The Impact of Monetary Union and the Euro on European Capital Markets: What May Be Achieved in Capital Market Integration

Rosa Giovanna Barresi*
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Abstract

Up to now, the Euro has been successful in replacing the traditional European currencies and in altering the landscape of European Capital Markets. Domestic users of the Euro are almost the same in number as the population of the United States, although the Gross Domestic Products of the two economies are clearly not comparable. Still, if the Member States within the Euro-area truly want to be recognized as an integrated capital market, some work must be done. This Article will estimate, from current economic thought, what remains to be done and what can be achieved in the short term. Some historical analysis will help in identifying the players and the main trends at work. Moreover, some of the international issues that have been raised by the new role of the European Monetary Union ("EMU") will be presented.
THE IMPACT OF MONETARY UNION AND THE EURO ON EUROPEAN CAPITAL MARKETS: WHAT MAY BE ACHIEVED IN CAPITAL MARKET INTEGRATION

Rosa Giovanna Barresi*

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* LL.M. in Corporate, Banking and Finance Law, Fordham University School of Law, New York; Certificate in U.S. Law and Methodologies, New York University, School of Continuing and Professional Studies, New York; Admitted to the Italian Bar (Rome, Italy) (1996); J.D., University of Rome's La Sapienza School of Law, Italy; former senior associate at Studio Internazionale Legale Tributario, Rome, Italy; former junior associate at Capua, Varrenti Rome, Italy. The author would like to thank Professor Roger J. Goebel for his inestimable guidance and criticism.
INTRODUCTION

To achieve high productivity with available resources, any economy must develop an efficient way to allocate investment to high-productivity projects. An efficient capital market benefits the economy by lowering the cost of capital and ensuring its financial sector is not tying up unnecessary resources.

Up to now, the Euro has been successful in replacing the traditional European currencies and in altering the landscape of European Capital Markets. Domestic users of the Euro are almost the same in number as the population of the United States, although the Gross Domestic Products ("GDPs") of the two economies are clearly not comparable. Still, if the Member States within the Euro-area truly want to be recognized as an integrated capital market, some work must be done.

This Article will estimate, from current economic thought, what remains to be done and what can be achieved in the short term. Some historical analysis will help in identifying the players and the main trends at work. Moreover, some of the international issues that have been raised by the new role of the European Monetary Union ("EMU") will be presented.

I. PLAYERS AND TRENDS

A. EMU and Euro — Historical Overview

The introduction of a single European currency can be considered the final step in the largest monetary changeover to ever
occur. The European Economic Community Treaty ("EEC Treaty")\(^3\) set up the Common European Market as a way to foster a closer union among the people of Europe through commercial interchange. At that time, however, the idea of a monetary union had not yet even been conceived.\(^4\)

During those early years, the Bretton Woods System,\(^5\) developed in 1947, guaranteed a global monetary stability based on fixed exchange rates, "whereby the United States fixed the price of the dollar in terms of gold and all the other countries then fixed the value of their currency in terms of the dollar."\(^6\) In May 1964, the Committee of Governors of the Central Banks\(^7\) was created, whose function was to encourage cooperation among the National Central Banks ("NCBs") of the Member States of the European Economic Community. The Bretton Woods System ruled the global economy until 1971: in that year, as a consequence of the growing imbalance between U.S. imports and exports, the dollar experienced heavy pressure from the foreign exchange markets. President Nixon had to acknowledge the end of the gold standard, leaving the U.S. dollar free to float


(i.e., devalue) against other currencies.⁸

In 1971, while the Smithsonian Accord⁹ established a new system of floating exchange rates, the Werner Report,¹⁰ named after the Prime Minister and Finance Minister of Luxembourg, contemplated the introduction of a single European currency by 1980, as a way to improve the stability of the European economy. In view of the collapse of the Bretton Woods System, the Council approved the Werner Report and planned to develop some form of economic and monetary union.¹¹ Unfortunately, the mid-1970s heralded a global recession, spurred by events in the Middle-East (the Yom Kippur War¹² and the subsequent oil embargo), preventing the European Community from implementing the provisions of the Werner Report.

In 1979, the European Economic Community introduced the European Monetary System ("EMS")¹³, providing for mutual support between NCBs in the event of a foreign exchange crisis, and granting European Community ("EC") currencies a decade of relative stability. In 1989, Jacques Delors, then President of the EC Commission, published a Report¹⁴ outlining the proposals for monetary unification that were put forward by the Committee of Governors of the NCBs and several other experts. The proposals of the Delors Report developed into the portions of

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⁹ See Goebel, Will the EMU Ever Fly?, supra note 4, at 257.

¹⁰ See Report to the Council and the Commission on the Realization by Stages of the Economic and Monetary Union in the Community, 3 E.C. Bull. no.11 (1970) [hereinafter Werner Report].

¹¹ See Goebel, Will the EMU Ever Fly?, supra note 4, at 256.


the Treaty of Maastricht ("TEU")\textsuperscript{15} touching Economic and Monetary Union ("EMU").

On June 1, 1990, the first stage\textsuperscript{16} of the process of EMU was marked by the achievement of free movement of capital inside the European Union ("EU") and an increase in responsibilities given to the Committee of Governors of the Central Banks. The TEU\textsuperscript{17} amended the EEC Treaty, adding the goal of a Monetary Union, introducing requirements to be met by Member States and defining the three stages of the EMU-building process. Essentially, only Member States with low inflation and proper public finance policies could adopt the new currency, after delegating their monetary policy to the soon-to-be-formed European Central Bank ("ECB").\textsuperscript{18}

The TEU required, as a political criterion,\textsuperscript{19} each Member


\textsuperscript{19} Consolidated version of the Treaty establishing the European Community ("EC Treaty"), art. 109, O.J. C 325/33 (2002), 37 I.L.M. 79, incorporating changes made by the Treaty of Nice amending the Treaties establishing the European Commu-
State to guarantee the independence of its NCB from any political authority. Moreover, the TEU stated the four monetary convergence criteria that had to be met to join the third stage, namely: (i.) price stability; (ii.) budgetary discipline; (iii.) currency stability; and (iv.) interest rate convergence. Further, the TEU provided that, at the start of the second stage on January 1, 1994, a European Monetary Institute ("EMI") would be created to do the following:

a.) To coordinate and supervise the Member States in their transition to the single monetary system;

b.) To prepare draft legislation and other plans for the later ECB; and

c.) To commence the technical preparation for the Euro.

Member States that qualified to participate in the final stage of EMU began to be collectively known as the Euro-area.

In December 1995, the Madrid European Council officially adopted the name "Euro" for the currency, but no symbol was adopted. In July 1997, the European Commission introduced the "€" symbol after its endorsement by the Dublin European Council on December 13-14, 1996. The Commission stated that the € symbol was "inspired by the Greek letter epsilon and certain related acts, March 10, 2001, O.J. C 80/1 (2001) (amending Treaty on European Union ("TEU" or the Treaty of Maastricht), Treaty establishing the European Community, Treaty establishing the European Coal Steel Community ("ECSC"), and Treaty establishing the European Atomic Energy Community ("Euratom Treaty") and renumbering articles of TEU and EC Treaty) [hereinafter EC Treaty].

20. In accordance with the ESCB, ECB, and NCBs cannot "seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. See EC Treaty, id. note 19, art. 108, O.J. C 325/33 (2002).

21. See id. art. 121, O.J. C 325/33 (2002); see also Goebel, Will the EMU Ever Fly?, supra note 4, at 304.


23. See EC Treaty, supra note 19, art. 117(1), O.J. C 325/33 (2002); see also Protocol on the Statute of the European Monetary Institute, available at http://Europa.eu.int/eur-lex/en/treaties/selected/livre334.html (last visited June 17, 2005). The European Monetary Institute ("EMI") replaced the Committee of Governors of NCBs and European Monetary Cooperation Fund ("EMCF"), which were dissolved at the beginning of the second stage of EMU.


27. Dublin European Council, O.J. C 33 (1997), at 63. For an overview on Euro
ion, in reference to the cradle of European civilization and to the first letter of the word 'Europe'. Then two parallel lines represent the stability of the Euro."^{28}

On June 1, 1998, the ECB^{29} was finally established, with the primary objective of price stability, to be achieved through a two-pillar strategy consisting of a planned growth of the monetary base and of a broadly-based assessment of the risks to price stability^{30} in the Euro-area.^{31} The ECB, based in Frankfurt am Main, operates in cooperation with the NCBs of the Euro-area Member States, within the European System of Central Banks^{32} ("ESCB"). The United Kingdom^{33} and Denmark obtained Protocols to the Maastricht Treaty enabling them to opt out of the final stage of EMU, but reserving the right to participate later. Sweden^{34} did not qualify to join the final stage because it failed to make its central bank independent from political power, as required by the Treaty of Maastricht.^{35}

As a result, eleven countries^{36} (Austria, Belgium, Germany, Finland, France, Ireland, Italy, Luxembourg, Spain, Portugal

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30. On December 31, 1998, the Council fixed the conversion rates between the Euro and the participating national currencies, to be used for all conversions from national currencies to the Euro. See Council Regulation No. 2866/98 O.J. L 359 (1998), at 1-2 (on the conversion rates between the Euro and the currencies of the Member States adopting the Euro).
33. The result of the U.K. opt-out is that the United Kingdom maintains its powers in monetary policy and the provisions of the ESCB and the ECB do not directly apply. See Protocol on Certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, O.J. C 191 (1992).
34. Sweden did not obtain an official "opt out." The Swedish referendum held in September 2003, on joining the third stage of EMU, was unsuccessful.
35. See EC Treaty, supra note 19, art. 109, O.J. C 325/33 (2002); see also BERMANN ET AL., CASES AND MATERIALS ON EUROPEAN UNION LAW 16 (2002).
and the Netherlands) joined in the third stage of EMU on January 1, 1999, after meeting the five economic and political conditions set forth in the Treaty of Maastricht and its Protocol. Although Greece initially failed to meet the convergence criteria stated by the Treaty, it reached compliance during the period 1999-2000 and joined the final stage on January 1, 2001.

During the transition period (January 1999-December 2001), the Euro could only be used as a virtual currency along with national currencies, but, in order to facilitate the transition, the European Commission recommended that every retail activity (shops, banks, post-offices, etc.) display amounts both in Euros and national currencies. On January 1, 2002, the new Euro banknotes and coinage were put into circulation in the twelve Member States as the only legal currency. After February 28, 2002, national currencies ceased circulation in the Euro-area, but until June 30, 2002, banks still accepted them for the sole purpose of exchanging them for Euros.

B. European and U.S. Capital Markets — General Facts

In order to appraise the capital markets within the Euro-area, the most intuitive approach is to compare them with their natural U.S. counterparts. Even after acknowledging that sta-

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38. The Council decided that "Greece fulfil[led] the necessary conditions for the adoption of the single currency." Council Decision No. 2000/427/EC, O.J. L 167 (2000), at 19–21, art. 1 ("on 19 June 2000 the Council decided in accordance with Article 122(2) of the Treaty on the adoption by Greece of the single currency on 1 January 2001").
41. See Council Regulation No. 974/98, O.J. L 139/1, art. 10 (regulation on May 3, 1998 concerning the introduction of the Euro).
42. See id. art. 15.
statistical procedures and data-filtering techniques are different, and that exchange rates can only add to the difficulty in achieving comparability, the advantages of a direct comparison make it a valuable exercise.\textsuperscript{44} On the other hand, available literature offers few reliable comparative studies: NCBs do not publish comparative analyses; financial services charge fees for them; and Economic Research Institutes publish reports only after considerable lapses of time.\textsuperscript{45}

\textbf{TABLE 1}

<table>
<thead>
<tr>
<th></th>
<th>U.S.</th>
<th>Euro-area</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population in millions</td>
<td>285</td>
<td>305</td>
</tr>
<tr>
<td>GDP in trillions of U.S. dollars</td>
<td>10</td>
<td>6</td>
</tr>
<tr>
<td>GDP as share of world GDP</td>
<td>22%</td>
<td>16%</td>
</tr>
<tr>
<td>Exports as share of world exports</td>
<td>15%</td>
<td>19%</td>
</tr>
<tr>
<td>Stock market capitalization as share of national GDP</td>
<td>140%</td>
<td>75%</td>
</tr>
<tr>
<td>Bank loans as share of national GDP</td>
<td>12%</td>
<td>45%</td>
</tr>
<tr>
<td>Foreign exchange reserves as share of national GDP</td>
<td>0.29%</td>
<td>3.41%</td>
</tr>
</tbody>
</table>

Table 1 summarizes the few data\textsuperscript{46} available, but enough to start a comparison between the capital markets of the two biggest economies in the world.\textsuperscript{47} Economists acknowledge that, after 1995, a U.S.-EU productivity gap set in: according to current estimates, EU Gross Domestic Product \textit{per capita} (the ratio between GDP and population) is between 65\% and 70\% of its U.S. equivalent.\textsuperscript{48} Table 1 also documents the different ways in which


\textsuperscript{48} See MICHELE CINCERA & OLIVIA GALGAI, IMPACT OF MARKET ENTRY AND EXIT ON EU PRODUCTIVITY AND GROWTH PERFORMANCE 3 (Eur. Commission, Directorate Gen. for Econ. & Fin. Aff. — Econ. Papers No. 222, 2005); see also GAËTAN NICODÈME & JACQUES-BERNARD SAUNER-LEROY, PRODUCT MARKET REFORMS AND PRODUCTIVITY: A REVIEW OF
corporations on either side of the Atlantic have access to operating capital. In Euro-area countries, internal finance is the major source of funding for the corporate sector, followed by bank loans and trade credit.

Leaving aside the episodes of privatization of companies in the Public Sector, in the Euro-area, bond issues come last in corporate financing, even during the stock market boom of the last decade. While some differences exist at the regional level, the central role of banking in Euro-area economies is confirmed by two additional facts: (i.) through consumer credits and mortgage financing, banks are net creditors of households; (ii.) financing (short-term loans against accounts receivables) covers at least half of bank loans to the corporate sector.49

The reasons for the importance of banking in the Euro-area can be found in European History. At first, bankers were simple businessmen who attracted deposits by the sheer force of their wealth and attitudes,50 using this money to finance their lines of business and to lend money to other businessmen. Later, political power forced bankers to discover the production of money without any collateral by arbitrary extensions of credits and the forced loans needed to support them.51 Following the Austrian economist Ludwig Von Mises, the part of money supply that is not backed by any collateral, but only by the good faith (Latin fiducia) of the depositaries is called "Fiduciary Media."52

During the Middle Ages, mints and banks were worked by private entrepreneurs, but by the end of the thirteenth century, mints were strictly supervised by Court Officials. The practice of National States of getting revenue by printing money is still called seigniorage as it derives from the notion that minting money was considered a direct right of the Kings.53

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52. See Ludwig Von Mises, The Theory of Money and Credit ch. 16 (1953).
53. In ancient times, the seigniorage was the tax paid by minters to the king: "the changer also charged the bullion holder 6d per pound for the king's seigniorage, according to 'the right and accustomed farm.'" Only later, with the advent of the National Mints, did it acquire its current meaning of revenue from the overall money-issuance.
While working full-time for political power, bankers were able to preserve their independence until the end of the seventeenth century. After the end of the Thirty Years’ War, bankers put themselves at the exclusive service of their sovereigns and National Central Banks ("NCBs") were established in 1668, Risen Standers Bank in Sweden, later Sveriges Riksbank, and in 1694, The Bank of England.

The dispute on what powers should be granted to NCBs continued for four centuries. After World War II, politicians assigned to NCBs the primary objective of reducing unemployment and granted them the power to develop tight controls over the economy, implementing exchange regulations, limiting credit offerings, and fixing exchange rates on international markets. On the other hand, politicians felt free to criticize NCBs when their policy did not suit them: Helmut Schmidt, then Chancellor of the Federal Republic of Germany), devised the slogan: "Five percent inflation is better than five percent unemployment," in order to criticize the attitude of the German NCB.

With the development of the international markets, the statutory objective of NCBs, namely, to safeguard the value of their national currencies, caused them to fight against massive attacks

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54. The Thirty Years' War (1618-1648) began in the form of a religious conflict between Protestants and Catholics, but later evolved in a succession war for the preservation of the Habsburg dynasty.


from international speculators. International speculation, as opposed to NCB policy, was aimed at causing the devaluation of a currency by aggressive selling on Foreign Exchange Markets. Moreover, European NCBs had to fend off pressures from their own national governments, who wanted them to finance public sector deficits by excess borrowing on capital markets, and sometimes by printing money.59

In 1973, the Bundesbank (the NCB for the Federal Republic of Germany) began to declare monetary stability as its primary objective. As Otmar Emminger said in his inaugural speech upon becoming Bundesbank president in 1977, “Monetary stability is linked up with general social stability — and with political stability.”60 After recurring episodes of crisis in the financial markets, observers began to recognize that the primary task of NCBs was preserving stability in the global economy.61

A good insight into the process of integration in European capital markets can be gained by comparing the evolution of the first two monetary aggregates, M1 and M2, for the Euro-area and U.S. economies.62 In capital markets, the definition of the supply-side is problematic, as it involves questions on the nature of money itself.63 For example, from a consumer’s standpoint, a banknote is as good as a credit card, but while the former is issued by an NCB, the ceiling of the latter is controlled by a pri-

59. Bankers are proverbially discrete and Central Bankers show considerable restraint, at least during their public life. Sometimes, though, their real opinions can be gleaned from their memoirs or from late interviews. See generally Guido Carli, Intervista sul Capitalismo Italiano (1975).


62. According to economists, demand and supply can be defined for any commodity, including money, the principal vehicle for exchanging goods and services. The monetary aggregates measure the supply for money. One of the tasks assigned to a National Central Bank is to control the money supplied to the economy, i.e., the monetary aggregates. “By buying or selling bonds, bills, and other financial instruments in the open market, a Central Bank can expand or contract the amount of reserves in the banking system and can ultimately influence the country’s money supply.” Stephen H. Axilrod, Transformations to Open Market Operations. Developing Economies and Emerging Markets 5 (1996), available at http://www.imf.org/external/pubs/ft/issues5/issue5.pdf (last visited June 10, 2005).

vate-sector credit institution. In order to clarify the matter, economists have classified at least three types (tiers) of money, according to who is controlling their issuing processes. M1 is the most basic form of money in an economy. M1 consists of currency bills and coins in circulation, held by the non-bank public, together with the amount of the short-term deposits held by banking institutions in their NCB.\(^6\)

Historical experience has proved that a scarce supply of M1 money leads to insufficient circulation and to recession.\(^6\)

**TABLE 2: M1 MONETARY AGGREGATES FOR UNITED STATES**

<table>
<thead>
<tr>
<th>Source: Board of Governors of the Federal Reserve System</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>M1 Money Stock</strong></td>
</tr>
<tr>
<td><strong>(Billions of Dollars)</strong></td>
</tr>
<tr>
<td>2000</td>
</tr>
<tr>
<td>2001</td>
</tr>
<tr>
<td>2002</td>
</tr>
<tr>
<td>2003</td>
</tr>
<tr>
<td>2004</td>
</tr>
<tr>
<td>2005</td>
</tr>
</tbody>
</table>

The above and following charts show M1-money end-of-period stocks for U.S. and Euro-area economies, in currency units of U.S. dollars and Euro billions, according to the data published by the Federal Reserve Bank ("FED") and the ECB. The charts confirm that the European economy still has an M1-tied


structure, as M1 money stocks for the Euro-area are nearly double their U.S. counterparts. The dependence of Euro-area economy on M1-money is further shown by the fact that the creation-rate of M1 does not show any indication of slowing down.

The second-tier monetary aggregate, called M2, is composed of M1 money stocks plus other forms of mobile capital such as savings deposits, certificates of deposits, money market liquidities and short-term repurchase agreements. The general concept is that M2 money can not circulate at the same speed as M1, but can still be turned into liquidity with some ease, since it is employed in short-term investments.

Charts Nos. 4 and 5 drawn following the same sources and with the same conventions of previous two, show that Euro-area M2 money stocks, although some way behind their U.S. counterparts, are indeed trying to catch up. According to ECB President Jean-Claude Trichet, “The mar-

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67. See EHRMANN & FRATZSCHER, supra note 64.

TABLE 4: M2 MONETARY AGGREGATES FOR UNITED STATES

<table>
<thead>
<tr>
<th>M2 Money Stock (Billions of Dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source: Board of Governors of the Federal Reserve System</td>
</tr>
</tbody>
</table>

![Graph showing M2 Money Stock for United States from 2000 to 2005](https://research.stlouisfed.org)

TABLE 5: M2 MONETARY AGGREGATES FOR EURO-AREA

![Graph showing M2 Money Stock for Euro-Area from 1990 to 2004](https://www.economagic.com)

The market’s size for commercial paper in the EU represents about EUR 1000 billion, which is about two-thirds of the size the U.S. market for commercial paper.  

C. Institutional and Operational Players

The European Parliament, the Council of Ministers and the European Commission, the three leading EU institutions, can be

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considered institutional players. Member States are both institutional players, in their role of national legislators and regulators, and operational players, in their role of public debt issuers. The other players on European Capital Markets, as banks, financial intermediaries, building societies and insurance companies, are limited to an operational role.

In the development of the three stages of EMU, the European Parliament had only a consultative role, as stated by the EC Treaty. The Council of the European Union or Council of Ministers ("Council"), among its many roles, held (and holds) the legislative power in monetary matters. Moreover, meeting as Heads of State and Government, the Council has a primary role in deciding whether a State fulfils the criteria to join the final stage of EMU. The European Commission, well described as a "guardian of coordination through Euro economic governance," is the executive and regulatory body, which exercises the powers delegated to it by the Council.

The primary objective of EMU monetary policy, which is to maintain price stability, has been delegated to the ECB. The union of the ECB and the twelve NCBs of Euro-area Member States forms the ESCB. The ECB, in its institutional role, adopts and enforces monetary regulations but also has an operational role on the capital markets. With its "decision making

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71. See EC Treaty, supra note 19, arts.121 (2), 112 (2b) and 189-201, O.J. C 325/33 (2002), (related to the European Parliament); see also BERMANN ET AL., supra note 35, at 51.


73. See EC Treaty, supra note 19, arts. 211-19, O.J. C 325/33 (2002), (related to the Commission); BERMANN ET AL., supra note 35, at 43.

74. See Kenneth Dyson, European States and the Euro 360 (2002).

75. See EC Treaty, supra note 19, art. 211, O.J. C 325/33 (2002).

76. The Governing Council defined price stability as "a year-on-year increase in the Harmonised Index of Consumer Prices of below 2%." Otmar Issing, The ECB's Monetary Policy: Experience After the First Year, 22 J. POLICY MODELING 325, 328 (2000).

77. See EC Treaty, supra note 19, art. 107, O.J. C 325/33 (2002).

78. See EC Treaty, supra note 19, art. 105, O.J. C 325/33 (2002); see also Peter BOFINGER, The Monetary Policy Framework of the ECB 7 (European Inst. of Public Admin. ("EIPA"): EMU Halfway Through the Transition Period, Conference Paper,
bodies,” the Executive Board and the Governing Council, ECB sets the monetary policy for the Euro-area. Moreover, given that international organizations, such as the World Bank (“WB”), the International Monetary Fund (“IMF”), the Organization for Economic Co-operation and Development (“OCDE”), and the Bank for International Settlements (“BIS”), as institutional players, allow the ECB to participate, as an observer, in their meetings, the ECB represents the Member States of the Euro-area.

National governments have both an institutional role, as market supervisors, and an operational one as issuers of public debt. The banking community and the investment community are operational players. Banks, by far the biggest operational players, offer services to their customers, according to banking laws and regulations. Any non-banking company operating in capital markets, e.g., a fund management company, a building society, an insurance company, is part of the investment community and constitutes an operational player.

In accord with contemporary government technique, the process of decision-making in the EU is split at several levels. In order to reach all the decision-makers, many pressure groups find it convenient to produce position documents and to publish their view under their own name. As an alternative, some other players prefer to support independent think-tanks.

81. The European Banking Federation represents all European Banks. According to their charter, European Savings Banks are further represented by European Savings Banks Group, while Cooperative Banks are represented by the European Association of Co-operative Banks. These three associations established the European Committee for Banking Standards. See, e.g., European Committee for Banking Standards, at http://www.ecbs.org (last visited June 15, 2005).
82. See id.
D. Economic Theories

In the 1920's, John Maynard Keynes brought the role of public expenditure to the attention of the economists. According to Keynes, an incremental increase in government purchases will force the GDP to change by more than that amount. The rationale is that since consumer spending depends upon income, any sum spent by somebody gives someone else an additional income, which will lead to additional spending.

The Keynesian approach accompanied world economic theory long after the Depression and well into the Cold War. In the 1970's, the necessity for a new approach became evident: economic theories had to account for monetary circulation and international trade. The so-called Monetarist approach suggested monetary policy, to be an effective instrument for controlling an economy.

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85. "Keynes offered a theory of depression economics that asserted, famously, that the market mechanism could not be relied upon to spontaneously rebound from a slump, and that advocated public spending, preferably involving a deficit in the government budget, to stimulate demand." M. Woodford, Revolution and Evolution in Twentieth-Century Macroeconomics 5 (Frontiers of the Mind in the Twenty-First Century, Conference Paper, June 14-18, 1999), available at http://www.princeton.edu/%7Ewoodford/macro20C.pdf.

86. An example of how politicians misappropriated Keynes' theories is set by Richard Nixon. In his 1971 State of the Union Address, Nixon declared that "by spending as if we were at full employment, we will help to bring about full employment". Herbert Stein, Presidential Economics 172-73 (1985).

87. "The 1970s saw inflation and unemployment simultaneously at relatively elevated levels for some time. The notion that this could occur was nowhere to be found in the conventional wisdom of the ... Keynesian revolution of the 1930s and its subsequent empirical applications. Moreover, these models embodied the view that aggregate demand expansion, from almost any level, would permanently create new jobs." Alan Greenspan, The Challenge of Central Banking in a Democratic Society, Remarks at the Annual Dinner and Francis Boyer Lecture of The American Enterprise Institute for Public Policy Research (Dec. 5, 1996), available at http://www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm

88. "Monetarism, and new insights into the effects of anticipatory expectations on economic activity and price setting, competed strongly against the traditional Keynesianism." Id.

89. "In their Monetary History, Friedman and Schwartz reviewed nearly a century of American monetary experience in painstaking detail, providing an historical analysis that demonstrated the importance of monetary forces in the economy far more convincingly than any purely theoretical or even econometric analysis could ever do." Ben S. Bernanke, Remarks by Governor at the Federal Reserve Bank of Dallas Conference
According to this approach, the way to control an economy is through the setting of the short-term interest rate and of the monetary aggregate. Using a mathematical formula, it is even possible to estimate at what value they should be set in order to maintain desired rates for inflation and growth.\(^{90}\) Generally speaking, current economic thought recognizes monetary stability as the primary objective of an economy.\(^ {91}\)

To this end, economists try to identify and neutralize the channels that can transmit economic shocks across the system. According to the analysis of Angeloni and Ehrmann,\(^ {92}\) four mechanisms can transmit monetary policy shocks in Europe: (i.) Corporate loan interest rates, by influencing long-term investment decisions (the bank-lending channel); (ii.) Personal loan interest rates, by altering the perception of risk of the consumers (the consumer interest-rate channel); (iii.) Stock market indices, by influencing the opinion of the consumer's own wealth (the asset-market channel); (iv.) Foreign exchange rates, by influencing the price of imported goods (the exchange-rate channel).

A more detailed study\(^ {93}\) from the ECB, based on linking in-

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\(^{90}\) "The Taylor rule seems to track, very successfully, broad policy moves since 1987. This success seems remarkable because Taylor's rule is so simple: It is set according to only four components. The first factor is the Fed's long-term inflation target. . . . The second factor is the "natural" real, or inflation-adjusted, federal funds interest rate. . . . The two remaining factors address the way policy should respond in the short run to changing circumstances, namely, to changes in output and inflation. These third and fourth components of the Taylor rule are the current rates of inflation and output." See Charles T. Calrstrom & Timoty S. Fuerst, The Taylor Rule: A Guidepost for Monetary Policy, FED. RESERVE BANK OF CLEV. ECON. COMMENT., July 2003, at 1, available at http://www.clevelandfed.org/Research/Com2003/0703.pdf (last visited June 15, 2005).

\(^{91}\) "Gradually the power of state intervention to achieve particular economic outcomes came to be seen as much more limited. A consensus gradually emerged in the late 1970s that inflation destroyed jobs, or at least could not create them. . . . That inflation could reduce employment was a highly controversial subject in the mid-1970s when introduced into communique language drafts. . . . Today in similar communiqués such language is accepted boiler plate and rarely the focus of discussion." Greenspan, supra note 87.


\(^{93}\) See Robert-Paul Berben et al., CROSS-COUNTRY DIFFERENCES IN MONETARY
individual models of National Economies in a harmonized overall simulation, leads to similar results, recognizing five channels:

(i.) "The cost-of-capital channel": the interest rate, as perceived by the corporate segment of the economy, represents the cost of operating capital, as invested in inventories and durable goods. The shock transmission capacity of this channel depends on the financial structure of the corporate-lending market. 

(ii.) "The substitution-effect-in-consumption channel": the interest rate experienced by the consumers represents the substitution effect between present consumption and future risk. Sensing that interest rates are on the upswing, consumers can opt to delay consumption and increase saving, with the result of propagating a negative shock to the entire economy. This effect can be reinforced by the structure of the labor market: self-employed consumers, who expect less job security, may feel a higher need for precautionary savings;

(iii.) "The income and cash-flow channel": a rise in financial yields increases the disposable income of net lenders and worsens the cash flows of net borrowers, altering consumption capability. For example, in Italy households are net creditors, so an increase in bond interest rates can raise consumption levels. In more mature economies, as in Finland and the Netherlands, households are net debtors and a rise in interest rates can depress consumption;

(iv.) "The Exchange-rate channel": as almost all raw materials (e.g., oil) and most imported products are still priced in dollars, the Euro-dollar exchange rate is a powerful mechanism for the transmission of economic shocks across the world econom-

References:

94. See id. at 21.
95. "For instance, effects may be larger in countries where firms are more indebted or where they borrow on short-term interest rates." Id. at 21.
96. See id.
97. See id.
98. "In Italy, the positive contribution of the income channel reflects the fact that households are net creditors, and raise consumption in response to the increase in interest payments received on holdings of government debt." Id. at 25.
100. See BERBEN ET AL., supra note 93, at 25.
101. See id. at 26.
When the Euro devalues in respect to the dollar, the immediate effect is that European products become more competitive in the global market, as their price in dollars is lowered. Sooner or later, European manufacturers are going to pay more for the dollars they use to pay their raw materials, and they will be forced to raise the prices of their products. In the reverse, a devaluation of the dollar has the immediate effect of raising the prices of European products, rapidly driving European offerings out of the market, and effectively stopping industrial production. (v.) The Monetary-circulation channel: although central banks know that excess monetary supply can lead to inflation; they are sometimes forced to finance public sector expenditure at the expense of monetary circulation (e.g., by issuances in National Currency or in Government Bonds).

102. "For instance it might be expected that changes in the price of raw materials and fuels, which are determined on international markets, would be passed through into domestic prices. If this was the case, then a high share of such items in total imports may be reflected in a larger change in domestic prices, following the change in the exchange rate." Id. at 27. The first findings established for the exchange-rate the role of a shock absorber, but with the notable exceptions of Denmark and Sweden economies. Michael J. Artis & Michael Ehrmann, The Exchange Rate. A Shock Absorber or Source of Shocks? A Study of Four Open Economies 16 (Robert Shumann Center for Advanced Studies, EUI Working Paper No. 38, 2000), available at http://www.iue.it/RSCAS/WP-Texts/00_38.pdf (last visited June 15, 2005). With a more detailed analysis, new findings are consistently reversing this position. In the theoretical case of a long-run analysis of a two-country model "[w]e find an important role for the exchange rate as a shock absorber. Specifically, most of the variation in real exchange rates can be explained by relative aggregate demand shocks"; on the other hand, in the short-term, analysis of practical cases note that "[e]ven if we extend the model, and make a distinction between monetary policy shocks and pure exchange rate shocks, we still find an important role for the latter. Hence, the exchange rate is still an important source of shocks." Katie Farrant & Gert Peersman, Is The Exchange Rate A Shock Absorber or a Source of Shocks? New Empirical Evidence 15(Ghent Univ. Faculty of Econ. and Bus. Admin., Working Paper No. 285, 2005), available at http://www.feb.ugent.be/fac/research/WP/Papers/wp_05_285.pdf (last visited June 15, 2005).


105. See Berben et al., supra note 93, at 34.
II. BACKGROUND ON EMU INSTITUTIONAL INITIATIVES

A. Financial Services Action Plan — The Lamfalussy Framework

In June 1999, the Cologne European Council adopted the Financial Services Action Plan ("FSAP"), seeking to create a single market for wholesale and retail financial services and enforce the adoption of state-of-the-art prudential rules and supervision. In March 2000, at the Council summit in Lisbon, the Economic and Financial Affairs Council ("ECOFIN") reaffirmed the FSAP and set a deadline for its achievement in 2005. At the same time, recognizing a need for extraordinary measures, the Council established a Committee of Wise Men on the Regulation of European Securities Markets, under the chairmanship of Baron Alexandre Lamfalussy ("Lamfalussy Committee").

The Lamfalussy Committee published its final report in February 2001 ("Lamfalussy Report"), recommending changes to the legislative process for approving legislation on securities market regulation. In its opening comments, the Lamfalussy Report, referring to an integrated financial market, stated that "the basic legislation is not in place." The mosaic of European regulatory structures is well documented; there are over forty of them, with different "powers and competencies."
current regulatory system is simply "too slow, too rigid"\textsuperscript{114} and ill adapted to the needs of modern financial markets. After recognizing these problems, the Lamfalussy Committee proposed a way of resolving them.

The so-called "Lamfalussy framework" consists of four levels:\textsuperscript{115}

- **Level 1**: framework principles that the Commission proposes to the Council of Ministers and to the European Parliament for co-decision.

- **Level 2**: the European Securities Committee and the Committee for European Securities Regulators will assist the European Commission in the definition of details.

- **Level 3**: cooperation and networking among EU securities regulators to ensure common standards for implementing the legislation developed at Levels 1 and 2.

- **Level 4**: cooperation between the Member States, their regulators; and the private sector in order to ensure issuance of national legislation and regulations.

The Lamfalussy\textsuperscript{116} proposals were endorsed at the Stockholm Council in March 2001, but Parliament delayed the adoption until February 2002, and the final structure was put in operation by the end of the same year. On this occasion, the ECOFIN\textsuperscript{117} endorsed a Report from the Economic and Financial Committee ("EFC")\textsuperscript{118} on financial regulation, supervision and stability extending the principles from the Lamfalussy framework to other financial sectors (banking, insurance, and pensions).\textsuperscript{119}

\textsuperscript{114} See id. at 14.

\textsuperscript{115} See id. at 19.


\textsuperscript{118} The Member States, the European Commission and the ECB form the EFC. NCBs join the Committee when the issues require the NCBs' expertise. See EC Treaty, supra note 19, art. 114(2) & (4), O.J. C 325/33 (2002) (listing the tasks of the EFC); see also Council Decision No. 03/476/EEC, O.J. L 158/58 (2003) (on a revision of the Statutes of the Economic and Financial Committee).

\textsuperscript{119} See Bouwen, supra note 110; see also European Parliament, Committee on Economic and Monetary Affairs, Activity Report, 5th Parliamentary Term 1999-2004, at 41
The Committee, reiterating the June 1985 White Paper,\textsuperscript{120} established two basic guidelines for financial market integration:

(i.) the \textit{mutual recognition principle},\textsuperscript{121} requiring only essential standards to be harmonized, allowing for the coexistence of national variants and implementations; and

(ii.) the \textit{home-country principle}, stating that in cross-border operation of branches or provision of services, the regulations, laws and practices of the country of incorporation must be accepted by any country.\textsuperscript{122}

In order to appraise the time and the effort it takes to pass legislation in EU institutions, a few episodes may be of interest. The Directive\textsuperscript{123} on \textit{Securities Trading and Prospectuses} aimed at simplifying regulatory compliance by standardizing a \textit{prospectus}, the proposal used in public offerings of securities, and a \textit{passport}, the documentation to supplement the request to trade a security in a regulated market.\textsuperscript{124} While a first draft of the Prospectus Directive was presented in May 2001, the final adoption did not take place until July 2003 and came into force, with its publication, in December of the same year.\textsuperscript{125}

The Regulation\textsuperscript{126} implementing the Prospectus Directive comes into force in July 2005. The Commission\textsuperscript{127} gave mandate

\begin{itemize}
\item \textsuperscript{120} See Commission of the European Communities, Completing the Internal Market: White Paper from the Commission to the European Council, COM (85) 310 Final (June 1985) [hereinafter White Paper]; see also BERMANN ET AL., supra note 35, at 540.
\item \textsuperscript{121} See LAMFALUSSY REPORT, supra note 111, at 104.
\item \textsuperscript{122} See id. at 13.
\item \textsuperscript{124} See id.
\item \textsuperscript{127} See European Commission, Formal Mandate to CESR for Technical Advice on a Possible Amendment to the Requirements in Commission Regulation (EC) 809/2004 Regarding the Historical Financial Information Which Must Be Included in a Prospe-
to the Committee of European Securities Regulation ("CESR") to provide technical advice, to amend the Regulation by October 31, 2005. The amendment is related to "the historical financial information which must be included in a prospectus" in order to let the investor obtain an informed evaluation of the issuer.

Attempts to create a common framework for pension funds in the European Union go back to the early 1990's. In October 2000, the Commission proposed a Pension Fund Directive stating detailed rules of operation for banking institutions to run a pension scheme on behalf of a company located in another Member State. In application of the subsidiarity principle, the organization of pension schemes is a matter essentially subject to Member States' sovereign competence. The Pension Fund Directive, which left a number of issues open to national legislation, was finally adopted in May 2003. The deadline for implementing the Pension Fund Directive is September 23, 2005, even though "Member States may postpone" the implementation until September 23, 2010.

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130. See LAMFalussy REPORT, supra note 111, at 14.


132. See Pension Funds Directive, supra note 131, art. 22 (5), O.J. L 235/10 (2003). During this grace period, IORPs may not operate pension schemes on a cross border basis if they do not comply with the Directive. See Arnot, supra note 131, at 61; see also Department for Work and Pensions, Implementing the European Directive on the Activities and Supervision of Institutions for Occupational Retirement Provision:
B. EMU Gross Clearing and Settlement Arrangements

Trans-European Automated Real-time Gross-settlement Express Transfer ("TARGET") is used for the settlement of central bank operations, and large-value Euro inter-bank transfers. In 2004, it processed a daily average of more than 267,000 transactions, with an average daily value of more than EUR 1,700 billion. Target operates on the principle that payments become irrevocable once the originating account has been debited: this feature, called "immediate finality," of payments in central bank money, eliminates any settlement risk.

This means that all participants can deliver a payment to the customer at the same moment they are credited with the right amount of money. The implementation of TARGET was part of the technical infrastructure required by the third stage of EMU. EMI started drafting its structure in November 1994 and it started operation in January 1999, interconnecting national Real Time Gross Settlement ("RTGS") systems of fifteen European countries and the ECB. Among non Euro-area countries, TARGET is linked with CHAPS (the RTGS system of the Bank of England), RIX (the RTGS system of the Bank of Sweden), DEBES and DNF (the Bank of Denmark operates two RTGS systems, the former for the Danish krone and the latter for the Euro).

In March 2004, TARGET was linked also to the Polish Euro RTGS system, called SORBNET-EURO and managed by the Polish NCB Narodowy Bank Polski. Building on this experience, in October 2002, the Eurosystem, the management structure of TARGET, composed of ECB and the twelve NCBs of the Euro-area, started designing a second-generation system ("TAR-
GET2”), now scheduled to start operation in 2007. The declared improvements of TARGET2, are to be found in service levels, increased cost efficiency, and improved flexibility to future developments, such as the projected enlargements of the European Union.

The most interesting feature of TARGET2 will be its market-oriented cost structure, based on the co-existence of a Single Shared Platform (“SSP”) and other national components. In July 2003, the German, French and Italian NCBs, which account for more than 50% of TARGET payments, have offered to operate the SSP, providing basic services at a single Eurosystem-wide tariff structure. In December 2004, the ECB granted the three partners NCBs the right to build and operate the new platform. NCBs of accession countries will have the option of connecting to TARGET2 from the day they join the EU, and also of using TARGET2 as their own RTGS system.

C. EMU Securities Clearing and Settlement Arrangements

In 1996, the Italian banker Alberto Giovannini was invited by the European Commission to form a group of financial market experts, known as the Giovannini Group, to offer advice on how to prepare the capital markets for EMU. Up to now, the Giovannini Group has produced five reports. The first report, dealing with the impact of the introduction of the Euro on capital markets, was published in July 1997. The Giovannini Introduction report became a major source for the process of re-denomination of public debt into the Euro and in establishing common bond-market conventions for the Euro-area.

Since then, the Giovannini Group has published reports on

140. See id. at 63.
142. See id.
143. Alberto Giovannini, then with Banca di Roma, now with Unifortune Asset Management SGR.
the EU repo market (1999)\textsuperscript{145}, on co-ordinated public debt issuance in the Euro-area (2000)\textsuperscript{146}, and two reports on EU cross-border clearing and settlement arrangements, 2001 and 2003.\textsuperscript{147} The Giovannini First Cross-Border report affirms: "It is perhaps no exaggeration to conclude, from the analysis in this report, that inefficiencies in clearing and settlement represent the most primitive and thus most important barrier to integrated financial markets in Europe."\textsuperscript{148} The basic objective of the clearing and settlement process is to provide a safe and confidential transfer of securities from a seller to a buyer, in exchange for a payment.

The European Central Securities Depositories Association ("ECSDA")\textsuperscript{149} standard on cross-border settlement, which was established as a result of the activities of the Giovannini Group, recognizes four main steps in a securities transactions:

(i.) confirmation of the terms, as subordinate to the actual execution of the trade;

(ii.) clearance of the trade, with actual exchange of obligations between counterparts;

(iii.) delivery of the securities from the seller to the buyer, i.e. recording the change of property in a central registry;

(iv.) actual payment, through debiting and crediting of funds.

When both delivery and payment are finalized, the transac-


\textsuperscript{148} See Giovannini, First Cross-Border, supra note 147, foreword.

tion is declared settled, and its results, size and price, can be published for market-making purposes. Moreover, as everybody agrees in having some obligation to preserve the confidentiality of the trade, it is usual for the clearing and settlement process to involve intermediaries in addition to the buyer and the seller. 150

A Central Counter-Party ("CCP") is an entity that interposes itself legally by a process of novation: buyer and seller undertake to consider the trade as cleared when the CCP has received notice by both parties involved. In this way, buyers and sellers can remain unknown to each other, since they interact only with the CCP. 151 Another entity is required to record the change of ownership: Central Securities Depositories ("CSDs") 152 hold securities in paper form and record property-changes by some form of book-keeping.

The result is that, for a successful transaction to be carried out, at least four entities must be connected with the same information processing platform: buyer, seller, CCP and CSD. In an international environment, the two national CCPs, which represent buyer and seller, may resort to an international CCP for actual novation on the trade. In the same way, when the transaction crosses national borders, it is usual for the two CSDs to communicate through an International Central Securities Depository ("ICSD"). 153

Another aspect of securities trading 154 is that, as every position must be financed, traders have to pay for the liquidity involved, and are interested in using it in an efficient manner. Consequently, CCPs usually offer netting services. In netting, at a certain time of each day, the CCP offsets all the amounts owed by and to participants in order to reduce all outstanding residuals to a single debit/credit between itself and each member. 155

The process of netting brings obvious savings in liquidity, at the price of incrementing the risk factor: a default of a partner could easily spread to all the others. In order to reduce the probability of this event, netting procedures require a partner to deposit some form of guarantee. Partners undertake to stop

150. See id. at 65 (concerning confidentiality and protection of beneficiary data).
151. See GIOVANNINI, FIRST CROSS-BORDER, supra note 147, at 12.
152. See id. at 5.
153. See id.
154. See id.
155. See id.
trading when their amounts due or theirs securities deficits reach some threshold value.\textsuperscript{156}

Netting procedures can be convenient only when few intermediaries are involved. In the event of a cross-border transaction, the amount of the guarantees involved and the uncertainty about the costs and the risks can easily prevent the transaction from being carried out. Building on this view of the problem, the Giovannini Group identified "15 barriers" obstructing the efficient provisioning of clearing and settlement services in the EU.\textsuperscript{157}

In its Second Cross-Border Report on clearing and settlement,\textsuperscript{158} the Giovannini Group analyzed what actions could be performed to lower the above barriers. Interventions suggested ranged from the technical-logistic levels (definition of new protocols for information interchange, harmonization of operating schedules, etc.) down to specific incentives for achieving international consolidation between CPPs and CSDs.\textsuperscript{159} At that time EU legislation was already in place, as in 2002 a Directive\textsuperscript{160} was approved, specifically covering netting arrangements and the broader use of securities as collateral.

Applying two base-principles of European Legislation, the mutual recognition and the home-country principles, the Collateral Directive affirmed that, whenever securities are held as collateral by an intermediary, the legal system of reference is that of the intermediary.\textsuperscript{161} In the special case of clearing and settlement arrangements, universal opinion was this ruling to be the most sensible, as it brought certainty and transparency to the process of trading securities. The extension of this regulatory approach to the general case did not appeal to international jurists.

Almost as soon as the Collateral Directive was adopted, the Hague Conference, in its Hague Securities Convention, developed a ruling on the law applicable to any case of securities held

\begin{itemize}
\item 156. See ESCDA, \textit{supra} note 149, at 12.
\item 157. See Giovannini, \textit{First Cross-Border}, \textit{supra} note 147, at 44.
\item 158. See Giovannini, \textit{Second Cross-Border}, \textit{supra} note 147, at 4.
\item 159. See id.
\item 161. See id. art. 2(g).
\end{itemize}
with an intermediary. According to this wider ruling, clearly not limited to the use of securities as collateral, securities held by an intermediary are subject to a legal system of election (i.e., that must have been explicitly "chosen by agreement between the account holder and the intermediary"). In order to thwart the institutional conflict that might have developed, the European Commission acted swiftly.

In its Proposal for a Council Decision, issued in Brussels on December 15, 2003, it recommended that the immediate signature of the Hague Securities Convention, followed by a second step of ratification. This second step will be based on a Council Decision requiring the approval of the European Parliament. In the meantime, the Commission will amend the unfortunate Collateral Directive. The proposal pledges that, in a favorable scenario, the ratification of the Hague Securities Convention may take place by 2005.

D. Single Euro Payments Area and European Payment Council

According to the provisions of the EC Treaty, NCBs of EC member countries had the task to "promote the smooth operation of payment systems". In 1999, this task was delegated to the specially-formed ESCB, comprised of the European Central Banks and the twelve NBCs of Euro-area member countries. Initially, Directive 97/5/EC tried to improve efficiency in cross-border credit transfers by suggesting a number of "fair dealing" principles: (i.) publicity and transparency in both the charges and the cost structure; (ii.) compensation based on the reference rate of interest applied to the period beyond the agreed time limit for the transfer; (iii.) all charges to be borne by the sender of the transfer, usually abbreviated with the "NOS-

162. See Giovannini, Second Cross-Border, supra note 147, at 16.
163. See id. at 13.
TRO" or "OUR" keywords, except where explicitly agreed otherwise.\(^{170}\)

As the market for cross-border retail transactions was expanding, a number of surveys for cross-border credit transfers confirmed that banks were not complying with the principles stated in the Directive. In fact, normal bank practice was to charge both sender and receiver without even asking the customer. In addition, the surveys\(^ {171}\) brought to light the wide disparity in the amounts charged, which varied depending on the countries of origin and destination and a number of other factors. For example, in 2001, the average charge for a cross-border credit transfer of EUR 100 was estimated at EUR 22.70, but the effective price paid by the customer could range anywhere between EUR 3 and EUR 60.\(^ {172}\)

The Regulation implementing the Directive\(^ {173}\) covered both electronic payment transactions and credit transfers, affirming the principle of uniform charges: for cross-border retail transactions, banks were to charge the same tariff they charged for domestic ones. While the principle of uniform charges should be applied to all form of payments, the Regulation states\(^ {174}\) that it will be enforced only for the electronic form of money, since older means of payment (cross-border cheques, regulated in the Geneva Convention of March 19, 1931)\(^ {175}\) were likely to incur higher costs of processing. Starting in July 2002, cross-border electronic payments under €12,500 were to be effected under

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171. See European Commission, Study on the Verification of a Common and Coherent Application of Directive 97/5/EC on Cross-Border Credit Transfers in the 15 Member States — Transfer Exercice (2001), available at http://europa.eu.int/comm/internal_market/payments/crossborder/archive_en.htm#pricestudy2001 (last visited June 14, 2005). The study collected data of the following indicators: Total time-per transfer; Total cost-per transfer; Sender cost-per transfer; Foreign exchange loss per transfer; and Receiver deductions-per transfer. See id.


174. See id. Recital (8).

the same charges levied for national payments.\textsuperscript{176}

The same rules were to be applied to cross border electronic credit transfers under €12,500, but only starting in July 2003\textsuperscript{177}. On the correspondence with their customers, banks were asked to indicate the International Bank Account Number ("IBAN") and Member States were to remove any national reporting obligations (auditing procedures for balance-of-payment statistics, or anti money-laundering activity) which could prevent effective automation of retail transactions.\textsuperscript{178} With effect from January 1, 2006, the threshold of €12,500 will be raised to €50,000.\textsuperscript{179}

After the United States, the Euro-area is the world’s second largest retail payment market, but its members still have widely divergent payment preferences. According to a study of the European Saving Banks Group ("ESBG"),\textsuperscript{180} 30.4\% of Germans pay by credit card, 47.2\% of the French pay by check, while 60.2\% of Italians still prefer to pay in cash.

Even after the adoption of international standards such as the International Bank Account Number ("IBAN") and the Bank Identifier Code ("BIC"),\textsuperscript{181} European Straight-through Processing ("STP") rates are still 33\% for cross-border payments compared to 99\% for domestic transfers,\textsuperscript{182} while the time to complete a domestic transaction is about one-third of that needed by a cross-border one.

\begin{itemize}
\item \textsuperscript{177} See Regulation No. 2560/2001, supra note 173, O.J. L 344/13 (2001).
\item \textsuperscript{178} See id.
\item \textsuperscript{179} See id., art. 3, O.J. L 344/13 (2001). The Regulation establishes that banks cannot charge for cross-border electronic payments, and credit transfers up to €12,500, more than for corresponding national payments. The amount of €12,500 will be revised to €50,000 as from January 1, 2006. See id.
\item \textsuperscript{180} See European Savings Banks Group, ESBG Response to European Financial Integration Reports of the Four Independent Groups of Experts 4 (Position Paper, Bruxelles, Sept. 10, 2004).
\item \textsuperscript{181} See Regulation No. 2560/2001, supra note 173, art. 5, O.J. L 344/13 (2001).
\end{itemize}
A de facto obstacle to market integration is that most European countries have already developed a national Automated Clearing-House ("ACH")\(^{183}\) system, usually based on national standards and procedures. Recently, £75 millions were invested in the refurbishing of BACS, the United Kingdom's ACH.\(^ {184}\) A study by McKinsey & Co\(^ {185}\) estimates that the cost of the consolidation of National ACHs is in the region between €1 billion and €2 billion, with banks bearing the majority of the effort.

Not surprisingly, many bankers lament that regulatory mandate (as opposed to customer demand) is the main force driving towards a single European payment infrastructure. On the other hand, many observers, though conceding that the issue is politically relevant, argue it could well be the only way to preserve the decentralized structure of European capital markets, including the banks themselves. In the end, European banks resorted to a self-governance effort, undertaking to achieve a Single Euro Payments Area ("SEPA") by 2010,\(^ {186}\) under the guidance of the European Payments Council ("EPC"),\(^ {187}\) the decision-making body of the European banking industry in payment processing.

The EPC fostered the development of a Pan-European Au-

\(^{183}\) See id. at 5.

\(^{184}\) "Clearing house BACS has started work ahead of schedule on the second phase of a £75m project to re-engineer its IT infrastructure . . . . Anticipated growth in the volumes of transactions handled by BACS was the driver for NewBACS. The clearing house, which is owned by the major banks, currently handles over 3.5 billion financial transactions a year, such as direct debits and standing orders, and this is expected to rise to 5 billion by 2005." Andy McCue, BACS Ahead of Schedule with £75m IT Overhaul, Aug. 8, 2002, available at http://www.financialdirector.co.uk/news/1130259.


\(^{186}\) See Jean-Claude Trichet, Testimony before the Committee on Economic and Monetary Affairs of the European Parliament, Introductory Statement, ECB (Mar. 14, 2005) available at http://www.ecb.int/press/key/date/2005/hdm/sp050314.en.htm. On March 14, 2005, Mr. Jean-Claude Trichet, President of the European Central Bank, in his Testimony said that "the Eurosystem has requested that a Single Euro Payments Area ("SEPA") be created for the Euro area from 1 January 2008," meaning that citizens and enterprises could make payments throughout the Euro area from a single bank account, using a single set of payment instruments, as easily and safely as in the national context today. Id. In addition, "national infrastructures should migrate to a pan-European payments infrastructure by the end of 2010." Id.

automated Clearing House ("PE-ACH")\(^{188}\) and on April 28, 2003, the STEP2 consortium became the first service provider for PE-ACH and started processing cross-border credit transfers.\(^{189}\) The ECB estimates that to break even economically in its operation, PE-ACH should process about 50% of current cross-border credit transfers.\(^{190}\) In the current phase of the economy, this critical mass could be reached only by routing through PE-ACH all transactions that were previously processed by correspondent accounts, or by attracting payments from all EU members that are not yet in the Euro-area. As target dates become nearer, the future of PE-ACH and of TARGET2 is becoming more and more intertwined with political issues, as the development of a European payment system is increasingly perceived as another milestone toward European Integration.

III. THE IMPACT OF EURO AND EMU ON EUROPEAN CAPITAL MARKETS

A. Money Market

The adoption of the single currency has effectively eliminated foreign exchange risk from Euro-area cross-border transactions, and European Banks that are market-makers, ("Euro-prime Banks"), can manage liquidity in a virtual single pool, that is, can easily lend and borrow liquidity between themselves.\(^{191}\) Real Time Gross Settlement ("RTGS") systems, fully-automated message systems used to transfer liquidity in the Gross Capital Market, are contributing to the integration of Euro trading and the settlement process.\(^{192}\) Short-term interest rates have con-


\(^{190}\) "[I]n order to ensure the economic viability of a PE-ACH, a first critical mass of roughly 50% of the current cross-border credit transfer volume needs to be processed via the pan-European infrastructure." ECB, First Report, supra note 188.


verged, as evidence of the complete integration of the short-term money market.193

Through a mechanism of weekly auctions, the ECB leverages on reserves regulations for setting the interest rate in the money market. In the Euro-area, every bank is required to hold an account with its National Central Bank, and (on a monthly average) the balance of this reserve account must be greater than 2% of the amount of deposits and short-term customer loans.194

After deciding in advance the liquidity it wants to supply to the banking system and the minimum interest rate it is going to ask, the ECB collects bids on Tuesday morning, and executes the auction. On Wednesday, every bank receives its money allocation on its National Central Bank reserve account - via the TARGET Real Time Gross Settlement System.195 Between the auctions, a bank, which wants to better its monthly deposit average, has to borrow liquidity from its NCB or from another bank: the interest rates in this “over-night market” reflect both the offerings of the ECB and the overall status of the economy.196

The Euro Over-Night Index Average (“EONIA”) is the reference rate at which liquidity is offered between Euro-prime banks for very short periods, typically, the periods involved in the processing of settlements, which spans between two successive openings of the TARGET system. The Euro Inter-bank Offered Rate (“EURIBOR”)197 is the benchmark rate at which Euro-prime banks offer short-term deposits to each other. These two reference rates are calculated from the data provided by a select and CHIPS Finality 10 (2000), available at http://www.ny.frb.org/prc/ILM.pdf (last visited June 20, 2005).


195. See ECB, Implementation of Monetary Policy, supra note 194, at 29.  
196. See PRECUP ET AL., supra note 194.  
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panel of European banks, and are used in the formulation of interest-rate spreads as in, for example, “twenty basis points above EURIBOR.”

In order to protect the confidentiality of the data, the management of the panel is delegated to EURIBOR FBE, a Belgian “international non-profit association”\(^\text{198}\) funded by the European Banking Federation (“FBE”) and by the Financial Markets Association (“ACI”). As the calculation of EONIA is central to the operation of the settlement process, its calculation is affected by the ECB.\(^\text{199}\)

For longer periods, from a few days, up to one year, repurchase transactions, usually called “repos,” are carried out.\(^\text{200}\) A “repo” consists of the exchange of a security and money with an agreement to reverse the transaction at a later date and at a given price. These secured transactions are used by the ECB for implementing its monetary policy: every week, the ECB tenders funds for the period of two weeks, at a selected interest rate.

With these open market operations, the ECB earns money, exerting control over both the monetary aggregate M2 and the primary interest rate of the market.\(^\text{201}\) Securities that are eligible as collateral for the ECB have also become widely accepted as collateral in the market for private repos: its reference rate is called EUREPO,\(^\text{202}\) and is managed by EURIBOR FBE in the same manner as the previous benchmarks. The EUREPO market is used by private sector banking institutions to manage their liquidity requirements.

Despite the efforts of the ECB, however, the adoption of as-

\(^{198}\) “Euribor FBE and Euribor ACI are Belgian ‘international non-profit associations[,]’ established pursuant to the Act of October 25, 1919[,] concerning the Granting of Legal Personality to International Associations with a Scientific Purpose (as amended).” EURIBOR, The Benchmark Rate of the Euro Money Market, available at http://www.euribor.org/html/content/faq.html (last visited June 20, 2005).

\(^{199}\) See ECB, Guide, supra note 134.

\(^{200}\) See Giovannini, Repo, supra note 145.

\(^{201}\) The general perception is that up to the present time, ECB interventions are mainly targeted to limit the consequences of the occasional liquidity shocks. See Steen Ejerskov et al., How Does the ECB Allot Liquidity in Its Weekly Main Refinancing Operations: A Look at the Empirical Evidence, (ECB Working Paper No. 244, 2003) available at http://www.ecb.int/pub/pdf/scpwps/ecbwp244.pdf (last visited June 20, 2005).

set-backed securities in the Euro-area is not yet as substantial as in the United States, and the national markets were somewhat successful in resisting integration. According to the Giovanni Group, the securitization of the short-term capital market failed for both logistical and legislative reasons. The cross-border transactions that could lead to a real market integration are still impractical to handle with the current trading and settlement infrastructures.

Moreover, legislation is not helpful in stating the risk profile of multi-stage transactions, the process of offering to a third party the securities received in a previous "repo" operation. In the event of insolvency of somebody along the chain, the last taker of the collateral needs assurance that it has a perfect interest in it, that is, free from the grasp of other creditors. The Settlement Finality Directive and the more recent Directive on Financial Collateral Arrangements will improve the legal certainty of the private "repo" market.

The structural changes in the Euro gross money markets have brought forward interesting changes at the retail level. The Euro-area is developing a distinctive two-tier structure: informal banking networks span Member States, with large banks dominating the international scene, while smaller banks operate at a local level. The apparent reason for this is that usually a small bank can be more selective in approving a loan, taking ad-

204. See Giovanni, Repo, supra note 145.
205. See id at 7.
206. See id at 17.
vantage of the segmentation of the market, while only a large bank can access the cross-border capital market.

While big cross-border transactions are efficiently managed on RTGS (Real-Time Gross Settlement) systems, smaller banks are still relying for their operation on "NOSTRO" deposit accounts opened at their "umbrella" bank, sometimes tying up liquidity and obstructing the tracing of money-laundering activities.211

B. Government Bond Market

In the Government-bond market, a common platform, named Euro-MTS,212 has been created for trading the bonds of the twelve Euro-area member countries, with the exception of Luxembourg.213 Since the integration reached by the G-bond market is second only to that of the European money market, economists have been puzzled by the persistence of long-term spreads between the National Debt issuances of Euro-area member countries.214 Before the advent of the Single Currency, foreign exchange risk had been widely regarded as the main factor in European interest-rates spreads: as short-term differences dwindled to virtually nil, alternative explanations were proposed


212. The juridical status of Euro-MTS ("MTS") is that of an Italian Private Venture (Società per Azioni). Recently, Euronext, the Paris-based European Exchange, announced it had teamed up with Borsa Italiana, the Milan stock exchange, to make an offer in the auction for MTS. See Martin Arnold, Euronext Makes Joint MTS Offer, Fin. TIMES (London), Mar. 16, 2005, at 31.

213. The Banque Centrale de Luxembourg does not issue National Debt Certificates. In 1935, a monetary agreement linked Belgium and Luxembourg: accordingly, the Banque Centrale du Luxembourg was not established until June 1, 1998 (the same day as the European Central Bank), as it was a prerequisite for participation of the Grand-Duchy of Luxembourg in EMU. For a short monetary history of Luxembourg, see Banque Centrale du Luxembourg, Monetary History, at http://www.bcl.lu/en/bcl/history/index.html (last visited June 20, 2005).

for the residual differences in long-term interest rates.\textsuperscript{215}

If the differences were to be ascribed to liquidity factors, they could be considered a sign of market inefficiency, and acted upon by adjustments in debt management policies by NCBs and Market Regulators.\textsuperscript{216} The twelve Euro-area member countries plan their issuance calendar on a yearly basis, but they still regard the issuance of National Debt as a sovereign competence, and adopt different issuing techniques. Current standards call for a two-stage procedure: after a first-round competitive auction, aimed at setting the interest rate of the issue, there is a second phase during which non-competitive bidding takes place.\textsuperscript{217}

In 2000, the Giovannini Group,\textsuperscript{218} recognizing wide differences in relative shares and durations, focused on the coordination of debt issuance, but in the end the Giovannini Group was unable to publish a recommendation, as a result of disparity between national views. On the other hand, if the long-term interest spreads could be explained by different credit risks, they should be evaluated as the indication of an efficient G-Bond market, which allocates capital to each National Economy according to its expected results. Perhaps the main obstacle to resolving the puzzle lies in the evaluation of anecdotal evidence and quantitative data, and it will be difficult to reach a definitive explanation.

For instance, although pension system deficits are not published among the fundamentals of a National Economy, the universal opinion is they have some impact on National Debt risk factors.\textsuperscript{219} On the other hand, quantitative analysis has shown that, contrary to common prejudice, the liquidity of the futures'...
market for German G-Bonds has no influence on long-term interest spreads. The evaluation of the interest rate spread is of great relevance for countries like Italy and Belgium, which feature high values for gearing (this ratio of National Debt vs. Gross Domestic Product should not exceed 60%, according to the Maastricht criterion of budgetary discipline). In the Italian economy, surges in short-term interest rates can soak up available resources, effectively blocking public expenditure and consumer consumption.

C. Corporate Bond Markets

In the fixed income securities market, the history of the adoption of Euro in bond denominations can be represented as a success without any doubt. The surge in issuance in 1999 was the attempt to recover from the bad year of 1998 (Russian Debt default, Long-Term Capital Management crisis). In 2000 and 2001, the sector continued to grow, but some of the new issuances were simply replacement for previous issues. In 2002,
the corporate bond market fell, due to the deteriorating global economic environment, but in 2003, the entire bond market bounced back.\textsuperscript{225}

\textbf{TABLE 6:}
\textit{EURO-DENOMINATED BOND MARKETS: VOLUMES ISSUED BY TYPE OF ISSUER}
\textit{In billions of euros}

<table>
<thead>
<tr>
<th>Year</th>
<th>Government</th>
<th>Financial</th>
<th>Corporates</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>1,800</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>1,600</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td>1,400</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td>1,200</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td>1,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: European Directorate General for Economic and Financial Affairs
Elaboration: OECD 2004

\textsuperscript{225} "According to the international statistics of the BIS, the Euro overtook the U.S. dollar in 1999 as the most heavily used currency for international debt issues." Pagano & von Thadden, \textit{supra} note 221, at 534. However, Pagano & von Thadden remark that BIS criteria for classifying international issuing cover both financing and investment components, an argument proposed by Carsten Detken & Philipp Hartmann, who stated that "This targeting... is a qualitative judgement [sic] made on the basis of a number of criteria... Because of this last component, measures based on that definition would to some extents combine financing and investment currency use." \textbf{CARSTEN DETKEN \& PHILIPP HARTMANN, THE EURO AND INTERNATIONAL CAPITAL MARKETS} 7 (Center for Fin. Studies, Working Paper No. 2000/9, 2000), \textit{available at} http://www.ifk-cfs.de/papers/00_09.pdf.
Table 7: Net Issuance of US Bonds

Billions of US dollars

<table>
<thead>
<tr>
<th>Year</th>
<th>Government</th>
<th>Financial sectors</th>
<th>Non-financial corp. business</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td></td>
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<td>2002</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: U.S. Federal Reserve Board, Flow of Funds Accounts of the United States
Elaboration: OECD 2004

One of the simplest indicators of the role of a market in a national economy is its capitalization or its current-price assets value, expressed as a share of GDP. When computing the index for the financial and the corporate sector together, the 2001 values were 73% for the Euro-area and 80% for the U.S. area, as an illustration that the economic structures were remarkably similar on either side of the Atlantic, at least at this aggregate level.

If the same calculation is performed for the corporate sector alone, the Euro-area share drops to 11%, which should be compared with the U.S. result of 27%. This disparity illustrates that financial intermediaries still retain much influence over Euro-area capital markets, while in the U.S., the corporate sector has more confidence in the bond market as a direct supply of capital. According to expert opinion, "[c]losing the gap with the United States in bond market financing of businesses will be

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a very slow process. Over the last three years, the Euro-area has started to catch up, but the speed is not increasing.”228 The controversial Private Finance Initiative (“PFI”) is one of the innovative ways devised by the services banking industry to alter the landscape of European capital markets.229 The PFI originated as British Labour’s favored method of funding new public sector projects: instead of relying on the traditional financing of building property, British Government sub-contracts the complete infrastructure (designing, building, management and staffing throughout its operational life) to a purpose-built consortium.230 The consortium leases the project, typically for 30 years, to a public authority, such as a council or health trust, and gets paid a fixed rate, as in a fixed-coupon bond. While PFI is widely recognized as an important channel for technology transfer,231 others have been quick to perceive its disruptive potential of a consolidated market structure.

The most important piece of legislation promoting the Bond Market in the EU is the afore-mentioned Prospectus Directive232 that defined a European standard for the two documents needed to qualify any issuance of securities. Investments Bankers can now focus on the prospectus (mandatory proposal to be used in public offerings) and on the passport (documentation used for requesting admission to regulated markets), instead of trying to follow the technicalities of National Regulations.233 A Parliamentary amendment granted exemption to companies with assets lower than €350 million, encouraging small businesses to resort to this form of financing.

Parliament has finally approved the so-called Transparency

228. See Gjersem, supra note 46, at 19.
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238. See ROSSI ET AL., supra note 236.

239. See ADAM ET AL., supra note 211, at 4.

240. See William Sharpe, Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk, 19 J. OF FIN. 425 (1964); see also ENRICO C. PEROTTI & ERNST-LUDWIG...
In the bond market, the interest rate can be an adequate measure of the risk profile of the investment, and the spread in interest rates is an indicator of financial integration. On the other hand, for equities it is not easy to define a simple indicator linking the volume of asset capitalization, returns, and investment risk. Indeed, the EU’s “Regional Innovation Strategies” (“RIS”) approach aims to lower equity price-correlation across member countries, by actively supporting geographical and historical specialization.

Equities funds are natural market-makers: it is only natural to look at them for assistance in equity matters. Economists look at investment portfolios of equity funds in order to appraise equity market integration. In a similar way, the European Commission recognized the role of the fund industry in financial markets when it asked the Giovannini Group to start its fact-finding mission.

Relevant information for investment funds is collected by the Fédération Européenne des Fonds et Sociétés d'Investissement (“FEFSI”). Funds are classified according to their international investment strategy and their preferred in-

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strurnents, as declared to their investors. The statistical analysis reveals that, after the advent of the single currency, international investment funds increased their quota of Euro-denominated equities.

Moreover, "the average increase for the Euro-area countries is stronger than for the remaining European Union countries."244 On the other hand, the evidence gleaned from the behavior of pension funds and insurance companies is not definitive, but it should be noted that, in this case, data is provided only by financial research firms and that any problem in collecting data should be considered an intrinsic indication of an imperfect market.245

In 2002, according to Eurostat estimates, the total number of memberships in autonomous pension funds in the EU stood at around 21 million.246 Observers feel that in the pension funds and insurance industry, the trend towards concentration is somewhat feebler than in the banking industry: nonetheless, recently a rash of mergers & acquisitions occurred between insurers and banks throughout Euro-area countries, known as "bancassurance."247

E. Covered Bond (Mortgage Bond) Market

In a mature economy, households tend to assume a net debt position, and usually offer their dwellings as collateral for their loans. Standard traditional practice rules that in these mortgage operations the loan should not exceed 50% of the value of the collateral, in other words, the Loan To Value ("LTV") ratio should not exceed 50. Mortgages ceased to be a simple fact of

244. See Adam et al., supra note 211, at 3.
life when, in June 2003, the U.K. Treasury argued that structural differences in housing and credit markets between the United Kingdom and the continent were a significant impediment to the United Kingdom’s adoption of the Euro as the national currency.248

When the market liberalized, UK mortgage firms actively offered variable-rate mortgages, accepting for the first time very high levels of LTV ratio, thereby mirroring the activity of U.S. firms,249 which were then offering 125-LTV loans (that is, disposed to lend up to 125% of the value of the collateral). National planning process and housing regulations, effectively clamping down on the supply of housing, contributed to stepping up the tension in the UK mortgage market. Waving aside political implications, the whole episode could be seen as evidence of a real necessity to back retail mortgage markets with some second-tier structure.

An over-geared, non securitized mortgage market can be a real instability factor for the whole economy, as shocks in the short-term interest rates can soak available resources in the form of mortgage payments, affecting consumer spending.

The European Mortgage Federation ("EMF")250 defines mortgage bonds (covered bonds) as "debt securities issued by mortgage credit institutions and covered by certain types of assets, usually mortgage loans, which remain on the balance sheet of the issuer." Article 22(4) of the UCITS Directive,251 which most EU Member States have transposed into national legislation, establishes minimum standard criteria that mortgage bonds have to meet.


(i.) The institution issuing the bonds has to have its registered office in an EU Member State.

(ii.) The bond-issuer must comply with its National Supervisor regulations.

(iii.) There must be adequate coverage for depreciation and liabilities for the entire duration of the investment.

(iv.) In the event of the bankruptcy of the issuer, bond-holders can recover their capital and interest before any other creditor.252

The classic instrument on the European Mortgage market is the Pfandbrief253 (“covered bond”), traditionally issued by German mortgage banks for funding their operations. The risk profile of the instrument is regulated by the German Mortgage Bank Act: mortgage loans remain on the balance-sheet of the issuer, although in legally separated asset pools, and must guarantee a mean loan-to-value ratio of 50% and 55%.254 In order to reach this ratio, any surplus must be funded through other debt instruments (usually, medium-term promissory notes).

“The Jumbo-Pfandbrief, the market segment for big-volume issues”255 is very liquid, with at least three market-makers and electronic trading. From July 2002, in an implicit recognition of the maturity of the market, the Mortgage Bank Act permitted issuers to engage in lending activities outside Europe.256

In order to lower the risk profiles of deals with a loan-to-value ratio above 60%, the European mortgage industry leveraged on available financial instruments, developing the practice of securitization.257 If the mortgage loans are effectively “removed from the originator’s balance sheet”,258 the transaction is


256. See id. at 1.

257. See Lassen, supra note 252, at 24.

258. See Shengzhe Wang, True Sale Securitization in Germany and China, 9 (Inst.
called a true-sale securitization. True-sale structures account for more than 90% of the market share in Europe. In a true-sale, the bank establishes a separate legal entity, called a Special Purpose Vehicle ("SPV") and sells mortgage loans to it.\textsuperscript{259} In this way, the assets of the SPV are legally separated from those of the originator and the vehicle can issue securities that are sold to investors. Current rating procedures for a true-sale have set standards for risk-covering provisions: a fully funded cash reserve of about 3% of the transaction size and an additional 10% stand-by liquidity line for the first five years of operation. In contrast, if the mortgage assets remain on the balance sheet at the originating bank, and only the credit default risk is transferred to the investor, the transaction is called synthetic securitization: its end product bears all the features of a credit default swap, with the premium information that it originated from the mortgage market.\textsuperscript{260} Synthetic securitizations, the dominant practice in the German market, came about as a result of the complexity of mortgage assets transfer procedures (it effectively circumvents existing obligations in borrower notification and agreement) and by the absence of national regulation in SPV fiscal treatment.\textsuperscript{261}

The EMF, the central organization of mortgage lenders in Europe, launched the European Covered Bond Council ("ECBC")\textsuperscript{262} during the EMF Conference on November 24 and 25, 2004.\textsuperscript{263} The aim of the ECBC is to promote dialogue be-

\begin{itemize}
\item \textsuperscript{259} A Special Purpose Vehicle ("SPV") is a controlled entity enjoying a legal status completely separate from the mother company, and is usually established for financing purposes. See WILLIAM M. BURKE ET AL., HANDBOOK ON CROSS-BORDER SECURITIZATION 9, available at http://www.shearman.com/documents/CrossBorderSecu.pdf (last visited June 20, 2005).
\item \textsuperscript{261} See WANG, supra note 258, at 9.
\item \textsuperscript{263} A panel consisting of Mr. Louis Hagen (the ECBC Chairman), Mr. Thierry Dufour, Mr. Torben Gjede, Mr. David Balai, Mr. Antonio Torio and Mrs. Judith Hardt officially launched the European Covered Bond Council. See Eur. Mortgage Fed., EMF
tween market participants and, at the same time, to sharpen the profile of covered bonds in the public eye. A further purpose will be to represent the joint positions of the covered bond industry by raising issues with the Commission and the Parliament of the EU.

Moreover, the participation in the European Covered Bond Council will not be reserved solely for members of the EMF. According to the EMF, covered bonds are the single largest component of privately issued instruments "with the volume outstanding at the end of 2003 amounting to over EUR 1.5 trillion," a 3% increase with respect to 2002. Today there are active covered bond markets in almost twenty different European jurisdictions and there is a strong expectation that the covered bond market will continue to grow. For 2004, an overall growth of up to 25% is expected.

IV. OPEN ISSUES

A. European Capital Market — Geographical Structure

The European capital market is heavily localized, probably as a consequence of frictional factors: the development of skills in the financial services industry is a multi-generational process and human resources cannot be easily resettled in another country. In the same way as in other sectors of economic activity, the European capital market has become concentrated in a number of local areas where strong competition is established around specialized products. The reasons that led to the development of these Regional Innovation Strategies range from historical


267. See EUROPEAN COMMISSION DG REGIONAL POLICY, supra note 242, at 8.
tradition, sociological and linguistic affinity to the availability of a favorable institutional environment.

Spatial dispersion factors are not a relevant issue: Europe is contained in only three time-zones and state-of-the-art Information Technology ("IT")\(^{268}\) infrastructures such as trading platforms and real-time fund transfer systems, RTGS,\(^{269}\) and ACHs,\(^{270}\) can help in keeping down the costs of localization.\(^{271}\) According to Economic Growth theorists,\(^{272}\) technological specialization in a regional district can evolve in two different ways.\(^{273}\) Smithian\(^{274}\) technological specialization, approximately "learning by doing,"\(^{275}\) describes the marketplace as the force leading to the optimal sizing of production processes.

On the other hand, Ricardian\(^{276}\) technological specialization, "push pull,"\(^{277}\) regards technology transfer, creativity and

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\(^{269}\) See supra note 137 and accompanying text.

\(^{270}\) See supra note 183 and accompanying text.


\(^{272}\) See B. Dalum et al., Does Specialization Matter for Growth, 8 INDUS & CORP. CHANGE, 267, 288 (1999).


\(^{275}\) See JUNGMITTAG, supra note 273, at 3.

\(^{276}\) See id.; see also DAVID B. RICARDO, ON THE PRINCIPLES OF POLITICAL ECONOMY AND TAXATION, in 1 THE WORKS AND CORRESPONDENCE OF DAVID RICARDO (Piero Sraffa ed., Cambridge Univ. Press 1952) (1817).

\(^{277}\) See R. W. Zmud, An Examination of "Push-Pull" Theory Applied to Process Innovation in Knowledge Work, 30 MGMT. SCI. 727, 727-738 (1984); see also Brian E. Mennecke,
cross-breeding as the main drivers to achieve structural changes to production processes. The European capital market appears to have four distinct districts:

(i.) London\(^{278}\) has successfully kept its role as the main entrance for foreign capital\(^{279}\) into the EMU. This is confirmed by the steady growth of its market share relative to the issuance of Euro-denominated bonds. The history of innovation and creativity in the design of financial instruments in the City of London is probably the best example of Ricardian specialization applied to Capital Markets;

(ii.) Frankfurt am Main, as the main gateway from EMU to Switzerland, is affirming itself as the leader in Over-The-Counter ("OTC")\(^{280}\) derivatives and in cross-border payment systems;

(iii.) Dublin has established its financial district as the main location for European fund management;

(iv.) the Grand Duchy of Luxembourg offers very convenient legislation for the establishment of SPV.\(^{281}\)

An independent confirmation of the geographical structure of the European Economy is the evidence of a disappointing rate for the process of consolidation between banking institutions. Regulators and analysts hoped the single currency would launch a new wave of Mergers and Acquisitions ("M&A"), but, after four years, Angeloni and Ehrman\(^{282}\) evaluated the situation. They pointed out that: (i.) cross-border lending and deposit taking\(^{283}\) has shown a tendency to increase, but no dramatic changes have taken place; (ii.) inter-bank activity has been rising sharply,\(^{284}\) as further testimony of the integration of the inter-bank capital market; (iii.) cross-border branch-establishing activities remains negligible; and (iv.) M&A activities are indeed


\(^{281}\) See supra note 259 and accompanying text.

\(^{282}\) See Angeloni & Ehrmann, supra note 92, at 183.

\(^{283}\) See id.

\(^{284}\) See id.
taking place, but at a level less than desired by regulators and forecast by analysts.

In the literature, many explanations have been given for this phenomenon: (i.) the overall fragmentation of the lending market, due to the considerable proportion of small firms, both on the lending and on the borrowing side; (ii.) the European tradition of relationship banking, entailing close ties between corporations and banks; (iii.) the hypothesis that banks have de facto agreed not to compete in the retail market, at least for the time being; and (iv.) the evidence of national obstacles in M&A. As an example, the Italian NCB (Banca d’Italia), in its role of national regulator for banking activity, has significantly opposed most M&A activities directed towards Italian Banks. While protectionism is still at work in Europe, it is significant that the intervention of the Italian Regulator has been censored by EU authorities, the media and most political parties.

Still, the alternative exists as to whether the geographical dispersion of capital markets in European economy is a distinctive feature that should be preserved, or a problem that should be addressed. Market forces and EU interventions are slowly changing the landscape of the banking profession in the Euro-area. From this standpoint, it appears that some distinctive regional traditions are going to be abandoned, as a consequence of: (i.) the mandatory adoption of International Standards both at operational level (Basel II) and at accounting level

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285. See id. at 179.
286. See id. at 189.
288. On June 24, 2004, the new capital adequacy framework, commonly known as “Basel II,” was published and submitted for review by NCBs and Banking Supervision authorities. The Basel II Framework sets out the details for adopting more risk-sensi-
(IAS39)\(^2\)89; and (ii.) the emergence of the Single Euro Payments Area.\(^2\)90

**B. EMU and EU - Mutual Roles and Objectives**

Joining the European Union is both an economic and political act,\(^2\)91 but adopting the Euro requires a much greater effort. The ten accessing states\(^2\)92 (Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovenia and Slovak Republic), which became members of the European Union on May 1, 2004, appear eager to reach the required criteria and adopt the Euro. Bulgaria and Romania are scheduled to join the European Union in 2007.\(^2\)93

From a purely economic standpoint, the adoption of the Euro is very convenient, as it brings to the new Member States some saving from the pooling of National Reserves, minus the reduced revenues from *seigniorage* activity.\(^2\)94 The costs to be paid are all at political level. The Maastricht Treaty’s four eco-


289. *See* Rossi et al., *supra* note 236.

290. *See supra* pt. II(D).


Economic convergence criteria\textsuperscript{295} are: (i.) price stability (an average inflation rate not in excess by more than 1.5\% that of the three best-performing Member States); (ii.) budgetary discipline (a public budget deficit of less than 3\% of GDP and a public debt ratio not exceeding 60\% of GDP); (iii.) currency stability (a minimum of two-year permanence in the exchange rate mechanism, ERM-II (2.25\%), of the European Monetary System); and (iv.) interest rate convergence (an average long-term interest rate not exceeding by more than 2\% that of the three best-performing Member States).\textsuperscript{296} A fifth criterion requires the independence of the NCBs from political authorities.\textsuperscript{297} Conformity to the Maastricht criteria is assessed by the ECOFIN,\textsuperscript{298} on the basis of reports by the European Commission and the ECB. Recently,\textsuperscript{299} the EMU Member States and all the EU Member States succeeded in improving the budgetary discipline criterion, supporting a slight temporary overspend against the reference value of the 3\% of the deficit. "Rather than referring to a theoretical list of relevant factors, the agreement sets out chapter headings, that is general and basic principles enabling Member States and institutions of the European Union to reach a better understanding of the treatment of the relevant factors."\textsuperscript{300}

From a commercial standpoint, as the area of influence of the Single Currency has already expanded beyond the original EMU Member States without any political intervention, in due course, attention of the observers has focused on the role Euro can achieve on the international markets.

C. Euro as International Currency

Euro-area Member States have delegated to the ECB their rights to lay out a monetary policy. As a result, the Euro is the only currency not directly connected to political power.\textsuperscript{301} The

\textsuperscript{295} See EC Treaty, supra note 19, art. 121, O.J. C 325/33 (2002).
\textsuperscript{296} See Goebel, Will the EMU Ever Fly?, supra note 4, at 304.
\textsuperscript{298} See supra note 108.
\textsuperscript{301} See CHRISTA RANDZIO-PLATH & TOMMASO PADOA-SCHIOPPA, THE EUROPEAN
success of the Euro in capital markets could well reflect the growing trend towards less political control over the economy.302

Before the introduction of the Euro, the management of Interest Rates and of National Reserves were the two main activities of a NCB.303 In the handling of National Reserves two primary objectives can be recognized: (i) in order to protect their National Economies from foreign-exchange shocks, NCBs influence the quotations of their National Currencies, by selling or buying on the Foreign Exchange markets, (Intervention role of National Reserves); (ii) when not involved in intervention, National Reserves, as any other form of capital, should bring an adequate revenue to their owners (Investment role of National Reserves).304 In order to realize these objectives, NCBs usually resort to some form of “currency anchoring.”305

Acting against current market trends (i.e., buying when the majority offers to sell and selling when others are trying to buy) the intervention of NCBs is usually carried out in order to maintain a predefined parity level between its National Currency and some other reference currencies.306 Backed as they are by National Reserves, even the mere intentions of a National Central Bank can alter the trend of the market: accordingly, NCBs do not routinely publish their guidelines for intervention, but rely on episodic announcements. After an analysis of all the arrangements that developed over the years in different countries, four main alternatives of currency anchoring can be detected.307


304. See Axelrod, supra note 62, at 1.


At first level, an NCB can announce the presence of the Euro on its currency board, *tableau de bord*. By doing so, the NCB admits that it is monitoring the exchange rate between its National Currency and the Euro, and that rate plays a role in its policy of intervention. This approach is followed, among others, by Bosnia-Herzegovina, Bulgaria and Estonia.\(^\text{308}\)

As international trade develops and the National Economy becomes increasingly dependent on monetary stability, an NCB cannot rely on the simple *tableau de bord* to supervise its currency. Economists name a currency basket the mathematical process of averaging the rates of a set of currencies, usually weighted by their relevance in international trade.\(^\text{309}\) The NCBs of Hungary, Iceland, Poland, Commonwealth of Independent States ("CSI"), and Ukraine have announced that Euro features in each of their currency baskets (used for setting a reference for each of their National Currencies).

At a more binding level, an NCB can announce that the Euro has become its *anchor currency*: the Single Currency is the only reference in setting its monetary policy. Thus its National Currency will follow the trend set by the Euro, although with some slack and delay. This shadowing practice is favored by Czech Republic, Slovak Republic and Slovenia.\(^\text{310}\)

Finally, an NCB can set for its National Currency a fixed exchange rate against the Euro. This approach, known as *pegging*, has been adopted by Denmark, Cyprus and Macedonia.\(^\text{311}\) The area of influence for the Euro is not limited to Europe: as a consequence of their colonial history, a number of African States have kept their National Currencies pegged to the French Franc.

With the advent of the Euro, they simply chose to move their peg to the new currency: as a result, both the eight west-African countries of the "Commonauté Financière de l’Afrique" and the six central-African countries of the "Coopération Financière Africaine"\(^\text{312}\), have a national currency (the CFA

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308. See ECB, Review of the International Role of the Euro, *supra* note 305, at 44.
311. See id. at 43.
Euro) pegged to the Euro. The success of the Euro appears as confirmation of a world trend toward limiting the money-creating autonomy of NCBs, and therefore the number of independent global currencies.

Independent NCBs are beginning to recognize that they cannot offer for their National Debt issues at an interest rate below that set by ECB or by the Federal Reserve. Moreover, they are also recognized that they do not possess the liquidity to operate against the Dollar or the Euro capital markets. A country with strong links to the Euro-area has three basic alternatives:

(i.) a complete membership, which means its National Central Bank has to delegate its monetary policy to the ECB;

(ii.) a committed policy of pegging or shadowing the Euro, de facto limiting the power of its NCB;

(iii.) a traditional approach, trusting its National Central Bank with the relative power of the currency board or of the currency basket.

Even these more autonomous NCBs, however, have started to feel the effects of the appearance of the Euro on capital markets on their National Reserves.

D. Euro as Reserve Currency

From a purely financial point of view, in order to manage its National Reserves, a Central Bank has to bear a transaction cost (which depends on its interventions on the market) and the equivalent costs of three (global-economy dependent) risk factors: interest risk, foreign exchange risk and credit risk. The transaction costs are estimated by the average difference between sell and buy prices, and are usually assumed to be in inverse relationship with the liquidity of the market. When there is a relative abundance of buyers and sellers, there is little space for negotiation: if a deal is refused, it is easier to forward it to somebody else.


When operators become scarcer, the difference between sell and buy prices increases, reflecting the need for a tougher negotiation. Until the advent of the Euro, only the U.S. capital market featured low transaction costs and, therefore, the dollar was almost the only currency featured in National Reserves.\textsuperscript{316} Now, the Euro can be thought of as a second-best reserve currency, as its gross capital market features sufficient liquidity and its transaction costs are comparable to those experienced on the dollar-based capital markets.

Interest risk and foreign exchange risk factors can be evaluated only in the short term, for a number of reasons: (i) the interventions of the National Central Bank itself modify foreign exchange rates; (ii) in the management of National Reserves, the decisions of anchoring, intervention and investment are interrelated; (iii) the increased presence of managers from the fund industry is evidence of a trend towards a more active management of National Reserves.\textsuperscript{317} Past and present episodes warn that, sometimes, the costs of keeping a peg to the U.S. dollar can be just too expensive: in the last decade, Argentina\textsuperscript{318} fell victim of this strategy of dollarization\textsuperscript{319} which caused a severe recession. In January 2002, finally, Eduardo Duhalde, Argentina’s fifth leader in two weeks, declared officially the default on the nation’s foreign debt, estimated at U.S.$141 billion; it was the biggest default in history.\textsuperscript{320}

In November 1997, after the onset of an East Asian crisis, the Russian Rouble came under speculative attack.\textsuperscript{321} In this epi-

\textsuperscript{316} See Salvatore, The Euro: Expectations and Performance, supra note 39, at 121.


\textsuperscript{319} Dollarization is a strong pegging of a national currency to the dollar. See Dominick Salvatore, Euroization, Dollarization, and the International Monetary System, in MONETARY UNIONS AND HARD PEGS 27-40 (Alexander et al., eds., 2004).


sode, the Central Bank of Russia ("CBR") aggressively defended the parity of its National Currency, losing nearly U.S.$6 billion in foreign-exchange reserves, but in the end it was unable to prevent the default of its National Public Debt. The widespread instability that followed involved even some of the speculators which originated the attack.

During the last year, some NCBs invested hugely in U.S. Federal Reserve Bonds, in an attempt to maintain favorable conditions for their exports, nominally, a high USD foreign exchange rate and a low U.S. domestic interest rate. The results of this policy are shown in the following diagram, based on data from the Federal Reserve’s Treasury International Capital System.

Japan’s position is so strong that it has to be recorded on the right-hand scale, while the assets of the next four greatest buyers of Treasury Bonds (People’s Republic of China, United Kingdom, Republic of Korea, and the aggregate of Caribbean countries) can be described by the vertical scale on the left. All these Central Banks are now victims of the “Prisoner’s Dilemma:” acting in their intervention role, they invested most of their National Reserves in dollar-based assets. As the market is slowly turning against the dollar, they are realizing that there is no formal agreement forbidding one of them to cut its own losses, by dumping its dollar assets on the market. The first

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325. See JOHN NASH, Two-Person Cooperative Games, in THE ESSENTIAL JOHN NASH 99 (Harold W. Kuhn & Sylvia Nasar eds., 2002). The Prisoner’s Dilemma is one of the first examples considered in Mathematical Game Theory. It derives its name from the traditional policy of giving a remission to the first suspect to confess, in exchange for collaboration against the others. Its name has extended to cover all the situations in which the first player to do something wins, at the prejudice to everybody else (a particular case of non-zero sum games).
one to back off from its investment could experience much less damage than the others.

On the other hand, its action could send shockwaves throughout its National Economy, and, in a longer term, this could lead to instability in the whole Asian economy.

As time is slowly finding a way out of this impasse, the episode will probably be remembered as the confirmation of the importance of the investment role of National Reserves. The availability of a second currency for allocating National Reserves should be considered a welcome novelty, as it offers Reserve Managers the opportunity of improving both stability and profits.

**CONCLUSION**

Economic and Monetary Union Member States have tried to establish a sound macroeconomic framework characterized by price stability, sound public finances and low interest rates. The Euro-area as a whole is far better equipped to withstand economic shocks than the previous national economies: moreover, corporations can benefit from lower costs of doing business in Europe. Backed by a liquid and integrated money market, the Euro is poised to become the major currency in all transactions.
where the dollar is not feasible for political or economical reasons.

Some work has still to be done, however, to attain the level of integration at which U.S. bond and equity markets have been operating in the recent years.326

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326. See Trichet, supra note 69 ("Wholesale money and bond markets tend to be relatively well integrated, but only the unsecured Euro money market has reached a fully satisfactory challenges, level of integration.").