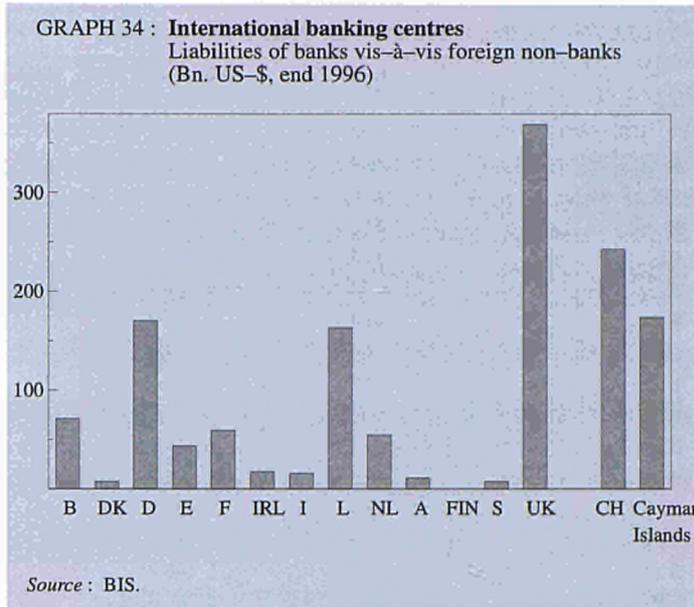
income). Given the general objective of promoting risk-taking and entrepreneurship, this would not seem to be the appropriate policy prescription.

Even in the area of dividend taxation, the complex interaction of different forms of corporate taxation, withholding taxes and bilateral double taxation arrangements, means that the tax rate on dividends from another EU country, in one specific case recently analyzed by the Commission services, can be up to 20% higher than that charged on domestic dividends. Such distortions, which are undoubtedly widespread, result in a suboptimal allocation of savings at a Community level as well as wasted resources involved in the search for the most tax-efficient solutions.

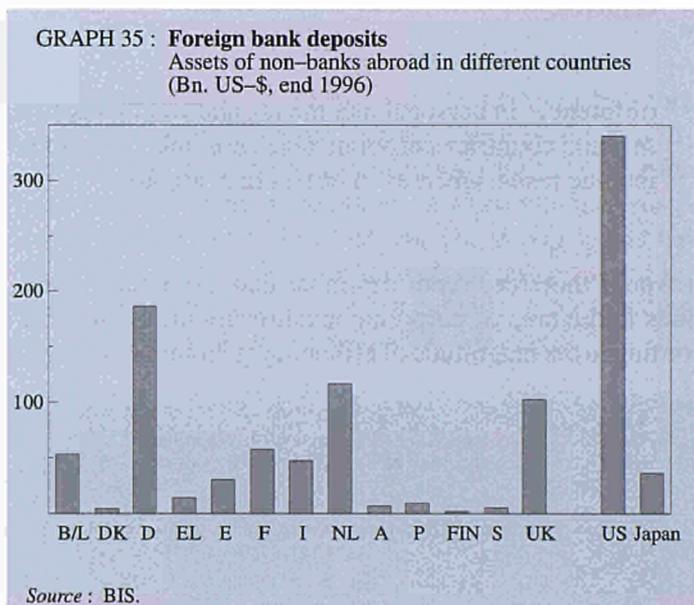
On the taxation of interest income, the most direct way to combat tax evasion would be the introduction of generalized reporting requirements. However given the difficulties on achieving agreement within the Community on such a measure, as well as the wider international coordination desirable to avoid delocalization, current proposals for a minimum Community withholding tax, while not fully addressing distortions between debt and equity financing, would, if adopted, go some way to reducing the tax competition for mobile capital and setting a floor to effective taxation of interest income.²⁴

Although the effect of such a tax, or a more generalized reporting system, would be to increase the wedge between interest paid by the borrower and interest received by the lender, it can be demonstrated that the economic welfare-losses associated with such an increase could be more than compensated for by gains achieved by a corresponding re

²⁴ See also the Commission documents on this subject: "Taxation in the European Union", 20.03 1996 (SEC(96) 487 final) and "Taxation in the European Union - Report on the Development of Tax Systems", 22 10. 1996 (COM(96)546 final).



duction in taxation on inputs which are presently taxed at high rates. In addition it should be pointed out that the present taxation bias in favour of bonds and bank interest, can result in an additional link in the intermediation chain, and also gives a competitive edge to government financing as opposed to publicly quoted companies, which, apart from large multinationals, rarely tap the bond market.



It is considered that any move towards a more equal and transparent tax treatment of the different forms of financing of the economy, would result in a more efficient flow of savings into productive job-creating investment.

5.5 Restrictions on capital allocation for institutional investors

In the majority of European countries, prudential regulations on institutional investors as regards the types of financial instruments in which they can invest their funds take

the form of explicit limits, which tend to penalize equities and any other form of risk capital investment and to favour fixed-income securities. One specific set of restrictions on investment abroad by insurance companies is given below.

Initially, these regulations were introduced many years ago, firstly, since fixed-income securities were a less risky asset as compared to equity holdings and, thus, as a way of reducing the volatility in the institutional investors' portfolios returns and assuring their financial stability.

Secondly, as an indirect way of placing the ever increasing amounts of public debt issues to fund persistent deficits in a sure, easier and less costly way. This has been typically the case in continental European countries, which have used these kind of limits extensively. On the contrary, Anglo-Saxon economies have tended to implement the so-called "prudent-man" rule by which institutional investors decide freely the mix of their portfolios, subject only to some general principles based on prudence, such as diversification of instruments and risks, no excessive concentration in one single issuer, etc. ...

This major difference in regulatory structures as regards the freedom of institutional investors to invest their funds has had an important impact in their portfolio mix. Insurance companies and pension funds in continental Europe tend to be heavily invested in fixed-income securities while their Anglo-Saxon counterparts are in equities, based on the understanding that, from a long-term perspective, returns in equities are higher than in fixed-income securities (as has been proved frequently in various studies) and provide a better protection against inflation.

Specifically, there are four major restrictions usually imposed on institutional investors as regards their freedom to invest:

1. restrictions on **equity holdings**: the regulatory reasoning behind this being that equities are riskier assets and their returns present a higher degree of volatility than fixed-income securities, which is true in the short term
2. restrictions on **controlling-stake equity holdings**: the regulatory reasoning behind this being that the purpose of institutional investors investment decisions should be exclusively based on a portfolio strategy and not in getting involved in corporate governance of the undertakings where their funds are invested.

3. restrictions on a **single issuer**: the reasoning being that the institutional investor portfolio should be invested in a wide variety of issuers and undertakings to reduce the impact that a bankruptcy of any of them could have on its financial stability.
4. restrictions on **foreign (currency) holdings**: the reasoning being that the currency risk of any portfolio is a specific risk against which any institutional investor should be covered.

TABLE 22 : **Regulations on investment abroad by insurance companies** (Ceilings on investment in foreign assets or assets denominated in foreign currency)

| | |
|------------|--|
| B | Technical reserves : to be located in Belgium. |
| DK | None. |
| D | Up to 5% of the premium reserve stock and 20% of the remaining restricted assets. In addition, specific ceilings range from 5% to 20% depending on the foreign assets concerned. |
| EL | EC legislation applies. |
| E | None vis-à-vis OECD countries. Documents of title to capital assets to be located in Spain. |
| F | None vis-à-vis OECD countries. Documents of title to capital assets must normally be located in France. |
| IRL | None. |
| I | EC legislation applies. |
| L | Technical reserves : up to 10% in securities of other OECD countries. |
| NL | None. |
| A | Technical reserves for contracts denominated in Austrian currency : located in Austria. |
| P | Assets to be located in EC countries. |
| FIN | Technical reserves : Finnish real estate, securities, or assets guaranteed by residents. |
| S | Technical reserves : no more than 20% (unless to cover liabilities in the same currency), to be localized in Sweden. |
| UK | None. |

Source : OECD.

Restrictions on equity holdings partly overlook the fact that institutional investors, specially pension funds, have a long term perspective because their liabilities come due, normally, many years ahead and, thus, short term volatility of equity holdings are not relevant for their long term investment strategies. Furthermore, past evidence shows that particularly equity holdings allow institutional investors to hedge against the inflation risk associated to a much higher degree with fixed-income securities or loans.

Restrictions on foreign holdings are in contrast to modern portfolio theory²⁵, which defends and demonstrates empirically that diversification is a much better and more powerful way of reducing currency risk than any kind of alternative regulation based on specific limits on foreign currency

²⁵ Of which the major exponents are the recent Nobel prize winners, Markowitz, Sharpe and Miller.

holdings (the so-called currency matching rules). Moreover, this kind of regulatory approach has a negative impact on cross border capital movements, with negative consequences on an efficient allocation of capital resources across Europe, since, with a very few exceptions, institutional investors are indirectly obliged to invest within their national boundaries given the fact that very few national-currency-denominated financial instruments exist abroad.

Restrictions on the investment in single companies are driven by regulatory concern about the total risk of the portfolio of these institutional investors. It is unquestioned, that all other things being equal, the broader diversification of the equity assets on more companies reduces the overall portfolio risk.

However, two major developments on the financial markets of all major industrialized countries challenge, at least to some degree, the wisdom of such restrictions. Firstly, modern financial markets, and particularly stock and stock index derivative markets allow efficient hedging against certain risks stemming from unexpected changes of prices of financial assets. Secondly, the increasing role of institutional investors as shareholders bears the risk that, together with those mentioned restrictions, more and more companies will end up with a relatively dispersed ownership structure. This poses the mentioned problems of management control and might change the long-term objectives of the companies in a disadvantageous way.

All restrictions listed above have a compound effect on the way institutional investors place their funds between different financial instruments. They allocate a relatively small proportion of their resources to equities and other risk-capital instruments (except for Anglo-Saxon institutional investors which are subject to a more flexible regulatory structure). Moreover, this part is basically invested in well-established companies (the so-called blue chips), because these are the only firms whose shares present enough liquidity in the markets (usually another regulatory requirement). Thus, this fact has, as its major consequence, that unquoted companies and small and medium-sized firms do not benefit from the most important source of capital in today's financial markets (a very rough estimate places at between 60% to 80% the participation of institutional investors in today's capital markets transactions).

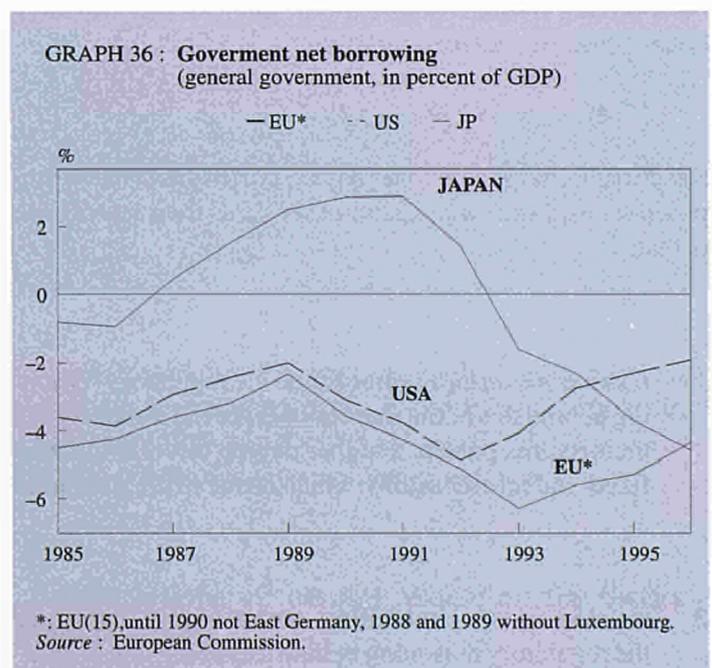
A second consequence is that, even in the predominantly fixed-income securities part of institutional investors' portfolio, private sector debt plays a relatively modest role. This is, in part, due to a general lack of development of this

segment of capital markets throughout Europe (with a very few exceptions) and to the crowding-out effect that public debt securities exert on private issues, not only at the market level, but also at portfolio level through liquidity, quality of the issuer, concentration on a single issuer and other similar regulatory requirements.

Thus, the major conclusion is that, although institutional investors are important suppliers of long term capital, they allocate a relatively small proportion of their resources to the productive sector of the economy, partly due to regulatory requirements based, initially, on prudential considerations, but not always justified on these grounds.

5.6 Government crowding out

The level and development of government debt can have significant adverse effects on the access of the private sector to funding for job creating investment projects. While the significance of crowding out may be less pronounced than in the eighties, as governments, encouraged by the quantitative goals set out in the Treaty, have increasingly raised the profile of debt and budget targeting and as recent slippage in the area is counteracted by more buoyant receipts in the recovery phase, this recovery will also bring a growing funding demand from business. In those countries with a large outstanding stock of public debt and high deficits, if public spending is not kept on a tight rein, private job-creating investment will suffer the consequences of this policy failure.





Principal economic policy measures – November 1997

Community (EUR-15)

5.11 The Ecofin Council has an in depth exchange of views on employment issues, based on the Commission's proposal for guidelines for Member States employment policies 1998.

The Commission adopts a communication on a package to tackle harmful tax competition in the European Union. The main components of the package are a code of conduct for business taxation and measures to eliminate distortions to the taxation of capital income.

12.11 The Commission adopts a communication on the possibility of a reduced VAT rate on labour intense services for an experimental period and on an optional basis.

17.11 The Ecofin Council notes that circulation of euro notes and coins shall begin on 1 January 2002.

An extraordinary Ecofin/Labour and Social Affairs Joint Council meeting approves the draft 1997 Joint Employment Report.

18.11 The Commission endorses general orientations for a review of the application of state aide rules to measures relating to the direct taxation of companies.

20./21.11 The extraordinary European Council arrives at a political agreement on the guidelines for Member States employment policies 1998. The guidelines centre on improving employability, developing entrepreneurship, encouraging adaptability and strengthening equal opportunities.

Belgium (B)

None.

Denmark (DK)

None.

Germany (D)

6.11 The Cabinet approves a draft bill reforming stock company law. The new regulations aim at improving control over and transparency of companies, giving more powers and duties to the Supervisory Board (*Aufsichtsrat*).

Greece (GR)

12.11 Presentation of the 1998 Budget to Parliament; it provides for the reduction of the central government deficit from 6.2% of GDP in 1997 to 4.4% of GDP in 1998. The general government deficit is projected to be 2.4% of GDP in 1998 from 4.2% of GDP in 1997. Nominal GDP is projected to rise by 8.4% in 1998 and inflation to be 2.5% at year-end or 3.7% on average.

Spain (E)

28.11 The central and regional governments reach an agreement on the new territorial health financing system for the period 1998-2001. Under this agreement, the budgeted expenditure for the whole health system will be increased in 1998 by ESP 316 billion to ESP 3 769 billion.

France (F)

19.11 The government adopts the Supplementary Finance Bill for 1997, which presents the final projections for the 1997 budget. The State budget deficit for 1997 is now projected to stand at FRF 270.7 bn (3.35% of GDP)

compared with an initial objective of FRF 284.8 bn (3.45% of GDP). According to the government, this good performance will make it possible to achieve the 3.1% of GDP target for the 1997 general government deficit.

Ireland (IRL)

None.

Italy (I)

21.11 The Italian Senate approves the Budget Law for 1998.

Luxembourg (L)

14.11 Government approves an investment package amounting to LUF 121 billion for the period 1997-2001.

Netherlands (NL)

28.11 Government introduces an urban toll from 2001.

Austria (A)

5.11 The Parliament approves the reform of the public officials' pension system. The reform aims at an alignment of the officials' pension system with private sector systems, including the introduction of a calculation period for pension assessment.

6.11 In order to implement the 1998 budget proposal, the Parliament adopts various changes to regulations concerning public prices, which are intended to increase government revenues by 1 % of GDP in 1998.

7.11 The Parliament approves a reform of various Social Insurance Laws, centred on the inclusion of disincentives for early retirement, the extension of the number of insured beneficiaries and an increase in the upper limit for social security contributions.

Portugal (P)

18.11 Social security pensions increase by 4% on average from 1 December 1997; the pensioners with the lowest pensions receive the largest increase.

18.11 The Bank of Portugal lowers the repo rate by 20 basis points to 5.3%.

Finland (SF)

26.11 The central organisations of employers and employees reach agreement on a comprehensive wage settlement, which will increase wages by 2.5% on average in 1998 and by 1.6% in 1999. If the settlement is implemented in actual branch-level agreements by 11 December, the government will ease the taxation of earned income: employees' sickness insurance contribution down by 0.4 of a percentage point in 1998 and further in 1999. In 1999, also the tax-exempt part of earned income in local taxation will be increased, and the income tax rates reduced by 0.5 of a percentage point except in the highest income bracket.

Sweden (S)

None.

United Kingdom (UK)

6.11 The Bank of England raises official interest rates to 7¼% from 7% with immediate effect.

Price (excluding VAT) in Luxembourg

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