30 April 2008

Provisional
Not to be quoted without permission of the author

A single European financial market: a progress report after half a century

Ivo Maes*

Paper prepared for the EUSA (Economics Section) and Federal Reserve of St. Louis Workshop "The Implications of European Integration"

St. Louis, 14-16 May 2008

* National Bank of Belgium, Robert Triffin Chair, Université catholique de Louvain and University of Leuven. The author would like to thank everybody who contributed to this project, especially J.-P. Abraham. The usual restrictions apply.

Address:

Research Department
National Bank of Belgium
Boulevard de Berlaimont
1000 Brussels
Belgium

mail: ivo.maes@nbb.be

A single European financial market: a progress report after half a century

1. Introduction **3**
2. The financial landscape in the late 1950s **3**
3. Some first attempts at financial integration **6**
4. A changing financial landscape: internationalisation and innovation **8**
5. The single market project **10**
6. The single currency and the single monetary policy **12**
7. Recent policy initiatives **17**
7.1. The Financial Services Action Plan (FSAP) 18
7.2. The Lamfalussy procedure 19
7.3. The Markets in Financial Instruments Directive (MiFID) 21
7.4. The Single Euro Payments Area (SEPA) project 22
8. Conclusion **22**
References **25**

1. INTRODUCTION

Since the Rome Treaty, a 'common market' is a key objective of the European Community. However, notwithstanding several projects (like the Rome Treaty, the single market programme, the Financial services Action Plan), barriers remain. This contrasts with the 'single currency' which was introduced in two steps (1999, the official changeover date, which was crucial for the financial markets, and 2002, for notes and coins). It leads to the question: why is it so difficult to achieve a real single market. In this paper we will analyze this question for the financial sector.

Naturally, one has to take into account that financial integration was not an important element of the first attempts at European integration in the 1950s. The Rome Treaty focussed very much on the free movement of goods (with the abolition of tariffs and quota's) and certain accompanying policies, especially competition policy and the common agricultural policy. This should not be surprising as agriculture and industry were still crucial economic sectors, and probably even more so in the perception of most policy-makers. Moreover, integration in these sectors was already considered a very ambitious project. It is further important to keep in mind that European economic integration has never been an end in itself. It has been part of the general process of European integration, a fundamental political process, to restore peace and prosperity after the destructions of the Second World War.

In this paper the focus is on the process of European financial integration and how, through time, several barriers to a single financial market have, progressively, been eliminated. The paper starts with an overview of the financial landscape in the late 1950s. Thereafter, different initiatives which affected European financial integration are analysed, like the Rome Treaty, the single market project, EMU and the Financial services Action Plan. Attention is also paid to the growing globalization of the financial system and the growth of financial innovations and how they interacted with European policy initiatives.

2. THE FINANCIAL LANDSCAPE IN THE LATE 1950S

At the end of the 1950s, at the time of the Rome Treaty, capital controls were pervasive, leading to a significant partitioning of financial markets between countries (Maes, 2007). Moreover, there were very significant differences between the financial systems of the countries of the European Community. They

concerned, for instance, the role of the government, the size of the various financial markets, the role of different types of financial institutions or the significance of institutional investors. In several countries, financial systems were characterised by significant degrees of segmentation, leading even to the question whether one could speak of a 'national' financial market (CEC, 1966).

A crucial element, was that the financial sector was regarded as a very special sector, in which the government had an important role. This was to a large extent a legacy of the interwar period, when bank runs, stock market crashes and the Great Depression had led to a significant government intervention in the financial sector. Crucial objectives of the government were the protection of small savers and the prevention of systemic financial crises. The government intervened in a multitude of ways: different forms of regulation (like the prohibition of banks to take shares in industry), the creation of institutions which were responsible for the supervision of the financial sector (in Belgium, the Banking Commission was established in 1935), government financial institutions providing market financial services (mostly to provide credit to a specific group which was considered to be neglected by the financial markets). The situation was concisely summarised in the Segré Report: ‘The way available resources are distributed between the various sectors… depends essentially on decisions taken by the authorities. The scale of public investment, the major role played by official financial intermediaries and the dominant position on the market held by the public authorities leave only a relatively small area in which the play of traditional market forces can determine the allocation of resources.’ (CEC, 1966, p. XV).

Table 1 - The Rome Treaty: Part Two - Bases of the Community

Title I.	Free movement of Goods
Chapter 1:	The customs union
Chapter 2:	The elimination of quantitative restrictions as between Member States
Title II.	Agriculture
Title III.	The Free Movement of Persons, Services and Capital
Chapter 1:	The workers
Chapter 2:	The right of establishment
Chapter 3:	Services

Chapter 4: Capital

Title IV Transport

Financial integration was not the topic of a separate chapter in the Rome Treaty. It involves three different types of activities (which are the subject of three different chapters of the Treaty, cf. Table 1): the right of establishment, the free movement of services and the free movement of capital (Servais, 1995). While these three activities are strongly interrelated, it is important to keep in mind that they are conceptually different. Let us give a short definition of them:

- the concept of establishment involves (a financial institution) setting up permanently in a Member State, other than the country of origin, in order to exercise activities;
- the free movement of services means the supply of services, by an establishment located in one country, for the benefit of a client in another country;
- a capital movement implies a transfer of assets from one country to another (or, if it is within a Member State, to a non-resident). Moreover, it has to be an independent transaction in its own right (otherwise, it would be a payment).

That financial integration did not enjoy the same priority as the customs union is clear from the chapter on the free movement of capital. The first article of which states: "Member States shall, in the course of the transitional period and to the extent necessary for the proper functioning of the Common Market, progressively abolish as between themselves restrictions on the movement of capital". (Article 67.1). The Treaty thus clearly subordinates the free movement of capital to the common market (comprising free movement of goods and foreign direct investment, cf. Vigneron, 2007). However, abolishing barriers to trade in goods was already a highly ambitious objective, and was made subject to Article 109's safeguard clause. What's more, Article 73 stipulates that in 'the event of movements of capital leading to disturbances in the functioning of the capital market in any Member State', the country concerned can take 'protective measures'.

So, the movement of capital was subject to severe limitations in the Rome Treaty. Hereby, one has to take into account the context of the time: the Second World War had ended only a decade earlier, the dollar was still scarce and the convertibility of the European currencies was only just restored. Moreover,

financial markets were small and not very developed. Capital restrictions were then very much in line with the prevailing ideas of the time. Three motives were crucial (Bakker, 1996): the wish to maintain an autonomous monetary and economic policy, the idea that it was necessary to raise obstacles to speculative short-term capital movements, and the desire to protect domestic capital markets (and savings).

The Rome Treaty further established a clear link between the liberalization of capital movements and the freedom of financial services. Article 61.2 states: "The liberalization of banking and insurance services connected with movements of capital shall be effected in harmony with the progressive liberalization of the movement of capital."

3. SOME FIRST ATTEMPTS AT FINANCIAL INTEGRATION

In matters of financial integration, the crucial issue was initially the liberalisation of capital movements. Indeed, capital controls were the most evident barrier to a single financial market. They clearly separated the different national financial markets.

There were important differences between the positions of Member States (Bakker, 1996, p. 80). So was Germany in favour of a full liberalisation of capital movements, not only inside the Community, but also with countries outside the Community (the so-called 'erga omnes' principle). Other countries, fearing that speculative capital flows would hinder monetary policy, were more reluctant. France argued that capital liberalisation should go together with a strengthening of monetary policy coordination.

So, in general, the liberalization of capital movements was not so much regarded as a single market issue but much more as a monetary policy issue. This is also clear if one looks at the institutional setting of the discussions. For instance, capital controls were a responsibility of the Monetary Committee. Inside the Commission, capital movements were a responsibility of DG II (Economic and Financial Affairs, the macroeconomic research DG of the Commission) and not DG IV (Internal Market).

The first directive concerning the liberalization of capital movements was adopted by the Council in May 1960. As might have been expected, it fell far short of full liberalization. Member countries were obliged to unconditionally liberalize short

and medium-term trade-related credits, direct investment flows, and transactions in listed shares. These were the financial transactions which were directly related to the physical creation of the common market. They were directly linked to the clause in Article 67, ‘to ensure the proper functioning of the Common Market’. Short-term financial transactions, however, did not fall under any obligation to liberalize. A second directive, much less important, was adopted by the Council in December 1962. The main element was the extension of the unconditional liberalization of short- and medium-term credits to trade in services (as opposed to goods only in the 1960 directive).

Meanwhile however, the first cracks in the Bretton-Woods system had appeared (Maes, 2006). In 1960, divergences in monetary policy between Germany and the United States led to interest rate differentials. Consequently, Germany was hit by massive capital inflows, threatening its monetary policy objective. In June 1960, Germany reimposed certain regulatory measures, like the prohibition of interest payments on Deutsche mark deposits held by non-residents. In March 1961, the German mark and the Dutch guilder were revalued.

From the end of the 1960s the Bretton-Woods fixed exchange rate system was increasingly under stress. Also in the EEC itself, cracks began to appear in the exchange rate system. The after-effects of the May 1968 revolt caused great difficulty for the French franc. Consequently, the French government decided to use the safeguard clause and took temporary protectionist measures.

During the early 1970s, in a context of turbulence on the foreign exchange markets, the European countries resorted again to capital controls in order to defend their exchange rates (Bakker, 1996). Even Germany, very much against its free market views, introduced measures to limit capital inflows. Also other countries, especially France and Italy, introduced capital controls. However, in these last two countries, they were essentially aimed at the control of capital outflows, as their currencies were under downward pressure.

At the height of the international monetary crisis, in February 1973, in the face of massive capital flows from the United States to Germany, it was even decided to close the foreign exchange markets. In the ensuing month the Bretton-Woods system was given up and the dollar started floating. From 1974 onwards, Germany relaxed and abolished most of the controls it had installed. An important reason herefore was that the authorities had more and more doubts about their effectiveness. In other countries however, like France and Italy, controls, especially on capital outflows, were kept in place (some of them until the late

1980s). Two elements were important for maintaining controls: firstly, these currencies remained under downward pressure during most of the 1970s and 1980s, and, secondly, the prevailing idea was that it was easier to control capital outflows than inflows, as outflows were mainly by domestic residents and went through the domestic banking system.

4. A CHANGING FINANCIAL LANDSCAPE: INTERNATIONALISATION AND INNOVATION

In the 1970s and the 1980s, the financial landscape went through fundamental changes, 'both a quantitative and a qualitative jump' (Abraham, 2003, p. 145). Two tendencies were crucial: the internationalisation of the financial markets and financial innovations. It went together with a growing influence of market forces.

The internationalisation of the financial markets was most evident in the growth of the so-called Eurocurrency markets. As such, Eurocurrencies were not a significant product innovation. Indeed, operations in foreign currency deposits were well known in London before World War One (Toniolo, 2005, p. 453). At the core of the euro-markets was the eurodollar market. Eurodollars, in Milton Friedman's (1969, p. 3) classical definition, 'are deposit liabilities, denominated in dollars, of banks outside the United States'. However, there were also euro-markets for deposits denominated in other currencies, like the Deutsche mark, the pound sterling or the Swiss franc. The prefix 'euro' derived from the fact that banks originally active in this market were located in European financial centres.

Moreover, from the 1970 onwards, financial innovations started flourishing, especially on the international financial scene. Besides the sharp acceleration in the globalisation of financial markets, two broad tendencies can be distinguished (BIS, 1986). Firstly, a move towards securitisation, with banks trying to increase the marketability of their assets. This contributed to a blurring of the distinction between bank credits and the capital markets. Secondly, an increasing importance of off-balance-sheet items. The BIS report here paid special attention to four major instruments: note issuance facilities, which enable a borrower to issue a stream of short-term notes over a medium-term period, and three types of derivative products: currency and interest rate swaps, currency and interest rate options and forward rate agreements.

Several factors were driving this process of financial innovation (BIS, 1986): (1) high inflation and major current-account imbalances, leading to an increased volatility of interest rates and exchange rates; (2) the changing regulatory

environment, with deregulation, but also a greater attention of supervisors to the adequacy of financial institution's capital ratio's, often making off-balance-sheet products more attractive; (3) the widespread application of new communications and computing technology and (4) a growing competition in financial markets.

Moreover, attitudes towards risk capital were changing. In several European countries the idea was growing that the aversion of savers towards shares was contributing to a weak financial structure of firms, making them much more vulnerable to averse economic circumstances. In France, the Barre government passed, in July 1978, the so-called 'Monory law' (after Finance Minister René Monory). It foresaw in tax incentives for French households, when they acquired shares of French companies, and for certain firms (especially medium-sized companies), when they issued new shares. A crucial aim of the law was to redirect savings from short-term financial assets towards risk capital. Moreover, the law crucially aimed at reinforcing the role of market forces in the French financial system, which was very segmented and oligopolistic (Métais, 1985, p. 98). In the following years, several other European countries took similar measures.

In the 1970s and, especially, in the 1980s, financial markets gained in importance in most countries (Akhtar, 1983). Three elements were important: (1) existing markets expanded and deepened significantly. In several countries, the government played a key role, with reforms of the markets and measures like tax incentives or privatisations; (2) new financial markets emerged; and (3) secondary markets for many instruments developed. Most spectacular was probably the emergence of new financial markets. These included, among others, markets for various types of unconventional bonds (e.g. floating rate bonds, zero coupon bonds, convertibles, commodity-linked bonds) and various types of mortgage financing securities. However, the most innovative and startling new markets were those for financial futures, options and stock index futures. Financial futures started trading in the United States in the mid-1970s and in the United Kingdom in 1982.

Naturally, with the growing internationalisation of financial markets and the accelerating pace of financial innovations, the effectiveness of capital controls became more and more eroded. Also, and very crucially, free and open financial markets were increasingly seen as important determinants of the competitiveness of financial centres and financial institutions. Moreover, with the Thatcher government, the free market camp in the European Community was significantly strengthened.

The internationalization of the financial markets and financial innovations even accelerated in the 1990s and early 21st century. Crucial drivers of these processes were strong advances in communications and computing technology, steadily intensifying competition in financial markets and a changing regulatory environment. These were accompanied by the growing institutionalization of savings with the growth of players such as investment funds, insurance companies, pension funds and hedge funds. Moreover, thanks to computing power, financial products have become infinitely more malleable.

However, the generalized use of derivatives is also rendering the financial system much more opaque (Lamfalussy, 2006, p. 10). This implies that public authorities are losing sight of who is really holding the risk associated with certain financial operations, and of the interconnections between different financial markets. This was clearly demonstrated in the summer of 2007, when problems with US mortgages affected the world-wide financial system.

A crucial structural development has been the growth of institutional investors, such as pension funds and insurance companies (ECB, 2007b). Against a background of ageing populations and rising longevity, a larger proportion of household savings is now being placed in private-funded pension schemes and life insurance policies. They provide so institutional investors with more funds, which are managed by professional fund managers. This is also changing the set of incentives faced by corporations and increasing the attention to corporate governance. Overall, institutional investors have become an increasingly important channel for the savings of households. In this way they are investing indirectly in equity and corporate bonds.

5. THE SINGLE MARKET PROJECT

Financial integration came effectively on the agenda of the Community with the single market project in 1985. In its 'White Paper', the Commission (1985, p. 27) clearly stated, 'The liberalisation of financial services, linked to that of capital movements, will represent a major step towards Community financial integration and the widening of the Internal Market'.

As mentioned earlier, a single European financial market involved two main elements: the free movement of capital and the freedom to provide financial services – i.e. the freedom to establish financial institutions and the cross-border

selling of financial products. As already discussed, the free movement of capital was closely linked with monetary cooperation. This would also be so in the 1980s.

In May 1986, in order to put into practice the White Paper on the internal market, the Commission presented a programme for the complete liberalisation of capital movements (Servais, 1995, p. 47)[1]. The programme was implemented in two phases. A first directive was approved by the Council of Ministers in November 1986 and entered into force on 28 February 1987. This directive chiefly deregulated the capital transactions which are essential to the smooth functioning of the common market and the integration of the national securities markets. A few months later, in November 1987, the Commission published a Communication on the establishment of a European financial area. The cornerstone of this communication was the complete freedom of capital movements and, thus, the removal of all remaining controls on capital movements. The Directive, which set out the timetable and arrangements for the free movement of capital, was adopted by the Council on 24 June 1988. It came into force on the 1 June 1990, the same date as the start of the first phase of Economic and Monetary Union. Furthermore, the Maastricht Treaty placed the free movement of capital on a par with the other freedoms of the Rome Treaty (Vigneron, 1994)[2]. These dispositions on capital movements came into force on 1 January 2004, the date of the start of the second phase of EMU.

As regards the freedom of establishment of financial institutions and the cross-border selling of financial products, two issues were of crucial importance: supervision and consumer protection. Differences between countries in these areas had formed significant barriers to a single financial market. The Commission's 1992 strategy aimed to abolish barriers through three major principles: (1) minimum coordination of individual national rules; (2) mutual recognition; and (3) home-country control (CEC, 1989, p. 18).

As observed in the White Paper (CEC, 1985), 'Some comparison can be made between the approach followed by the Commission after the "Cassis de Dijon" judgements with regard to industrial and agricultural products and what now has to be done for insurance policies, home-ownership savings contracts, consumer credit, participation in collective investment schemes, etc. The Commission considers that it should be possible to facilitate the exchange of such "financial

---

[1] Together with the growing liberalisation of capital movements, policy-makers have become more concerned about money laundering. Also the European Community has adopted several measures to combat money-laundering (Vigneron, 2006).

[2] One could even argue that the free movement of capital was of a higher order as it was 'erga omnes' (also with respect to countries outside the Community).

products" at a Community level, using a minimal coordination of rules (especially on such matters as authorisation, financial supervision and reorganisation, winding up, etc) as the basis for mutual recognition by Member States... Such harmonisation, particularly as regards the supervision of ongoing activities, should be guided by the principle of "home country control". This means attributing the primary task of supervising the financial institution to the competent authorities of its Member State of origin'. The only exceptions are for reasons like, for example, public health or public morality (as explicitly mentioned in Article 36 of the Rome Treaty).

The internal market programme adopted this approach for the financial sector (banking, insurance and the securities markets). Four key directives defined the provisions that had to be harmonized in order to allow the free provision of financial services: the Second Banking Directive; the Investment Services Directive; and new Life and Non-Life Insurance Directives. In essence, these directives gave financial institutions the opportunity to offer their services across the EU with a single licence (Gros and Lannoo, 2000, p. 30). It marked the start of the quest for a single passport. The measures were supplemented by directives defining specific subjects, such as the solvency ratio and own funds directives in banking, and directives covering unit trusts, listing prospectuses and initial public offerings, in the area of investment services.

The approach was first implemented in the banking sector. Underpinning the new (Second) Banking Directive, was the issue of a single authorization or ‘passport’, valid for all Community countries. The directive was adopted in the Council in December 1989 and came into force on 1 January 1993. A broad definition of credit institutions was adopted in the directive, quite similar to the German model of universal banking (Vander Vennet, 2002). Consequently, banks, investment firms and insurance companies were permitted to hold unlimited reciprocal equity participations, implying that there were no limits to the formation of financial conglomerates. However, the directive also allowed the host country to impose specific regulations if they were deemed to be ‘in the public interest’. (Gold-plating?)

6. THE SINGLE CURRENCY AND THE SINGLE MONETARY POLICY

It is widely argued that the financial integration process ‘did not really take off until the introduction of the euro’, Almunia (2006, p. 2). On the eve of EMU, Europe was still very much characterized by a number of national markets. Borrowers and

investors in financial markets tended to come largely from their own country (the ‘home bias’) and often used instruments specific to it.

The introduction of the euro and the single monetary policy has had a particularly strong impact on the financial markets. A significant integration process is under way, as seen most clearly in the money market and above all in the unsecured interbank market (Hartmann et al., 2003). It is safe to refer in this regard to a genuine single European market that is the direct result of the common monetary policy. There were two key factors: the way the implementation of monetary policy is organized and the introduction of a new cross-border settlement system for euro payments.

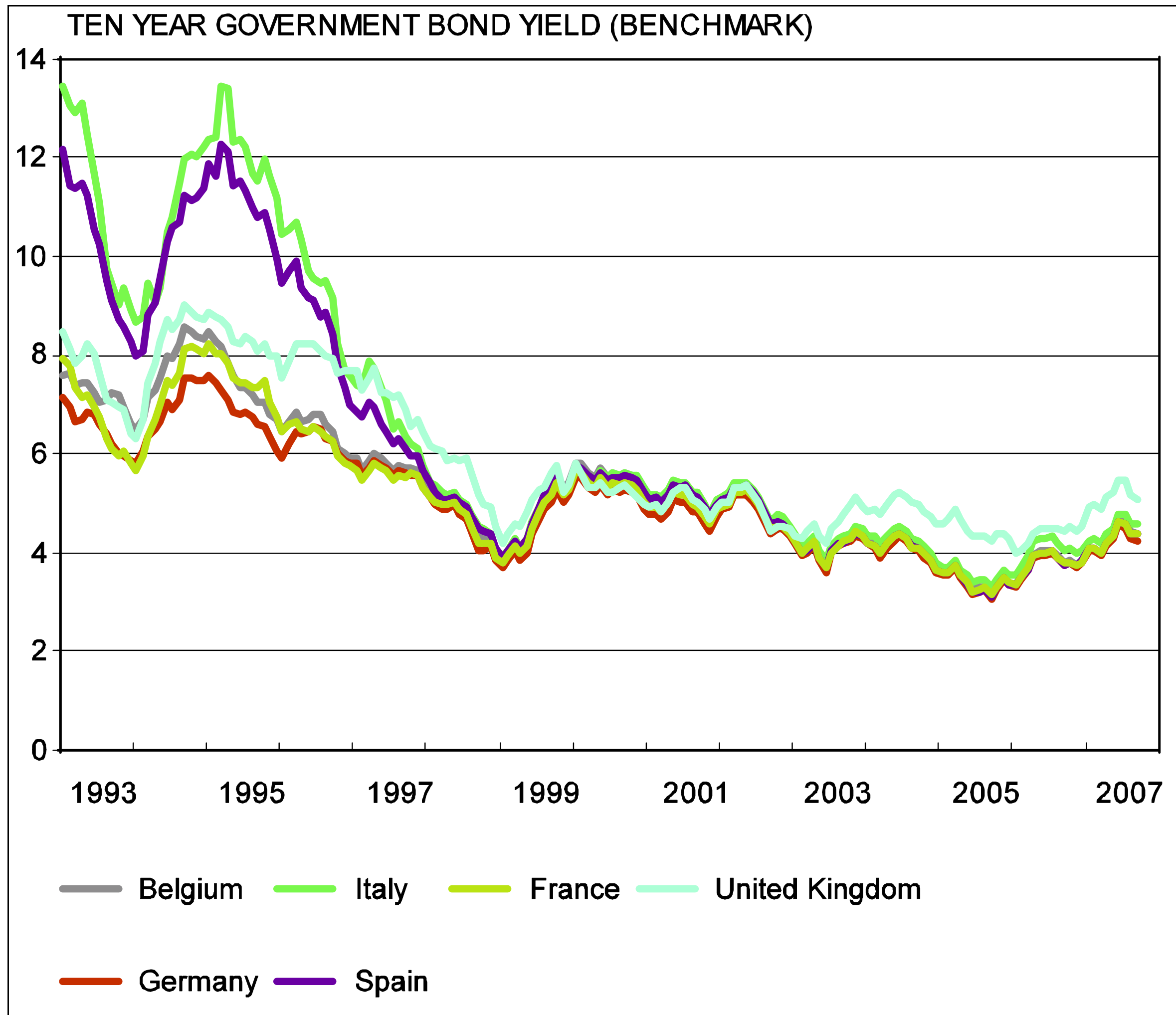
The Eurosystem is the euro area’s ‘bankers’ bank’, providing liquidity to financial institutions. It is primarily by setting the interest rates on these credits that the Eurosystem conducts monetary policy and steers market interest rates. It can draw on a set of monetary policy instruments to that end, the most important of which are the main refinancing operations. These weekly credit tenders with a maturity of one week provide the banking system with liquidity, while the interest rate on them signals the Eurosystem’s monetary policy stance.

Otherwise, the Eurosystem primarily leaves it to the credit institutions to standardize interest rates in the euro area via their arbitrage operations. They can use the TARGET system to that end, which ensures the efficient handling of cross-border payments and their final, immediate and secure settlement. TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) is provided by the Eurosystem and is used for the settlement of central bank operations, large-value euro interbank transfers as well as other euro payments. It provides real-time processing, settlement in central bank money and immediate finality. The system consists of national real-time gross settlement (RTGS) systems and the ECB payment mechanism, which are interconnected. TARGET has been in operation since the start of EMU in January 1999.

The Eurosystem has further built a new generation of TARGET, TARGET2. The new system went live in November 2007 and is characterised by a harmonised and centralised technical infrastructure. Building further on TARGET2, the Eurosystem is also working on a settlement system for securities transactions, TARGET2-Securities (T2S). This would provide delivery versus payment (DvP) for securities against central bank money. The Eurosystem is further considering the development of a common platform for Eurosystem collateral management.

The disappearance of exchange rate risk within the euro area and the integration of the money market also provided a great boost to the integration of the other financial markets (ECB, 2007a). A sector in which impressive changes have taken place is the euro-denominated bond market.

Chart 1 Ten-year government bond yields (1993–2007)



Source: Eurostat.

With the removal of exchange rate risk and the introduction of the euro, yields in the government bond market have converged in all countries, although the importance of national factors has not completely disappeared. These relate in part to the characteristics of the markets in the different countries. Differences in liquidity and the availability of developed derivatives markets may partly account for the yield differentials. However, bond yields also reflect differences in perceived credit risk, which ought not, of course, to be seen as indicating a lack of integration. The consolidation of public finances under the influence of the convergence criteria and the Stability and Growth Pact has also contributed to a decline in credit risk premia and hence to a convergence of bond yields.

The introduction of the euro also contributed, together with the globalization of the economy, to changes in the behaviour of stock market investors as well as issuers of shares. Investors in shares traditionally adopted a ‘country’ perspective, as the determinants of share prices (profits of firms and interest rates) were strongly shaped by country-specific factors like the evolution of the business cycle and national monetary policies. As we saw above, money market rates and bond yields have both converged significantly since the introduction of the euro. Greater synchronization can also be observed in the business cycle, due in part to the single monetary policy. National determinants of share prices are thus losing in importance and investors are increasingly adopting a euro area and global perspective. In more general terms, they are attaching greater importance to a sector-based allocation of shares, as profits depend to a significant extent on the evolution of the sector in which the firm operates.

Moreover, the stock exchanges were undergoing fundamental changes (Lefebvre, 1999). From a 'club', were members would meet, they were increasingly transformed into electronic trading platforms. So, their role as 'infrastructure providers' for intermediaries on the financial markets was more and more accentuated. Moreover, stock exchanges were becoming businesses on their own. Often they were 'demutualised', with their own shares also listed on the exchange and their capital opened up to non-members. Mostly, their supervisory functions, like the investigation of market abuse, were transferred to public authorities. In these transformations, technology was playing a driving role. Furthermore, as electronic trading platforms imply massive fixed costs, economies of scale are becoming ever more important, a crucial driver for a consolidation of the exchanges. Also, the product of a stock exchange is the liquidity that it provides for the shares which are traded. This depends very much on the accessibility of the exchange, with a better accessibility leading to higher liquidity. So, network externalities are important, another crucial driver for a consolidation of the exchanges.

So, around the turn of the millennium the time was increasingly ripe for a consolidation process for the traditional stock exchanges. Already in 1998, the Deutsche Börse (DB) and the London Stock Exchange (LSE) elaborated plans to merge. However, they did not reach an agreement. In September 2000, Euronext was created, by the merger of the stock exchanges of Amsterdam, Brussels, and Paris (Lefebvre, 2000). In 2001, Euronext acquired Liffe, the London derivatives trading platform, and concluded an agreement to integrate the Lisbon exchange. The consolidation process of the stock exchanges is further continuing, surpassing

the European Union. For instance, in 2007, Euronext merged with the New York Stock Exchange, creating NYSE Euronext.

In the banking markets, the wholesale market and capital market-related activities are displaying significant signs of increasing integration, whereas the retail markets remain fragmented (ECB, 2007a). The introduction of the euro removed one of the barriers between national markets. What's more, together with growing competition and globalization, the euro is contributing to more aggressive bank strategies in Europe (Abraham, 1998). The low level of retail banking integration reflects barriers such as differences in legal frameworks and practices (e.g. consumer protection and mortgages); traditions and culture; and technical infrastructure (e.g. relatively high fragmentation in retail payment infrastructures).

Cross-border banking has increased in the euro area in recent years (ECB, 2007a). The cross-border share in banks' financial holdings, mergers and acquisitions, as well as permanent establishments has been growing. Large euro area banking groups account for an increasing share of total euro area banking assets. An important development in cross-border banking is the growing degree of organizational integration within banking groups, often cutting across different legal entities. In particular, banks have increasingly centralized their business functions across borders.

A general overview of the state of financial integration can be found in table 2. As observed by Papademos (2008), financial integration is generally more advanced in those market segments that are closer to the single monetary policy. Moreover, it depends also on the degree of integration of the respective market infrastructure.

Table 2: The state of financial integration in the euro area

Market	State of integration	Related infrastructures
Money markets		
a) Unsecured	Near perfect	Fully integrated
b) Secured	Advanced	Collateral leg fragmented
Bond markets		
a) Government bonds	Very advanced	Fragmented
b) Corporate bonds	Fair	Fragmented
Equity markets	Incipient	Highly fragmented
Banking markets		
Wholesale banking	Well advanced	Fully integrated
Capital-market activities	Advanced	Fragmented
Retail banking	Very low	Highly fragmented

Source: Papademos (2008)

7. RECENT POLICY INITIATIVES

The introduction of the euro acted as a powerful catalyst for the creation of an integrated European financial market. At the same time, it led to a greater awareness of the existence of other barriers and of the need to eliminate them. Consequently, public authorities in the European Union took several initiatives to push forward the process of financial integration. In this section we will focus on four of these: (1) the Financial Services Action Plan of 1999, which developed a comprehensive framework for legislative reform in the first years of the 21st century; (2) the Lamfalussy procedure, which fundamentally reformed the decision-making process for financial legislation; (3) the Markets in Financial Instruments Directive, which has been characterised as a 'revolution in European securities markets' (Casey and Lannoo, 2006, p. 5); and (4) the Single Euro Payments Area, which will harmonise the use of payment instruments.

7.1. The Financial Services Action Plan (FSAP)

The Cardiff European Council of June 1998 placed the functioning of markets at the centre of the economic reform process. Consequently, in the spring of 1999, the European Commission adopted the Financial Services Action Plan (CEC, 1999). The FSAP aimed to tackle three strategic objectives: (1) a Single Market for wholesale financial services; (2) open and secure retail markets; and (3) state-of-the-art prudential rules and supervision. Moreover, it foresaw 'flanking measures', especially in the area of taxation. The FSAP contained a set of 42 concrete measures which had to be implemented in a five year period. However, clearing and settlement issues were not taken up in the FSAP (Norman, 2007)

The FSAP also addressed broader issues concerning an optimal single financial market, including the elimination of tax obstacles and distortions. Even before, in December 1997, an agreement had been concluded on a package to tackle harmful tax competition in the EU, including the principle of a tax on savings income. In June 2000, at the Feira European Council, an agreement was reached on the crucial elements of this tax on savings income, in particular the exchange of information between the tax authorities of the different Member States. Belgium, Luxembourg and Austria may temporarily replace that exchange of information with a withholding tax on interest payments to individuals resident in other Member States. The agreement was embodied in a Directive of 3 June 2003 that came into force on 1 July 2005, after also the conclusion of bilateral agreements with certain other countries. However, while progress was made in taxation, several studies show that tax systems still remain important barriers for a single European financial market. An often quoted example is the existence of cases of double taxation of dividends, already mentioned in the 1966 Segré Report.

It is still too early for an overall assessment of the FSAP. There is a broad consensus that, at the EU legislative level, the FSAP was a significant success. At the end of the five year period, nearly all of the proposed measures were adopted by the Council and the Parliament. It showed the commitment of Europe's policy-makers, notwithstanding significant differences of opinion, to go ahead with the process of financial integration. However, with respect to the transposition at the national level and an effective application, the picture is more mixed and opinions are more divergent (Breuer, 2005). However, the FSAP was certainly an important and necessary phase in the process of European financial integration. It was crucial in adapting the legislative framework for financial services. This made it

also possible to see more clearly other barriers on the road towards European financial integration.

In the following years, the Commission considered its strategy. A key idea was that less emphasis should be placed on new regulation, but that the transposition and enforcement of existing measures should be privileged. In December 2005, the Commission issued a White Paper on Financial Services Policy (CEC, 2005). This set the agenda for the period 2005-2010. The White Paper gave a high priority to a timely and consistent implementation of the FSAP, as well as to continuous ex-post evaluation of existing policies and rules. However, it argued also that certain areas required further policy efforts: (1) clearing and settlement, where cross-border clearing and settlement transactions are far more costly than domestic transactions, due to technical, legal and fiscal obstacles; (2) the retail sector, a clear priority for the Commission, with important initiatives in the areas of mortgage credit, consumer credit and payment services; (3) EU supervisory arrangements; (4) the investment fund industry; and (5) a new EU framework for risk management in the insurance sector (Solvency II).

7.2. The Lamfalussy procedure

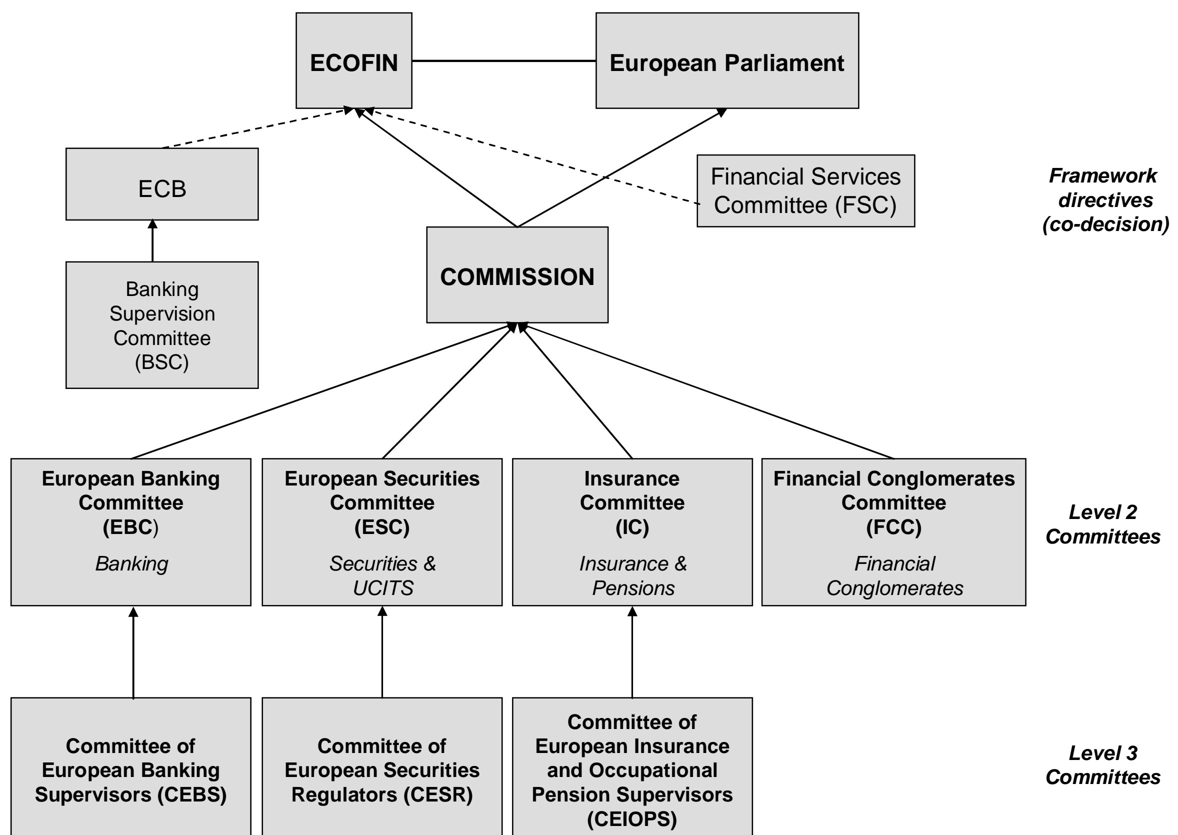
A key issue of the FSAP was the functioning of the securities markets, especially how to adapt the European regulatory framework to the continuously evolving financial markets. In July 2000, the ECOFIN Council appointed an ad hoc Committee of Wise Men, led by Alexandre Lamfalussy, the first President of the European Monetary Institute, to analyse 'practical arrangements for implementation of the Communtiy rules' and 'propose various approaches to adjusting the practice of regulation and cooperation between regulators'.

The Committee of Wise Men was harsh in its analysis of the existing European regulatory framework: It summarized the situation as follows: ‘The challenges facing the creation of an integrated securities market in Europe are that the basic legislation is not in place; that there is still insufficient prioritization; and that the present system cannot produce quickly or flexibly enough the type of legislation that modern financial markets require; and that inconsistent implementation is severely handicapping the emergence of a pan-European market’ (Committee of Wise Men, 2001, p. 18).

In order to remedy these deficiencies, the Committee of Wise Men proposed a four-level approach. The new procedure made a clear distinction between key political decisions and technical implementation. The crucial aim was to speed up

changes in regulation. Moreover, it significantly increased the transparency of the regulatory process and extended greatly private sector consultation (Quaglia, 2007). The approach of the Committee of Wise Men was broadly accepted by the European Council of Stockholm of March 2001. In 2002 followed an overhaul of the institutional arrangements for banking and insurance. This extended the Lamfalussy approach to banking, insurance & pensions, and financial conglomerates.

Table 3 - The extension of the Lamfalussy-framework



It is interesting to note that this time the approach developed for the securities markets was later also adopted for banking and insurance. This marked a change from the traditional sequence whereby banking was the first sector were new European initiatives would be elaborated, which were afterwards applied to the other sectors. It is an indication of a growing maturity of the process of European financial integration.

One should further remark that Europe's supervisory arrangements are increasingly a topic of discussion. As remarked by European Commissioner

McCreevy (2007a), 'Europe's supervisory system seems to be creaking under its own weight'. Concerns are expressed regarding both efficiency and stability aspects. So financial operators are complaining about the costs of complying with so many supervisory structures and practices. Moreover, from a financial stability perspective, the framework has been described as a 'mind-boggling patchwork' (Lamfalussy, 2003, p. 17), who further advocates a strengthening of its crisis-prevention and crisis-fighting capabilities.

With the sub-prime crisis, the issue of financial stability has come again to the forefront. Globalisation, liberalisation and European integration have, with the elimination of barriers, led to a more closely integrated financial system. This increases the possibilities for the sharing and diversifying of risks and also raises market liquidity. However, it also increases the scope for spill-over effects and contagion, so that financial viruses can spread quickly.

The Lamfalussy procedure created, with the Level 3 Committees, new fora where Europe's financial supervisors meet. Even if they were created for very different reasons, the Level 3 Committees might play a role in a new European supervisory architecture.

7.3. The Markets in Financial Instruments Directive (MiFID)

The Markets in Financial Instruments Directive (MiFID), adopted in April 2004, has become the cornerstone of the Financial Services Action Plan. It replaces and expands the 1993 Investment Services Directive (ISD). The directive is very comprehensive (and complex). A crucial aim is to increase competition across borders (McCreevy, 2007b). The main concrete objectives are to remove obstacles to the use of the single passport by investment firms and to foster competition and a level playing field between Europe's trading venues. However, MiFID also aims to ensure a high level of protection for investors across Europe.

MiFID is updating the 'single passport' for investment firms, allowing investment firms to operate across the EU on the basis of an effective single authorisation, across a wide range of financial instruments and investments activities (Lannoo, 2007). The 'single passport' means that a firm needs only to answer to one regulator for most of its compliance questions. Conflicts of interest, internal control, and all activities done on a cross-border basis will be subject to home state control. The host state regulator will have a limited role in supervising branches in

its territory. A further crucial objective of MiFID is the strenghtening of competition among different order-execution systems (regulated markets, Multilateral Trading Facilities and systematic internalisation, cf. Casey and Lannoo, 2006).

7.4. The Single Euro Payments Area (SEPA) project

As discussed earlier, the introduction of the euro provided a strong boost to the integration of wholesale payment services. However, less progress was made in the integration of retail payment services, especially as there is no equivalent to the TARGET system. Indeed, there were still 15 retail payment systems in 2005, only slightly fewer than the 19 that existed in 1998 (ECB, 2007a, p. 44). So, there remained significant differences in the handling of retail payments between the different euro area countries. Moreover, the quality of retail payment services for cross-border transactions in the euro area remained often much lower than for these at the domestic level.

To address these discrepancies between countries and the lack of integration of retail payments services, the European banking industry set up the Single Euro Payments Area (SEPA) project. The European institutions are also contributing actively to the SEPA project.

SEPA constitutes a significant step in the move towards financial integration. SEPA will harmonise the use of payment instruments (credit transfers, direct debits and card payments) for all users throughout the SEPA (the 27 countries of the European Union plus Iceland, Liechtenstein, Norway and Switzerland). The SEPA project consists further of a series of initiatives aiming at common instruments, standards and infrastructures for euro area retail payments. So, consumers, companies and all other economic actors will be able to make cross-border euro payments in exactly the same way as domestic euro payments.

8. Conclusion

Looking back after half a century, one sees that Europe's financial landscape has changed tremendously. Significant progress at financial integration has been made, especially at the wholesale level. However, also for the wholesale markets barriers remain, especially ones related to clearing and settlement. Naturally, there is even more work to do at the level of the retail markets. This is not really surprising, as retail markets are even more embedded in their national societies, with their traditions, languages, and regulatory systems.

Financial integration is a complex process. Integration is partly hampered by natural barriers, like language, culture and consumer preferences. But there are also other type of barriers, like market infrastructure and differing regulatory frameworks. A financial system reflects the socio-economic preferences of a country. These preferences are embodied in legal frameworks, taxation systems or regulatory requirements (especially regarding the protection of savers and mortgages). As observed by Papademos (2008), these barriers should be addressed by policy-makers and market participants. However, given the complexity of these frameworks, it is not simple. Removing barriers to integration is then a little bit like playing with a Russian doll: it is only after the removal of a barrier, that one really sees the significance of the next barrier.

Initially, in the 1960s, the focus was on capital controls. They were clearly the most significant barrier to financial integration, as they made for a clear segmentation between countries' financial markets. However, they were also closely related to monetary policy. In the following decades, capital controls were more and more evaded and eroded. This contributed to their abolition at the end of the 1980s, in the framework of the EMU project.

With the 1985 single market project, the freedom to provide cross-border financial services was also put on the agenda. The key element was the idea of a 'single passport'. Initially, most progress was made in the banking sector, which was more homogeneous and were one could draw on work done at the international level (the G10 in Basle). Thereafter, the model developed for the integration of the banking sector would be an inspiration for the other financial sectors (investment firms, unit trusts, insurance). Another pattern is that, initially, attention is focused on core ideas, especially a 'single passport'. Later, one observes that the different elements which provide a framework for the market (legal systems, customs, market infrastructure, ...) often also constitute barriers to a really single financial market and need to be tackled.

The introduction of the euro provided a significant boost to the integration of the financial markets, especially for the countries which adopted the single currency. Indeed, not only were several barriers slaughtered, but there were also significant steps to introduce new frameworks and strengthen market infrastructure. So led the single monetary policy to a single money market. A crucial element hereby was the TARGET system, a new cross-border settlement system for euro payments. It strengthened significantly the infrastructure of the financial markets. Moreover, with the disappearance of the different national currencies, exchange

rate risk disappeared. It was, together with the single money market, a crucial element for the integration of the bond markets.

So, one can note the close and intimate relation between monetary and financial integration. From the negotiations of the Rome Treaty to the Maastricht Treaty, were the liberalisation of capital movements and monetary cooperation nearly always linked. Moreover, the single currency and the single monetary policy needed, to function effectively, a single money market. This necessitated the central banks to elaborate a new infrastructure for cross-border euro payments. It was an important stimulus for further improvements in the infrastructure of the financial markets.

For understanding the respective roles of market forces and policy initiatives, Tinbergen's distinction between 'negative' and 'positive' integration can be useful. Negative integration concerns the abolition of barriers to free movement (Tinbergen, 1954, p. 117). However, in his view also a number of positive measures are necessary for integration, to create a framework for the market. Market forces play especially a role in 'negative' integration. The growing role of market forces is a global, word-wide phenomenon. The internationalisation of financial markets and financial innovations contributed significantly to the erosion of capital controls in the 1970s and 1980s. Policy-makers had not much choice than to abolish capital controls, as they were becoming ineffective and, moreover, rendered their financial centres less attractive. So, market forces are especially successful at eliminating forms of segmentation through arbitrage operations. However, in case of barriers, market forces will also affect the allocation of economic activities. A crucial objective for policy-makers is then to create a framework wherein market forces can develop. This is close to Tinbergen's notion of positive integration. During the last decades, policy-makers in Europe have made significant progress. However, further efforts are necessary to advance financial integration and strengthen both the efficiency and stability aspects of Europe's financial framework.

REFERENCES

Abraham J.-P. (1998), De euro en de bankherstructureringen in het Beneluxgebied, *Revue de la Banque/Bank- en Financiewezen*, No. 9.

Abraham J.-P. (2003), *Monetary and Financial Thinking in Europe*, *Evidence from Four Decades of SUERF*, SUERF Studies.

Akhtar M. A. (1983), Financial Innovations and their Implications for Monetary Policy: an International Perspective, Bank for International Settlements, *Economic Papers*, No. 9, September.

Almunia J. (2006), *European financial integration: assessing the pace of progress*, Speech, Ambrosetti Forum, Villa d'Este, Cernobbio, 1st April.

Bakker A. (1996), *The Liberalization of capital movements in Europe. The Monetary Committee and financial integration 1958–1994,* Dordrecht: Kluwer Academic Publishers.

Bank for International Settlement (1986), *Recent Innovations in International Banking*, Prepared by a Study Group established by the Central Banks of the Group of Ten Countries, Basle.

Breuer R.-E. (2005), The Future of EU Financial Market Integration: A Post-FSAP Agenda, *SUERF Newsletter*, April.

Casey J.-P. and K. Lannoo (2006), The MiFID Revolution*, ECMI Policy Brief, no. 3*, November.

Commission of the European Communities (1966), *Le développement d'un marché européen des capitaux*, Rapport Segré, Bruxelles.

Commission of the European Communities (1985), Completing the Internal Market, White paper, Luxembourg.

Commission of the European Communities (1989), *The European Financial Common Market*, European Documentation, 4/1989, Luxembourg.

Commission of the European Communities (1999), *Financial Services: Implementing the framework for financial markets: Action plan*, COM (1999) 232, May.

Commission of the European Communities (2005), *Financial Services Policy 2005–2010*, White paper, SEC (2005) 1574.

Committee of Wise Men (2001), *Final Report on the Regulation of European Securities Markets,* February.

European Central Bank (2007a), *Financial Integration in Europe*, Frankfurt, March.

European Central Bank (2007b), *Corporate Finance in the Euro Area*, Frankfurt, Structural Issues Report, May.

Friedman M. (1969), *The Euro-Dollar Market: Some First Principles*, Graduate School of Business, University of Chicago, Paper No. 34.

Gros D. and K. Lannoo (2000), *The Euro Capital Market*, West Sussex: John Wiley & Sons.

Hartmann P., A. Maddaloni and S. Manganelli (2003), The euro-area financial system: structure, integration, and policy initiatives, *Oxford Review of Economic Policy*, Vol. 19, No. 1.

Lamfalussy A. (2003), *Central Banks and Financial Stability*, 2nd Pierre Werner Lecture, Luxembourg: Banque Centrale de Luxembourg.

Lamfalussy A. (2006), *Monetary Policy and Systematic Risk Prevention – Challenges ahead for Central Banks*, The Bank of Greece Zolotas Lecture, Athens, 29 September.

Lannoo K. (2007), MiFID and Reg NMS: A test-case for ‘substituted compliance’?, *ECMI Policy Brief*, No. 8, July.

Lefebvre O. (1999), Bourses: entre fusions et alliances?, *Revue de la Banque/Bank- en Financiewezen*, No. 6.

Lefebvre O. (2000), Euronext: un pas décisif pour la consolidation boursière européenne, *Revue de la Banque/Bank- en Financiewezen*, No. 7.

Maes I. (2006), The Ascent of the European Commission as an Actor in the Monetary Integration Process in the 1960s, *Scottish Journal of Political Economy*, Vol. 53, No. 2, May, pp. 222–241.

Maes I. (2007), *Half a Century of European Financial Integration. From the Rome Treaty to the 21st Century*. Brussels: Mercatorfonds.

McCreevy Ch. (2007a), *Challenges for EU supervisory arrangements in an increasingly global financial environment*, Speech, Conference organised by the European Commission, Brussels, 26 June.

McCreevy C. (2007b), *Preparing for MiFID*, Institute for European Affairs, Speech/06/430, Dublin, 30 June.

Métais J. (1985), Equity finance in France after the Monory and Delors reforms, *The Banker*, April, No. 710, pp. 97–105.

Norman (2007), *Plumbers and Visionaries*, London: Wiley

Papademos L. (2008), Financial Integration in Europe, Speech, ECB, 29 April.

Quaglia L. (2007), The Politics of Financial Service Regulation and Supervision Reform in the European Union, *European Journal of Political Research*, Vol. 46, No. 2, pp. 269–90.

Servais D. (1995), *A single financial market*, European Commission, Document series, third edition.

Tinbergen H. (1954), *International Economic Integration*. Amsterdam: North-Holland.

Toniolo G. (2005), *Central Bank Cooperation at the Bank for International Settlements*, *1930–1973*, Cambridge: Cambridge University Press.

Vander Vennet R. (2002), Cost and profit efficiency of financial conglomerates and universal banks in Europe, *Journal of Money, Credit, and Banking*, Vol. 34, No. 1, February.

Vigneron P. (1994), La libre circulation des capitaux: les nouvelles dispositions du traité de Maastricht, *ECU*, No. 27, p. 32-36.

Vigneron P. (2006), La libre circulation des capitaux in *Marché intérieur*, L. Defalque, J. Pertek, P. Steinfeld, P. Vigneron, Éditions de l'Université de Bruxelles, 3 édition.