Towards a European Integrated Financial Market

Introduction

The financial environment has changed enormously in recent years. This mutation is the result of unprecedented innovation in financial instruments, information processing, trading techniques, market structures and intermediaries. International integration of the major financial centres has led to the creation of a 24-hour global market, in which information is available in real time throughout the world. This has created difficult problems as well as considerable opportunities for operators and authorities alike. Both sides have to learn to live in this new environment and to exploit all its advantages while preserving the soundness and stability not only of individual financial firms but also of the system as a whole.

This paper reviews the main trends in international financial markets and their policy implications, focusing, in particular, on the nature of innovation, the consequences for the globalization of capital markets, the attendant risks and how they can be managed and supervised. Against this background I will then discuss the issues raised by the liberalization of capital transactions and more broadly the process of financial integration in Europe.

Innovation in the International Capital Markets

Financial innovation in the leading industrial countries is producing major changes in instruments and services, altering the structure of intermediation and creating new forms of competition. No one factor has produced this situation, rather a series of events have combined at different times to influence its development.

In recent years there has been another pronounced shift in the pattern of saving and investment flows, with clearly visible effects on external imbalances. The sharp decline in OPEC surpluses and the virtual closing of credit markets to major LDC borrowers since the external debt crisis have been accompanied by slower growth in international banking. The transformation of the US into a large net borrower and debtor and the parallel increase in payments surpluses in Japan and Europe have coincided with an expansion in the use of negotiable debt instruments, available almost exclusively to prime international borrowers. Lenders' search for quality and liquidity, and borrowers' desire for more flexible financing have led to widespread adoption of variable interest rates and to the development of new financing instruments, such as note issuance and revolving underwriting facilities, which combine features of both syndicated credits and bond issues.

The increase in interest rates that followed the adoption in major countries of strict anti-inflationary policies in the wake of the second oil crisis, has been a powerful incentive for banks and thrift institutions to find ways to circumvent regulatory constraints and respond to the enhanced competition of unregulated non-bank financial intermediaries. Greater interest and exchange rate volatility has made it desirable to be able to shift quickly and cheaply between instruments, thus stimulating the development of new techniques for risk management (options, futures, interest rate and currency swaps): their distinguishing feature is that they allow the different risks attaching to financial transactions — interest, currency, liquidity and maturity — to be individually priced and negotiated in separate markets.

Deregulation of financial markets has been another important factor. Initially, it was in response to the growing conflict between the regulatory framework in place and the financial innovations being introduced. The opening up of new channels of intermediation intensified pressure for the relaxation of regulations. Faced with the choice of imposing new regulations or liberalizing, most national authorities opted for the latter course. In turn, regulators' more favourable attitude towards competition encouraged financial institutions to test the limits of their permitted activities. In some countries — such as France and, up to a point, Italy — innovation was prompted by the authorities themselves, to foster more efficient resource allocation and facilitate the transition to a monetary policy based on interest rates rather than direct controls.

Subsequently, however, innovation has acquired a momentum of its own. With the decline of traditional banking business and the rise of financial and advisory services, competitiveness has come increasingly to depend on firms' ability to create new instruments and operations. Innovation is thus becoming a permanent feature of financial markets.

Finally, innovation has been stimulated by the widespread application of advanced information and communications technology to financial transactions. This has reduced the cost and increased the speed and efficiency of acquiring and evaluating information, and has made it possible to trade in a global market.

Innovation can be seen as having three main strands: securitization; the blurring of the demarcation lines between the various institutions supplying financial services; and the closer international integration of national markets.

A growing share of intermediation has been flowing through securities markets, with a marked shift from bank credit to negotiable instruments. A rough indication of the size of this shift is that syndicated Euromarket loans were running at an annual rate of around $100 billion in 1981-82, while they are not expected to exceed $40 billion this year; by contrast, bond issues have risen from $50 billion to about $200 billion a year over the same period.

The traditional distinctions between financial instruments and institutions have also become less clearcut. In particular, bond issues and loans increasingly have overlapping features and different categories of institutions increasingly do both kinds of business. Much of the recent growth in banks' business has involved contingent liabilities in connection with securitized debt. This has been associated with a tendency for traditionally specialized institutions to expand the range of their activities. In the US, for example, interstate banking restrictions are being relaxed in practice and securities firms are being acquired by insurance companies and non-financial corporations. In the UK, banks have entered the home loan market, while building societies are offering services previously reserved to banks. Even in Germany, the dominant universal banking system is being flanked by financial conglomerates with interests in insurance and other fields.

Finally, securities markets are becoming more integrated internationally. In part this is the result of portfolio diversification by investors seeking their desired combinations of risk and return. In addition, financial innovation and the rapid growth of the Euromarkets have forced firms and intermediaries to turn to international markets in

order to remain competitive. This has fostered integration and the global trading of securities. Eurobonds have been traded internationally since the seventies and equities are increasingly listed on more than one stock exchange. Innovation has been particularly rapid in the United States and the United Kingdom, where the City's position as an international financial centre has been strengthened. In turn, the growing competition of London has stimulated action to increase the flexibility and efficiency of other European securities markets, notably in France, Belgium and the Netherlands.

Innovation and global integration have already substantially altered the financial environment and will continue to do so. The pace of change may nonetheless slow somewhat, as some of the factors fueling innovation in the seventies and early eighties subside with the emergence of a more stable macroeconomic environment. However, other more permanent factors, such as technological progress, capital mobility and international portfolio diversification, will continue to foster the spread of new instruments. These, in turn, can be expected to lead to calls for further deregulation of domestic markets and liberalization of capital movements.

Policy Responses in the Face of Innovation

Let us now turn to some of the policy issues raised by innovation and increased integration of capital markets and then look at the response of the authorities.

One important issue concerns the quality of the financial information that is publicly available. The shift from bank intermediation to bond finance has seriously impaired the value of statistics on international capital flows. Whereas detailed information on bank credit flows is available from the BIS, data on bond markets are more difficult to collect, especially as regards keeping track of bondholders. Similar difficulties arise in connection with both bank borrowing in the Eurobond market, since little is known about the buyers of these bonds, and paper issued under back-up facilities or in the form of Eurocommercial paper. The report on "Recent Innovations in International Banking", published last April by the BIS, stressed the need for improved statistics and made some proposals. One was that the BIS

should use data collected by the Association of International Bond Dealers, which include information on outstanding bonds. In turn, EC member countries are discussing standard minimun reporting requirements for banks' off-balance-sheet operations as part of the proposed EC Directive on Bank Accounts. The OECD Committee on Financial Markets has also done extensive fact-finding work on international trade in banking and securities.

An even more important issue is the transparency of banks' exposures and the ability of investors and regulators to assess them properly. The growth of off-balance-sheet transactions and the complexity of some of the new instruments have made it more difficult to assess risk. The shift caused by bank disintermediation from the close customer relations associated with loans to multiple market relationships in which price is the main signalling and selection device, may have lowered the quality of lenders' information about ultimate borrowers' creditworthiness.

Credit assessment practices must keep up with the changes in the financial system. In general, the risks banks incur with the various new operations are similar to those normally associated with lending. However, the commitments associated with stand-by credit lines need to be regularly assessed in the light of market liquidity and the likelihood of their being drawn on. Besides the risk of illiquidity, credit risks may materialize, since NIFs and RUFs can involve banks in financing customers that the market has turned down. Interest and exchange rate risks are incurred whenever banks take up open positions by entering into swap, option or forward-rate contracts. In general, it is the now frequent multiple combination of risks that makes it difficult to assess individual operations. The maintenance of stability thus depends as much on banks' ability to develop adequate managerial resources and internal control systems as on their capital strength. The warning issued by the G-10 Governors last September was explicit in this respect.

The precautions banks are required to take do not relieve the supervisory authorities of their obligation to scrutinize the new types of business. In March 1986 the Basle Committee on Banking Regulations and Supervisory Practices recommended new guidelines for the treatment of banks' off-balance-sheet operations. Supervisors in a number of countries have already acted accordingly and included these operations in the calculation of capital ratios.

Complementary measures are also being considered to cover other financial operators now subject to little or no regulation, so as to prevent banks from being put at a competitive disadvantage. More generally, there is also concern lest a decline in the share of regulated business should weaken the overall effectiveness of supervision. Attempts to improve the stability of an integrated system through controls on a part can be thwarted by crisis situations spreading from other, unregulated parts of the system.

There is also the issue of systemic risk. Innovation has enabled financial and non-financial institutions to protect themselves from some of the risks inherent in a volatile and uncertain environment. But many of the new instruments and markets are merely designed to shift these risks rather than actually reduce them. As Professor Peter Kenen noted recently, "the risks have been taken on by those most willing to bear them, which is not necessarily the same as saying those most able to bear them".[1]

Innovation can increase systemic risk in various ways: the average quality of bank assets may decline as prime borrowers turn progressively to securities markets, leaving banks with less creditworthy customers; enhanced competition may result in new instruments being underpriced; the rapid growth in trading and turnover could also lead to failures in the payments system; and the spread of hedging instruments has created longer chains of credit exposures, thus increasing the danger that a default by one debtor will have domino effects on other operators.

One of policy-makers' responsibilities is to ensure that the benefits accruing to individual agents are not offset by greater systemic risk. Even in the countries where innovation has gone furthest, it is widely accepted that some regulation and supervision of financial markets is necessary. In a recent statement to a Congressional Committee,[2] the Chairman of the Federal Reserve Board suggested that regulators have mainly taken defensive action so far, to prevent immediate problems from undermining the financial system as a whole. However, he went on to note that distinctions among banking, other financial institutions and

[1] P. KENEN, Statement at the Conference on *Innovation in the Capital Markets*, New York, June 26-27, 1986.

[2] P. VOLCKER, Statement before the *Subcommittee on Telecommunication, Consumer Protection and Finance* of the Committee on Energy and Commerce, U.S. House of Representatives, April 23, 1986.

commercial firms are fast eroding with little considered debate and less action to guide the process, and that the provision of a public safety net backed up by special oversight and supervision may no longer be sufficient to maintain the stability of the system. His words can be applied to almost every modern financial system, and even more so to the unregulated world financial markets that have developed spontaneously beyond the reach of any public supervision.

Finally, innovation has important macroeconomic implications for monetary policy. As a result of financial innovation, deregulation and globalization, international capital has become more mobile and sensitive to interest rate differentials and expectations regarding exchange rates. As a consequence, the exchange rate has taken on greater importance in the transmission of monetary policy impulses, since shifts in relative monetary conditions in major markets lead rapidly to exchange rate changes, thus influencing actual and expected inflation, relative prices, and the level and composition of output.

Traditional channels and instruments of monetary policy have also been substantially affected. When intermediation was concentrated in the banking system, controls on banks — *e.g.* reserve requirements, interest rate ceilings, constraints on the growth and composition of banks' assets — played an important role in monetary control techniques. The development of close substitutes for bank credit and the decline in banks' share of intermediation have demoted these mechanisms. More generally, the ability of intermediaries to cushion and absorb restrictive impulses is likely to have increased, while the instruments of monetary control have probably become less precise in their results.

The consequences of innovation for the influence of interest rates on aggregate demand are also debated. In principle, wider recourse to variable rate financing and the new techniques of risk management make the financial system more responsive to interest rate changes. On the other hand, some financial innovations tend to weaken the interest rate link between monetary policy and the real economy. The greater flexibility of the new financial instruments has allowed an increasing number of non-financial enterprises to engage in liquidity management. Debtors may thus be partially shielded against rising interest rates. Consequently, even though monetary impulses spread through the financial system more rapidly, they may be attenuated by portfolio adjustments.

Altogether there is thus greater uncertainty about the effects of monetary policy and a recognition that greater care will have to be taken in the new environment to avoid excessive oscillations in interest and exchange rates.

The Liberalization of Capital Movements in Europe

In the last few years financial innovation and the liberalization of capital movements have both advanced rapidly in Europe. The segmentation of domestic markets has been reduced, although foreign exchange controls are still a significant barrier in some countries.

Efforts to liberalize capital movements in Europe date back to the early sixties, when the EC adopted two important Directives for the creation of a unified capital market. In the ensuing years most restrictions on financial transactions were lifted, although the integration of national markets remained modest.

In the early seventies, growing currency instability and the first oil shock led a number of countries to reintroduce exchange controls to weather the storm and "buy time" for a gradual adjustment of external imbalances. The EC Commission agreed to permit these restrictions under the safeguard clause of Article 108 of the Treaty. Though recourse to the clause was meant to be temporary and limited to special circumstances, it came to be tolerated as a normal practice, often outlasting the balance-of-payments difficulties invoked to justify the adoption of exchange controls. Free trade in goods thus came to coexist in Europe with a system of restricted financial flows.

One of the main aims of setting up the EMS was to protect Community trade from the disruptive effects of large swings in the dollar. Shortly after its inception, the second oil shock accentuated the divergences between member countries, and the priority that was given to preserving the cohesion of the EMS exchange rate arrangements did not encourage a change in the prevailing attitude towards use of the safeguard clause. It was only after payments strains and inflation had been substantially reduced that pressures for the removal of exchange controls and the liberalization of financial markets acquired new impetus.

A framework within which to pursue the liberalization of financial transactions was provided by the proposal put forward last May by Jacques Delors, President of the EC Commission, and subsequently approved by the European Council. The first task was to "normalize" use of the safeguard clause. Already in December 1984 the Commission had renewed the derogations granted to France, Italy and Ireland, specifying that they were to remain in force for a limited period and that they were to be removed earlier if possible. Compliance with these conditions was to be strictly monitored by the Monetary Committee of the EC. Since then, France has removed all its restrictions under the safeguard clause, Italy has reduced its foreign investment compulsory deposit rate to 15 per cent, and Ireland is making a comprehensive review of its exchange control system.

The second task was to resume progress in the integration of capital markets by extending the unconditional liberalization obligations of the 1962 Directive to long-term commercial credits and transactions in both listed and unlisted securities. The new Directive should be finalized by the end of 1986, and, together with the stricter criteria for use of the safeguard clause, will complete the first phase of the liberalization process. The second phase should then bring complete freedom of capital movements by 1992 in accordance with the objective laid down in the EC White Paper on completing the internal market in financial services.

This ambitious objective is unlikely to be achieved, however, unless other parallel conditions are fulfilled. In the first place, free movement of capital in the Community presupposes a gradual adjustment of economic structures to reduce regional disparities in resources, factor productivity and market flexibility. Progress on all these fronts, to be fostered through appropriate Community budget interventions, has been recognized as a prerequisite of integration since the start of the Community, but both the resources committed and the results obtained have remained small in this field.

Complete liberalization of all financial transactions will also require greater convergence of macroeconomic performance and more extensive policy coordination. As long as convergence is incomplete and there is a need for divergent courses in national policies, full freedom of capital movements will be in conflict with the cohesion of the EMS exchange rate agreements and freedom of trade. In other words, countries in a free-trade area with fixed exchange rates and full capital mobility cannot pursue independent national macroeconomic policies.

This means that progress in liberalizing capital flows will depend on how far the EC member countries can agree on the basic objectives of macroeconomic policy. This consensus will have to result not only in price stability but also in a reasonably balanced pattern of current external payments and adequate growth rates. Responsibility for the achievement of these objectives will have to be equitably shared and the external implications of domestic policies fully recognized by all countries.

Completing European Financial Integration

On its own, the liberalization of capital movements is not sufficient to bring about full integration of European financial markets. Differing prudential regulations and controls as well as dissimilar legal and administrative systems are obstacles that will also have to be overcome.

A few years ago the advocates of deregulation would have proposed wiping the regulatory slate clean. However, recent experience with rapid innovation has made even ardent supporters of free markets more cautious.

Indeed, several developments — including the LDC debt crisis, the difficulties of savings and loans institutions, the run on a major US bank, inappropriate and even fraudulent practices in securities markets, as well as underpricing of risks and insufficient loss provisions — have been a sharp reminder that financial stability is a public good, with which unrestrained competition is in potential conflict. Furthermore, as already mentioned, deregulation of the banking sector needs to be matched by suitable regulation and supervision of other financial markets and intermediaries to ensure a level playing field. Such regulation, however, can easily create artificial barriers to the free movement of capital as a by-product.

It is therefore necessary to assess the various regulatory and prudential provisions in force, to see where the objectives of stability and integration are in conflict and make appropriate arrangements and compromises to reconcile them.

For instance, quite a few countries impose restrictions on foreign investment and screen projects to determine whether they are in the national interest. The boundary between such protection of national interests and discrimination against foreign capital is often tenuous. In addition, numerous regulations and procedures originally introduced for prudential purposes no longer serve this end and unintentionally discriminate against foreign businesses. Barriers of this kind will have to be gradually dismantled. The often substantial differences between national regulatory and prudential systems are also an important obstacle to the integration of financial markets. In this case, however, conflicting provisions cannot always be easily amended since they are often key elements in the structure of each system.

One basic difference of this kind stems from the existence of universal banking in some countries and of strict separation between commercial and investment banking in others. This institutional difference can result in universal banks not being authorized to operate in countries that have opted for the separation of banking functions. Conversely, unless they are first authorized to operate as a bank, non-bank operators may be unable to do business in countries that have opted for universal banking. Similar obstacles may be caused by countries' different disclosure requirements and technical standards for the prevention of fraud.

It is thus clear that non-discriminatory application of national regulations is not in itself sufficient to ensure the integration of financial markets. Since the forces underlying the internationalization of financial markets will continue to act, failure to reduce the segmentation implicit in national administrative and legislative systems could have two undesirable consequences: first, business might shift to the less regulated and supervised markets; and, second, competition between national markets could undermine investor protection.

If these consequences are to be avoided, the necessary changes in national legislative and administrative systems will have to be internationally coordinated. The convergence of regulatory provisions and the mutual recognition of financial regulations and techniques will have to be pursued through suitable policies.

These two courses are not alternatives. Indeed, to some extent the first is a prerequisite of the second. Mutual recognition of financial techniques is only feasible if there is sufficient institutional common ground or harmonization. Otherwise, the initial disparities in competitive conditions will generate undesirable strains and evasive behaviour in financial markets. Moreover, mutual recognition tends to be a second best solution since its unequal application in international agreements would entail a return to bilateralism.

The scope for harmonization and mutual recognition depends, of course, on which group of countries is considered. International cooperation to promote the convergence of financial regulations and standards among the Group of Ten countries is of great significance in view of their financial importance and the efforts they make to have the results adopted outside the Group. However, the agreements reached in Basle are essentially gentlemen's agreements, and the G-10 central bank governors have formally approved only the most important provisions.

The situation is different within the EC, since the Community has legislative powers and, as mentioned earlier, a detailed proposal has been formulated for the completion of the internal market by 1992. This sets out the objectives to be achieved and a timetable for specific measures to be taken over the next five years. In contrast with the proposals put forward in other venues, the EC White Paper has firm political backing from the member states of the Community.

The integration of the financial market is to be achieved by liberalizing both the establishment of financial firms and the provision of services, once sufficient harmonization and mutual recognition of regulatory provisions and financial products have been achieved.

The final result will depend on the ability of member countries to agree on common rules and the strength of the forces that will be unleashed in the market. This process will necessarily influence and be influenced by the international financial system.

Concluding Remarks

In conclusion, two remarks seem warranted. The first concerns the attitude of central banks and regulatory authorities towards the changes under way in financial markets. The nature and training of central bankers and supervisors make them wary of change and prudent in assessing their consequences and implications. This does not mean, of course, that they seek to resist change. Integration can bring substantial benefits and we must learn to live in the new environment. Indeed, in certain instances it may be the duty of central bankers to encourage innovation in order to foster the efficiency of the financial system. This advancement, however, should not put the soundness and stability of

the financial structure at risk. While there is no presumption that the new environment will necessarily be less stable, our traditional benchmarks and methods of assessing intermediaries' liquidity and capital adequacy will clearly have to be revised. More broadly, there will continue to be a need for a regulatory framework, to protect both confidence and savings from the excesses of unrestrained competition. Indeed, we will have to monitor and control previously unregulated parts of the financial system.

The second remark concerns the operators and the intermediaries in the market. The ease with which they can now trade in a wide range of financial instruments and shift funds virtually instantaneously between instruments and currencies and across national boundaries makes the management of financial transactions and risk enormously more complex. To meet the demands of this new environment, new computer-assisted trading strategies are being continuously developed. Taken in isolation, these appear to offer ready-made answers for all situations. However, it is essential that market operators and the managements of financial intermediaries make sure that these procedures are also consistent with both the liquidity and solvency of individual firms and the stability of the system as a whole. This means that management and risk control techniques must be upgraded to meet the higher standards imposed by the new competitive environment.

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