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New Financial Markets in Euroland: On Conceiving and Implementing a Blueprint

> *Europe, the ancient bastion of chauvinism, economic protectionism, fragmented markets,....was changing fast into a powerful, streamlined, semi-Americanized, market-valued version of itself.*
>
> Ingo Walter and Roy Smith 2000

I. 'Exercise in European Governance'

Ever since the Treaty of Rome of 1957, the integration of capital markets has been a chief objective of economic policy in Europe. Among the milestones along the way to the latest project – the Financial Services Action Plan (FSAP) of 1999 – was the Segré Report of 1966, which anticipated to a large degree the ensuing (de-)regulatory initiatives that finally ushered in the White Paper approach of 1985. Its underlying philosophy was to produce contested markets. As a result, the position

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[*] To be published in Jean-Philippe Touffut (ed., 2005): *The Instability of Finance. Lessons from European Integration*, Saint Gobain Center for Economic Studies Series (edited by Robert M. Solow), Edward Elgar: Cheltenham. This paper is written in a purely personal capacity. It is not exclusively positive and technical, but substantially normative. Given such conditions one should, as the great Swedish economist Gunnar Myrdal argued, lay bare one's premises. We do have a deep respect for markets, that is, a supply and demand driven allocation of resources (and claims on future resources, that is financial assets). The burden of proof therefore should always rest with those who propose intervention. This principled, pro-market perspective, however, is tempered by the limitations financial markets, in particular, sport at times – negative externalities, asymmetries of information and a lack of competition or contestedness (and hence the problem of market power). Those are the canonical reasons why public policy comes into play. This philosophy has been convincingly formulated in the US Council of Economic Adviser's 1997 *Economic Report of the President*. It holds that 'government [should] recognize both the market's efficiencies *and* its imperfections….Government has [as well] its strengths and its limitations. We need to understand those limitations and, where possible, work to improve government's performance…'.

of final users of capital markets (that is to say, investors and borrowers) was to be improved in a number of ways.

First, their respective choice sets were to be broadened. Second, the services offered were to be made available at lower cost. In fact, Article 8a of the Single European Act essentially reiterated what the Rome Treaty already tried to achieve – namely the creation of 'an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured'.

The European Economic and Monetary Union (EMU) – the Europeanization of monetary policy – was perceived as a logical corollary of the Single Market, essentially its capstone. The official case, as programmatically rendered in the EU Commission's study One Market, One Money from 1990, starts from the observation that foreign exchange markets are too volatile and too prone to misalignments to warrant a policy of benign neglect. It is interesting to note in passing this (rather implicit) reliance on the 'market failure' argument as the chief reason for championing the single currency. From a conceptual angle, the official view – subscribing to the Mundellian 'Unholy Trinity' argument – alludes to the fundamental incompatibility between the freedom of capital movements (as the Single European Act called for), the commitment to stable intra-European exchange rates (as enshrined in the old European Monetary System), and the existence of autonomous, national monetary policies.

Be that as it may, the introduction of the Euro has placed the financial sector under substantial pressure to adjust. Obviously, not everything happening in this sector is an immediate consequence of a shrinking currency universe. Moreover, a variety of strategic reactions have already been set in motion by an institutional precursor, the common market project. This holds in particular true for the Second Banking Directive, the Investment Services Directive, and related regulations. Nonetheless, against the context of setting the stage for the EMU, this process of restructuring financial markets has substantially gained speed. Starting from the diagnosis that their integration was still found wanting, in 1999 the EU embarked on its 'Financial Services Action Plan', comprising some 40 regulatory projects, ranging from rules for pension funds, prospectuses, and takeover guidelines to clearing and settlement.

In order to complete these projects by 2005, processes of policy formation – where issues of substance are always involved – were streamlined following the propositions of the Lamfalussy group.

Moreover, the financial sector has to cope with two additional change factors. One consists of dramatic cost reductions in communications technology, effectively reducing economic distances and spawning an ever greater integration of markets (as measured by shrinking interest spreads and increased return correlations). In addition, and equally significant, the enhanced cross-border integration of the financial market is, to a substantial extent, the consequence of a broad-based application of inventions in analytical constructs. These are, in particular, portfolio optimization along the lines of equilibrium models (as developed by Henry Markowitz, James Tobin and William Sharpe in the late 1950s and early 1960s), and the valuation of contingent claims by means of option-pricing models; here, of course, Fischer Black, Myron Scholes and Robert Merton broke ground in the early 1970s. The diversification concept was decisive for systematically broadening the horizon in asset allocation decisions. The pricing of contingent claims, perhaps even more powerful, allowed for the comparison of an increasing variety of cash flows to take place against a common benchmark.

This paper, however, focuses on the politics of EU financial law-making. This process has been frequently rendered as cumbersome and arcane. As a prime example, the debate on the takeover directive is habitually mentioned. Hence, a widely shared diagnosis states that, '[t]he central problem can be summarized quite simply: the current regulatory system is not working; it is too slow and too rigid, produces too much ambiguity and fails to make a distinction between core principles and detail'.[1]

It was in fact from here that the Wise Men's Committee, chaired by Baron Lamfalussy, set to its task of making recommendations on how to overhaul the European system of rule making in the area of securities business with an eye on 'im-

[1] See Lamfalussy, Alexandre (2001), 'Reflections on the Regulation of European Securities Markets', *SUERF Studies*, No. 14, p. 10.

prov[ing], as speedily as possible, the legislative process and, by implication, the regulatory structures'.[2]

The Committee's proposals have been much lauded and, following its chairman's judgment, 'some 90 to 95% of (its) recommendations' were approved by the European Council in Stockholm in 2000. The institutional structure, as suggested by the Committee for the legislation and rule-making in the securities area, directly flows from its diagnosis of prevailing dysfunctions: the poor working of the system was, according to this analysis, caused by three core elements: (1) the failure to make a distinction between primary legislation and secondary implementation, which swamped lawmakers with details and technicalities thereby overtaxing their capacity to pass sensible judgment; (2) as concerns the 'standard-production' level, the lack of consultation with those immediately concerned produced rules which were impractical; (3) finally, the opaqueness of the legislative structure created a 'debilitating effect on the quality of the legislative process' in particular through 'reciprocal concessions in [...] field[s] totally unrelated'.[3]

The Wise Men came up with the well-known four-level approach. The first level involves the remit of politics. Here, the so-called core principles are deliberated. Then, on the second, more 'engineering' level, experts from the national securities regulators deal with the details of standards to be implemented. At this echelon, two Committees – one in a rule-devising ('comitology') and the other in an advisory capacity – operate to take care of technicalities. The Wise Men suggest, however, that the European Parliament should be kept fully informed. Level three, then, is about generating a common interpretation for guiding day-to-day operations, with the aim of achieving convergence across Europe in terms of the actual application of regulations and directives. Finally, level four involves enforcement and compliance.

This set-up has been implemented in the securities field (and meanwhile tested in a number of cases). The Parliament approved this general approach in its resolution of 5 February 2002 – with one proviso, that is, the request for a treatment at Level

[2] Ibid., p. 12.
[3] Ibid., p. 18.

Two equal to the one extended to the Council. Meanwhile, in December 2002, the Council suggested taking the Lamfalussy approach (LA) as a blueprint for the over-all architecture of committees for banking, insurance and investment industry in Europe. The Commission's response to this proposal was positive.[4] Thus, the Wise Men's judgment was prescient when they stated: 'In short, we [the Wise Men] felt ourselves drawn into an exercise in European Governance'.[5]

While agreeing with the view that the LA opens up possibilities for improving EU rule making in the financial area, the aim of this paper is to address some of the queries that could be leveled against this arrangement. The LA is obviously about more than procedural issues. In alluding to three 'case studies', this paper pinpoints possible problems with the proposed institutional set-up. As a result, it seems to be sensible to debate an augmentation of the LA: that is, in order to legitimize and to control the application of allegedly purely implementational technicalities, Parliament should be in a position to recall Level-Two proposals. Moreover, given the politics involved even in purportedly technical issues, it appears to be advisable to inform the policy-formulation process with the input of disinterested positions. The following section, however, begins with a functional, and at the same time, normative issue – speed of reaction versus adequacy of rules – which has had a decisive influence in shaping the Wise Men's suggestions.

II. Politics of procedures

Raising the question about speed versus adequacy might appear as a debater's point. Obviously, however, what is of importance is the quality of the rule making. On the other hand, both the slowness and the rigidity of the European regulatory system have been addressed as major impediments to the integration of European financial markets, as well as barriers to all the welfare-enhancing effects which possibly flow from this.

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[4] See COM(2003) 659 final.

[5] See Lamfalussy, ibid., p. 12.

Thus, if tardy processes come with such high opportunity costs, then where does this slowness emanate from? Of course, one reason for reluctance to change might be the resistance of prospective losers (from their perspective: rational) from an overhauling of the system. Slowing down adaptation translates for these groups into the defense of their access to real sources of income. Then, however, when, from a general point of view, proposals would produce net (societal) benefits, it is in the 'collective' interest to overcome those forces of opposition.

Another reason for resistance to change might come from different judgments about what the optimal policy is. The Wise Men explicitly show that they are in favor of a capital-market-oriented system. This is a view in the martially portrayed 'battle of systems', which one can obviously argue, but which is, for sure, not generally shared.[6] At the same time, it is a core plank in the purportedly exclusively procedural argument of the Wise Men. Thus, it has implications in a number of areas – from pension funding to corporate governance, to issues of financial market stability. Obviously, the Wise Men's positions are not beyond or above critique. Moreover, since financial sector institutions are societally embedded, a reform in the financial sectors spells adjustment requirements in numerous other areas. Therefore, any policy assessment has to account for the larger, encompassing range of consequences.

Hence, this debate is, most emphatically, not about innocent procedures. In fact, here we are deep in politics. Interestingly, 'politics' has become a notion that has taken on pejorative connotations. However, in a society with a pluralistic set-up of preferences and interests, it appears to be perfectly legitimate to come to different views and conclusions about the appropriateness of specific policy suggestions. That is *the* reason why the Parliament's request for equal treatment with regard to Level-Two proposals is deemed to be well founded.

Even in financial matters, one simply does not deal with physical phenomena, which can be described by (simple) equations, and for which categories of true/false are applicable. Instead, the conflict between justifiable interests must be resolved by political process. Realistically, in such an environment pork-barreling is inevitable. Therefore, it is difficult to accept when experts claim technocratic virtue while devising policies (with clearly non-Pareto optimal outcomes, that is, favoring some at the expense of others). Technocrats overreach their competence when they deal with political issues in a true/false way in lieu of a discursive or normative mode. That is exactly what the call for democratic control is about.

The technocratic pretense is, however, somehow inherent in the LA distinction between Levels One and Two. In fact, political issues, such as the distribution of incomes and rents, are frequently decided at the implementational level. It is thus here where the lobbying of interest groups should be expected to be most forceful and ultimately effective. Curiously, the political economics of finance is an approach that has been very much neglected.[7] In this area, however, as in many others, 'Schattschneider's law' probably holds: while, overall, interests supporting and opposing a legislative proposal might be balanced, Schattschneider observed in his case study about the introduction of the (obviously very detrimental) Smoot-Hawley tariff in the early 1930s that the 'pressures on Congress are extremely unbalanced'[8].

What counts is not the virtual – in the aggregate – balance of interests, but the real dispersion of those interests, that is, their factual imbalance. Hence, the most forceful attempts at influencing a policy outcome will come from special interest groups that are particularly implied by a proposal. The imbalance in intensity or concentration translates into clear incentives in terms of lobbying activity. In the domain of finance, it is palpably the suppliers of those services who have most at stake individually. At the same time, consumers' interests appear to be much more diffuse and, as an upshot, less influential policy-wise. Ideally, the Parliament, therefore, is assumed to cater to the common weal and, in particular, to consumer interests in or-

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[6] On this debate, which was reopened in the wake of all the recent failures in the US system, see, for example, Story, Jonathan and Ingo Walter (1997), *Political Economy of Financial Integration in Europe. The Battle of Systems*, Cambridge: MIT Press.

[7] See, however, for example, Hellwig and Martin (2000), 'On the Economics and Politics of Corporate Finance and Corporate Control', in: Xavier Vives (ed.), *Corporate Governance: Theoretical and Empirical Perspectives*, Cambridge: CUP; Pagano, Marco and Paolo Volpin (2001), 'The Political Economy of Finance', *Oxford Review of Economic Policy*.

[8] Schattschneider, E. E. (1935), *Politics, Pressures and the Tariff*, New York: Prentice-Hall, p. 285.

der to rebalance the political background conditions. Obviously, consumer interests are particularly implied at the operational level.

III. Technocratic politics

The procedural reforms, as suggested by the EU Commission, at the end of the day try to promote the integration of European financial markets. It is held that all sorts of benefits will flow from this in terms of a more efficient allocation of capital and thereby ‘contribute to stronger growth and employment’.[9] Qualitatively or directionally this judgment will most probably be correct. But it is easy to exaggerate effects quantitatively. The point to be made here, however, has to do with possible illusions being implicitly nurtured by some of the arguments that are put forward in a fundamental mode to make the case for a re-engineering of legal procedures, in other words, their technocratization.

In the absence of barriers to arbitrage, financial flows should establish (the law of) one price for claims on future cash flows with identical attributes (expected yield, default risk, term to maturity, covariance of expected return). As Alfred Marshall wrote: ‘the more nearly perfect a market is, the stronger is the tendency for the same price to be paid for the same thing’.[10] But that is, in fact, something we do not even see in the national context, not even in the case of commodities where differential costs about obtaining information are almost negligible. Therefore, in the domestic environment, even though the legal and institutional backdrop is essentially one and the same, there is still a fair degree of price dispersion. The law of one price cannot be regulated into being.

Indeed, the failure for the principle that marginal costs should equate prices to hold is largely documented empirically. It is one symptom, and at the same time, a metric of market power. With demand being in our case rather inelastic, the influence of suppliers over market outcomes is buttressed. That is, even when markets are

[9] See Lamfalussy, loc. cit., p. 11. Here it is even claimed that ‘enhanced liquidity (…) will benefit all companies and most especially SMEs’. The latter suggestion is particularly difficult to accept.

perfectly contested, price dispersion can be maintained. Generally speaking, if the gamut of substitutes is compressed, the monopoly power of suppliers is buoyed. This market-power reducing effect has, in fact, always been the basic argument in favor of the integration of European markets.

This has practical implications: a low elasticity of demand can be portrayed differently – as substantial inertia on the side of consumers. To take one example, according to a study by Deutsche Bank's European Equity Research, '[i]n stock-market terms this means [that] over 43 % of the [big UK retail] banks' value relies on customers lacking the will to find a better deal'.[11] Enhanced competition would, of course, as this study clearly bears out, chip away at the market value added of those banks. As Marshall wrote, however, 'the special charge on account of delivery', which consumers are prepared to pay in view of further conveniences they derive from an ongoing relationship, will not be squeezed to zero. With regard to the integration of European financial markets, the chief objective should therefore be to increase substitutability between instruments and markets in order to fill, using a metaphor of Joan Robinson from the early 1960s, the gaps in the chain of substitution. We will, however, probably never see the law of one price hold for financial markets all over Europe.

A further unit of measurement that is frequently used to judge the degree of integration is the number of cross-border mergers. Indeed, in particular in retail banking, the market's geographical reach is currently still rather small. New technologies of delivery notwithstanding, distance still seems to matter. While the relevant dimension of markets appears to increase, national borders (which are often language borders as well) make a difference. From a public policy point of view, what therefore is important for the conduct and performance of banks is the structure (concentration) in regional markets. It is against this background that the consolidation movement in European banking should be judged. In other words, from a consumer's point of view, financial consolidation could also produce negative results. This might, at times, even hold true for the stakeholders in those merging/consolidating institutions.

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[10] See Marshall, Alfred (1920), *Principles of Economics*, Vol. 1, London: MacMillan, p. 325.

[11] See Giedroyc, Miko *et al.* (2000), 'Spotlight on UK Banks', *Equity Research*, 20 January 2000.

Indeed, since economies of scale and scope appear to be rapidly exploited – giving way to diseconomies of scale – it comes as no surprise when 'the literature has failed to find convincing evidence of [the] advantages and thus questions [as to] the usefulness of M&As'.[12] Empire building and increasing market power are, from a welfare or policy point of view, clearly detrimental. That is why concentration, which in some public circles is sometimes viewed as positive, in light of standard economic arguments, poses problems. Contrary to numerous statements, therefore, analytical approaches do not unequivocally qualify consolidations – even when they are cross-border – as a healthy outcome. (The dismal science, in fact, is happy to tell that in the long-run equilibrium, the optimal number of firms will make short-run firm profits zero.) As a rule, economists admit to their preference for entities with a minimum efficient scale. According to this argument, small is beautiful – even in banking. It reduces market access problems for small and medium-sized companies, and it can provide a region with a valuable reservoir of know-how.[13] Proximity appears to be an asset, and distance seems to increase transaction costs.

IV. Political technicalities

In this section three case studies are briefly sketched to illustrate the central point of this paper: implementation is about politics and, hence, should not be placed beyond the scrutiny of the Parliament. Here non-procedural issues (of economic substance) are addressed since they form a core plank for the Wise Men's general approach.

Pension funding. The Wise Men's report – echoing a number of official positions as well as some private sector views – states that 'the inadequate development of funded pension schemes in most member states' is one of the five decisive barriers to 'the development of European securities markets' (p. 10). This might be the case, a critic could respond. But the ultimate purpose of pension funding is a reliable funding of retirement income, not developing European capital markets. Only inso-

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[12] See Focarelli, D., *et al*. (1999), 'Why do Banks Merge?', in: Banca d'Italia, *Temi di discussione*, p. 10.

far as capital markets contribute to this objective, future retirees might take an – indirect – interest in their development.

While such a proposition appears to be no less than self-evident to the Wise Men, a funded retirement system, relying on investments in stocks and bonds, is not dominating the pay-as-you go system. In fact, when comparing the two systems from a theoretical angle, one ends up with equivalence theorems and, therefore, arguments for a diversified system. The return on a (mature) pay-as-you-go system equals, as Paul Samuelson showed in 1958, the growth in employment plus the gain in real wages, which, over the long haul, equals the growth rate of GDP. The return on investments, on the other hand, equals roughly the real rate of interest, which cannot evolve too far away from the growth of real output either. In both systems, future retirees hold a real option: a claim on a future GDP, yet to be generated.

Thus, the issue here is whether funded systems unequivocally dominate a pay-as-you-go approach in terms of risk and return. This is a question to which empirical work can contribute. Here, however, the data might be sobering to the Wise Men. 'Financial Archeology', as practiced by Philippe Jorion and William Goetzmann, shows that between 1921 and 1996 the best performing market – the US stock market – produced a 4.3 annualized return.[14] This was, for sure, a bit more than the pay-as-you-go system could deliver; it was not, however, dramatically higher, as far too many financial analysts wanted to make us believe during the heydays of the recent stock-market bubble. On the other hand, and most importantly, the collective insurance scheme has been more stable. (And, from an investor's, and in particular a retiree's perspective, it is *risk-adjusted* returns that count.) Then, the actual outcome of a retirement savings plan, as a result of the variability of financial market returns, is largely driven by the time period during which one invests – that is, by luck. A defined-contribution plan thus carries a substantial shortfall risk. That is exactly the major advantage of a pay-as-you-go system, because it makes it possible to spread risk over a larger population and over time. Through the 'generational contract' it allows for time diversification, something that is beyond the individual capacities of

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[13] See Drèze, Jaques (1999), *Piccolo è bello. Anche per le Banche. Potrà Durare?*, p. 424.

us mortals. (All of this makes the current author a defendant of a mixed system with a dominating share of pay-as-you-go.)

This paper lacks the space to go deeper into these issues, but return expectations have frequently been much too optimistic.[15] In fact, from there flow a number of more basic concerns. In particular, the underfunding of pensions, by which three-quarters of the S&P 500 companies seem to be threatened, poses a major problem for the US Pension Benefit Guaranty Corporation. This even leads not exactly disinterested institutions to raise the question of whether 'pension funds [should] invest in equities'.[16] Indeed, a whole roster of accounting queries still awaits a viable answer. And those issues, evidently, do have macro, or societal, effects, for example, on the level of share prices. This is the conclusion of Coronado and Sharpe's (2003) careful study, which produced evidence that accounting for the very optimistic evaluation of net pension assets most probably buoyed the stock market bubble.[17]

In other words, what is rendered as an unassailable and above-politics diagnosis – the need for funded pension schemes – is the subject of an intensive academic debate. And here, the political arena cannot be avoided (*nota bene*: not negatively loaded). As Gary Burtless holds – basing his argument on that of Peter Diamond (MIT), one of the most important scholars on these questions – '…the main issues dividing supporters and opponents of privatization (of the retirement system) hinge on political rather than economic considerations'.[18]

The appropriate arena for politics is the European Parliament. This is particularly important for pension funding, due to the systemic implications that result as a logical corollary: an increased institutionalization of the capital allocation system (that

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[14] See Jorion, Philippe and William Goetzmann (2000), *A Century of Global Stock Markets*, NBER Working Paper No. 7565. Their central result is that one falls prey to a selection bias if one does not acknowledge the much less impressive results of the overall, worldwide developments.

[15] See Diamond, Peter (2000), 'What Stock Market Returns to Expect for the Future', *Social Security Bulletin*, 63 (2), pp. 38-52.

[16] See Cooper, Stephen and David Bianco (2003), 'Should Pension Funds Invest in Equities?', *UBS Global Equity Research*, 4 September 2003.

[17] See Coronado, Julia and Steven Sharpe (2003), 'Did Pension Plan Accounting Contribute to the Stock Market Bubble?', *Brookings Papers on Economic Activity*, pp. 323-371.

[18] See Burtless, Gary (2000), *Social Security Privatization and Financial Market Risk*, Center on Social and Economic Dynamics, Working Paper No. 10.

is, disintermediation), the resulting questions about financial market stability, and so on.[19]

Bank regulation. In the same vein, an apparently technical issue like capital requirements is highly politically loaded. One would be very much tested, to take an important example, to explain the movements in the shape of the risk-weight function, serving to calculate capital requirements in the new Basel II rules. Obviously, this formula has substantial consequences for funding costs, in particular those of small and medium-sized companies. In the new environment, small business credit might become less information- and relationship-driven and more transaction-oriented. Such relationship loans, however, are particularly adequate for the more opaque SMEs, that is, those businesses with high information compactedness. As a result, these smaller and medium-sized enterprises might have to cope with higher costs of external funds and, possibly, market access problems, particularly in less benign cyclical environments.

Those formulas – as their over-time-substantially-changing shape amply proves – do not fall from mathematical heavens. Indeed, the devil is in the details – details, which are highly political.[20] Technocrats, unless they can claim to be Platonian philosopher kings, do not have the legitimacy to settle cases in these issues. Technocratization amounts to de-politization of questions that are inherently political.

Another topic should be briefly alluded to since it might have an impact on the way national regulatory institutions need to be adapted. Over the last couple of years, at least in the European context, the concept of a supervisory and regulatory authority that deals with all financial sector institutions, with no regard to their specialization, has gained ground. Yet again, this approach is not beyond doubt. Bank supervision and monetary policy do show a high degree of complimentary. Stability-oriented monetary policy and bank supervision are joint products. Therefore, 'it is surprising that many countries have sought to reduce their central bank's involvement in bank

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[19] On these topics, see Borio and Claudio (2003), 'Towards a macroprudential framework for financial supervision and regulation', BIS Working Papers, No. 128.

[20] See Kupiec, Paul (2001), *The New Basel Capital Accord: The Devil is in the (Calibration) Details*, IMF Working Paper 01/113.

supervision'[21]To underwrite financial market stability and control systemic risk, a central bank must be deeply knowledgeable about what is happening in the markets.

Micro-structure of securities markets. In academia there is an intensive debate about the relative merits of call auction versus continuous markets. Clearly, sensible and respectable people are on both sides of the issue. When it comes to practitioners, however, it is easy to tell their position from their affiliations. In other words, here again, technical issues appear to be politically loaded.

The notion of the standard (or normal) market size (Schwartz, 1994) was introduced into the debate on the Investment Securities Directive (ISD): this concept was used by (amongst others) the 'Elwes Committee' (March 1990) – a UK commission created to end the 'price war' starting on the London Stock Exchange in August 1988. The aim was to replace the classification of shares into alphas (that is, the largest, most liquid stocks with a minimum firm quote size of 5000 shares), betas (next group of less liquid stocks with a minimum firm quote size 1000 shares), and so on, in order to define for individual securities the threshold for partial suspension of (or delayed) trade reporting. (Incidentally, at that time the retreat from transparency was criticized as blatantly unfair and an attempt at restricting competition.)

Empirical research on the price aggregation consequences of the micro-structure of markets – building on a theoretical model by Glosten and Harris (1988) to differentiate between permanent and transitory as well as trade-induced changes in prices – has shown that those trades below block-trade size produce the most significant price impact. Mid-size orders, however, would be excluded if firm bid-offer quotes had only to be posed for retail-size orders. The information content of quotes would hence be substantially reduced. (The importance of mid-size order flows is the upshot of institutional investors' trading strategies to split up blocks.). In a context with asymmetrical information, information (beyond the purely fundamental one) can be gleaned from the respective market participants as well as from the direction of the trading (buying or selling). Basically, the debate is about how to provide depth – that is, tighter spreads (as a result of prices in close neighborhood to the

[21] See Peek, Joe *et al*. (1999), 'Is Bank Supervision Central to Central Banking?', *Quarterly Journal of Economics*, May 1999, pp. 629-653.

equilibrium quote); breadth – substantial volume underlying the equilibrium quote; and resilience/price continuity – rapid absorption of imbalances.

The suggestion to use the normal market size as a point of reference in the debate on the ISD was intended to contribute, by increasing options/choices, to competition. Bourses, MTFs, and so on, are functional substitutes in terms of the value chain (information processing, market access, price aggregation and, sometimes as well, clearing and settlement) – that is the product bundle ultimate clients ultimately value. This makes it evident that healthy competition will involve improving technologies, and thus reducing costs – in lieu of rent-seeking. It is doubtful that such an issue, which is much more than a mere technicality, should be dealt with at Level Two.

V. Policy issues

A lot more details and case studies could be put forward here. For example, the debate on US GAAP is a highly political one. Consider the disputes over the recording of stock options as an expense. From a theoretical perspective, this is indeed incomprehensible[22] and has important macroeconomic consequences: in certain cases 'reported earnings under the intrinsic value model … were up to three times higher than the fair value method'.[23] Moreover, in the wake of the stock-market crash at the turn of the century, a number of latent problems, of a dominating capital-market orientation, surfaced. The earnings game with its inherent attending core problem – the conforming of companies to unattainable expectations, and the resulting misallocation of resources and the ensuing potential for market instability – led a number of scholars to reassess their views.[24]

The above issues are not purely technical in nature. As a result, it is generally uninformative to dig into the contemporaneous academic literature on financial issues,

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[22] See Bodie, Zvi, Robert Kaplan and Robert Merton (2003) 'For the Last Time: Stock Options are An Expense, *Harvard Business Review*, March 2003, pp. 63- 71.

[23] See Kieso, Donald, *et al*. (2001): *Intermediate Accounting*, New York: John Wiley, p. 871.

when the task is to understand the genesis of policies. Instead, a political economy approach, dealing with politics in lieu of policies, is called for (Pagano and Volpin, 2001). A number of different interest groups are (legitimately) involved in reshaping the design of European financial markets. Thus, the *politics* of capital markets is about striking a balance between the interests of investors (be they small or large), of different types of intermediaries or service providers (again, with rather different traits as concerns their position in the value chain), and of companies whose deployment of real assets to be funded in primary markets decides on the real return of investments.

From a certain angle, the question arises of whether the trend towards capital markets really does enhance the functional efficiency of Euroland economies. In a comparative institutional context, dis-intermediation (that is, at the expense of intermediation via credit institutions) would only enhance general welfare if markets were, on average, better than intermediaries – a position that is definitely open to debate (see for example Allen and Gale, 2000). Moreover, capital markets do not seem to be always working in a functionally efficient way, that is, in a way that reflects fundamental values. This is, of course, an old view, but one that has gained support in light of what has occurred since March 2000 (see for example Shiller 2000). Indeed, a complete body of literature exists, pointing out all sorts of anomalies as seen from the perspective of weakly efficient markets. Therefore, it is legitimate to cast – in our third-best world – some doubt on the proposition that financing should be forcefully re-oriented to a capital-market-based system (Tobin, 1984; King and Levine, 1994). Specifically, it has been claimed that market-based financing is more conducive to the funding of new enterprises (Allen and Gale, 2000). This is an idea which does not fly, however, in the face of traditional judgments held since at least Schumpeter's days – namely that the opaqueness of new enterprises means they require very close relations with those externally funding their ventures. Developments in the financing of the ominous 'new economy' (Artus, 2001) flatly contradicted this argument up until March 2000. Some warned that such developments amounted to betting on future returns on equity, simply stretching credulity (see, for example, Wadhwani, 1999). Still, notwithstanding a strong

[24] Fuller, Joseph, and Michael Jensen (2002), 'Just Say No to Wall Street', in: *Journal of Applied Finance*, 14 (4), pp. 41-46.

likelihood of disappointment, there was close interaction between venture-capital financing (average first-day returns in 1999 in the US were 71.7 percent; see Ritter and Welch, 2002), the puzzling upsurge in equity prices, and the funding of enterprises by the financial sector. After the bursting of the bubble in the spring of 2000, a kind of post-modern credit crunch developed for about two years. This was a period of real dearth for private equity financing and prohibitive spreads. It also led to a substantially reduced volume of commercial paper issues even within the more seasoned segments of the market.

Does this mean that we are back to square one? Not really; developments in financial markets are not the mechanical upshot of technological change. Of course, such factors have an impact. At the same time, politics is arguably a more decisive driver. (The same appears to apply to the driving forces behind globalization, which involve deeper market integration; see Krugman, 1995). Here, concepts are important. The European Commission in Brussels clearly seems to favor a stronger capital market orientation. Thus, politics – as with the aborigines in Bruce Chatwin's novel *Songlines* – is about to 'sing' a certain financial structure into being.

From the above reasoning, it could be deduced that constraining the Parliament's influence might speed up the legislative process. This would come at a price, however – one that translates into opportunity costs and is measured in terms of not achieving the ultimate goals. These costs would be borne primarily by consumers. Tilting the balance in favor of committees and the sub-level one procedures is therefore only acceptable when the consumers' – or, more generally, ultimate clients' – advocates in Parliament remain in play. This is particularly important in order to consent to the trend of taking out national parliaments in their law-making mode. (This is defendable when, in a very much interdependent Europe, issues with externalities should be treated on a supra-national level, provided that preferences within Europe do not diverge too much. If they do, 'the benefits of centralization would be limited …[and] the costs of harmonization would be high.[25])

[25] See Alesina, Alberto and Ignazio Angeloni (2003): Una Costituzione per l'Europa, manuscript.

Nevertheless, it is important to add a further dimension to the Lamfalussy approach: as a result of the incentive structure to participate in the debate, diffuse interests, though being concerned, do not get their appropriate billing. Therefore, consultation should go beyond (very much interested) market practitioners to include disinterested experts who will take a broader view. Developing one’s case against all the contradicting arguments makes it stronger. Even if that is more time consuming, it is a price worth paying if the outcome is appropriate.