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Towards a Truly European Financial Market

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The principle of subsidiarity

The Lisbon Special European Council, held in March of this year, set 2005 as the deadline for implementing a single European financial market. But if Europe really wants to achieve this goal and be able to compete with other international financial markets, it must accept the political consequences that come with such an objective: ultimately, it will have to equip itself with an integrated regulatory and prudential system. Just as Monetary Union requires a single currency and a European central bank, a single European financial market can hardly be implemented without broad convergence of the regulatory and supervisory framework. If we are not ready to take this step forward and adopt the necessary measures, it might be preferable to abandon the objective rather than have to come to the realisation, in the not too distant future, that Europe has again failed to achieve one of its targets.

Those who follow European affairs may have wondered why the need has been felt to reset an objective that was already incorporated in the 1986 Single European Act. The reason is that not enough progress has been made in integrating the European financial market in the last 15 years. This delay has become particularly evident since the adoption of the euro.

One of the causes for the delay resides in the inappropriate recourse to the principle of subsidiarity. The principle of subsidiarity calls for examination of "why" and "how" certain policies should be conducted at a given level of government. Unfortunately, no analysis of this kind has been undertaken in the field of financial

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market regulation and supervision, contrary to what occurred for monetary policy.[2]

The policy consistency test

Implementing subsidiarity means performing a "policy consistency test" on the instruments and objectives of policy. This consistency test was carried out in the case of EMU, to assess whether it was possible to achieve contemporaneously: *i)* monetary (exchange rate) stability and *ii)* full capital mobility, while *iii)* retaining national monetary sovereignty.

The "policy consistency test" could also be applied to financial policy: in order to achieve a single financial market, possibly by 2005, as requested by the Lisbon European Council, is it possible to *i)* ensure a stable financial system, that is, efficiency and stability, while *ii)* maintaining national sovereignty in financial regulation and supervision, with only a minimal degree of harmonisation?

It would seem not. Already now, developments affecting the 20-30 largest banking institutions in Europe can create systemic effects for the entire European market. The stability of the European financial market cannot be ensured by regulating and supervising these institutions at the national level only, because of the externalities that would result from problems affecting any of them.

Yet, several objections to this conclusion have been put forward. The first is that we still do not have a truly unified financial market in Europe. It would thus be premature to deprive national authorities of their prerogatives in the field of prudential supervision. However, this is a typical "chicken and egg" critique. It is widely recognised that the existing differences between national regulations and supervisory systems are a major factor hampering the achievement of a more integrated market. On the other hand, the way EU directives are implemented leaves ample room for establishing differentiated treatment across countries, thus creating barriers to integration. In short, the persistence of national prerogatives in the field of financial regulation and supervision does not help the process of market integration.

A second objection that is often mentioned is that there are currently other obstacles, in addition to the regulatory ones, to a single financial market, such as taxation, company law, customary practices, etc. According to this view, it isuseless to proceed towards harmonisation of prudential rules until all the other obstacles have been removed. However, this objection can simply be reversed and taken as an appeal for extending the harmonisation effort to other areas, especially taxation, rather than as a justification for the *status quo*. If differences between national systems are indeed so well known, why should the realisation of a single financial market still be a primary goal for Europe? Why have the European heads of state indicated 2005 as a target for achieving a single European financial market?

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2 See, for instance, the EC publication "One market, one money", *European Economy*, no. 44, 1990.

A third objection is that the process of financial market integration has a global – not just a European – dimension. This would call for harmonisation of regulatory and supervisory practices worldwide, rather than only at the European level. However, the integration taking place in Europe is of a different quality and intensity than that which is taking place at the global level. One cannot confuse the objective of creating a single market with the ongoing process of globalisation. The fact that markets are becoming more global cannot be seen as a justification for not joining forces among European countries.

A final objection is that the current treaty does not provide for further progress in harmonisation and centralisation of financial policy. This position is basically predicated on an *ex-ante* refusal to address the question of subsidiarity. Had this approach been adopted for the single currency, Europe would have never moved to Monetary Union, as this was not envisaged in the Treaty of Rome, prior to the amendments provided for by the Maastricht Treaty.

The objective of a common financial policy

Demonstrating that the "policy consistency test" fails in the financial sphere is a necessary – but not sufficient – condition for moving policy responsibility from the national to the European level. It may be useful to recall, in this context, that the first attempt to achieve EMU in the early seventies with the Werner Report failed. There was no agreement on the objective that the single monetary policy was expected to achieve. Indeed, monetary policy can be used to reach a variety of objectives, including stimulating growth and employment. As long as the potential members of EMU did not agree on how to use the single monetary policy, the advantages of adopting a single currency could not be fully shared.

The second try at monetary union, pursued through the Maastricht Treaty, succeeded because it clarified that the primary objective of monetary policy was price stability, implemented by an independent central bank. Thus, the main obstacle to transferring power from the national to the European level was eliminated.

There does not seem to be any clear agreement today on what a single European financial policy should achieve and, in particular, on how to implement the trade-off between efficiency and stability of financial markets. Some instruments used to ensure stability might impinge on efficiency and vice versa. Defining a balance between the two objectives is a political problem. In short, it is not sufficient to suggest the establishment of a European supervisory authority, even structured in a federal manner like the European System of Central Banks, unless we clarify what it should do, what its main objectives are and to whom it should be accountable. The answers to these questions have not yet been provided.

Until there is agreement in Europe on how to move with regard to these two objectives, and how to account for these choices politically, it will be hard to transfer powers to the European level. The objective of creating an integrated financial market in Europe by 2005 is a political goal, calling for political responses. This does not mean that the objective cannot be met. Europe has already taken such decisions in the past, transferring policies in specific areas such as competition, trade and agriculture to the community level.

The way forward

How can a truly single financial market and a single financial policy be achieved in Europe? The method adopted in the past has not allowed for sufficient progress. Minimum harmonisation has produced an insufficient number of directives, most of which have, in any case, been implemented differently from country to country. The deregulation and mutual recognition approach that Europe is implicitly following, in particular by integrating stock exchanges while maintaining national differences, aims at harmonisation through competition among national regulations. But this method entails several risks, in particular of a political nature. Competition between regulatory systems leads to the adoption of the system used by the most competitive financial centre. The trade-off between stability and efficiency is thus determined by a selection mechanism that is totally unrelated to national political processes.

A selection process based on competition between national systems is not without political tensions. Competition is desirable, in an integrated financial market, among firms, financial institutions and possibly financial centres, as is the case, for instance, in the US. But it is hard to accept that competition should also take place among rules, possibly leading to the result that several countries – those that lose the contest, which are often those that ensure the greatest protection for depositors – have to accept the rules set by others. This process was rejected for Monetary Union. It is unlikely that it can lead to financial market unification.

EMU was possible partly because the one country that had the most to gain from the realisation of a hegemonic system – Germany – realised that competition between currencies was not a politically viable method for achieving monetary integration in Europe. As regards financial markets, it is not clear whether the one or few countries that could be the potential beneficiaries of a hegemonic selection process – in particular the United Kingdom – are equally aware that such a solution would not be politically acceptable to the others.

If the final objective is not clear, and we are not ready to adopt the necessary measures to achieve it, in particular shifting sovereignty to the European level, it may be better not to embark on this delicate phase of transition at all – better to avoid the disappointment of another missed European objective and to admit that Europe, or at least a part of it, is not yet ready to go ahead with true financial integration.

If Europe really wants a fully integrated capital market, the most efficient capital market in the world, it must be ready to accept the political consequences of having, among other things, a European regulatory system and a European prudential decision-making body. This solution can only prevail, however, if those who have to make the ultimate political decision are presented with a clear blueprint, similar to the Delors Report for EMU, plainly spelling out the objectives, the tasks and the accountability of such a European system.

How to proceed then? If Europe wants to implement a single market within the next five years, it must first and foremost examine what kind of progress can be made in the context of the current institutional framework, in particular through the EU Commission Financial Services Action Plan. But it must also be aware of the limits of this process. In the case of EMU, the governments of the member countries realised at the end of the eighties that it would not be possible to go beyond a certain level of monetary integration without changing the treaty. Ultimately, financial market integration will probably call for another change. Not to acknowledge this today means to lack vision about the future of Europe.