The European experience of Financial Market Integration

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Outline

- Why Regional Financial Market Integration?
- Conceptual framework
- Historical Background
- Crisis, crisis-management and Reform
- Lessons
- Conclusion: Preliminary Policy Recommendations

Why Regional Financial Market Integration?

- Fundamentally, internally, providing the financing for growth and employment and, externally, establishing role of region in global economy to attract investment.
- However, beyond this perspectives diverge and change over time. Three dominant approaches:
- Keynesian: controlling finance with its animal spirits. Provide certainty. Certainly, prevent financial markets from practicing the idea that risk can be meaningfully calculated.
- Market Fundamentalism: liberalise finance. Liberalised financial markets are self-equilibrating. They allocate resources efficiently and reduce costs of investment. Provide effective mechanisms for pricing of risk.
- Neo-classical synthesis/Regulatory Liberalism. Harnessing positive side (positive optimal allocation of resources, promotion of efficiency through competition, tendency towards equilibrium) to the public benefit through market-enhancing regulation. I will return later to EU version(s).
- Necessary to keep in mind, however, at core of integration process is legitimation because within our economic system there are inevitable tensions that financial market integration will interact with – convergence, sustaining variation, etc., depending on direction of policy-making.

From Theory to European Policy-Making: Some Concepts

- Regulation: Market-Making or Market-correcting
- Internal (message to member states) and external dimension (managing globalisation/competition)(e.g. Fioretos)
- Pragmatism and Dogmatism (Mugge)
- Positive and Negative Integration: empowering purpose (normativity)(Scharpf)

European Integration - Origins

- An elite peace project through functionalist economic integration of spill-over effects (embedding Germany with US support) and/or intergovernmental struggle over direction and terms of integration?
- European Financial Market Integration was slow under quasi-Keynesian Bretton Woods of an international monetary system of fixed exchange rates (cf. Bancor) and weak IMF (*Pace* strong IMF and WB).
- Managing internationalisation of trade and buttressing its socio-economic impact. Supporting national development/reconstruction and adjustment to an international liberal order of increasing openness. Compensating for impact of market through social transfers and labour market policies (welfare state). Embedded Liberalism (Ruggie 1982)
- Strong national regulation of finance (broadly Keynesian) and across borders through capital controls and IMF (Europe and beyond).
- *Les Trentes Glorieuses*

Cont.

- Late 1960s, growing speculation against Dollar with public indebtedness and budget deficits (esp. Eurodollar market in City of London), Collapse of Bretton Woods, floating exchange rates.
- Difficult 1970s (stagflation and policy fumbling) and 1980s (French U-turn) and ideological shift towards Embedded Neoliberalism of monetarism with the structural adjustment that came that.
- Liberalisation of financial markets, removal of capital controls, etc. Washington Consensus – globalisation accelerates.
- Failures of Exchange Rate Mechanism (ERM) and Exchange Rate System (ESM)

Financial Market Integration: Revitalising the European Economy

- Single European Market (1987), scale and competition (four economic freedoms: labour, capital, goods and services)
- Maastricht and EMU (1992), pragmatic approach to monetary integration (non-OCA)
- Transfer of monetary policy to European Central Bank (interest rates)
- Disciplinary Growth and Stability Pact to prevent free-riding of member states on policy and EMU credibility (3% budget deficit and 60% public debt) – excessive debt=inflation=bad.
- Open Method of Coordination (soft governance)
- Towards late 1990s, confidence regained (German unification) and economy booming. Take advantage of EURO.
- Looking to US model of liberalised markets, knowledge-based economy underpinned by venture capital channelled to innovative startups facilitated by NASDAQ, and aiming at catching up and overtaking the US. EASDAQ. Already convergence towards US stock markets (pricing and practices).

Cont.

- Forging of (uneven) consensus around Lisbon Strategy, Financial Services Action Plan (FSAP) and Lamfalussy process of governance (Committee of Wise Men), from Northern-Southern divide to convergence around Neo-classical Northerns (London)
- Lisbon Conclusions: "Efficient and transparent financial markets foster growth and employment by better allocation of capital and reducing its cost. They therefore play an essential role in fuelling new ideas, supporting entrepreneurial culture and promoting access to and use of new technologies. It is essential to exploit the *potential of the euro* to push forward the integration of EU financial markets. Furthermore, efficient risk capital markets play a major role in innovative high-growth SMEs and the creation of new and sustainable jobs." Also, "modernising" social model (activation and training).
- Competing against the US on US terms, in a Dollar-dominated increasingly finance-led growth regime…
- However, to overcome was embedded *models* of European production and innovation through university research and state funded as stabilised by highly coordinated social economies based on corporatist compromises with state as active manager, cross-shareholding, long-term financing, etc.

Lisbon Strategy, FSAP, etc.

- Financial Services Action Plan by 2005:

a) access to investment capital on an EU-wide basis, including for SMEs, by means of a "single passport" for issuers;

b) facilitating the successful participation of all (esp. institutional) investors in an integrated market eliminating barriers to investment in pension funds;

c) promoting further integration and better functioning of government bond markets through greater consultation and transparency on debt issuing calendars, techniques and instruments, and improved functioning of cross-border sale and repurchase ("repo") markets;

d) enhancing the comparability of companies' financial statements; and more intensive cooperation by EU financial market regulators;

Cont.

- Risk Capital Action Plan by 2003;
- Takeover Directive (Bolkestein) on takeover bids
- Winding Up directive: the restructuring and winding-up of credit institutions and insurance companies in order to improve the functioning and stability of the European financial market;
- Capital Requirements Directive (Basle II) – lax self-regulation
- Auditing Standards

European Crisis

- When US financial markets and firms sneeze, European economy catches a cold (submission to US model)
- Revealing effects of persisting variety of growth models (OMC) and persistent failure to abide by GSP (growth, inflation, social models, tax) (incl. France and Germany)
- Non-OCA (single market for financial services not completed (London), wage flexibility
- Shareholder value paradigm in Corporate governance has reduced willingness to provide credit for innovation and production (premium on long-term investments, privileging exit rather than voice (Hirschmann)
- Only real adjustment opportunity is (social) wages – austerity. Labour is not as flexible/mobile as capital, goods and services. Result is labour market conflict, hollowing out of citizenship and European identity.
- Decline of democracy – technocracy and supranationalisation of governance (Troika)

Lessons and Challenges

- OCA is meaningful
- Soft governance and lack of legitimacy (deficit, democratic and positive integration)
- Market-making policy reforms without common social purpose that actually undermine the institutional requirements for the construction of such a common purpose (negative integration)
- Unintended policy paradigm of divestment (shareholder value in a European coordinated market context that rewards exit rather than voice)
- Focus on internal negotiations rather than external purpose (managing globalisation)
- Challenge underestimated and mistackled
- Plus: Challenge of enlargement and internal democracy and integration

Preliminary Policy Recommendations

- Take positive integration seriously
- Common purpose (external – managing globalisation)
- Democracy - Consultation and embedding
- Not overestimating transformative powers of markets
- Avoid dogmatism (pragmatism far from always good though)