

The Subordination of European Finance

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Introduction

The last fifteen years have seen the complete subordination of European finance to the globalised US financial system. This shift was supported enthusiastically by both political and corporate leaderships. Its consequences are firstly that European finance was as heavily implicated in credit crisis as was American finance and secondly that the Europeans are at a disadvantage in formulating a response to the crisis.

This does not mean that the Europeans were wrong to integrate and open their financial systems. The development of a global financial system posed a challenge that could not be met by the fragmented, particularist, national and regional systems of the past. However, the integration and liberalisation measures adopted by the Europeans were simplistic and reckless. The aim was simply to reduce financial transactions costs as quickly as possible. In pursuit of this objective virtually every aspect of social control was compromised.

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Americanisation of German Finance

In the 1990s virtually every member state government in the EU decided to complete the liberalisation of its financial sector and to promote the development of its security markets. The most significant of these moves was in Germany where it involved the dismantlement of a complex financial system centred on bank credit.

An important step in the abandonment of Germany's stakeholder financial system, with concentrated holdings, inter-firm linkages and the role of the banks as shareholders, was the abolition, by the Schröder government, of capital gains tax on the cross-holdings of equity by German banks and other corporations. This was to prepare the way for the dissolution of *Deutschland AG* (see Streeck and Höpner).

Data on actual ownership structures may overestimate the continuity of German finance: even before shares are disposed of, a bank might start to regard them as components of a portfolio rather than as supports for a long-term involvement in the enterprise concerned.

The long-standing complaint that Germany was unable to attract FDI proves to have been completely unfounded. The reality was that German proprietors were unwilling to sell – there was always a big potential market for German industrial assets. UNCTAD reports that in 2007, Germany received \$50 billion in FDI inflows – still behind the UK, France and Spain, but ahead of the other EU member states. The data on M&As also indicates that Germany now welcomes inward investment into major industrial companies.

The switch in German policy and objectives came late – the change was earlier in France and many other EU member states. However, the transformation in Germany

Finance and the Lisbon Strategy

At the end of a decade which culminated in an enormous financial crisis, it may be salutary to recall that the strategy (“Lisbon agenda”) adopted at its beginning by EU leaderships not only had the integration and liberalisation of European finance as a key theme, but specified its objectives directly in terms of the reduction of transactions costs. The Stockholm Council of 2001 repeated its endorsement of the strategy:

At Lisbon the European Council defined an **ambitious strategy for change**. A strategy to make the European Union by 2010 “*the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion.*”

Insisting on the “right regulatory environment” it spelt out the aims of the strategy in a notorious phrase:

“Business and citizens in the European Union need a regulatory environment which is clear, effective and workable in a rapidly changing, global market place. This is a key element if the European Union is to become the **cheapest and easiest place to do business** in the world.”

(European Commission, 2001, emphasis in original)

Subsequent events were to make it clear that cheap business is not always good business.

The Lisbon strategy was adopted at the height of the “new economy” euphoria in the US. The recent performance of the US economy seemed to have put an end to the long catch-up by EU countries. The rapid deployment of new technologies was seen as the basis for this reversal: the role of macroeconomic policies in sustaining US development, on the other hand, was not considered.

In retrospect the obsession with US productivity growth seems to have been something of a moral panic. The aggregate data on labour productivity trends concealed two important factors in the comparison of EU and US data.

Firstly, the surge in US productivity was heavily concentrated on a few sectors. The huge lead enjoyed by the US in retail distribution, for example, hardly seems to provide grounds for alarm among the Europeans. Secondly, the deterioration of European performance relative to that in the US is by no means EU-wide. A comprehensive study by O’Mahoney and van Ark (2003) showed that, on the contrary, it could be attributed to two countries, Germany and Italy, “with Germany about twice as important as Italy.”

Thus, there was little evidence of a Europe-wide problem. Nevertheless, Europe-wide institutional and policy reform was the solution. For example, the Sapir (2003) report, giving a first assessment of the launch of the Lisbon agenda, prescribed as follows:

The main reason for disappointing growth in the EU is quite clear. During the past decades, the economy has been confronted by a series of long-lasting shocks – the information technology revolution, German re-unification, the opening up to the new market economies of central and eastern Europe, globalisation – which called for new organisational forms of production. The situation demanded less vertically integrated firms, greater mobility within and across firms, greater flexibility of labour markets, greater reliance on market finance and higher investment in both R&D and higher education. In other words, this required massive change in economic institutions and organisations, which has

not yet occurred on a large scale in Europe.

(Sapir, 2003, p. 123)

In fact, the “disappointing” growth could also be attributed very plausibly to the long period of restrictive macroeconomic policies leading up to monetary unification, but this is not an acceptable thought in the EU. It remains the case, however, that US macroeconomic policies have been much more committed to growth and much less committed to price stability than have EU policies over the last three decades.

On the perceived gap, Joseph Stiglitz has recently commented:

Flawed statistics may also lead us to make incorrect inferences. In the years preceding the crisis, many in Europe, focusing on America’s higher rates of GDP growth, were drawn to the US model. Had they focused on metrics such as median income – providing a better picture of what is happening to most Americans – or made corrections for the increased indebtedness of households and the country as a whole, their enthusiasm might have been more muted.

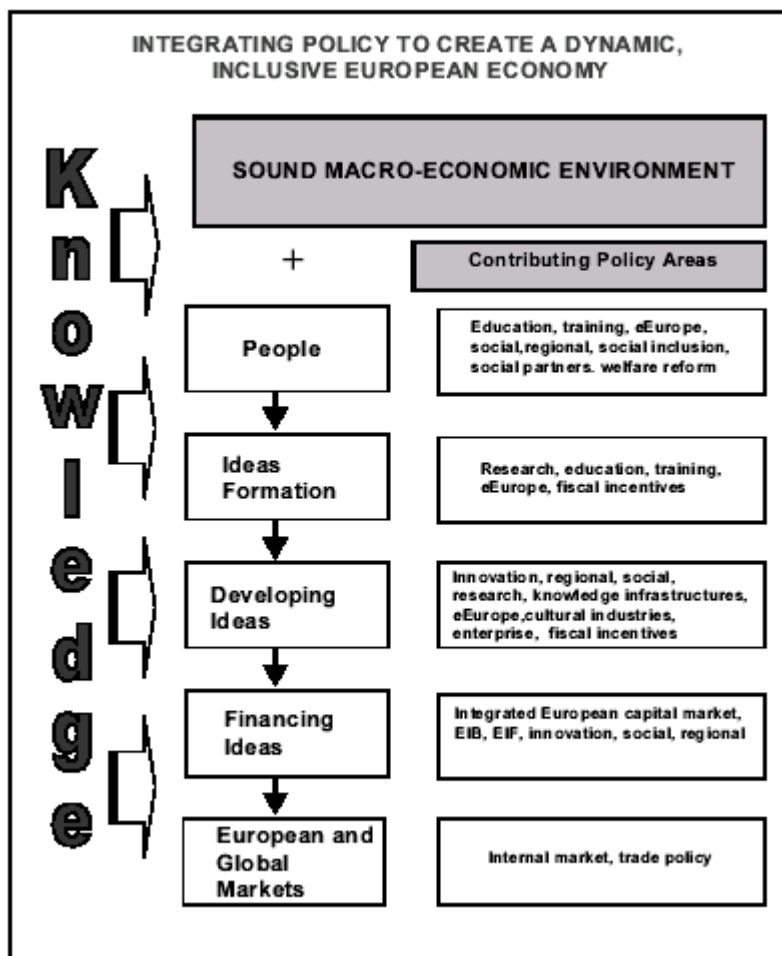
(“Towards a Better Measure of Well-Being”. *Financial Times*, 13th September, 2009)

On these somewhat flimsy foundations, the Lisbon agenda raised a comprehensive programme of institutional change. Finance was central to the agenda. It was thought that the more fluid and liquid US system, with its greater reliance on security markets, was a key factor behind its productivity performance. Europe should respond by integrating its capital markets and by removing administrative and legal obstacles to security trading. These measures would overcome the fragmentation and inadequate capitalisation of European equity markets. At the same time portfolio restrictions on pension funds should be removed: “if these funds in other member states were to reach the level achieved in the Netherlands, five trillion euro could be placed on EU capital markets” (European Commission, 2000).

No argument will be made here against the integration of European financial markets as such. On the one hand, the often-vaunted precision of certain European financial structures and practices (the local banks of the Italian industrial districts, the role of the banks in German industrial investment) was based on specific national or regional affinities and this prevented these systems from either combining their forces or expanding beyond their home bases. On the other hand globalisation trends in the world economy were supporting a massive expansion of the US financial system and it was important to meet this challenge. If the Europeans failed to build big liquid capital markets the consequence would be to drive every issuer and investor on the planet into the North American ones (Grahl, 2001). Such an outcome would not necessarily disadvantage the Europeans but it could mean that, as specialised financial functions were outsourced to US markets and corporations, the EU would lose influence over the evolution of the global system. There could also be a loss of income if Europe lost market share in a sector characterised by considerable market power and the associated profitability.

Nevertheless, although the integration objective was very reasonable, the way it was pursued (with D.-G. Internal Market leading the Commission’s drive towards unified financial markets) was much less so. The goal of the strategy became the simple reduction of transactions costs to the exclusion of virtually all other considerations and several public goods essential to the effective functioning of the financial sector were completely neglected.

Figure 1: Finance and the Lisbon Strategy



European Commission (2000) p10

FSAP and RCAP

The Financial Services Action Plan and the Risk Capital Action Plan were adopted before the Lisbon Agenda but became key components of it.

Market-led integration took priority over:

- a) **investor protection**; in fact user groups were hardly consulted until the FSAP was virtually complete. They were then extremely critical.

FIN-USE Critique: Benefits of Strict Protection Laws

□ In order to prevent the sale of “false” or unnecessary insurance – sometimes combined or “packed” with legitimate insurance products – consumer protection legislation and case law often guarantees that insurance must provide coverage of risks that the target group actually faces. These same laws specify “cooling off” periods (i.e., periods during which the purchase of insurance products can be cancelled without penalty) and set maxima for the length of time that buyers must pay insurance premiums.

□ In payment systems, some countries have created a right to a basic bank account for all citizens (including over-indebted individuals and those with very low income). In addition, some countries have placed restrictions on the ability of service providers to terminate payment services. These laws presumably reflect a societal belief that access to financial services should not depend only on the ability of suppliers to profit from service provision.

□ In securities markets, an increasing body of national law concerns the allocation of risk in particular investment vehicles. The idea is that adequate advice, informed by the individual financial situation of the investor, must be provided.

□ Laws against excessive pricing (including, for example, usurious interest rates, excessive fees for unwanted services and excessive penalties for exiting long-term contracts), predatory lending, fraudulent investments have a long history especially on the continent.

□ Laws that protect the elderly against fraudulent investment products.

Source: FIN-USE Forum (2004)

The lessons of British experience ignored: Treasury Select Committee, Myners Report on institutional investment, Sandler Report on Medium-Term Savings, work of Treasury Select Committee, any Sunday paper, any week.

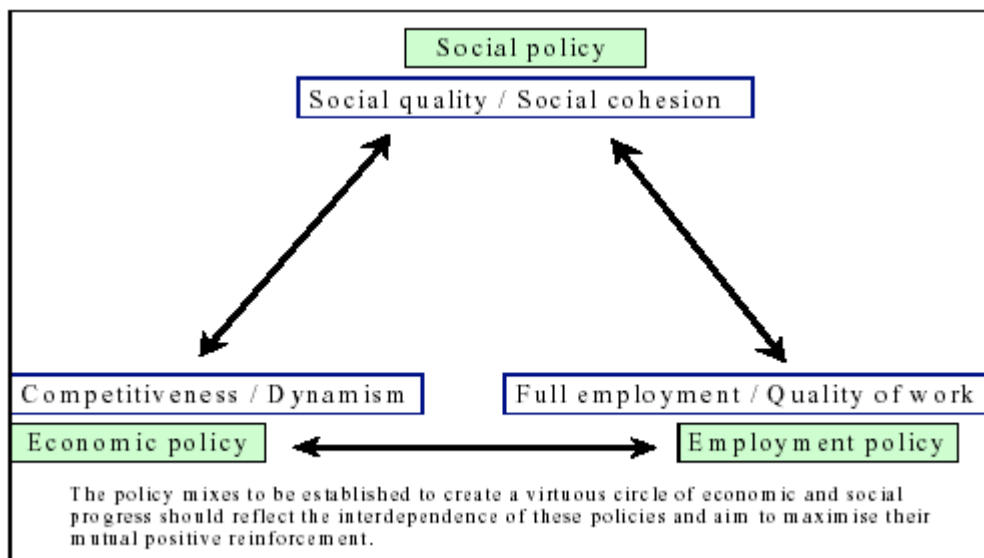
Attack on “gold-plating.”

Market-led integration took priority over:

b) Social Policy

Compare the EU Commission drive for “modernisation” of social protection, that is, introduction or promotion of market-based pensions.

Throughout the Lisbon Agenda, social protection is instrumentalised. It is valuable when it raises employment; otherwise, growth comes first: Social Policy and the Lisbon Strategy



European Commission (2000a), *Social Policy Agenda* p6

Market-led integration took priority over:

c) Stability

Alexandre Lamfalussy (former Director-General of BIS):

Lamfalussy draft report....“...greater efficiency does not necessarily go hand in hand with enhanced stability....Increased integration of securities markets entails more interconnection between financial intermediaries on a cross-border basis, increasing their exposure to common shocks....there is an urgent need to strengthen cooperation at the European level between financial market regulators and the institutions in charge of micro and macro prudential regulation.”

Response of Commission:

“It was politely but firmly suggested that we drop the subject.”

Mortgages – an embarrassing proposal

The shallow and mechanical approach to financial policy in the Commission is well illustrated by its abortive initiative on mortgages. When the legislative programme designed primarily to integrate wholesale securities markets was virtually complete, D.-G. Internal Market began to look for new market integration projects. It decided to press for integration of the mortgage market (*Green Paper: mortgage credit in the EU*, COM (2005) 327).

American practice was in the background here. One example was the view that with improved “risk assessment”, the risk capital required in the mortgage sector could be reduced (p11). Another was the belief that a big secondary market in mortgages was the way forward: “Many..... express the view that the further integration of the EU mortgage markets could be considerably enhanced by the emergence of a pan-European funding market” (p13). There is no hint in this document that a continent-wide secondary market in mortgages might pose certain informational difficulties and the word, “stability” does not appear in the *Green Paper*.

The usual tame contract economists were hired to give their blessing to this fatuous proposal. Their report (London Economics, *The Costs and Benefits of Integration of EU Mortgage Markets*, August 2005) sang the praises of the US system, including its sub-prime component: “US experience suggests that

- o Legal or other restrictions to banks’ geographical expansions will reduce the efficiency of the mortgage-lending industry.
- o Steps to create a single EU mortgage market would increase incentives to develop automated systems to process loan applications, which would reduce origination costs.
- o Removing restrictions on maximum mortgage interest rates would **allow a subprime mortgage market to develop**, thus expanding total mortgage lending.” (p168, emphasis added)

The long processes of development which have adjusted housing markets in different member countries to their specific social conditions and social priorities mean nothing to the officials of D.-G. Internal Market, who would sweep everything aside to build another, quite pointless, pan-European market. As late as February 2007, the mortgage proposal was still being promoted, but by the time of the *White Paper: on the Integration of EU Mortgage Credit Markets* (COM (2007) 807) at the end of the year there were signs of a reappraisal. The *White Paper* made the breath-taking assertion that “recent events in global mortgage markets have confirmed the pertinence of the approach proposed” (p10). Of course, the opposite is the truth – the whole D.-G. Internal Market argument was based on the supposed desirability of more product diversity, although product diversity was a key factor making US mortgage-backed securities opaque and risky.

In 2008, the theme of mortgage market integration has been quietly dropped – one has to look very hard to find it on the Commission’s web-site.

Huge Leverage of European Banks

A press release from D.-G. Internal Market and Services (27/2/2008) asserts that European banks are well capitalised: “The origin of the current financial turmoil came from the US sub-prime mortgage sector and a large portion of the European financial sector is not directly affected by the turmoil at this stage. Where financial institutions have sizeable direct exposures to the US sub-prime market, or indirect exposures through structured products, the affected entities have well diversified portfolios and large capital buffers.”

It seems that this is simply not the case. Daniel Gros and Stefano Micosi report that, “the dozen largest European banks have now on average an overall leverage ratio (shareholder equity to total assets) of 35, compared to less than 20 for the largest US banks.” These economists recognise that the leverage numbers reported to regulators are much lower, but they explain this by the “massive in-house investment banking operations of European banks” which “are not subject to any regulatory capital requirement.” They give the following figures for the leverage ratios of European banks as of 30th June 2008: UBS, 46.9; ING 48.8; Barclays, 61.3; Crédit Agricole, 40.4, Deutsche (2007) 52.5. (Gros & Micosi, www.voxeu.org).

This exceptionally high leverage translates into particularly high exposures to “toxic” assets. Wolfgang Münchau of the *Financial Times*, reacting to a recent IMF stability report, emphasised both the scale of these exposures and the fact that they had still not been written down by the banks concerned:

The most shocking news from last week’s excellent [Global Financial Stability Report](#) from the International Monetary Fund was not the headline estimate of total bad assets. That number stands at \$4,100bn (£2,800bn, €3,000bn) and will almost certainly be revised upwards. Much more shocking was that the lion’s share of these assets belong to European, not North American, banks. Of the total \$4,100bn, the global banking system accounts for \$2,800bn. Of that, a little over half – \$1,426bn – is sitting in European banks, while US banks account for only \$1,050bn.

Even worse, European banks have written down much less than American ones. According to Reuters, the US and European banking and insurance sector has so far written down \$740bn. More than 70 per cent of the write-downs come from the US. The eurozone’s share has been an appalling 14 per cent.

Another statistic from the IMF report: to recapitalise the banking system to reach capital ratios that prevailed in the mid-1990s, capital injections of \$275bn would be required for US banks, and a whopping \$500bn for European banks.

You get the picture. All these data tell us that Europe has both the biggest problem and has made the least progress.

Financial Times, 26th April 2009

In such a situation, it is surely unsafe to rely principally on US policies to stabilise the financial system and combat recession. Yet that seems to be what European leaders are doing. In Britain, the will to take decisive action is there, but not the means. In the eurozone, necessarily led by Germany, there is sufficient financial strength both to

stabilise the banks and to counter a damaging contraction of expenditure, but the will to do so is lacking.

Tensions in the Eurozone

Strong internal and external arguments for Eurozone expansion. On standard Mundell-Fleming lines, this might even strengthen the euro. Useful both to sustain EU employment and to ease adjustment of US position.

Institutions: no budgetary policy; no external policy (unless one is promulgated by the Council).

Aglietta and Berrebi: a “false monetary union”: no compensation for or correction of asymmetric developments.

Crisis management and rescue plans at member state level, uncoordinated or coordinated only in an *ad hoc* way.

General strength of the eurozone; but widening polarisation:

Pressure on German Wages

Nominal Unit Labour Costs (euros) 2000=100		
	Germany	Eurozone
1999	99.3	98.9
2000	100.0	100.0
2001	100.9	102.3
2002	101.8	104.7
2003	102.8	106.9
2004	102.8	107.8
2005	101.9	108.9
2006	100.9	110.0
2007	101.0	111.6
2008	102.3	114.3
2009	103.6	116.4

Current Account Imbalances

Current Account Balance (% of GDP): The Surplus Pole			
	Germany	Netherlands	Austria
1999	-1.2	4.2	-1.0
2000	-1.6	6.4	-1.0
2001	0.0	5.2	-0.3
2002	2.2	6.1	2.5
2003	2.1	6.1	1.4
2004	4.5	8.6	2.4
2005	4.7	7.1	3.0
2006	5.2	8.6	3.5
2007	6.9	8.4	4.7
2008	7.2	9.0	5.0
2009	7.3	10.0	5.2

Current Account Balance (% of GDP): The Deficit Pole				
	Ireland	Spain	Greece	Portugal
1999	0.3	-2.7	-5.7	-8.9
2000	-0.4	-4.0	-12.0	-10.7
2001	-0.4	-4.3	-10.5	-10.4
2002	-0.3	-3.8	-11.6	-8.5
2003	0.9	-4.0	-13.2	-6.4
2004	-0.3	-5.9	-13.3	-7.8
2005	-3.5	-7.5	-13.4	-9.8
2006	-4.2	-8.8	-14.4	-9.8
2007	-5.0	-10.0	-16.2	-9.8
2008	-4.8	-11.0	-16.2	-10.1
2009	-4.7	-11.2	-16.2	-9.4

Financial Divergence:

Eurozone Ten Year Government Bond Yields		
	London close 6/2/09	Change over Year
Germany	3.38	0.05
France	3.79	-0.03
Netherlands	3.97	0.23
Finland	4.05	0.19
Austria	4.27	0.29
Belgium	4.30	0.26
Portugal	4.45	0.37
Spain	4.49	0.60
Italy	4.56	0.14
Ireland	5.47	1.10
Greece	5.70	0.87

Can the EU make a coherent response to the crisis without addressing these disparities?

For both external reasons – to help ease the reduction of the US deficit – and internal reasons – to respond to a deep recession – there is a need for at least a temporary current account deficit in the eurozone. The aggregate strength of the eurozone would make this easy to finance when investors around the world are preoccupied with safety rather than yield. However, the acute imbalances within the zone make such a response problematic.

Twice in the era since the second world war, the extremism of German macroeconomic policy has led to international economic disruption. In both cases the consequences were eventually adverse not only for Germany's partners but for Germany itself. One of these episodes is well known – the crisis of the EMS in 1992 and 1993. The other European countries were trying to use a hard peg to the D-mark to bring down inflation. The Germans raised interest rates to 12%, making it quite impossible for their partners to continue this strategy even though inflation in Germany – supposedly the justification for the squeeze – was never above 4%.

It is less well known that Germany also had a hand in the Volcker shock – the very costly US credit squeeze in 1979 and the early 1980s which was carried out to stabilise the dollar on the foreign exchanges.

At the start of 2007, Germany raised its VAT rate from 16% to 19%, with a counterbalancing cut in social security contributions. The domestic rationale for this move is clear: to stimulate employment by cutting labour costs. In an international view the two moves, equivalent to a devaluation, might be regarded as very aggressive coming from a country with an enormous and growing export surplus.

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