

When Will European Financial Markets Be Truly Integrated?

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Over the past decade, Europeans have surely looked with envy across the Atlantic at the boom in American financial markets. Not only have equity valuations risen by a factor of four since 1990, but initial public offers have exploded as well. From the beginning to the end of the decade, the number of firms issuing equity rose by a factor of five, with the total level of dollar financing rising by ten times. Share issuance has been one of the important engines of finance for new technology companies. As a result, the dot coms are not at all dependent on banks for the cash that they need to grow.

This move away from traditional financial intermediaries has some important collateral benefits as well. In many ways, it has destroyed banks as we used to know them. Instead of transforming deposits into loans, and retaining substantial risk on their balance sheets, banks are increasingly acting simply as brokers with a much closer match between the risk characteristics of their assets and liabilities. As a result, the American financial system is now much less likely to experience disruptions brought on by bank failures than it was even five years ago.

When will this miracle come to Europe? The euro area is roughly the size of the U.S., and yet its financial market remains much smaller. Won't monetary union be the catalyst for catching up?

Of course the euro area, and the European Union more broadly, is not monolithic. The member countries differ substantially from one to the other. In some countries, particularly the U.K. and the Netherlands, financial markets are quite important as the market capitalization of publicly traded firms exceeds 1.5 times GDP --- a level roughly in line with that in the U.S. But in countries such as Italy, equity market capitalization is less than one-half of GDP.

Corporate bond issuance in Europe has picked up substantially since monetary union, with the recent rate of issuance slightly exceeding that in the U.S. But again, there are significant differences across countries. In Germany, for example, we saw the biggest bond offering in history: the Deutsche Telekom issue of €14,500 million on 30 June. Then came the first Italian securitized issue in the European market: Fiat's issued of €65 million in debt backed by vehicle loans on 5 July.

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European countries remain dramatically different. In some, firms raise funds directly in capital markets, as in the U.S. In others countries, however, traditional bank loans remain the predominant mode of financing. Will this now change rapidly?

The first step in answering this question is to understand why the national financial systems are so different today. I believe that differences in legal structures are the primary reason for divergences in banking and finance across countries. Here is why.

Investors provide capital to firms only if they believe they will get their money back. For equity holders, this means that they must be able to vote out directors and managers who do not pay them. For creditors and holders of bonds, this means that they must have authority to repossess collateral. Furthermore, these nominal legal rights must be accompanied by confidence that the laws will be enforced.

While there are differences across U.S. states in the rights accorded equity and bond owners, they are modest when compared with the divergence in legal structures within the euro area. A single example will suffice to make the point. In Germany, France and the U.K., following a mortgage default, it takes between 11 and 15 months on average to repossess the home that was used as collateral. In Italy, repossession takes an average of 48 months --- four times as long. These legal difficulties extend into the corporate sector as well. As a result, Italian financial markets are substantially smaller than those in nearly every other European country.

The trend toward consolidation of European market trading, exemplified most recently by the proposed link between London and Frankfurt, is really beside the point. What is important is not where the shares or bonds are exchanged, but the laws governing the management of the firm should they fail to perform adequately, and the physical location of the collateral that would need to be seized. Firms can be identical in all respects, but if they operate in different countries they are likely to choose to finance their activities in very different ways.

Until corporate legal structures are harmonized, and enforcement of the new laws is equally effective across countries, there will be substantial differences in financial markets. Only when holders of the shares issued by Italian, German, French and Dutch firms all have the same rights to vote out directors and fire managers will financial markets become equally important across all of the countries in Europe.

While monetary union will surely simplify the creation of a pan-European financial market, on its own it cannot do the job. In fact, I believe that the introduction of the euro has made corporate legal reform even more pressing. Interest rate changes influence economic activity through a number of channels. One of the most important is that they affect the banking system's willingness to lend. But since banks are of varying degrees of importance in across the euro area, we can expect that monetary policy will have very different affects by country. The sooner legal structures are harmonized, the sooner financial structures will converge and monetary policy will have more uniform effects.