The Single European Market: Finance[1]

The EEC Treaty provides for the progressive abolishment of restrictions "on freedom to provide services within the Community" (art. 59) and of "all restrictions on the movement of capital belonging to persons resident in Member States and any discrimination based on the nationality or on the place of residence of the parties or on the place where such capital is invested" (art. 67). It also states that "the liberalization of banking and insurance services connected with movements of capital shall be effected in step with the progressive liberalization of movement of capital" (art. 61).[2]

For more than 25 years after the EEC Treaty was signed, progress in financial integration was discontinuous, uneven, and on the whole modest. This can be attributed to a combination of economic difficulties and policy priorities, but also reflects the lack of a coherent, comprehensive approach. Circumstances started to change in 1983-84, by which time considerable progress had been made in correcting domestic and external imbalances in Community countries. In addition, pressure for deregulation and integration was created by financial innovation, the rapid development of international financial markets, and the decision of some Community countries to dismantle their foreign exchange controls, notably their complete elimination by the

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[2] Efforts to liberalize *capital movements* in Europe date back to the early sixties, when the Community adopted two important directives for the creation of a unified capital market (in 1960 and 1962). Since the seventies the Community also began the enactment of legislation promoting *freedom of supply of financial services*. In 1977 the first coordination directive on *banking* laid down provisions concerning the authorization and licensing of credit institutions, adopting the fundamental principle that these procedures must be based on objective, non-discriminatory criteria and requisites; and in 1983 a directive provided for credit institutions to be supervised on a consolidated basis. Legislation on *securities* markets came somewhat later and primarily aimed at protecting investors. In 1973 and 1979 coordination directives were also promulgated to ensure the right of establishment, though not Community-wide freedom to supply services, in the field of *insurance*. Table 1 summarizes the directives adopted in these fields.

United Kingdom in 1979. In June 1985 the Commission presented to the European Council its White Paper on "Completing the Internal Market", which sets the ambitious objective of complete integration of financial markets by 1992 and concretely identifies the steps required to achieve it. A plan for the full liberalization of capital movements was also presented to the European Council that year. Shortly afterwards, the approval of the European Single Act introduced in the EEC Treaty decision-making on a (qualified) majority basis for a broad range of Community matters, creating the conditions for speedier approval of legislation. The formulation of a comprehensive approach to the integration of financial markets, the agreement on a final date for its realization, and the introduction of new procedures for Community decisions have created a momentum that was unthinkable only a few years ago.

In the Commission's approach, financial market integration involves the elimination of all restrictions on capital movements and, in addition, full freedom for financial intermediaries to offer their services throughout the Community.[3] It entails the elimination of restrictions and discriminatory regulations and administrative practices concerning: (i) the right of establishment and acquisition of participations by foreign institutions in domestic financial markets; (ii) permitted operations of foreign-controlled financial institutions; (iii) cross-border transactions in financial services. The first two items basically involve the freedom to supply services in EC national markets, the third, the freedom to move capital throughout the Community.

As regards freedom to supply financial services, the White Paper identifies a number of principles to be followed.[4] In particular: (i) a minimal harmonization of prudential rules and standards will have to be achieved before all restrictions to the free supply of services can be lifted, to ensure the solvency and stability of financial institutions and equivalent standards of investor, depositor and consumer protection; (ii) full freedom in the supply of services would then be allowed based on mutual recognition of national laws, regulations, and market practices; (iii) home country control will apply in that all the activities of a bank or other financial intermediary are to be supervised by the authorities of the country of residence of its head office, while the authorities of the country where the service is sold will only play a complementary role. This approach has the obvious advantage of simplifying the task for Community legislation, which is narrowed to the identification of a platform of common standards for the safeguard of the public good of financial stability; at the same time, it leaves considerable scope for accommodating different institutions, market practices, and prudential approaches. A further feature of this approach is that it will stimulate competition not only between private agents, but also between national institutions and regulatory frameworks; as will be seen, this has advantages but may also raise difficulties. The exercise of regulatory and supervisory functions will be left with the national authorities that already perform them, and no attempt will be made to set up supranational authorities at Community level in this field.[5]

The simplicity and flexibility of this approach has already permitted considerable progress in the negotiations for the Second Coordination Directive on credit institutions that will regulate a number of key issues of minimal harmonization[6] and, once in force, will entail a unified licencing procedure throughout the Community; other directives will address the procedures for liquidation and the setting up of deposit-insurance schemes. As for the securities markets, the Commission's approach places emphasis on the need to improve transparency and to reduce the costs and delays in cross-border transactions.[7] Finally, a new directive is under consideration in the insurance field to spell out the role and functions of the national supervisory authorities in cross-border operations; further work is also envisaged to reconcile freedom of supply with the special safeguards governing life insurance in member states.

[3] The Commission's programme and approach are summarized in its Communication to the European Council on the *Creation of a European Financial Area*, November 1987.

[4] Cf. *White Paper*, para.s 101-107. Table 2 compares the current situation with the White Paper timetable in regard of credit institutions and securities markets.

[5] Cf. PADOA-SCHIOPPA (1986).

[6] The proposed Directive has been finalized by the Commission and has been put before the ECOFIN Council for consideration in January 1988. It covers: the definition of credit institutions for supervisory purposes, broadened to encompass institutions that either raise deposits with the public or extend loans on their own account; the requisites and conditions for the exercise of these activities, including minimum capital requirements; management standards; monitoring of shareholders of banks, notably with a view to safeguarding their autonomy; limits on banks' purchases of shares in credit institutions or other companies.

[7] The main elements of its programme include: (i) realization of the Interbourse Data Information System (IDIS), to create a "real time" information exchange system between European stock exchanges and promote the establishment of a Community-wide trading system; (ii) improving the settlement systems for cross-border transactions through agreements between central securities depositaries; (iii) adoption of a directive on a unified prospectus for public offers of securities, to facilitate simultaneous issues on different national markets.

Turning to the liberalization of capital movements, capital market transactions and long-term commercial credit have already been liberalized by an amendment to the 1962 Directive approved in November 1986. In October 1987 the Commission presented a draft directive to the ECOFIN Council providing for the liberalization of transactions in short-term securities, financial loans and credits, and of current and deposit account operations.[8] Under this proposal EC residents will have full and equal access to any Community national system for the purpose of concluding investment, placement, lending and borrowing operations; operations will be governed by the regulatory framework of the country in which they are conducted.[9]

The Commission recognizes that "minimal harmonization" is still far from complete, that important changes are required in the taxation field to avoid competitive distortions,[10] and, at a more general level, that the current degree of harmonization and coordination of economic policies in Community countries is not fully consistent with complete freedom of capital movements, if exchange rate stability within the EMS is to be preserved. It has, however, taken the view that liberalization can now proceed without further *conditions préalables*, and that this will create pressure to accelerate progress in all the other areas mentioned above. In other words, liberalization is seen at this stage as the lever that will break resistance to full monetary and financial integration, by creating a "dynamic disequilibrium" that will force all the parties in this complex process to adopt the required decisions.

[8] The liberalization obligation would extend to the elimination of all domestic rules and administrative provisions that discriminate between residents and non-residents in the performance of capital transactions or, more broadly, that hinder the performance of these transactions. The proposal would also require transactions made for purposes of capital transfer to be implemented on the same exchange rate conditions as current payments. This would rule out the possibility of a dual exchange market, unless this were authorized under a safeguard clause.

[9] The proposed directive also includes a new safeguard provision that would permit the introduction, under a Community procedure and for strictly limited periods (six months), of administrative controls on short-term capital movements to assist member countries in dealing with destabilizing capital flows that could jeopardize exchange rate or monetary policy objectives. A new safeguard instrument is required since those in existence are either based on a balance-of-payment criterion (art. 109) or would only be applicable to capital market transactions (art. 73 and the 1972 directive on capital flows). In addition the Commission has also proposed to strengthen the Community mechanisms for medium-term financial assistance, both by extending access to them in support of liberalization programmes and by increasing the amounts available.

[10] Three issues have been highlighted by the Commission: (i) harmonization of company taxation as regards both the tax base and tax rates, to eliminate possible distortions in investment decisions; (ii) tax evasion: the Commission is considering the alternative courses of introducing either a generalized withholding tax on interest and dividend incomes, or information disclosure obligations on these incomes to the tax authorities of the country of residence of the recipient; (iii) the elimination of discriminatory provisions in national tax systems fostering investment in national securities.

The Commission's approach has the great merit of setting European integration in motion again at a time when progress in commercial integration seems to have come to a halt, the Community budget and its ability to undertake new initiatives are paralyzed by the failure to deal with the waste and distortions of the Common Agricultural Policy, and there seems to be strong resistance to further development of the EMS. The key to this result is the reversal of the centralistic approach traditionally followed in the past: rather than trying first to build up a complete body of Community law and a central authority to administer it, and then lift barriers that separate national markets, the Commission has taken the course of seeking an immediate lifting of barriers, based only on a minimum platform of harmonization, while leaving national authorities in control. Recognition of the vision, audacity and effectiveness of this approach should not lead to complacency about the many issues that have to be tackled. A complete analysis of these issues is beyond the scope of the present note. However, by briefly recalling the most important ones, a clearer perception can be gained of the enormous tasks facing policy-makers and market agents along the path to the 1992 deadline for the internal market.

A first set of problems relates to existing financial market structures. The British system, centered on the London market, is the most highly developed and sophisticated, with its differentiated structure of banking and capital market intermediaries, large participation of foreign intermediaries, fiercely competitive market environment. By contrast, financial markets in continental Europe are in the main characterized by a dominant role of banking institutions, less developed capital markets that still remain very much confined to national operators, and a variety of *de jure* or *de facto* restrictions on the operations that can be performed by the various agents. Major differences are present in the securities and capital market operations that can be performed by commercial banks, with variants of the "universal" banking approach prevailing in Germany, Denmark, Luxembourg, the Netherlands and the UK, and various forms of specialized banking prevailing in France, Italy, Belgium, Spain.[11] Competitive structures are also very much

[11] Universal banking is generally defined as a system where banks are permitted to engage in the full range of (primary and secondary) capital market operations (including the direct acquisition of shares in industrial companies). Within this general approach, a further distinction can be made between systems in which a banking license is required in all cases to engage in certain specified operations, and systems where non-bank financial companies can be authorized to perform as capital market intermediaries. Cf. OECD (1987), *International Trade in Services: Securities*.

influenced by market practices and customer relationships difficult to pinpoint and identify in their effects, that can nonetheless play an important role in segmenting financial markets.[12] The structure of taxation adds a further element of differentiation: table 3 summarizes some aspects of national tax systems regarding the interest, dividend and capital gains regimes.

Even a cursory examination of the structure of financial intermediation, of the types, functions and balance sheets of intermediaries, and of the prices and pricing techniques of financial services in European countries, leaves little doubt as to the potential implications of eliminating existing barriers between national markets. Major changes can be expected in the location, degree of concentration and specialization of the financial services industry. Although some adjustment is under way in various countries, the pace of change will have to accelerate considerably: indeed, with the sole exception of London, European financial markets have in the main not shared in the innovation process taking place in international markets. The broad tendencies in this process provide an indication of the direction of change to be expected.[13] Traditional demarcation lines between intermediaries can be expected to be eroded, placing pressure on national legal and regulatory frameworks. The general trend to the "securitization" of finance, the elimination of functional barriers that effectively acted to reduce and separate financial risks, the attendant increase in capital requirements, the globalization of banking and securities markets, will also represent powerful forces for concentration of intermediation structures. Since the commercial banks already control a large share of intermediation and are in a position to meet large capital requirements, a further evolution in the direction of the universal banking system seems likely. Traditional functions and distinctions of capacity (broker, dealer, market maker), present in various forms in most capital markets, are also likely to disappear, in favour of multi-purpose finance houses

[12] Most striking in this regard is the German case, where both the banking and the industrial structures are highly concentrated and "cartelized" and, in addition, banks hold in their portfolios large shares of industrial concerns' equity capital. "Rent" positions and a solid profit base in the domestic markets can also be a source of competitive distortion, to the extent that they provide room to underprice competitors in the non-protected international markets.

[13] Cf. CFM of the OECD (1985), *Trends in Banking in OECD Countries*, especially Chapter II; OECD (1987), *International Trade in Services: Securities*, Chapter II; and GOODHART (1987).

(the US-type broker-dealer-market maker), possibly incorporated in or directly controlled by German-type universal banks.[14] The ability of less efficient stock-exchanges to maintain their share of prime customers' business is open to question, once the option of raising capital in deeper, cheaper and better organized markets will be open; there is a concrete possibility that these exchanges may find their role reduced to that of providers of finance to local business.[15] In addition, all exchanges face the common threat that securities trading could bypass them completely.[16] Not only the ability to compete of traditional intermediation structures will face a severe test; but also, the entire system of checks and balances that in different countries have provided safeguards against excessive risk taking, conflicts of interest, market manipulation, and have protected overall financial stability, may have to undergo thorough revision.

Yet, with the exception of the United Kingdom, where a global and comprehensive approach to change has been adopted both as regards market structures and prudential regulation,[17] the attitude of EC national authorities has mostly been one of piecemeal, gradual adaptation of existing structures, with great weight still assigned to the preservation of national traditions, practices and competitive balances.[18] An important consideration has been the special role often assigned to financial institutions in the protection and development of certain sectors of economic activity and the pursuit of national policy goals. The Commission, for its part, has not tried to sort out this tangle of approaches, institutions and national traditions, and has not taken

[14] A possible way of limiting risk concentration and conflict-of-interest problems, while not losing the advantages of concentration and integration in the financial services industry — notably the ability to provide complex diversified "packages" of services tailored to customers' needs — is the "multi-functional group": under this approach, different services can be provided by separate institutional and legal entities with separate capital, belonging to a single group with centralized ownership and control. This approach is being followed in Italy (cf. Bank of Italy's *Annual Report on 1986*, Final Remarks by the Governor, p. 184).

[15] GOODHART (1987) plausibly argues (p. 52) that participation in the global market is likely to remain restricted to major players, while a large proportion of intermediation will continue to be undertaken locally within each country, basically because of segmented information.

[16] Cf. GORDON (1987).

[17] Cf. LOEHNIS (1987).

[18] A comprehensive review of the supervisory approach and, more broadly, of the desirable evolution of the financial structure is now under way in Italy. Cf. *Annual Report on 1986*, Final Remarks by the Governor, pp. 179-185.

TABLE 1

MAIN DIRECTIVES ADOPTED BY THE COMMUNITY

Date of issue	Directive number	Subject: Capital Movements	Internal Market - Free Supply of Services: Credit Institutions	Internal Market - Free Supply of Services: Other Financial Services
11/5/60	—	First Directive for the implementation of Art. 67 of the Treaty (liberalization of capital movements)		
18/12/62	63/21	Second Directive on liberalization of capital movements (amending the First Directive)		
21/3/72	72/156	Regulating international capital flows for domestic monetary control purposes		
27/4/72	72/166			Insurance: harmonization of liability insurance
28/6/73	73/183	Suppressing restrictions to freedom of establishment		
27/7/73	73/239			First Coordination Directive on Insurance (other than life)
27/7/73	73/240			Elimination of restrictions on freedom of establishment for insurance (other than life)
12/12/77	77/780		First Coordination Directive on Credit Institutions: criteria for license as banking institutions. Creation of the Banking Advisory Committee	
15/3/79	79/267			First Coordination Directive on life insurance
16/3/79	79/279			Securities: minimum criteria for admission to stock-exchange listing
17/4/80	80/390			Securities: disclosure requirements for admission to stock-exchange listing
20/2/82	82/121			Securities: disclosure requirements for companies listed on stock-exchange
13/6/83	83/350		Consolidated supervision of credit institutions	
20/12/85	85/583	Liberalization of collective investment undertakings (amending the directive 18/12/62)		
20/12/85	85/611			Securities: minimum standards for collective investment undertakings in transferable securities
17/11/86	86/566	Full freedom of capital market operations and long-term commercial credits (amending the directive 18/12/62)		
8/12/86	86/635		Requirements for banks annual accounts	
22/6/87	87/345			Securities: harmonization of public offer prospectuses

Source: BANCA COMMERCIALE ITALIANA, *Tendenze Monetarie*, July 1987, our updating.

TABLE 2

COMPLETING THE INTERNAL MARKET IN FINANCIAL SERVICES: WHITE PAPER TIMETABLE AND CURRENT SITUATION [1]

	White Paper Timetable		Current Situation
	Proposed by Commission	Adoption by Council	
CREDIT INSTITUTIONS			
Directive on banks' annual accounts	1984	1987	adopted (8/12/86)
Directive on accounts of banks' foreign branches	1985	1987	proposed (16/7/86)
Directive on freedom of establishment and supply of services for mortgage credit	1985	1988	proposed (7/2/85)
Directive on reorganisation and winding-up of credit institutions	1985	1987	proposed (23/12/85)
Recommendation on harmonization of definition of banks' own funds	1985	1986	proposed as a Directive (18/9/86)
Recommendation on establishment of deposit insurance systems	1986	1987	adopted (22/12/86)
Recommendation on control of large exposures of credit institutions	1986	1988	adopted (22/12/86)
Second Coordination Directive on Credit Institutions (minimal harmonization of prudential controls)	1987	1989	proposed (13/1/88)
SECURITIES MARKETS			
Directive for the coordination of laws, regulations, and administration provisions regarding collective investment undertakings for transferable securities	1976	1985	adopted (31/12/85)
Directive on information to be published when large holdings of equity capital of a listed company are purchased or sold	1985	1988	proposed Com (85) 791
Directive concerning prospectus requirements for securities offers to the public	1981	1988	partly adopted (22/6/87)
Directive on investment advisors	1987	1989	...
Directive on insider trading	not included	not included	proposed (21/5/87)
Directive on liquidation of companies	not included	not included	to be proposed
Directive on take-over bids	not included	not included	to be proposed

Source: BANCA COMMERCIALE ITALIANA *White Paper, Tendenze Monetarie*, July 1987, our updating.

[1] Excluding insurance.

TABLE 3

TAXATION OF INTEREST AND CAPITAL INCOME

	Interest Income	Major "tax-facilitated" Special Circuits	Treatment of Dividends	Taxation of Capital Gains
Belgium	Withholding tax (25%)	Interest on certain saving deposits not taxed below a threshhold	25% withholding tax on dividends	Yes if of a "speculative" nature
Denmark	Taxed as income		30% withholding tax	Yes
France	Taxed as income. Individuals may opt for a withholding tax which ranges from 25% to 50% according to the type of bonds	Interest on certain deposits not taxable below a threshold. Investment in French shares deductable from tax liability up to a threshold	Taxed as income	Yes
Germany	Taxed as income	Housing finance	Taxed as income. Tax credit in respect of taxes paid by companies	Yes, for shares if of a speculative nature. No for bonds
Italy	Withholding tax-25%	Interest on corporate bonds taxed at 12.5%	Tax credit in respect of taxes paid by companies since 1977. Taxed as earned income. Withholding tax of 15% on some dividends	No, excluding some particular cases
Luxembourg	Taxed as income	Interest on government bonds treated preferentially	15% withholding tax	Generally not taxed
Netherlands	Taxed as income	Interest on deposits not taxable below a threshold	Withholding tax of 25%	Yes if of a speculative nature
United Kingdom	Taxed as income		Tax credit in respect of corporate taxes paid	Yes

Source: OECD. *Banking and Monetary Policy* (1985), and our partial updating.

explicit position either on the desirable direction of change or on the possible problems that may arise along the way. The possibility that the process of liberalization and integration will meet increasing resistance once its implications become fully apparent and make themselves felt, or that strains develop within national financial systems, cannot be ruled out.

An area of special concern raised in face of sweeping changes in financial markets is, of course, that of preserving financial stability and adequate standards of investor, saver and consumer protection. Here too certain broad tendencies have already emerged in the efforts to adapt existing regulatory and prudential frameworks to innovation and the globalization of financial markets. Being confronted with increased competition, a blurring of traditional demarcation lines between intermediaries, and a flourishing of new products and services, regulatory and prudential authorities in the major industrial countries have been shifting increasingly to a functional approach to supervision, with a tendency to extend bank supervision to all institutions performing banking business regardless of their legal status; to base risk assessment for supervisory purposes on consolidated accounts; and to place increased reliance for prudential assessments on capital ratios, linked to standardized definitions of the various risks undertaken by credit institutions.[19] This, and the need to close supervisory loopholes, have also fostered international cooperation, notably within the framework of the Basle Committee on Banking Regulations and Supervisory Practices (Cooke Committee). A main result of these efforts has been agreement on the sharing of responsibility between national authorities for supervision over banks' foreign activities with regard to solvency, liquidity, and foreign exchange operations and positions.

The search for simplification and greater uniformity in the regulation of financial activities that were already regulated is going hand in hand with a tendency to extend a minimum of supervisory controls to previously unregulated activities and intermediaries. A main concern here has been that of ensuring minimum standards of information disclosure and trade reporting in the securities markets and providing a

[19] An agreement on a proposal for international convergence of capital standards for commercial banks, prepared by the Cooke Committee, was recently reached by the G-10 central bank Governors. It includes the adoption of a target standard capital ratio to (weighted) risk assets of 8 per cent, which international banks in member countries will be required to observe by 1992.

framework for the exchange of regulatory information internationally, so as to limit circumvention of national laws.[20] A fresh debate on the adequacy of this approach has now been opened following the October 1987 stock market crash, which, at least in the view of some, has pointed to a need for more penetrating controls on non-bank intermediaries and securities markets.[21]

The difficulties involved in agreeing on common principles and guidelines in all these areas are enhanced by problems of implementation. Definitions of financial activities and functional borderlines cannot easily be drawn in many cases; the problem is complicated by the wide variety of legal and institutional settings and approaches in European countries,[22] and by the continuing process of innovation. Difficulties also arise in connection with differences in supervisory techniques and standards, and in the different weight assigned in national supervisory approaches to such factors as market efficiency, competitive balances, financial stability, macro-policy objectives. The problems stemming from inconsistent national rules and their extra-territorial application may be even more serious in the securities field, where international cooperation has been lagging behind. Insofar as a uniform supervisory framework is not applied to all institutions operating in the financial services industry of a given country, there remains scope for competitive imbalances in favour of the unregulated or less regulated institutions. The application of a functional approach to supervision does not solve the problems arising from large differences in the size, capital base and structure of individual institutions. The solution of conflict-of-interest problems that may arise in the exercise of different intermediation activities by the same institution or group is enormously complicated by the coexistence on the same market of institutions responding to different organizational and supervisory requirements. In general, the

[20] International cooperation has been mainly developing on a bilateral basis, mostly under the impulse of the US and UK regulatory authorities. On this, cf. OECD (1987), *International Trade in Services: Securities*, pp. 21-26, and LOEHNIS (1987).

[21] Extensive reports on the October 1987 stock market crash and on various regulatory and supervisory issues raised by that event have been issued by the Presidential Commission on Market Mechanisms (Brady Commission) and the SEC in the US; a similar review is under way in the UK, where however a more favourable assessment of financial markets' performance seems to be emerging.

[22] As GORDON (1987) points out, since products in the financial-services industry are inseparable from the underlying contractual relationships, the industry is highly sensitive to its legal context.

possibility of circumventing prudential requirements will be increased by simultaneous access to a multiplicity of regulatory frameworks. There is thus a danger that the opening of financial services markets will lead to a lowering of prudential standards, partly as a direct consequence of the competition between regulatory and supervisory approaches, since national authorities may seek to avoid losing financial business to less regulated markets. The Commissions's approach and the work under way on minimal harmonization in the Banking Advisory Group of the EC broadly reflect the orientations, and hence all the problems, of emerging trends in financial markets regulation and supervision that have been described.

Two specific problems in the Commission's approach are worth being pointed out. The first one relates to the application of home-country control in intermediaries' supervision. The general allowance made, in the Commission's draft directive on capital liberalization, for administrative controls maintained for monetary policy and prudential objectives will *de facto* entail host-country control on a number of important aspects of intermediaries' operations. Not only domestic rules and administrative provisions may become a vehicle for reintroducing in disguise impediments to the free flow of capital; but in practice intermediaries may be confronted in certain areas with both home and host-country regulatory requirements. The extent and implications of this regulatory tangle have not been fully analyzed.

A second problem may be posed by the different attitude that the Commission has taken, on the one hand, to the free supply of services, where minimal harmonization is a precondition to the application of mutual recognition of national rules, and, on the other, to the liberalization of capital movements, to be realized with no precondition. In reality, we are dealing here with the two sides of the same coin: the supply of financial services, on the one hand, and the demand for financial services on the other. As a result of capital liberalization, all Community residents will gain immediate access to foreign markets on the basis of their regulatory frameworks; the principle of mutual recognition will in a sense apply immediately to those purchasing financial services abroad. At least to an extent, the needs and concerns underlying the build-up of a minimal platform of common rules may be forestalled by immediate capital liberalization. A similar difficulty will arise in connection with the objective of establishing a "level playing field" as a consequence of the decision to go ahead with liberalization before tax structures have been harmonized. This decision is due to the difficulties encountered in making progress in this field rather than

to a belief that the matter is one of minor importance. Increased tax evasion and a tendency for financial activities to move to less heavily taxed systems are likely results, although it may also be hoped that the evidence of such developments will increase pressure for the harmonization of tax structures.

Finally, the liberalization of capital will increase the need for economic policy coordination, notably, but not only, in the monetary field, and pose a risk for the cohesion and continued viability of the EMS exchange rate arrangements. Visible signs of this difficulty have already appeared in the course of 1987. Last January, a realignment of central rates was forced upon the EMS largely by financial factors, at a time when developments in fundamental economic conditions would have justified hopes for a period of calm. Strong strains developed again in the fall, mainly owing to the weakness of the dollar. The new facilities and management techniques introduced by the EC Committee of Governors in September 1987[23] were helpful in meeting these strains. It is clear, however, that as long as the dollar continues to fall and large external imbalances remain between the three major industrial countries, the international environment will remain a source of tension for the EMS. A weak dollar tends to strain the EMS because of the "fundamental" divergences that still exist within the system. In addition, the latter suffers increasingly from the apparent inability of the leading country, Germany, to provide, together with a stable nominal anchor, an engine for growth. Indeed, Germany has been living in the system with a somewhat undervalued currency in real terms and has "subtracted" growth from its partners through rising bilateral trade surpluses; the growth rate of German domestic demand has on average been lower than that of its EMS partners. Even with unchanged external conditions, there is a genuine risk that the "real" straitjacket imposed by the EMS may not be acceptable to all forever, especially in view of the

[23] These measures include: a presumption that financing through the Very Short Term Facility (VSTF) will be available for intramarginal interventions; an extension of the initial settlement date for such financing; and the *de facto* lifting of the 50 per cent limit on the obligation to accept ECUs in settlement of VSTF debts. Other measures have been adopted to improve the management of the EMS (through more flexible interest rate policies and a fuller use of the EMS oscillation bands in the presence of exchange rate pressures); appropriate use of this new approach will be assessed within the framework of a strengthened (multilateral) monitoring procedure within the Committee of Governors. Cf. MASTROPASQUA-MICOSSI-RINALDI (1987).

different employment situations and demographic trends.[24] Capital liberalization will make these inconsistencies more acute. The ability to reconcile stable exchange rates and inconsistent "real" policy objectives with monetary tools, which is not unlimited, will be further reduced. Precisely as it happened with the Louvre Accord, if the cost of exchange rate cohesion comes to be perceived as too high in terms of national objectives, the exchange rate constraint may be relaxed. The EMS could thus evolve towards a crawling peg system; its ability to perform a disciplinary macroeconomic function and to promote real economic integration by maintaining exchange rates in line with fundamentals may be compromised. Liberalization of monetary transactions will also raise a number of technical problems of monetary management, by making it more difficult to identify and control monetary and credit aggregates at national level. The Commission is of course betting that the result will be a strengthening of policy cooperation, perhaps through transition to the "institutional phase" and a transfer of economic policy powers to a Community authority. However, at present the room for progress towards strengthened coordination in macro-policy objectives, let alone for any surrender of sovereignty, seems modest. A decision to proceed with liberalization "no matter what" could thus result harmful, rather than helpful, to European integration.

In conclusion, I do not wish to leave the impression of a negative judgement of the Commission's strategy and of the prospects of construction of an integrated European financial area. The Commission has developed a comprehensive project, and has managed to stir the still waters of European cooperation. Its approach, however, is largely, and indeed intentionally, based on the notion of creating "dynamic disequilibria" that will force action by markets and official authorities. Clearly, the latter have major responsibilities to ensure that the process of integration being set in motion is governed and does not develop in a disorderly or distorted manner, both as regards the effects of increased

[24] Some of these aspects are discussed by MASTROPASQUA-MICOSSI-RINALDI (1987) and by BINI SMAGHI-VONA (1988). A more fundamental (long-run) issue is raised by DORNBUSCH (1988), who points to the costs and the risks involved with monetary integration at zero (very low) inflation when there are important divergences in fiscal positions. He argues that "countries for whom the efficient tax structure implies the use of an inflation tax... should not merge with others for whom zero inflation is the policy objective...", especially when public debt accumulation is a problem (since it will make debt sustainability more difficult).

competition on financial markets stability and the adaptation of regulatory-prudential frameworks. It is also clear that parallel progress in all the areas involved — liberalization, harmonization of regulatory, prudential and tax systems, and strengthened coordination of macroeconomic policies — is essential if this project is to succeed.

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