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The Single Market for Financial Services: the European Response to the Process of Financial Transnationalisation

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Abstract - A world-wide process controversially defined liberalisation is occurring in the financial sector. Its main causes can be identified in the changes of the international order after the end of the Cold War as well as in the technological revolution affecting production.

As suggested in this paper, this process has implied a de-regulation and re-regulation carried out in an international arena fragmented in regional blocks.

In this contest, the implementation of a European Single Market for financial services has been accelerated. *De facto*, states members are applying the provisions present in the Treaty of Rome, which were not taken into any account in the past. Moreover, in the last years, the path toward a financial integration has continued through new legislation within the European Community.

This paper will propose a reading of the Single Market for financial services as a response to the process of financial transnationalisation. This approach to the issue will be supported by two arguments. First of all, the creation of a common financial market has provided the European states with a means of participation in the international re-formulation of this sector; second, the establishment of the Single Market for financial services should prevent European Union (EU) members from financial instability.

The financial services sector is coming out of a process controversially defined "liberalisation". The main cause of this process is doubtless the decline of the American world leadership, which provoked a shift in political and economic international regimes. However, technological changes, high interest rates, and deceleration in productivity have played an important role in order to increase the speed of these developments. *De facto*, all these factors led to a world-wide de-regulation of the financial services sector, which has been implemented through a re-regulation of it.

As illustrated by the recent acceleration for a creation of a European Single Market for financial services, a regional shift has corresponded to the international development. Even if the provisions of a common market in financial services were present in the Treaty of Rome (25th of March 1957), they have become effective only recently, namely with the breakdown of the global order and the consequent advent of the process of financial transnationalisation. From then, much progress has been achieved within the European Union (EU) toward the implementation of a total financial integration.

This paper proposes a reading of the Single Market for financial services as a response to the financial transnationalisation. In doing so, it will underline the role of the European financial regulation in the transnational process of a widespread re-regulation as well as its role in avoiding the financial instability in a global background of increased volatility. This argument is developed in three sections: the first focuses on the Single Market for financial services by outlining its brief history, and its current achievements; the second one describes the process of financial transnationalisation and its implications; the third section concerns the two arguments supporting my reading of the Single Market for financial services in terms of a response of transnational developments.

However, before proceeding, some concepts need to be defined. Because the international process has been accomplished through a re-formulation of the international financial rules, I will speak in terms of re-regulation, rather than liberalisation. Moreover, as the re-regulation process has been, *de facto*, implemented by nation-states, I believe it is theoretically more correct to label it as transnational, rather global. For these reasons, in this paper the expression "financial transnationalisation" indicates this evolution in financial services.

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The Single Market for Financial Services

The principles of a common market for financial services were already present in the Treaty of Rome, when taking into account the right of establishment (Art. 52); the freedom to supply services across borders (Art. 59); and the free movement of capital

(Art. 67). However, in the history of European integration the emergence of a Single Market for financial services has been always delayed. Despite the provisions of the Treaty, which fixed also a transitional period ending in 1969, there have been several causes for this delay. Mainly, they can be summarised in the exchange controls limiting the free movements of capital, the limitations on cross-borders trade in financial services, and the numerous barriers to free location of financial institutions. However, the delay was also due to the fact that the provisions of the Treaty of Rome were quite cautious because of fears of potential instability in capital market.

A brief history

Because of national pride and restrictive practises, the path of the European Financial Area (EFA) has been quite irregular. Since the early 1960s, European Union actions were not very successful in the liberalisation of financial sector. Mainly, the ambition of creating a Single Market for financial services has been rooted in the determination to uniform these services to any others in the EU framework. Particularly, the main aim relied on establishing the right to provide financial services in the same way as any other services within the EU. However, only the early 1980s "eurosclerosis", as the economic stagnation in the region was called, made the governments look at further market developments as a solution to the economic situation.

In 1985, the limited progress achieved by the Commission pushed to re-launch the idea of a Single Market with the Lock Cockfield's White Paper, which proposed a new programme of legislation to be completed by 1992. In the Commission plans, 1992 should have not been "a "Big Bang" changing everything from the roots" (International Association of Studies in Economics and Business Report: 1988, 178), rather it had to be the achievement of long term developments. Indeed, according to the White Paper, the main characteristic elements of the Single Market had to be freedom of capital movements throughout the Union, freedom of financial services to establish activities and branches everywhere in the Union, and freedom of any financial institution to offer its services freely across Union boundaries. To achieve these goals, the White Paper recommended the harmonisation of regulation between countries as the most successful strategy. These new attempts of financial integration favoured also a growth of financial services sector within the EU (see table 1 and 2).

Table 1:

Economic Dimensions of the Financial Services Sector (1985)*

	Gorss value-added as % of GDP**	Employment as a % of total employment***	Compensatin of employees as a % of total for economy

EUR****	6,4	2,9	6,2
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* Defined in the narrow sense as credit and insurance institutions.

**Including net interest payments.

***Employment plus the self-employed.

****This aggregate accounted for 95% of total Community GDP in 1985.

Source: Eurostat as quoted by Price Waterhouse in Emerson (1988, 99).

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Table 2:

Economic Dimensions of the Main Financial Services Branches: Insurance Premiums, Bank loans Outstanding and Stock Market Capitalisation, as % of GDP

	Insurance premiums*	Bank loans**	Stock market capitalisation***
EUR****	5,2	142	104

*Average 1978-1984.

**1984.

***End 1985.

****Weighted average.

Source: Price Waterhouse in Emerson (1988, 99).

However, the bureaucratic and political problems of negotiating a set of rules in the context of national differences pushed the Commission to change strategy. By the mid-1980s, the new concept formulated in the White Paper was mutual recognition, rather than harmonisation. This new approach was based upon three principles (Llewellyn: 1993, 111): first of all, the recognition of a core of essential standard regulations; second, the mutual recognition of the rules of other member states; third, the concept that the

regulation of the home-country would have been applied to any of its institutions operating in other member states. The White Paper programme was formally adopted by the Union in the 1986 Single European Act (SEA).

The path toward a Single Market for financial services has proceeded with three main directives: the Directives on Own Funds (April 1989), which specifies better some definitions concerning bank capitals; the Directive on Solvency Ratios (December 1989), which deals with bank assets and off-balance sheet items as well as harmonised minimum solvency ratio (fixed on 8% for all credit institutions); and the Second Banking Directive (December 1989), which provides a framework of rules (as the creation of a Single banking license) for the banking sector. The goal is the development of a European universal bank which should go with the harmonisation of, at least, basic banking regulations. Therefore, with the advent of the Single Market, financial services have been sold across state borders and state companies can operate within the EU on the basis of mutual recognition.

In the EU, the business community has been the most enthusiast for the implementation of a European Financial Area. The reason for this is clear when considering the approach and the strategy of the Commission. Indeed, the Commission underlines that "the main beneficiaries of, for instance, a Single banking market will be business, not individuals" (Underhill in European Journal of Political Research 19: 1991, 205) because lower costs for capitals will spill over into manufacturing, contributing to an extra 1.5% to Community GDP (ibid.). Therefore, the main breakthrough of the EFA will be an increase in competitiveness, as I will better specify in the last section of this paper.

The current situation and the next necessary steps

The developments in the implementation of the Single Market for financial services should be seen in the wider context of the implementation of a European Common Market. As suggested by Underhill (Underhill in European Journal of Political Research 19, 1991), the original agreement to establish the Common Market was a political plan forcing an unnatural process of economic integration. The main reason for this relies on the resolution of creating a "market system and society" (Ibid. 203) in order to avoid protectionist outcomes as in the 1930s. However, at present, in terms of regulations, large differences exist among the financial market of each European member. There are two requirements for a fast implementation of a Single European Market for financial services (Gleed, Baker, and Blacknell: 1989, 78): first of all, the achievement of free capital movements, and, second, the harmonisation of national regulations which can provide a minimum common framework among EU members. However, whilst the UK, Germany, and Holland have already achieved free capital movements, Italy and Spain, for instance, are still protected markets.

Moreover, even if the Commission has reduced the concept of harmonisation with the acceptance of some basic rules (i.e. mutual recognition) in order to speed up the process,

the full implementation of a Single Market in this sector is still remote. This is confirmed by the effectiveness (since January 1996) of the Investment Services Directive (ISD). The purpose of this directive is to allow product providers or intermediaries in any EU state to set up in any other EU state, if they fit with their home regulation (FT, 16 February 1996). However, the impact of the ISD has not provoked many changes in the process of European financial integration. Indeed, as illustrated by the ISD, which has provided only minimum standards of both market and trade, the deceleration for developing the EFA is mainly due to the fact that the European Community is not a federal power and nation-states are still strong actors in an area as financial sector, which, as better argued below, has the main feature to affect the whole economy of a country.

Transnationalisation of Finance Services

The globalisation of finance from a nation-based to a global regulation started in the 1980s, when a process of modification in the national regulation of financial markets occurred. This process has both ideological and economic explanations. Ideologically, it was supported by a widespread feeling against state economic intervention, embodied by the Thatcherism in Great Britain and Reaganomics in the U.S.; economically, it was supported by the diffuse perception that the circle stagnation-inflation was the *natural* outcome of the welfare state and the management of the Keynesian demand. Moreover, by increasing the volatility of international capital flows, economic interdependence made it impossible to isolate national economies at both macroeconomic and microeconomic levels. Historically, this development is rooted in the political context of the Cold War. In that context, whilst the United States created an outflow of dollars into world economy through, for instance, the Marshall Plan and other post-World War II aid programmes, the decision to introduce external convertibility of most Western European currencies was taken. One of the main outcomes of this development has been the Euromarkets [\(1\)](#), which provided capitals for corporate, sovereign and supranational borrowers.

As suggested by Walter (1993, 202-204), several are the causes of the financial transnationalisation process. First of all, the technological change provides new forms of access to knowledge and information, which greatly affect competition and strategic decisions. Indeed, news about political shifts and economic and financial patterns of all major economies play an important role in provoking massive movements of capitals. A second cause of the globalisation of finance has been the high interest rates, which have increased the demand for high-yielding securities and equities. Third, since the 1970s, the deceleration in productivity in the industrial economies has provoked a movement toward a more active portfolio management, pushing for cross-countries arrangements.

However, as, in all countries, the financial sector is more regulated than the others, its deregulation has been more difficult. The reason for this relies on the different features of the financial services from goods and other services. Because the financial sector is used by both financial and industrial agents in the economy, it affects all economic performances. Therefore, inefficiencies in this sector are likely to influence the whole economy of a country. This particular position of the financial sector in the economy

risers several national policy issue (Llewellyn in Swann: 1993, 111). First, because of its central role in the economy, governments try to avoid domination by foreign institutions. Second, government regulation aims to prevent losses of confidence and danger of contagion. Third, all countries tend to have banks and insurance companies everywhere because of the importance of location. Taking into account all these factors, nation-state regulation of financial sector has been embodied by a "arms-length" financial system, resulting from the combination of active financial markets and a banking system providing short-term credit; and by a "strategic" type, characterised by financial structures providing long-term debt and decision-making through the linkages between the state, the banks and corporate networks (Cerny: 1993, 53).

However, as the Cold War international order was not able to maintain, protect, and guarantee its nationally based financial structure, the natural breakthrough was the so called "second financial revolution" of the 1980s and 1990s (2), which provoked a "liberalisation" of financial services as a response to the inadequacy of the system. Even if it does not imply a reduction of rules, rather than a drafting of new regulations, this process was better labelled as de-regulation. As stressed by Cerny (*Ibid.* 52), "de-regulation is the attempt by nation-states to impose upon market actors new market-oriented rules". Therefore, such a process can be also defined as re-regulation. Yet following Cerny (*ibid.*), it is possible to focus on two phases: the first one concerns the drawing and imposition of new market-orientated rules, whilst the second embodies the bureaucratisation of those rules in order to deal with new distortions and market failures.

The main features of this process are de-compartmentalisation, disintermediation and securitization, financial innovation, marketisation of government, and globalisation (Cerny: 1993, 56-69). Whilst compartmentalisation aims to restrict competition by creating several controls which other market powers cannot challenge, de-compartmentalisation attempts to create the conditions in which national financial institutions can resist losses of competitiveness. The greatest example is represented by the Euromarket which embodied a more open market forcing other financial markets to adapt themselves to the new structures of competitiveness. Disintermediation concerns, under the definition of Cerny, "the slower growth of the supply of intermediated bank credit" (1993: 62), whilst securitization involves the reduction of exposures to risks by higher securities. Then, financial innovation is related to the segmentation of market and the developments of the electronic system which makes cheaper capital investments. The fourth feature is the new role of the government in financial markets, which has become a participant, rather than a regulator of the market failures. Finally, globalisation, which links all the other changes together, gives the dimension of a transnational financial market.

Among the most industrialised economies, the most important step in de-regulation and re-regulation in financial services is represented by the negotiations in the last round of the GATT (General Agreement on Tariffs and Trade) - Uruguay Round. The achievement of the Uruguay Round in financial services (namely the General Agreement on Trade in Services- GATS) can be read as the attempt of the United States to de-regulate the financial services market, in order to avoid the loss of its hegemonic position.

Indeed, the characteristic feature of the transnationalisation process of financial services is the breakdown of the American world hegemony, both in economic and political terms. This explains why the U.S. was the most enthusiast promoter of an international de-regulation. By promoting a transnational bargaining, the United States had the opportunity to influence the current de-regulation through the elaboration of a new regulation process to which the U.S. has participated. *De facto*, it attempted to control the competitiveness coming from other countries, as illustrated by the American intention to apply the GATT principle of "national treatment" of foreign goods on national market to foreign suppliers of services. Indeed, this principle leads to a "foreigner's right to establish and right to do business" (Mark and Helleiner: 1988, 21 in Underhill in *European Journal of Political Research*, 19, 1991, 210). The Uruguay Round negotiations demonstrate also the important role, which nation-states still have in the current process. For this reason, as already argued above, I believe the term transnationalisation, rather than globalisation, is more suitable for describing this process.

The European response to the transnational process of financial services

After having outlined the process of financial transnationalisation, which provides the background to understand the establishment of the Single Market for financial services, I will propose a reading of the European developments as a response to the global process in the financial services sector. For this purpose, I will base my arguments upon two main crucial factors. I will argue that, through the institutionalisation of regional rules, Europe, as a unitary actor, has participated in the international re-formulation of financial regulation. Second, the regional regulation prevents financial instability in a global environment of increased volatility of relatively unregulated capital flows.

The Single Market for financial services as a means of participation in the international re-formulation process

The European implementation of a Single Market should be read as part of the cross-cutting linkages across the world. Indeed, the end of the American hegemony provoked a regional fragmentation of the global arena in the sense that, in the context of a world economy and policy, an international organisation in regional blocks is emerging. Moreover, as already stated above, the decline of the U.S. leadership marked a change in the world-wide rules of financial services, rather than a liberalisation. In this framework, the EU, which notably represents the most successful experiment of regional integration, has elaborated its own regulation of financial services. What actually is happening is a process of substitution of the post-World War II regulation in financial services, imposed by the U.S. as the hegemon of the system. For this reason, I followed Cenry (1993) by defining this process of financial transnationalisation as a de-regulation of the financial sector through re-regulation. In this context, the European regional regulation (i.e. the Single Market for financial service) has been a means through which the region has participated in the re-formulation of new rules. By creating a European compact (in term of rules) financial market, the establishment of the EFA has provided the opportunities to

the European countries to bargain the de-regulation at a transnational level as a unique actor.

The EU has played a central role in the international attempt of co-ordinating the process of re-formulation. Mainly dictated by interdependency characterising world politics and economics (not only the financial services sector), this co-ordination was implemented in the Uruguay Round negotiations. Indeed, whilst, in the beginning, the breakdown of the old set of rules was naturally provoked by the American decline, the establishment of new regulations has been implemented in international institutional arenas, as the example of the Uruguay Round negotiations illustrated. The reason for this relies, on one hand, on the American determination not to lose its position by promoting an international bargaining; on the other, on the interests of other powerful actors (i.e. Japan and Europe) in taking part actively to the re-formulation. In this sense, the Single Market for financial services can be seen as the European response to the process of financial transnationalisation. By the establishment of a Single Market for financial services, the European interests have weighted in the re-formulation process and European integration will be accomplished also in financial terms. Indeed, besides the Japanese and American market, Europe is emerging as a third pole in financial services. Even if there is not a Single location in Europe, as Tokyo in Japan and New York in the U.S., once the Single Market will be completely implemented, the major markets of London, Paris, Amsterdam, and Frankfurt will operate according to the same set of rules, which have been established through a widespread participation, rather than a world hegemony.

The Single Market for financial services as an attempt to prevent financial instability

The Single Market for financial services can also be read as a response to the process of financial transnationalisation in the sense that, by elaborating a common set of rules, European states have prevented financial instability in a global environment of increased volatility of relatively unregulated capital flows. Indeed, the international "liberalisation" of financial services might have had the effect of increasing risks of financial operations because of the absence of any regulation. However, as widely stated in the second section of this paper, the abandonment of the old rules, established in the era of the *Pax Americana* should be labelled as de-regulation, rather than liberalisation. Following this suggestion, it is easy to read the Single Market for financial services as an attempt, based upon mutual recognition and harmonisation, of regulating the financial sector at regional level. Both in long and short terms, one of its main goals is the elimination of risks of failures of an unregulated market. This assertion proves nation-states are still the main actors of the domestic and global domain, justifying the label of "transnational" given, in this paper, to the process of international liberalisation of financial services.

In an evaluation of the current results, the European formulation of financial rules has had some important achievements when considering the increased competitiveness in this sector within the EU. By guaranteeing control of instability and consequent dangerous effects on the domestic economy of each European state, the regulated elimination of

cross border barriers has given greater freedom and choice to the consumer. Therefore, this has led to a growth of the European financial sector and major efficiencies of resource allocation of sectors using financial markets. For these reasons, "Europe will attract new international business to its capital markets" (Cerny:1993, 205), as in the intentions of the Commission when it decided to launch a Single Market for financial services. Indeed, Europe is going to have a more unified Single Market for many financial services than the United States, where such a factor misses because of legal restrictions on universal banking. However, reading the implementation of the EFA as a response to the transnationalisation of finance does not imply that its full implementation will generate a "fortress Europe". Instead, it will contribute to the process of financial as well as political and economic international differentiation in regional blocks.

Conclusions

As proposed in this paper, the Single Market for financial services, as a regional regulation, has provided a means to participate to a more widespread re-formulation of the international financial rules. As stated above, this evolution implies a process of de-regulation through a re-regulation of the international financial services sector. The background of this process is the fragmentation of the "international" in regional blocks, after the collapse of the post-World War II order. Both this fragmentation as well as the influences of the European achievements in the financial integration could be found in the Uruguay Round negotiations, where the EU had a central role in drawing the new international financial regulation as established in GATS.

Another argument supporting the thesis that the Single Market for financial services is a response to the process of financial transnationalisation relies on its role in preventing financial instability within the EU, because of a global environment characterised by a growing volatility. Indeed, by planing and implementing a financial integration, the EU members have tried to guarantee a minimum level of security within the regional borders, whilst the increase of risks is the peculiar characteristic in the global domain.

Therefore, as argued in this paper, the Single Market for financial service has truly been a reaction of the European countries to the end of a political and economic era (i.e. the *Pax Americana*). In financial terms, this evolution has opened a discussion about new financial rules and has generated the need for a regional system able to prevent repercussions of international events in order to avoid damages to the regional economy. It follows that globalisation and EU financial integration have involved a process of harmonisation between the European and the other jurisdictions (namely the American and the Japanese ones). However, this process is conflictual when considering the difficulties in its implementation.

Footnotes

(1) *The Euromarket was originated by the "capital exports and withdrawals of foreign-owned deposits from the U.S." (Versluysen: 1981, 28). [Back to \(1\)](#)*

(2) *The "first financial revolution" mainly corresponds with the reaction to the breakdown of the pre-First World War international financial structures in the 1930s. [Back to \(2\)](#)*

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