

Prospects for the Direct Integration of EEC Capital Markets ⁽¹⁾

1. The Implementation of Article 67

In July 1957, the French Assembly debated the ratification of the Treaty of Rome. M. Maurice Faure, the French Secretary for European Affairs, lectured his peers:

"We are still living in the fiction of the four great powers. In reality, there are only two — America and Russia. Tomorrow there will be a third — China. It depends on you whether there will be a fourth — Europe. If you fail to make this choice, you condemn yourself to walking backwards toward the future!"

Since those dark days, which one day we may find marked the birth of a nation, the European Economic Community has made incredible strides toward the realization of the goals established by the architects of the Rome Treaty. The achievement of a customs union will occur a full year and a half in advance of the date laid down in the Treaty. In addition to the customs union, progress has been made toward the achievement of economic union, as proposals and guidelines developed by the Medium-term Economic Policy Committee are being debated in the Parliament and the Economic and Social Committee. At the same time, considerable strides have been made toward uniform policies in many other areas, including transportation, labor, taxation, and company organization. Probably the most difficult area in which the member countries have sought agreement — will it be the last? — has been that of capital movements. There have been successes. But the full implementation of Article 67 will not occur tomorrow, nor, probably, on the day after.

(1) This paper represents an adaptation of materials presented in IRA O. SCOTT, JR., *European Capital Markets*, to be published by the Office of the Comptroller of the Currency, Washington, D.C.

1) *The first Directive.*

In this directive the Council accorded varying degrees of freedom to each of four categories or lists of capital movements. The first three categories — Lists "A", "B" and "C" — consist of capital market transactions, while the fourth — List "D" — concerns the money market. List "A" includes direct investments, investment in real estate, capital movements of a personal character, and short- and medium-term credits arising out of commercial transactions. These kinds of capital movements were freed by the First Directive, although individual application procedures were maintained. Where special foreign exchange markets exist for capital transfers, the directive requires that member states maintain narrow differentials between "official" and "free" rates.

List "B" consists of transactions in securities listed on foreign stock exchanges. Here, the directive provides for general licensing arrangements rather than individual applications.

The first concrete step toward integration was taken on May 11, 1960, when the Council adopted the First Directive pursuant to Article 67, Paragraph 1 (2).

List "C" contemplates the crucial public placing domestically of foreign issues denominated in the domestic currency. It also encompasses the purchase of foreign unlisted securities, long-term credits involving resident-connected commercial transactions, and medium- and long-term loans involving commercial transactions by non-residents or those not arising out of commercial situations. In this case, the directive provides for liberalization only on the condition that such capital movements would not obstruct the path to national economic goals (3). Italy, the Netherlands, and France

(2) Article 67, Paragraph 1, of the Treaty of Rome 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 belonging to persons resident in Member States and also any discriminatory treatment based on the nationality or place of residence of the parties or on the place in which such capital is invested. The liberalization of capital movements clearly derives, also, from Articles 2 and 52-58. Article 2 states the promotion of a harmonious development of economic activities as an aim of the Community. Articles 52-58 deal with the right of establishment.

(3) Article 3, paragraph 2 of the First Directive provides: "If the freedom of these capital movements impedes the realization of the objective of economic policy of a member state, it may maintain or re-establish any exchange restrictions on such capital movements existing on the date this Directive becomes effective".

immediately informed the Commission of their intention to invoke this escape clause (4).

The fourth category, or List "D", consists mainly of investments in Treasury bills and other money market instruments, demand and time deposits, and short-term credits either not linked with commercial transactions or linked in this manner but in which no resident participates. None of the signatory powers has committed itself to liberalization in the short-term, or money market, sector.

2) *The Second and Third Directives: The Present Status of Controls over International Capital Movements within the EEC.*

On December 18, 1962, the Council promulgated the Second Directive (5). Whereas the First Directive dealt chiefly with commercial transactions, the Second Directive extended the same freedoms to the supply of services. In addition, the right to acquire foreign listed securities was, in effect, extended to natural persons and others. Previously, this right, in certain circumstances, might have been reserved to financial institutions and to companies acquiring an interest in foreign concerns in related industries.

The First and Second Directives represent important milestones on the path toward free capital movements. However, they are distinctly limited in scope inasmuch as they apply only to restrictions arising out of the regulation of foreign exchange markets (6). They fail, in other words, to cope effectively with statutory provisions or regulatory practices which may inhibit or obstruct the free movement of capital even if the exchanges were perfectly free. Pursuant, therefore, to Article 68, paragraph 2, of the Treaty (7), the Com-

(4) See European Economic Community, Commission, *Fourth General Report on the Activities of the Community*, May 1, 1960 - April 30, 1961, Brussels, June 1961, Chapter I, Section 56.

(5) *Journal Officiel des Communautés Européennes*, January 22, 1963. Also see European Economic Community, Commission, *Sixth General Report on the Activities of the Community*, May 1, 1962 - March 31, 1963, Brussels, June 1963, Chapter II, Section 36.

(6) European Economic Community, Commission, *Seventh General Report on the Activities of the Community*, April 1, 1963 - March 31, 1964, Brussels, June 1964, Chapter I, Section 57.

(7) Article 68, paragraph 2, states: "Where a Member State applies its domestic provisions in respect of the capital market and credit system to the movements of capital freed in accordance with the provisions of this Chapter, it shall do so in a non-discriminatory manner".

mission, on April 14, 1964, after consultation with the Monetary Committee, presented to the Council a proposal for a Third Directive for the further implementation of Article 67 (8). This directive in amended form, is still under consideration by the Council.

The Third Directive provides for the elimination of legal and administrative obstacles which hinder:

(a) the introduction of the securities of one country on the stock exchanges of another country;

(b) the purchase by the financial institutions of one country of the securities issued by residents of another country and denominated in the other country's currency; and

(c) the issuance of securities by the residents of one country in the capital market of another and denominated in the other country's currency.

Were these provisions to be fully implemented in all of their ramifications, international movements of medium- and long-term capital within the EEC would be virtually free. No better evidence of the truth of this statement need be cited than the fact that the Directive remains bottled up in the Council!

Momentarily, the arguments against liberalization will be reviewed systematically. Meanwhile, it should be noted that there is a technical reason for the continued stalemate. The proposed Third Directive assumes the continued validity of the First Directive's escape clause; and this clause has been invoked by Italy, the Netherlands, and France. Why, therefore, inquire the representatives of Belgium, Luxembourg, and Germany, should they acquiesce in the liberalization of the law and administrative practices while other countries may fall back on the safeguard clause in the foreign exchange markets. As noted earlier, a member state may retain or re-establish exchange restrictions on the capital movements enumerated in List "C" if freedom threatens the achievement of the country's economic goals. Belgium, Luxembourg, and Germany argue that while this escape clause exists in favor of Italy, France, and the Netherlands, there can be no genuine reciprocity in the area of liberalization. The provisions set forth in the Third Directive

(8) Communauté Economique Européenne, Commission, *Proposition de Troisième Directive pour la Mise en Oeuvre de l'Article 67 du Traité*, Brussels, April 9, 1964. Also see European Economic Community, Commission, *Eighth General Report on the Activities of the Community*, April 1, 1964 - March 31, 1965, Brussels, June 1965, Chapter III, Section 13.

can only be effectively binding for member states that do not impose exchange restrictions. Consequently, it is argued, the escape clause of the First Directive must be eliminated before the Third Directive can be accepted.

2. Origins of Obstacles to Further Liberalization

1) *The distribution of gains from foreign investment.*

The rationale for integrating national markets is relatively easy to delineate — not so the implementation of a program designed to achieve such integration. Cogent arguments have been made against integration; and these will now be described.

First, consider the gains from foreign investment. There are three possible levels or vantage points from which to view the potential returns to foreign investment. To begin with, there is the point of view expressed by the social interest. Then, there are the national gains. And, finally, there are the profits accruing to the private investor. The expression of social interest forms the rationale for international capital movements (9). There is, however, at the present time, no established body enjoying the prerogative of expressing the social interest. An evaluation of the prospects for the Third Directive must, therefore, consider the issue from a national point of view. Since private returns and national gains may diverge, it is possible to mount an intellectually respectable defense for restricting capital exports.

A divergence of private profits and national gains occurs when there are external economies and when the locus of the benefits of these economies is determined by the locus of the investment. Thus, the addition to the capital stock may reduce returns to the existing capital stock, due to the diminishing marginal productivity of capital. At the same time, the level of returns to other factors of production may be raised, because they are now being combined in the production process with a larger stock of capital. Consequently, the rewards of foreign investment accruing to the private investor

(9) Increased freedom of capital movements is desirable in principle because it may promote the growth of real income. That is, the free movement of financial capital, provided that financial flows are accompanied by flows of real capital goods, may lead to the equalization of expected real rates of return, after allowance for risk, and thus the maximization of total output.

may be offset by the decrease in the returns to other nationals who share in the ownership of existing capital abroad. In this way, national and private returns may differ. Moreover, in the case of foreign investment, the possible favorable effects upon other factor returns accrue to foreign workers and land-holders; whereas, if the investment occurred domestically, the nation would capture those benefits accruing to other factors of production (10).

National and private interests may also diverge because of differences in the potential impact of certain risks. For example, the risk of expropriation might be the same at home and abroad — thus, the same to the private investor. The risk to the nation in this case, on the other hand, is real abroad but non-existent at home.

The existence of a system of double taxation agreements may have a similar effect. Domestic investment yields its full harvest of taxes, while foreign investment yields only the excess of domestic over foreign income taxes to the home country. Again, private interests are indifferent between foreign and domestic investment; while, in the national interest, domestic is to be preferred to foreign investment (11).

Finally, investment abroad in industries producing substitutes for the investing country's exports may have unfavorable effects upon the latter's terms of trade (12). To the extent that private investors have not made sufficient allowance for such an effect in their evaluation of anticipated returns, the national may again diverge from the private interest.

In each of these cases that have been briefly reviewed, there is the implication that it would be in the national interest to have more domestic investment and less foreign investment than private investors in a perfect market would ordinarily undertake.

Proponents of the national interest would undoubtedly admit freely to the difficulties attending any attempt to establish their case on an empirical basis, due to the existence of offsetting forces and

(10) Owners of existing domestic capital, of course, may suffer as the nation's stock of capital is augmented.

(11) The burden of government services associated with the investment at home and abroad may provide an offset to this result.

(12) Alternatively, these terms of trade may improve if the investment is in industries producing the goods imported by the investing country. The final outcome depends also upon secondary and tertiary effects involving the resulting transfer problem, the levels of income and employment, and assumptions with regard to the fate of the export market had the foreign investment not have been made.

tendencies and because of the sheer complexity of the problem presented. Nevertheless, the presence of nagging doubts about the consistency of national and private interests strengthens the hand of those who oppose further liberalization.

2) *A lack in the harmonization of national economic policies.*

The need for harmonization of national economic policies is inherent in the fixed exchange rate system which governs currency relationships among the members of the community. Disparate rates of growth and selective tax policies may lead to effective price and interest rate level disparities that bode ill for a country's external position and hence lead to persistent pressure on the exchange rate.

The Council of Ministers is not unaware of the need for harmonization. Machinery has been established to achieve this Community goal. A Monetary Committee, a Committee of the Governors of the Central Banks, a Committee for Budgetary Policy, a Committee on Medium Term Policy, and a Committee on Current Economic Conditions have been appointed for the express purpose of insuring closer uniformity and Community surveillance of national economic policies.

Nevertheless, so long as uniformity has not been achieved (13) and differences in interest rate levels may appear, individual governments will be reluctant to expose their economies to freedom of international capital movements. To do so would subject the balance of payments to the threat of undesired outflows or inflows of capital.

Thus, the lack, or potential lack, of full harmonization ranks high among the obstacles to further integration.

3) *Implications for domestic resource allocation.*

Whatever may be the outcome of the relatively esoteric debate over the distribution of the gains from foreign investment, whatever may be accomplished in the area of harmonization, there are powerful groups within the member countries who view with alarm the

(13) Cf. European Economic Community Commission, *Ninth General Report on the Activities of the Community*, April 1, 1965 - March 31, 1966, Brussels, June 1966, pp. 133-134. In this Report, it was noted that the European Parliament acknowledged the fact "... that insufficient progress has been made in common economic policy and that tendencies towards national concepts in economic matters had remained strong".

potential access by foreigners to the domestic capital supply implied by further liberalization. These groups deem foreign borrowers to be a clear and present danger — a threat to the integrity of the growth of the nation. It is not difficult to imagine, for example, the explosion that would occur if, say, the capital issues committee of the Netherlands authorized a bond offering in Dutch guilders by a German manufacturing company desiring to expand its plant in Frankfurt at the same meeting at which it refuses the petition of the municipality of Rotterdam to borrow in the open market for the purpose of modernizing its sewage disposal facilities!

The pre-eminence of domestic priorities for resource allocation is perhaps as apparent in France as in any of the member countries. The need for monitoring capital flows was clearly envisaged by the architects of the Fourth Plan, which contains the following passage:

"... A cet égard, les mécanismes permettant d'assurer par priorité la réalisation d'équipements essentiels en fonction des objectifs du plan — c'est-à-dire le contrôle du crédit et des émissions — existent et ont en fait donné satisfaction. Dans l'hypothèse vraisemblable d'une pénurie relative de capitaux, ces mécanismes seront encore utilisés pour l'exécution du quatrième plan..."

Thus, the chief obstacle to the achievement of full capital market freedom does not, as one is led by some to believe, lie in the fear on the part of national monetary authorities that they will lose control of the balance of payments. Rather, there is a more subtle, yet more profound, problem at hand which is actually inherent in the definition of discrimination. All involved may, in fact, be agreed that all discrimination of treatment on the basis of the nationality or place of residence of the security issuer should be removed. But would such removal impart true freedom to the capital market? Not at all. Take the French case. In France, as has been seen, domestic, as well as foreign securities must be authorized by the government before they can be issued on the French market. The French could then readily accede to a Community rule for non-discrimination but at the same time reserve the right to ration capital to Frenchman and foreigner alike *according to the criterion that the proceeds of the issue should be consistent with the objectives of the French Plan*. Clearly, non-discrimination in a quite literal sense does not necessarily open up the French capital market to the foreigner.

In essence, it is extremely difficult for a national authority to admit foreign issues at the same time it requires local borrowers to stand in a queue.

It is true that an implicit interest rate ceiling is the cause of the queue. But it must not be overlooked that the queue itself is a means as well as a result. It is an instrument for controlling the pattern of investment activity, as well as its total volume.

4) *Inflexibilities in the policy mix* (14).

An earlier section of this chapter was devoted to the Community goal of harmonization. This goal, however, is not, as one might suppose, the simple one of providing the "same" economic policy in every member country. Such a policy must be treated as an exogenous variable or parameter, which must be adjusted in compensating fashion in reaction to a given environment. This environment may well, and probably will, differ in different countries. Consequently, true harmonization may, *per force*, imply *different* economic policies in different countries.

But a country's economic policy is, in reality, a mixture of policies; and its impact is, as a consequence, a variegated pattern of effects created by the totality of economic instruments in the policy mix. The multiple character of economic goals requires a corresponding multiplicity of economic instruments. And to qualify for its appointed role in the mix, an instrument must be flexible (15).

Suppose, for example, that a member country is suffering unemployment at home along with a capital exodus which causes a balance-of-payments deficit. To reach the target of balance-of-payments equilibrium, the central bank needs to foster a tight money policy. But to offset the adverse effect of such a policy on domestic employment, reliance must be placed upon an easy fiscal policy. If, in this case, fiscal policy cannot be relied upon, the central bank must maintain an easy money policy to promote full employment at home. And it may be necessary to resort to direct controls to halt the capital outflow and achieve balance-of-payments equilibrium.

(14) This discussion of flexibility is based on the assumption that monetary policy and fiscal policy are, in fact, potentially flexible. In other words, it is assumed that the lags associated with these policies are not so great as to render the policy instruments inflexible because of the lags.

(15) In truth, an instrument must, by definition, be flexible. But the question here is, of course, one of degree.

Alternatively, suppose there is an unwanted capital inflow at the same time there are strong inflationary pressures being generated at home. The central bank needs an easy money policy on balance-of-payments account. Fiscal policy must be relied upon to contain existing inflationary pressures, and offset in addition, the stimulating effects of the easy money policy. In the event fiscal policy is not equal to this task, and monetary policy must turn restrictive, it may be necessary to employ direct controls to stem the tide of capital imports.

From these hypothetical complexes of policy requirements, it is apparent that fiscal policy flexibility may be a necessary condition for erasing the need for direct controls over capital flows.

The state of fiscal policy flexibility in the European Economic Community leaves much to be desired. In each country, the budget must receive parliamentary approval, and parliaments may suffer from an overload of work. In a number of cases, the parliamentary process is further inhibited by the instability of a coalition /government — not having the efficiency of a two-party system. In some countries, parliaments are even subject to the straitjacket of constitutional provisions relating to the budget.

Fiscal policy involves government expenditures as well as taxes. But provincial and municipal budgets are often outside the purview of the central budgetary authority. Moreover, the local authorities may escape to the capital market to avoid budgetary constraints.

In most member countries there are a number of special credit institutions. The outlays of these parastatal bodies are often designed to bolster specific sectors of the private economy. Hence, they are either outside the budget entirely, or they occupy privileged positions on the scale of priorities and are protected from the pruning shears of a restrictive budgetary policy.

A progressive income tax system is an important element of "built-in", or automatic, flexibility. But such tax systems are not heavily relied upon in some Continental countries. In addition, withholding arrangements, the practice of paying taxes on estimated income, and other devices for improving the efficiency of a tax system are not always used, while some countries are still plagued by assessment systems in which the income tax base does not vary over the cycle and the authorities have to tolerate bargaining on the part of the taxpayer. Methods of collecting indirect taxes may also be inefficient.

The impediments to fiscal policy flexibility referred to above are not unknown outside the Common Market. But their existence within the Community is especially damaging to the case for freeing international capital movements. If there is a failure on the part of fiscal policy, the central bank must shoulder the burden of responsibility for domestic stability. It may, therefore, be necessary to maintain direct controls over capital movements in order to preserve the external position.

3. Prospects for the Third Directive

It was on April 14, 1964, that the Commission presented the original draft of the Third Directive to the Council. As noted earlier, this draft proved unacceptable to Belgium, Luxembourg, and Germany, because it dealt only with legal and administrative provisions and did not encompass liberalization in the area of exchange control. Consequently, the directive was amended to link the elimination of exchange controls with the removal of legal and administrative impediments. But, France, Italy and the Netherlands have refused to accept the unconditional elimination of exchange controls.

The prospects, even for an amended Third Directive, are not good. For one or more of the reasons elaborated earlier, the Six are not yet prepared to go all the way in the liberalization of capital movements. The first major provision of the Directive calls for the admission of the securities of a member country to the stock exchanges of other member countries. Though it is probably the least controversial reform contained in the Third Directive, its thoroughgoing acceptance would be facilitated by the harmonization of taxes on the augmentation of capital, stamp duties, listing requirements, and commission fees.

A much more difficult obstacle to overcome is opposition to freeing institutional portfolio policies. In this area of legal and regulatory restrictions, it is possible that some progress may be made in permitting greater discretionary authority for the managers of the portfolios of private investment companies, private pension funds, and private life insurance companies. However, the proposed Directive does not ban restrictive portfolio regulations when applied to the more important repositories of savings, the thrift institutions. Exceptions are thus made when the express purpose of the institu-

tions is to accumulate and use the savings by making loans to the savers, or when the loans of the institution's loans and investment are customarily limited geographically to the area from which the savings are drawn. Even in the case of pension funds and investment life insurance companies, true liberalization depends upon the effective elimination of exchange-rate risk, as financial intermediaries whose liabilities are denominated in domestic currency contemplate investments in securities denominated in foreign currencies.

Undoubtedly, the chief obstacle to acceptance of the Third Directive consists of the provision for admitting foreign securities to domestic capital markets. The recalcitrant countries are impressed by the merits of protectionist arguments, and the original version of the Third Directive has been rejected. The suggested "compromise" consists of a "gradual" liberalization through the acceptance by each member country of an annual quota of issues from other member countries. This compromise clearly does not provide for true liberalization in the sense that the escape clause allowing the invocation of exchange controls to protect the national savings remains essentially intact.

One is forced to conclude, therefore, that it is premature to rely upon the concept of the Third Directive as the means whereby freedom will be brought to the capital markets of Europe.

IRA O. SCOTT, Jr.

Greenvale, L.I., N.Y.