The EU Single Market: Implications for Globalisation

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- Ladies and Gentleman,

- It is a great pleasure for me to address you here today, and a particular pleasure for me to be speaking to you at an event sponsored by Goldman Sachs JBWere.

- I am grateful to the European Australian Business Council for inviting me to address this event.

- For an international enterprise like Goldman Sachs, Australia is an important part of our global vision. Some of our most important clients are here and we need to be here as well, which is why we are enormously proud to have linked up with JB Were, a firm that has over 150 years of history and a track record of exceptional client service.

- Might I also say that as an Irishman and a keen rugby supporter, I am markedly less delighted to have landed in Australia just in time to witness Ireland's dismal thrashing at the hands of the Wallabies.

- I've been asked today to provide some personal reflections on the EU's single market programme, how that programme is relevant to the phenomenon of globalisation and where the EU's current efforts in the field of financial services fits in.

- I see European integration and globalization as two sides of the same process. One of the most compelling reasons for advancing further towards an 'ever-closer union' in Europe is the imperative need for an adequate response, and contribution to, globalisation. We have a very rapidly changing, unstable external world around us. The world needs a strong, stable and prosperous European Union not merely as an example but as a participant.

- As with European integration, globalisation is redefining our notions of sovereignty. No single government – even the strongest – can any longer control, by itself, the growing interdependence between economies. Cooperation amongst countries and regions is thus increasingly necessary to achieve social and economic objectives. Where governments can exert power, in many cases it is a negative power. Their actions can determine a whether a country or region will remain equipped to take advantage of globalisation that is to become winners or losers.

- There are several schools of thought concerning the mythology of globalisation. The first is that the process is simply a reflection of technological developments which have taken economic and other policy management out of the hands of government. Thus, telecommunications coupled with deregulation supposedly make financial markets almost uncontrollable, with developing countries too often the innocent victims as their currencies fall to speculation.

- The second is that it is a giant conspiracy between corporations, aided and abetted by governments and international institutions like the European Union, the International Monetary Fund, the World Bank and the World Trade Organisation. This notion was at the root of much of the protest in the streets of Seattle at the end of 1999 and at various subsequent meetings of international institutions.

- Neither of these theories stands up to examination. The reality is that globalisation is neither especially new - arguably the nineteenth century was more globalised than the end of the twentieth - or the result of any one easily identified trend. Rather, it is the combined result of many changes, some recent and some not so recent.

- It reflects the gradual decline in trade barriers through the efforts of regional and international bodies such as the European Union and the GATT and WTO over some fifty years. It reflects the only marginally more recent change from fixed to market-dictated exchange rates for the main currencies. And it reflects a twenty-year move away from government direction of economies to greater market orientation through privatisation and deregulation.

- What one can say is that all these processes and trends have made the world a very different place and it is clearly going to continue to change, perhaps at an even faster rate. The real challenge is making sure that we can sustain it without a retreat into protectionism or conflict.

- One of the positive influences, I believe, on the process of globalisation has been the effect of European economic integration.

- Without European integration we would not have had a Uruguay Round or a WTO and without these we would not have had globalisation as we have experienced it.

- Had the European nation states negotiated individually in global trade rounds we would still be talking with no end in sight and while some elements of globalisation might exist today, other components in the process would be absent.

- Today for the first time in the economic sphere we are living by rules interpreted by a system of adjudication. Whilst this system is not secured by a capacity to enforce WTO decisions through national courts (as is the case in the EU) it still represents a significant inhibition on the freedom of action of nation states. Sovereignty may not be challenged as directly as it is in the European Union but it is certainly subject to some limitations.

- Europeans were the first to learn to live with such constraints on our freedom of action because the benefits are clearly seen to outweigh perceived costs. European integration and the single market program are a conscious pooling of sovereignty.

- Increasingly in the EU national political priorities and economic policies have to be worked out in the context of, and constrained by, EU institutions and EU policies.

- The rules of the EMU Stability and Growth Pact are perhaps the most visible manifestation of this – even limiting the ability of governments to implement promised tax cuts and spending increases.
- The single market, with its strong emphasis on deregulation and encouraging competition, has already brought enormous benefits to Europe's economy.

- If one looked back to the late 1980s, nobody would have foreseen then what has been achieved in Europe in terms of liberalisation of the European economy.

- A single market, free movement of goods, capital, services and people and the creation of a single currency.

- Who could have believed that the European Commission, with its limited resources, could have driven a privatisation process that has increased competition in telecoms, financial services and, increasingly, the energy sector? This reform process is unprecedented in scale and scope, and without it, Europe would have become an economic backwater.

- However, the single market remains incomplete. It is particularly important to achieve a genuine single market for services. Key services sectors like energy, financial services and telecoms are "economic lubricants".

- They form a significant part of the cost base of most, if not all, economic activity. It is very difficult to have a competitive economy and globally competitive businesses if you are saddled with inefficient and expensive service provision.

- That is why the EU's efforts to liberalise these sectors and to open them up to competition are so strongly supported by businesses across the European continent and beyond.

- Competition policy is another fundamental aspect of the EU's economic governance. For business and the financial markets, the most closely watched policy area is merger control. But equally important, perhaps more so for the economy as a whole, are the constraints placed on governments by EU state aid policy.

- In an integrated market, there is, or should be, no room for distortive subsidies. One of the EU's major achievements in seeking to create a single market has been to tackle the practice of state aids to failing industries, a practice that is inefficient and costly to taxpayers.

- Competition is the driving force behind dynamism and innovation. Subsidies distort it, and only delay the necessary structural change. Moreover, subsidies granted by individual Member States or regions are simply not compatible with increasingly integrated markets.

- It is in the OVERALL interests of a competitive European economy to have state aid policed by the Commission. The Commission was entrusted with the role of supervising State aid, because only by doing so, would that supervision be exercised independently.

- In March 2000 at Lisbon, EU leaders committed themselves to a host of market-oriented economic reforms aimed at boosting the competitiveness of the EU economy and creating the world's "most competitive and dynamic knowledge-based economy" by 2010.

- Looking back to the mid-to-late 1990s, it is possible to recall the strong belief among European policymakers that a major reason for the EU's lagging economic performance (when compared primarily with the US) was the greater scale and efficiency of US capital markets and the EU's historical reliance on bank financing.

- The underdevelopment of funded pensions in most EU countries was identified as a major factor in this difference.

- The Commission's Framework for Action document of 1998 highlighted this difference, noting that stock market capitalisation in the EU (with the exception of the UK and Netherlands) pales into insignificance when compared to that of US. At that time, the figures were 32% of EU GDP compared to over 100% in US.

- The desire was to make listing and trading of securities cheaper so that more companies, including more small and medium sized companies would be able to tap the capital markets and raise capital directly from the markets.

- By doing so, a virtuous circle would be set in motion: cost of capital would be reduced, investment returns would increase, more savings would be able to be invested in the markets.

- European companies would be able to compete on more even terms with US firms if their financing costs could be reduced to similar levels.

- This belief was one of the motivating factors behind the conception and adoption of the EU Financial Services Action Plan, and explains the Action Plan's particular focus on “ensuring a single market for wholesale financial services”.

- A number of useful studies – most recently those by *London Economics* (on behalf of the European Commission) – have demonstrated the aggregate benefits for the EU as a whole if truly integrated financial markets can be delivered.

- To cite just a few figures from the London Economics study.

- As a result of the combined reduction in the cost of equity, bond and bank finance, together with the increase in the share of bond finance in total debt finance, <u>potential</u> benefits include:

    - An increase in EU-wide GDP of 1.1%, or €130 billion in 2002 prices, in the long-run;

    - An increase in total business investment of almost 6.0% and an increase in private consumption of approximately 0.8%;

    - and an increase in total employment of half a percent.

- There may also be further, less easily measured, benefits from the creation of a genuine single market in this area. For example cost savings arising from consolidation of Europe’s fragmented national banking sectors, or resulting from increased competition between providers, more innovative services, and so on.

- Clearly, such economic benefits would be incredibly positive not just to the EU, increasing its attractiveness as a target for investment, but to the world by increasing European demand and providing a boost to global trade and growth.

- So the instincts of those who first proposed EU action in this area have been borne out by academic research, if not yet by concrete results.

- The European Commission’s Financial Services Action Plan, published in 1999, was a package of reforms and new legislative initiatives with the ultimate goal of creating integrated European capital markets, and a single market in financial services.

- It is undoubtedly the case that increasingly the direction <u>AND</u> detail of financial regulation is being set at the EU level. This is a marked shift from what has gone before and poses a number of challenges for the EU, national authorise and industry.

- As Callum McCarthy, the new Chairman of the UK’s Financial Services Authority noted in his maiden speech earlier this month. The financial services industry in Europe faces, over the period 2004 to 2008, the task of implementing more than 14 major EU legislative measures. At least eight of these measures have completed the primary legislative process in the EU.

- These include, the International Accounting Standards Regulation and directives such as the Prospectus Directive, Collateral, Investment Services Directive and Market Abuse Directive.

- Each of these will require financial institutions across Europe to make substantial efforts to prepare for implementation over the next 12 months. Speaking as someone involved in the securities industry, I can testify to the significance of this project, its impact on the markets, and the importance that market participants therefore attach to getting the constituent legislation right.
- For each of these measures, the test the market will apply and the test that the EU institutions, particularly the Commission, should apply is:

  - will this proposal increase competition in the European financial markets?

  - will it reduce costs for issuers, intermediaries and investors?

  - does it further the Action Plan goal of creating deeper, more liquid, and more efficient capital markets in Europe?

- My overall assessment of those Action Plan measures which have been adopted so far or which are currently under discussion, if measured against this standard, is that they are something of a mixed bag.

- Some measures will genuinely further the integration of the EU's capital markets by providing greater legal certainty (e.g. Collateral Directive) or by making it easier to do cross-border business on the basis of home country rules (e.g. certain aspects of the Investment Services Directive and the Prospectus Directive).

- Others will raise regulatory and prudential standards, with the intention of increasing investor confidence in markets and financial institutions (e.g. Capital Adequacy Directive, Market Abuse Directive).

- However, I detect that for a number of initiatives, the original Action Plan goals of integrating markets, removing barriers, and allowing the full force of competition to be felt in this sector have been made subordinate to a tendency, particularly on the part of national authorities, towards overly prescriptive legislation and, in the extreme, protection of markets (or rather market participants).

- What still seems to be lacking is basic trust between national authorities in each other's ability or willingness to apply the rules as agreed.

- It is this lack of trust, which leads to situations like that which arose during discussions last year on the Prospectus Directive.

- Amazingly, in the context of a directive that introduces far greater levels of disclosure than had previously existed in the majority of Member States, it still proved incredibly difficult to reach agreement on allowing corporate issuers to retain the <u>existing</u> ability to decide which competent authority to apply to for review of their prospectus.

- Resistance to issuer choice stemmed almost entirely from unwillingness on the part of regulators to give up an element of control over "their" companies.

- Were it not for some clear headed decisions by a number of governments to overrule their regulators and take a more Single Market inspired position, we might have been facing disastrous or at least hugely expensive consequences for European corporate bond issuance.

- It is instructive to contrast this continued lack of trust between EU authorities with the forward looking approach adopted by the Australian regulator to permitting cross-border provision of wholesale financial services without licensing requirements – provided they are subject to regulation that ensures "sufficiently equivalent" outcomes to Australia's regulatory framework.

- Mutual trust and a desire to accommodate different market models have also been notably absent in the recent debate over the EU's new Investment Services Directive.

- Also missing from that debate has been the resolve to stand firm against regulatory protectionism and to focus on removal of barriers.

- The Investment Services Directive covers a range of critical issues ranging from the rules for stock exchanges and other regulated markets through to the "Conduct of Business Rules" governing banks' relations with customers.

- The draft text was, in most respects, a well thought through and balanced document that benefited hugely from the extensive consultations undertaken by the Commission prior to publication.

- In my view, however, some of the proposed provisions run the risk of inappropriately prescribing the structure of EU securities markets.

- This was true of the Commission's original proposed treatment of off-exchange share trading, which is my view was a clear case of precautionary and ill informed regulation.

- In particular, by penalising firms that provide liquidity to their institutional clients – they ran the serious risk of reducing overall market liquidity in Europe.

- Despite improvements to the proposal made by the European parliament and, to a lesser extent, member governments, there is a distinct possibility that the ISD will raise trading costs for institutional investors and thus defeat one of the purposes of the Action Plan.

- Making it more costly for investors to enter and exit large trading positions will eventually make Europe's capital markets less attractive – thus increasing the costs for European companies wishing to raise capital.

- Such an outcome flies in the face of the overall objectives of the Action Plan and, it is to be hoped, can still be avoided.

- It is crucial that in negotiating the final shape of the Investment Services Directive, or any other Action Plan measure, no additional requirement be regarded as "cost free". There is always a cost attached to regulation, particularly when that regulation stands in the way of true competition.

- As the EU has worked its way through the Financial Services Action Plan, the extent to which the financial markets, particularly at the wholesale end, are already globalised has become apparent.

- I think it is fair to say that this is a factor that was not fully understood or appreciated by policy makers. In particular, the extent to which foreign companies issue non-equity securities in the EU was initially not well enough understood and came as something of a revelation to many.
- However, it is a fact that international business understands very well.

- 19 Australian companies have equity listings on the London Stock Exchange. And I am sure many more rely on the Eurobond markets for debt issuance programmes.

- And yet the international bond market is the one area where the EU can genuinely claim to have a lead on the US.

- It is imperative therefore that Action Plan measures not erode the competitive advantage presently enjoyed by the EU in this area.

- Too many Action Plan measures have insufficiently taken into account the specificities – not the mention the largely professional nature – of the debt markets.

- Protection of retail investors is obviously a legitimate policy objective of the EU.

- However, I must say, there has been a tendency in directives like the Prospectus Directive and the snappily named:

- "Directive on Transparency Obligations of with securities admitted to trading on a regulated market"

- to think always in terms of plain equity securities and then to apply the sorts of protections that might be necessary for investors in such securities to the full range of financial instruments.

- It is all very well to say that all issuers of securities in the EU should meet the same standards of transparency. But when over half of your market is made up of issuance is by foreign issuers, and when meeting the same standards might mean restating your accounts under a different accounting code, then Europe runs the risk of simply putting issuers off.

- So what is the solution? Increasingly, I observe that the EU and governments around the world need to step carefully when drafting legislation and regulations for what is now a global financial services business.

- We need to try to do better to avoid unintended consequences or to introduce complexity that can impose excessive cost. We need to consult more closely with other jurisdictions and with business on the underlying purpose of regulation.

- The Commission, in particular, has a duty to ensure that proposed regulations are formulated with a view to ensuring a high standard of quality. If achieving quality takes more time and consultation it should allow this. A tick box approach based on artificial political timetables will not increase credibility and as has been shown in some instances will do more harm than good. On the other hand, where the Commission stands by a quality solution, then Europe and the world will benefit greatly.

- Business and government must maintain regular communication and dialogue on key economic and financial issues. We must ensure that effective mechanisms exist to reduce and resolve strains where they exist and encourage mutual recognition and convergence on regulatory best practice.

- An important phase of work is reaching an end. Though further initiatives in the field of financial services will undoubtedly be brought forward. It seems unlikely that a second action plan will be required.

- Over the next 12 months, the EU will have to decide how it builds on the work already carried out in the Action Plan.

- Only by focussing on the international competitiveness of its financial markets will the EU ensure that they are capable of being even more important to the global economy.

- Ladies and Gentlemen, this is something I lend my wholehearted support and backing to.