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Financial Markets and 1992

Afterwards, though, we'll have liberty, security, lighter taxes, ease, trade. Everything will be better. . . .
Giuseppe Tomasi di Lampedusa, *The Leopard.*

IT STARTED QUIETLY, when it seemed that the European unification effort had inexorably run out of steam. It grew slowly inside the European Community, more for lack of opposition than because of strong support from any member state. Now it is one of the most talked about issues not only in Europe, but also in the United States and Japan. Europe 1992 is, at the same time, a source of excitement, fear, and skepticism.

In the area of financial markets, however, the most common response to 1992 is probably confusion. What is Brussels really promising? How is it going to achieve its goals? How likely is its success? What are the implications for countries outside the Community? Will 1992 make any difference after all? To these and other such questions, the answers commonly given are either essentially political—being positive or negative depending on which side of the Atlantic the opinion comes from—or strictly technical. The truth is that the issue is so complex in its economic, institutional, and regulatory ramifications that it is impossible to predict exactly what will happen.

The aim of this paper is to organize and put into perspective, without pretending to be exhaustive, the facts that are crucial to understanding the impact of the European integration project on the financial markets. The first section surveys the current world financial market. In particular, it summarizes the differences across national markets, with special

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attention devoted to regulations affecting foreign direct investment in financial services and the cross-border trade in securities (capital controls). The next section explains the goals of the European integration, its timetable, and its progress to date. Finally, I review and evaluate the European Commission's estimates of the benefits deriving from the liberalization of the capital markets and discuss some important unresolved issues.

International Financial Markets Today

To evaluate the financial integration project, it is necessary to know just how integrated the world financial market is now.

The most evident barrier to financial integration is the existence of two types of controls. The first limits the cross-border movements of securities, thus establishing different regulatory treatments of domestic and foreign assets. The second discriminates against nonresident agents and firms by limiting the activities that they are allowed to undertake in the national capital markets.

Table 1 summarizes the exchange controls and other measures affecting the cross-border trade in securities in the EC countries and other selected OECD countries, as of 1987. Of the EC countries, four (Germany, Luxembourg, the Netherlands, the United Kingdom) do not have significant impediments to international trade in securities. The only notable form of control in Belgium is a two-tier foreign exchange system, which implies that current account transactions and capital account transactions are cleared in different markets. However, it is not clear whether such an arrangement seriously impedes the free flow of capital. The other seven Community members all have various forms of controls which, albeit to different degrees, have prevented residents from freely accessing world capital markets. Of these countries, France and Italy have considerably cut back their restrictions in the past two years. There are no significant capital controls in the selected OECD countries listed in the table.

Regulatory impediments in the financial market, however, are not confined to the movements of securities across borders. They also involve restrictions on the activities that foreign financial firms can undertake in domestic financial markets, on direct foreign investments

Table 1. Exchange Controls and Equivalent Measures Affecting Cross-Border Operations in Securities, European Community and Other Selected OECD Countries

	Operations in foreign securities				*Operations in domestic securities*		
	Introduction of securities				*Introduction of securities*		
Country	*Primary market*	*Secondary market*	*Purchase or sale*	*Collective investments*	*Primary market*	*Secondary market*	*Purchase or sale*
European Community							
Belgium	O	O	O	O	O	O	O
Denmark	X[a]	O	O	O	X[b]	O	O
France	X	O	X[c]	O	X	O	O
Germany	O	O	O	O	O	O	O
Greece	X	X	X	X	X	O	O
Ireland	X	X	X	X	X	O	O
Italy	X	O	X[d]	X[d]	X	O	O
Luxembourg	O	O	O	O	O	O	O
Netherlands	O	O	O	O	O	O	O
Portugal	X	X	X	X	X	O	O
Spain	X	X	X	X	O	O	O
United Kingdom	O	O	O	O	O	O	O
Selected OECD countries							
Australia	O	O	O	O	O	O	O
Canada	O	O	O	O	O	O	O
Japan	O	O	O	O	O	O	O
Switzerland	O	O	O	O	O	O	O
United States	O	O	O	O	O	O	O

Source: OECD (1987f, p. 60). Countries with exchange controls are indicated by X; those without controls are indicated by O.
a. Bonds are restricted only.
b. Partial restriction.
c. Only securities traded on recognized markets are permitted.
d. Deposit requirement.

in financial services, and on the use of local capital markets by foreign companies to finance their direct investments.

Table 2 summarizes the restrictions faced by nonresident firms on their activity in local securities markets. Most of the EC countries discriminate against foreign firms, especially in limiting their direct access to the local secondary markets. Frequently, foreign firms cannot act as their own brokers, but must instead use resident authorized banks or brokers. Once again, the other OECD countries are more liberal.

A similar picture of the regulation of direct foreign investment in the banking and other financial sectors is drawn in table 3. The regulations and restrictions are extensive and, this time, not limited to EC countries. In general, foreign investments in the financial industry must be explicitly

Table 2. Restrictions on Nonresident Firms' Security-Related Activities, European Community and Other Selected OECD Countries[a]

Country	*Primary markets*	*Secondary markets*
European Community		
Belgium	0	III, IV
Denmark	0	III
France	0	III, V
Germany	I	0
Greece	0	II
Ireland	0	0
Italy	0	II, VI
Luxembourg	0	0
Netherlands	I	0
Portugal	0	II
Spain	0	II, V
United Kingdom	I	0
Selected OECD countries		
Australia	0	VI
Japan	VII	VII
Switzerland	0	0
United States	0	0

Source: OECD (1987f, pp. 56–59).
a. Restrictions are indicated as follows:
0: No restrictions.
I: Foreign firm may lead new issue only if reciprocity holds.
II: Broker license forbidden to foreigners.
III: Broker license limited to EC members.
IV: No direct sale to public, only to institutional investors.
V: Operations in exchange market must go through domestic local bank or broker.
VI: Limited foreign participation in domestic brokerage firms.
VII: Subject to approval.

authorized, and the authorization is normally subject to reciprocity requirements.[1]

Another form of capital market regulation that discriminates against nonresident firms involves local financing for their direct investments. As table 4 shows, half the EC member countries impose some type of restriction on local financing, at least in the form of prior authorization or notification. Of the non-EC countries considered, only Switzerland seems to have similar regulations.

Besides explicit regulations, the international integration and trade in

1. Reciprocity, in practice, has various meanings. I will be more precise later on in the paper.

Table 3. Sectoral Controls and Impediments to Direct Foreign Investment, European Community and Other Selected OECD Countries[a]

Country	Banking	Other financial services	Insurance
European Community			
Belgium	O	O	I
Denmark	O	O	RI
France	RI	RI	RI
Germany	I	O	O
Greece	RI	O	I
Ireland	RI	I	RI
Italy	RI	O	RI
Luxembourg	O	O	MI
Netherlands	RI	I	O
Portugal	R	O	RI
Spain	O	I	MI
United Kingdom	I	I	I
Selected OECD countries			
Australia	RI	R	O
Canada	RI	R	MR
Japan	I	I	O
Switzerland	RI	I	O
United States	I	O	I

Source: OECD (1987c).
a. Controls or impediments are indicated as follows:
O: No controls or impediments.
R: Sectors in which some or all activities are subject to controls or impediments to inward direct investment that are regarded as restrictions in the sense of the Code of Liberalization of Capital Movements.
I: Sectors in which some or all activities are restricted by other impediments.
M: Sectors in which some or all activities are closed to investment due to public, private, or mixed monopolies.

financial markets is discouraged by other, less evident factors as well. For example, the institutional organization of financial intermediaries varies dramatically across countries. Firms structured to operate in one institutional climate may find it too costly to fulfill the requirements they would face in a foreign country. In general, there are three types of institutional organizations: systems in which banking activities are separate from securities-related activities, universal banking systems, and systems in which banking and primary market activities are separate from secondary market activities.

In the first system—typical of the United States, Canada, and Japan—banking and security activities are considered intrinsically different, especially as far as risk is concerned. As a prudential measure, therefore,

Table 4. Restrictions on Local Financing of Foreign Direct Investment, European Community and Other Selected OECD Countries

Country	*Restriction*
European Community	
Belgium	None
Denmark	Restricted
France	Restricted
Germany	None
Greece	None
Ireland	Requires authorization
Italy	Requires authorization
Luxembourg	None
Netherlands	Requires notification
Portugal	None
Spain	Requires authorization
United Kingdom	None
Selected OECD countries	
Australia	None
Canada	None
Japan	None
Switzerland	Requires authorization
United States	None

Source: OECD (1987c).

the same institution is prevented from carrying on both activities. Under the universal banking systems, by contrast, the same institution is allowed to perform the full range of financial activities, including banking, brokerage, and portfolio management activities. Countries like Germany, the Netherlands, and Switzerland, which have adopted this system, believe that allowing the institution to carry out activity in different areas reduces the risk of financial failure arising from losses in a particular area. The third system, in use for example in Belgium, France, and Italy, is a compromise between the two extremes. Here, the financial institutions resemble universal banks except that they cannot participate directly in the secondary markets. Secondary market security trades are allowed to take place only in a recognized exchange, through a licensed broker. Table 5 gives a more complete picture of the regulations determining the range of markets and activities in which various types of financial intermediaries can participate. These regulations, even if not explicitly imposed to discriminate against foreign firms, may nonetheless constitute a significant deterrent to international market

Table 5. Institutions Performing Securities-Related Operations, European Community and Other Selected OECD Countries[a]

Country	*Primary markets*	*Secondary markets*	*Collective investment*	*Portfolios and counseling*
European Community				
Belgium	I, VI	I, II	III	I, II, IV, VI
Denmark	I, II, VI	I, II, VI	III	I, II, VI
France	I	I, II	I, II, III, V	I, II, IV
Germany	I	I, II	III	I, VII
Greece	I, II	I, II	III	I
Ireland	I, II	I, II, VII	I, III, V	I, II, IV
Italy	I, IV	I, II	I, III, V	
Luxembourg	I, II	I, II	I, II, III	I, II
Netherlands	I, II	I, II	III	I, II
Portugal	I, III	I, II, III	I, III	I, III
Spain	I, II	I, II	I, III	I, II
United Kingdom	I, II, VII	I, II	VI	I, II, V
Selected OECD countries				
Australia	I, II, VII	I, II, VII	I, II, VII	I, II, VII
Canada	I, II	I, II	I, VII	I, II, V
Japan	II	II	III	II, V
Switzerland	I, IV	I, IV	III	I, IV
United States	I,[b] IV	I,[b] II	I,[b] III	I,[b] II, IV

Source: OECD (1987f, pp. 53–55).
a. Institutions indicated as follows:
I: Commercial banks.
II: Brokers (stockbrokers, security firms, dealers, discount brokers).
III: Mutual funds, pension funds, investment funds, investment associations, investment societies.
IV: Investment banks, financial companies.
V: Insurance companies.
VI: Other credit institutions.
VII: Other financial institutions.
b. Limited to U.S. government, state, local, municipal bonds and certain money market investments.

integration. For example, banks resident in universal banking systems that are organized to combine credit and portfolio services would be denied security licenses in the United States or Japan.[2] Similarly, U.S. securities firms would be required to obtain a full banking license in Germany, even if they were not interested in performing any credit or deposit-taking activities.

These different regulations, together with innumerable country-spe-

2. Before 1978, the separation of banking and security activity was not required for foreign institutions. I will come back to this point later on.

Table 6. Summary Statistics on Selected Banking Systems, 1986

Country	*Commercial banks*	*Savings and mutual banks*	*Foreign banks*	*Domestic banks*	*Market share of five largest institutions (percent)*
European Community					
Belgium	86	31	61	56	70
Denmark	...	219	5	214	78
France	367	624	131	860	50
Germany	252	598[a]	148	702	44
Greece	33	2	19	16	83
Ireland	42	17	...	59	...
Italy	200	85	38	247	55
Luxembourg	122	...	102	20	30
Netherlands	81	67	0	108	84
Portugal	...	27	9	18	78
Spain	136	213	36	300	46
United Kingdom	611	140	300	451	36
EEC	2,176	17,777	...	3,064	13
Selected OECD countries					
Japan	141[b]	1,088[c]	64	1,165	20
Switzerland	233	215	109	339	65
United States	14,130	3,563	459	17,234	10

Source: Baltensperger and Dermine (1989). Data are for the end of 1986.
a. Does not include 3,604 cooperative credit institutions.
b. Includes city and regional banks.
c. Includes 929 credit associations and credit cooperatives.

cific historical developments, have resulted in national financial markets that are far from being homogeneous, even in the absence of explicit capital or exchange rate controls.[3] Tables 6, 7, and 8 provide some evidence of this cross-country heterogeneity in the banking sector. Together with the total number of banking institutions, tables 6 and 7 report the extent of foreign penetration and an indicator of concentration (the market share of the five largest institutions). Several interesting facts warrant attention. First, to judge from these data, the degree of capital control and the presence of other restrictive measures are not sufficient to explain the extent of the presence of foreign banks. For example, Germany, while completely free from any discriminatory

3. This is an important point, especially when considering the potential gains from 1992.

Table 7. Foreign Banks' Assets as Percentage of Total Assets of All Banks, Selected Countries
Percent

Country	*End-June 1985*
Belgium	51.0
France	18.2[a]
Germany[b]	2.4
Italy	2.4
Netherlands[c]	23.6
United Kingdom	62.6
Canada	6.3
Japan[b]	3.6
Switzerland	12.2
United States[d]	12.0

Source: Bank for International Settlements (1986, p. 152).
a. End-1984.
b. Branches only.
c. Universal branches only.
d. Foreign agencies and branches only.

regulations, has a minimal presence of foreign institutions. While their number is considerable, their weight in the industry, if judged by the size of their assets as shown in table 7, is relatively small. In France and Greece, on the other hand, the contingent of foreign banks is large, despite the formal restrictions and regulations on direct foreign investment. Second, the degree of concentration is not necessarily lower in countries characterized by a strong foreign participation in the market. Greece, the Netherlands, and Belgium are, at the same time, among the countries with the highest concentration and the largest foreign participation.

Finally, table 8 provides an indicator of the profitability efficiency of the banking systems, that is, the ratio between gross income and operating costs. Here, too, it is difficult to detect any clear relationship between the degree of openness of the markets and the profitability of banking.

Project 1992

The beginning of project 1992 is the Commission's 1985 White Paper, "Completing the Internal Market," which called for the liberalization of

Table 8. Profitability of Commercial Banks, Selected Countries

Country	Gross income as a multiple of operating expenses
Luxembourg	3.33
Switzerland	1.78
Portugal	1.64
Canada[a]	1.61
Netherlands	1.56
Germany	1.53
Italy	1.52
Spain	1.52
France	1.47
United States	1.46
Japan	1.41
Belgium	1.20

Source: OECD (1987a, 1987b). Figures are average for 1980–85.
a. 1982–85.

capital movements in the community and the creation of an integrated market for financial services.[4] To promote a common market in financial services, it proposed to remove the restrictions on capital movements in member states; to limit the applicability of the protective clause provided for in the Treaty of Rome, which allows for the temporary introduction of such restrictions; and to coordinate the conditions under which financial intermediaries operate.[5]

The White Paper suggested two general criteria to facilitate the achievement of these goals. The first is the *mutual recognition* principle. Member states should accept what each does in its jurisdiction to safeguard the interests of the public, particularly in such matters as authorization, supervision, and reorganization of financial institutions. The second is the *home country control* principle, according to which the primary task of supervising financial institutions is attributed to the competent authorities of the member state in which the institution has its primary residency. These two principles are supposed to guide the writing of the Community directives necessary to regulate and integrate the financial markets. The European Council adopted the White Paper program at the Milan Summit in June 1985.

4. Commission of the European Communities (1985).
5. Articles 73 and 108(3).

The second fundamental step toward the European integration was the Single European Act, which was signed in February 1986. It formally established December 31, 1992, as the deadline for the completion of the internal market. More important, the act introduced amendments to the Treaty of Rome to speed implementation of the project. These amendments, aimed at improving the decisionmaking process of the Community, abolished the requirement of unanimity for any Council decision, establishing instead the concept of a *qualified majority* for most decisions involving the establishment and functioning of the internal market. Three important exceptions are decisions involving fiscal measures, matters relating to the free movement of people, and the rights of workers. As I will show later, these exceptions now have important consequences.

As stated above, the goal of the 1992 project for the financial market is twofold. The first part is "destructive," that is, it is aimed at the elimination of existing impediments to trade in this sector. The second is "constructive," aimed at the definition of common rules and standards that could facilitate the creation of a single internal market.

The directive of June 1988 for the implementation of Article 67 of the treaty was designed to achieve the first objective.[6] It establishes the deadline of July 1, 1990, for the member states to "abolish restrictions on movements of capital taking place between persons resident in Member States."[7] For Greece, Ireland, Portugal, and Spain, the deadline is extended, in some cases to December 31, 1990, and for others to December 31, 1992.[8] Moreover, the directive requires the abolition of the dual exchange market system operated by Belgium and Luxembourg by December 1992.[9]

This directive also calls for the Commission to submit by December 31, 1988, "proposals aimed at eliminating or reducing risk of distortion, tax evasion and tax avoidance linked to the diversity of national systems for the taxation of savings" and for the Council to take a position on these proposals by June 30, 1989.[10] The Council, however, has not yet taken a decision on the taxation of savings, which, as will be discussed

6. Council of the European Communities (1988).
7. Article 6.1, Article 1.
8. Annex IV.
9. Annex V.
10. Article 6.5.

later, is one of the chief unresolved problems of the internal market project in the financial sector.

The implementation of this directive should create a barrier-free, but still segmented, European market. It is at this point that the "constructive" phase of 1992 should begin. In the 1985 White Paper, the Commission enumerates more than 20 directives involving financial services (banks, transactions in securities, and insurance) that, once proposed and approved, should guarantee the minimum level of coordination and harmonization necessary for a truly integrated internal market.[11] Of these proposed directives, the two most crucial in the field of banking and security markets are the second banking directive and the directive on "Investment in Services in Security Field."[12]

The proposed second banking directive aims to shape a unified European banking sector by guaranteeing the freedom of establishment and service in banking, by creating a single banking license and a single list of permissible banking activities, and by harmonizing the essential supervisory standards, that is, minimum capital requirements and controls of major stockholders.[13] Underlying this directive are the two criteria followed by the Commission in the rest of the 1992 project. The mutual recognition principle is the instrument by which freedom of establishment and service is achieved. Legal banking institutions in a member state will have the right to establish branches or offer services everywhere in the Community. This principle, however, has immediate consequences for the choice of a banking system for the single European banking license. This "everything goes" strategy naturally forces the choice toward the more liberal system, that is, universal banking, which, in fact, has been used as a model in drawing up the concept of the "European Bank."[14]

The other fundamental guideline is the home control principle. The supervision of a credit institution, including the activity it engages in on a cross-country basis, is the responsibility of the authorities of its country of origin. The principle, however, is somewhat bent in this case.

11. Annex to the White Paper.

12. Commission of the European Communities (1988b, 1989c).

13. Amending the First Banking Directive, Council of the European Communities (1977).

14. Annex to the White Paper.

Recognizing the crucial role of the banking sector in the management of liquidity and the insufficient coordination of monetary policies in the Community, the directive proposes that "Host Member States shall retain primary responsibility for the supervision of the liquidity of credit institutions until further coordination."[15] The phrasing is quite vague, and although it explicitly forbids discriminatory measures against nonresident institutions, it seems to leave open the possibility of extensive regulations. One obvious candidate for host country control is bank reserve levels, the implications of which are discussed later.[16]

The proposed directive on "Investment in Services in Security Field" is similar in spirit to the second banking directive. It is aimed at achieving a similar degree of harmonization and integration in security-related activities (brokerage, portfolio management, professional investment advice, underwriting services) and instruments (transferable securities, money market instruments, financial futures and options, exchange rate and interest rate instruments). Again, the basic philosophy is mutual recognition and home country control.

The Benefits of 1992: The Commission Perspective

Many Europeans strongly support 1992 for purely ideological reasons. For them, the European integration has a value of its own and does not require any economic justification. The Commission argument in favor of the integration, however, is not a political one. Project 1992 is sold mainly as an economically necessary and welfare-improving measure.

In addition to the standard argument that the liberalization of capital markets improves the international resource allocation, the Commission offers several other reasons why financial market integration is necessary and beneficial. First, it argues, the European financial sector cannot survive the challenge of an increasingly global financial industry, especially from the United States and Japan, if it is divided into 12 relatively

15. Article 12.

16. The directive was expected to be approved by the Council by June 30, 1989, but it has encountered "technical problems," especially because of the definition of reciprocity with respect to third countries (Article 7), which has been recently amended. The directive is now expected to be approved by the end of the year and to become operative January 1, 1993.

small markets, regulated by 12 different sets of national law. Second, welfare would be enhanced if savers could access financial products and intermediaries independently of their country of origin. Third, the manufacturing sector as a whole would benefit from a larger, more competitive financial sector.

These are, in principle, all good points, often made in discussions of any type of tariff reduction and a move toward free trade. No economist would deny the possibility of such gains, at least when phrased in such general terms. The real issue is to quantify them. It is undeniable that integration will be costly, involving a considerable amount of political and legislative effort and bureaucratic resources, not to mention the microeconomic costs of adaptation to a new environment, both by firms and consumers. Therefore, for 1992 to be justifiable in purely economic terms, the gains it will produce must be substantial. The Commission has made a considerable effort to estimate the size of these gains and has published its findings.

An entire volume of this research, prepared by Price Waterhouse, is devoted to the impact of 1992 on financial markets.[17] This study reports considerable welfare gains deriving from the integration of capital markets. The gains themselves are measured by calculating the increase in consumer surplus that results from the equalization of the prices of financial services within the Community. The methodology is easily summarized. The research first measured the prices of several financial products and found, across member states, large differences that are attributed to various barriers to trade in the sector. It then assumed that the likely effect of the financial integration is to move toward price equalization. Prices are thus assumed to fall toward the average of the four lowest prices recorded in the Community, in the relevant sector. Finally, using available measures of national value added of the credit and insurance sectors and assuming a price elasticity of demand of 0.75, estimates of gains in consumer surplus were computed. The results of this exercise are provided in table 9. The total estimated gains are certainly considerable: between 11 billion and 33 billion ECUs a year (approximately \$12 billion and \$36 billion), which represents between 0.3 percent and 1 percent of 1985 European Community GDP.

17. Price Waterhouse (1988).

Table 9. Estimated Gains in Consumer Surplus from Integrating Financial Markets
Millions of ECUs

Country	*Range*	*Midpoint*
Belgium	366–1,018	685
France	2,105–5,330	3,683
Germany	2,264–7,074	4,619
Italy	2,516–5,542	3,996
Luxembourg	16–73	44
Netherlands	86–796	347
Spain	2,376–4,040	3,189
United Kingdom	1,415–8,837	5,051
Total	11,144–32,710	21,614

Source: Price Waterhouse (1988, p. 166).

Evaluating the Impact of 1992

What will happen then? Oh, well. Just negotiations punctuated by a little harmless shooting, then all will be the same though all will be changed.
Giuseppe Tomasi di Lampedusa, *The Leopard*

Is the promise of the abolition of capital controls and, thus, of a permanently liberalized European financial market a credible one? I believe that some caution is justified. The idea of an integrated financial market is not new. In fact, it was an integral part of the Treaty of Rome. Article 67 of the treaty calls for the abolition of the restrictions on the movement of capital and of any discrimination based on the residence of the party or on the place of the investment. The treaty, however, also contains "safeguard clauses," which permit member states to suspend temporarily their obligation to liberalize their financial markets. If free movement of capital causes either disturbances in the workings of national capital markets or balance of payments problems, member states are entitled to take protective measures. These "safeguard clauses" permitted several countries (Denmark, France, Italy, Greece, and Ireland) to introduce strict exchange and capital controls. All five countries, however, have basically ignored the implicit understanding that the controls are for emergencies and are thus temporary.

The aforementioned June 1988 directive for implementing Article 67 contains a similar "safeguard clause."[18] Article 3.1 reads: "Where short term capital movements of exceptional magnitude impose severe strains on foreign-exchange markets and lead to serious disturbances in the conduct of a Member State's monetary and exchange rate policies, being reflected in particular in substantial variations in domestic liquidity, the Commission may, after consulting the Monetary Committee and the Committee of Governors of the Central Banks, authorize that Member State to take, in respect of the capital movements listed in Annex II, protective measures the conditions and details of which the Commission shall determine." The list in Annex II is quite extensive, including security trade, bank accounts, mutual funds, and financial loans and credit. Moreover, Article 3.2 allows, in case of emergency, the member states to take the protective measures without prior approval of the Commission.

How frequently will this safeguard clause be invoked? In the past, the protective clauses have been effectively used to isolate the national financial market for extended periods of time. Is that situation likely to recur? It is true that Article 3.4 explicitly limits the protective measures to six months. But how strictly will this rule be enforced? While the member countries' policymakers insist that these measures will be short-lived, in the unlikely event that they are ever introduced, the real test will come only when some real emergency occurs. In summary, the inclusion of this safeguard does not appear to have been a wise decision. First, it generates uncertainty about the real commitment of the member states to the project. Second, the temporary reintroduction of capital controls may not protect the monetary authorities against the speculative flows of funds. As discussed in Grilli and Hamaui, once the financial markets are completely liberalized, it would be difficult to restrict effectively the movements of domestic assets.[19] The liberalization, in fact, will allow the creation of considerable domestic assets abroad, which would be difficult to control. Moreover, the possibility of the introduction of these temporary measures may induce a greater outflow of capital and a greater international portfolio diversification than would have occurred in the absence of this risk.

But even if these issues are going to be clarified and resolved, and the

18. Council of the European Communities (1988).
19. Grilli and Hamaui (1989).

liberalization successfully takes place, its benefits remain to be established. Are the Commission's estimates of the welfare gains accurate? One disturbing element of table 9 is that the two countries that appear to be the greatest potential beneficiaries of the financial market liberalization are Germany and the United Kingdom, which are also the two countries that have the most liberalized financial markets in the European Community and thus, according to the Commission's logic, should be characterized by low, competitive prices. This observation raises some doubts about the reliability of these estimates, a suspicion that is strengthened by further evidence provided in table 10. The table presents data on the pricing of various financial services in the European Community, the same recorded by Price Waterhouse in the research on the cost of non-Europe. This table confirms the existence of a large cross-country variance in recorded prices. What it does not confirm is the assumption of the Price Waterhouse research that liberalization would bring a convergence of prices in the financial sector. From table 10 it is not at all evident that the price dispersion is any less across countries like Germany, Belgium, Luxembourg, the Netherlands and the United Kingdom, which are already completely liberalized, than in the rest of the Community.

There are two possible explanations for this evidence. The first is simply that liberalization does not necessarily increase competition enough to force price equalization. Even without formal controls and trade barriers, in fact, financial markets may remain segmented and geographically separated. Because of the high degree of concentration in the industry, these markets may be, in practice, noncontestable. Obviously, this interpretation is quite pessimistic about the real impact of the 1992 project on the financial markets. An alternative view is to recognize that such a cross-country price comparison is not very meaningful. Price differences may be reflecting something other than the lack of competition. Given the difference in institutional environments, pricing strategies could be very different for reasons other than mere economic efficiency. For example, in universal banking systems, products may be bundled together or extensive cross-subsidization of services may occur. If so, it would be misleading to interpret differences in the prices of single products as evidence for potential gains from trade. If bundling of products occurs, a low price of a particular commodity does not necessarily reflect low costs or a high level of competition, but

Table 10. Price of Financial Services, Selected Countries

ECU

Country	*Mortgages*[a]	*Consumer credit*[b]	*Credit cards*[c]	*Commercial draft*[d]	*Traveler checks*[e]	*Bank charges*[f]	*Commercial loans*[g]	*Equity*[h]	*Gilts*[i]
Germany	575	46	84	53	5.0	117	5,000	11	108
Luxembourg	n.a.	14	46	54	5.0	8	5,000	11	72
United Kingdom	290	43	61	47	5.0	112	6,875	23	77
Netherlands	343	26	75	22	7.2	0	6,750	22	148
Belgium	480	12	94	43	7.3	0	4,500	14	65
France	653	40	37	63	7.5	10	4,375	9	69
Italy	350	n.a.	99	50	6.6	240	5,125	10	21
Spain	800	27	66	120	7.0	2	5,625	17	180

Source: Price Waterhouse (1988, pp. 104–19). Data are as of end 1985.
n.a. Not available.
a. Annual cost of home loan of 25,000 ECU. Excess over money market rates.
b. Annual cost of consumer loan of 500 ECU. Excess over money market rates.
c. Annual cost of assuming 500 ECU debit. Excess over money market rates.
d. Cost to a large client of purchasing a commercial draft for 30,000 ECU.
e. Cost of purchasing 100 ECU worth of traveler checks.
f. Annual cost of assuming 200 checks, 20 standing orders, 50 cash withdrawals, 20 credits.
g. Annual cost to a medium-size firm of a commercial loan of 250,000 ECU. Excess over interbank rates.
h. Commission cost on a private equity transaction of cash bargain of 1,440 ECU.
i. Commission cost on a private gilts transaction of cash bargain of 14,000 ECU.

it may be the consequence of a high degree of cross-subsidization. In this case, therefore, assuming the convergence toward the lowest prices in the Community would lead to considerable over-estimates of the consumer gains. That does not mean that such gains are not possible and that the 1992 liberalization will not be welfare improving. What is true, however, is that the available data are not sufficiently informative to produce dependable forecasts of these gains.

Yet there are other reasons to be skeptical. Currently, the Community has not been able to reach a consensus on two closely related issues that are going to be crucial to the outcome of the liberalization: banking secrecy and the withholding tax on deposits. As reported in table 11, withholding tax rates on interest and dividends paid to nonresidents vary substantially by country, and EC residents are treated as nonresidents in other Community countries. Similarly, banking secrecy laws vary widely across the Community. In 1981, Luxembourg introduced a secrecy law so strict that it rivals Switzerland's. In the United Kingdom and Germany the principle of secrecy is recognized and applied, even if to a much lesser extent than in Luxembourg. In other countries, for example in France and Italy, bank confidentiality does not exist. The absence of any form of direct reporting of the interest earned abroad and the existence, in some cases, of the additional protection provided by confidentiality laws allows this form of income to remain largely undetected, thus providing an opportunity for tax evasion. In fact, in a recent paper in which I analyze the experience of the major industrialized countries between 1972 and 1987, bank secrecy regulation and withholding tax rates were shown to be the primary determinant of the cross-border movement of bank deposits.[20] That bank deposits appear to be attracted primarily by countries characterized by low levels of withholding taxes and by high levels of bank secrecy suggests that the tax evasion motive is, indeed, one of the most important determinants of this type of international capital movement.

The problem of coordinating tax policies in the Community is a more general issue, going beyond the taxation of interest on bank deposits. Giovannini convincingly argues that any type of investment income taxation based on the "source principle," like withholding taxes, is likely to be highly inefficient in an economically integrated area, because

20. Grilli (1989).

Table 11. Tax Treatments of Dividends, Interest, and Capital Gains in the European Community
Percent

Country	Withholding tax on interest paid to		Withholding tax on dividends paid to		Taxation of capital gains
	Residents	*Nonresidents*	*Residents*	*Nonresidents*	
Belgium	25	25	25	25	Yes, if speculative
Denmark	0[a]	0	30	30	Yes
France	27–47[b]	0–51	0	25	Yes
Germany	0[c]	0[c]	25	25	Yes, for shares No, for bonds
Greece	8–25[d]	49	42–53	42–53	n.a.
Ireland	0–35	0–35	0	0	n.a.
Italy	12.5–30	12.5–30	10	32	No, except in particular cases
Luxembourg	0	0	15	15	Generally not taxed
Netherlands	0[a]	0	25	25	Yes, if speculative
Portugal	30	30	12	12	n.a.
Spain	20	20	20	20	n.a.
United Kingdom	25	25	0	0	Yes

Source: Levich (1989).
n.a. Not available.
a. Banks report interest income to tax authorities.
b. Recipients can choose to pay 27 percent or 47 percent, depending on the savings instrument, or to lump interest income with other income. Banks report interest income to the tax authorities.
c. Banks do not report interest income to the tax authorities; a 10 percent withholding rate was introduced January 1, 1989, but was revoked later on in the year.
d. Corporations pay 25 percent; individuals pay 8 percent plus an amount linked to graduated rates applicable to income taxes.

it leads to disruptive tax competition.[21] From this point of view, withholding taxes should be replaced by taxes based on a "residence principle."[22] Such taxes eliminate the incentive to move capital to avoid taxes as long as the income earned abroad could be detected. It is clear, therefore, that the proper functioning of this type of taxation would

21. According to the source principle, income to residents is taxed at different rates depending whether it originated domestically or abroad. Giovannini (1989).

22. According to the residence principle, individuals are taxed on the basis of their total, worldwide investment income, without differentiating between domestic or foreign sources.

require the elimination of bank secrecy laws that prevent the tax authorities from assessing worldwide investment incomes. However, "the Commission has decided not to propose that banks be required to declare automatically to the tax authorities the interest payments they make. . . . [S]uch arrangement would be likely to encounter serious obstacles in those Member States where banking secrecy is a long-standing tradition, and it is often protected under the law or by the courts."[23]

Given the political infeasibility of setting up a workable tax system based on the residence principle, the Commission has proposed to limit tax evasion and the distortion on the flows of capital by introducing a minimum withholding tax of 15 percent on interest paid to all Community residents.[24] At a minimum, the coordination of tax rates would have prevented excess competition leading to suboptimal tax rates on capital income. From the beginning, this proposal has been opposed by countries like Luxembourg and the United Kingdom, which have very low levels of taxation and relatively large financial sectors. Their argument is that such a measure would not prevent tax evasion, but simply drive away savings from the Community toward other tax havens, resulting in a net loss of business for the EC. At the beginning of the year, Germany introduced a small (10 percent) withholding tax on interest. The immediate effect was a considerable capital outflow, which was brought to a halt only by the removal of the tax. Now Germany subscribes to Luxembourg's and the United Kingdom's point of view. Given that, as mentioned above, decisions on fiscal matters require a unanimous vote, the possibility of a common, positive withholding tax is out of the question. At this point, the Community is at a complete deadlock on the crucial issues of taxation and secrecy, raising further doubts about the extent of the welfare benefits of 1992.

The 1992 project has not yet addressed another related regulatory element that has important consequences for the pricing of bank deposits and loans: the level of bank reserves. Cross-country differences in deposit and loan interest rates are partly due to the considerable disparities in this requirement, as shown in table 12.

Finally, there is the problem of the effects of 1992 on third countries.

23. Commission of the European Communities (1989a, p. 6).
24. Ibid.

Table 12. Reserve Requirements in European Community Countries and United States, 1988

Country	*Percent of demand deposits in banks*
Belgium	0.0
Denmark	0.0
France	5.0
Germany	6.6–12.1
Greece[a]	7.5
Ireland	10.0
Italy[a]	25.0[b]
Luxembourg	0.0
Netherlands[c]	. . .
Portugal	15.0
Spain[a]	18.5
United Kingdom	0.5
United States[d]	3.0

Source: Levich (1989). Data are mid-1988.
a. Required reserves are remunerated to some degree.
b. Applied against the increase in deposits since May 1984; the effective level of required reserves is close to 20 percent.
c. A small, variable and remunerated reserve requirement was introduced in May 1988.
d. 12 percent on demand deposits larger than $40.5 million.

The major concern of countries outside Europe is whether their financial intermediaries will be able to access, on an equal basis, the liberalized European financial markets. Community officials have always denied that market integration will result in protectionist measures. However, it is clear that, at least at the beginning, there existed some tension between the EC and its major commercial partners, namely the United States and Japan. Some mixed signals were coming from Brussels on the topic, suggesting that the admission of U.S. or Japanese financial intermediaries to the EC markets should not be taken for granted: "But it is important to remember that the GATT does not cover all international trade. Where international obligations do not exist, as for example in the field of services, we see no reason why the benefit of our internal liberalization should be extended unilaterally to third countries."[25] This point of view was reflected in the interpretation of reciprocity, to be

25. Speech by Willy de Clercq (at the time Commissioner for External Relations), "1992: The Impact on the Outside World," London, July 12, 1988.

found, for example, in the original proposal of the second banking directive. According to this first proposal, any request to a member state for establishment or participation by a third country bank was subject to prior review by the Commission, which, before granting authorization, would examine whether the credit institutions of the Community enjoy reciprocal treatment in the third country (Article 7). At the time, moreover, reciprocity appeared to mean equivalent treatment (that is, treatment equivalent to that foreign banks would have received in the Community) and not just national treatment (that is, treatment identical to that received by domestic institutions). This is an important distinction given the different systems (universal banking vs. separated primary or secondary market systems) that characterize the EC on one side and the United States and Japan on the other. Recently, however, the position of the Community has become more liberal. Article 7 has been revised, abolishing the requirement of the Commission's prior authorization. The interpretation of reciprocity is now that of national treatment: "The proposed changes to the directive send a clear message to our trading partners: that we welcome the establishment of their banks in the Community. We seek to hit back only if there is in effect national discrimination against us. . . . [A]ny country providing genuine national treatment to Community banks would be under no threat."[26]

A "Fortress Europe" in financial markets, therefore, does not appear to be a likely outcome of 1992. On the contrary, foreign institutions may be able to take advantage of the ambiguities and uncertainty in the fields of taxation and secrecy that are still unresolved in the Community.

Conclusions

Financial markets in Europe are highly regulated and distorted. Project 1992 will eliminate some of these distortions, but others, of similar importance, will remain in place. Basic application of the "second-best" principle suggests that an unambiguous evaluation of the welfare effects of the liberalization project is quite difficult.

But distortions aside, it may still be hard to demonstrate that financial

26. European Commission, Spokesman's Service, Information Memo P15, April 13, 1989.

market liberalization leads to large welfare gains. For example, Harold Cole and Maurice Obstfeld suggest that, from a general equilibrium point of view, the gains from the removal of capital controls are likely to be small.[27] They argue that movements in the terms of trade tend to pool national economic risk automatically and, in some cases, such movements can substitute perfectly for financial markets.

The extent of the gains may also be limited by the specific strategy that has been used to achieve unification. The mutual recognition and the home control principles will create a situation in which similar institutions will be operating in the same markets, but under different national regulations and controls, depending on their country of origin. Agents will thus have to collect information about several different types of legislation to take full advantage of the liberalized environment. While large companies and specialized institutions may find this fairly simple to manage, it may be too costly for small investors who, therefore, may not be able to benefit fully from the new opportunities available.

27. Cole and Obstfeld (1989).