Beate Reszat

EUROPEAN FINANCIAL SYSTEMS IN THE GLOBAL ECONOMY

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Contents

1
Introduction

Financial markets are generally regarded as the forerunners of globalisation. Leading banks and investment houses have a presence in financial centres all over the world. There is 24-hour trading in foreign exchange and other financial instruments, and advances in communications and computer technologies allow anyone with a PC and telephone, even in the remotest parts of the world, access to financial information and trading and investment opportunities as has never been known before. The financial industry has long completed the transition from internationalisation to globalisation, from the central operation and control of worldwide activities to the dispersion of central functions to all major nodes of the world economy and their constant interaction within large networks. Globalisation has not only revolutionised the way in which financial instruments are traded but also a wide spectrum of activities from information gathering and price discovery, through portfolio and risk management, to clearing and settlement and mergers and acquisitions.

So why study European financial markets, which are embedded in this worldwide net of financial relations and activities, as a special entity? There are at least three reasons. The first is *history*: many financial systems, institutions and techniques in today's markets have their roots in early Europe. Examples are bonds, shares, techniques of forward trading, exchanges and central banks – but not banks, since bank-like institutions existed in other regions and eras too. Another aspect is that there are many peculiarities in Europe which represent a competitive advantage or disadvantage in the world system and that are rooted in the past. Those include institutions, legal systems and the role of governments in financial sector development.

The second reason is *diversity*: focusing on European financial markets offers the opportunity to study a wide range of institutions and systems, to make comparisons and learn to distinguish the main characteristics of, say, universal banking systems and specialised ones, strongly and less strictly regulated financial markets with direct or indirect policy interference, or the implications of different norms and rules.

The third reason is *specialty*: Europe is special among the world's regions. This does not only refer to the monetary union, this unique experiment in history. With the introduction of the Internal Market Programme for financial services the European Union has become the largest financial market worldwide. It has a unique system of regional bank supervision, and the centre of international supervision is located within Europe too. Europe is the location of what is in many respects the largest financial centre in the world; the European Central Bank is one of the world's leading central banks and the euro ranks second in the league of world currencies behind the US dollar. Besides all this, the experience with, and constant challenge of, integrating new entrance candidates into an existing framework of monetary and financial cooperation may provide many lessons to other regions.

This little book is thought of as a first introduction to Europe's financial markets and institutions, their performance and overall position in the world financial system. Although requiring some familiarity with basic principles of economics it is designed for students without prior knowledge of international finance. Since it developed from materials for a master course on European and International Financial Markets in an international university programme it may also be useful for readers outside Europe with no direct experience of European financial markets and systems. The text is a mixture of fundamentals and empirics with boxes giving short explanations of basic economic terms or referring to related case studies. Several appendices provide in-depth discussions or examples of related aspects of general interest that are not covered in the main text. Each chapter typically includes a brief summary, a set of exercises and a list of links and references at the end. The aim of the exercises goes beyond recapitulating the contents of the chapters; they are directed at stimulating discussion and further reading, and reflecting on arguments, in order to gain deeper insights into circumstances and developments that can be only briefly sketched here.

The book is organised as follows. Chapter 2 gives a short overview of the history of financial markets in Europe and explores the rise of centres and peripheries and the emergence of financial institutions and instruments. Chapter 3 examines market structures; European financial markets are characterised by a diversity of arrangements, products, assets and market types and in the first part of this chapter the reasons for this diversity are studied, while the second part deals with financial market typology in detail. It starts with various forms of financial intermediation focusing on the markets for money, credit and foreign exchange as well as for capital and derivatives. Attention then turns to financial systems discussing the main characteristics of bank-based and market-based systems as they are found in various parts of western Europe. Another focus is the development of financial systems in eastern European countries and here, in particular, in the new accession countries. The last part of this chapter turns to external markets, including traditional markets such as the Euromarkets and offshore centres, but also the virtual market places that have emerged with the internet revolution and the development of electronic finance in Europe.

Chapter 4 examines the role of European markets, systems and institutions in the world economy. One focus here is on the performance of banks and exchanges and the role of clearing and settlement systems for the international competitiveness of European markets. Another is on the consolidation process that is underway in the European financial industry and the way this changes the global position of European institutions. Chapter 5 focuses on market mechanisms and prices: in which ways do the choices and behaviours of investors, borrowers and lenders determine market conditions? Which are the main motives and strategies behind their actions and which role do expectations play in the process of price formation? How does the interplay of various groups of actors affect prices? What kinds of characteristic price patterns can be found in financial markets in Europe and elsewhere?

Containing price volatility and spill-over effects in times of crisis is one major policy issue these days. Others are overall financial stability and the relationship between finance and economic growth. Chapter 6 examines these and other topics in detail within the European context. One special aspect here is the efficiency of policy instruments in a globalised environment; as a rule, globalisation is weakening national sovereignty and limiting the use of policy instruments. In this it provides a strong rationale for policy cooperation. The European example demonstrates that agreement on cooperation, and a balance between national interests and international necessities, is easier to reach on a regional level than worldwide. However, as will also be shown, financial integration in Europe, too, is still fraught with uncertainties and hindered by countless impediments, and the introduction of the common currency, albeit an important element in the integration process, so far contributed less to the development than expected.

The book concludes with some general remarks on the prospects and challenges of the future of European monetary and financial integration.

2
European Financial Markets in History

Thinking of financial markets in Europe big financial metropoles like London, Paris, Frankfurt, Zurich or Amsterdam come to mind.

In contrast to developments on other continents, European financial history has always been a history of *places* where those in search of capital and those with idle funds came together. The European financial landscape has always been characterised by *centres and peripheries*.

Early financial activities stretching beyond the boundaries of the local town or village were rooted in long-distance trade. The earliest centres of the Middle Ages developed almost simultaneously with the rise of big *merchant empires* in the north and south of Europe. Before that time, up to the twelfth and even thirteenth centuries, European trade and finance was largely regionally limited. There was an infinity of states, sub-states, duchies, church-controlled territories and city states. Merchants' activities were restricted by the need to have personal knowledge of people and economic circumstances, limiting their business horizons to several days' walking distance and journeys along the major trade routes.

The first changes came when preferences for particular goods from remote places emerged, for example for salt from the Atlantic coast or wines from southern regions. Emerging crafts resulted in a rise in purchasing power in northern Europe and a taste for wines and other products from southern regions. Italian merchants introduced Flemish wool fabrics to the Mediterranean. Long-distance journeys such as pilgrimages and crusades heightened the awareness of other regions and aroused partiality to luxuries and exotic products such as ebony, silk and spices.

From the twelfth century onwards, increasing business activities led to the emergence of a threefold *division of labour* in Europe. Sedentary merchants, above all from northern Italy, specialised in the financing and organisation of trade. Specialist carriers then transported the goods from principals to agents by land or by sea. Full-time agents resident in foreign places engaged in sales and purchases according to the instructions sent by their principals.

The nascent merchant empires developed sophisticated business methods and forms of credit, ringing in what has been called *the classic succession of dominant cities*: Venice, Antwerp, Genoa, Florence, Amsterdam and London.

Each of those financial centres is known for the *innovations* they contributed to the development of European and international finance. This is particularly true for the financial instruments and practices introduced by Italian merchants:

- *Bills of exchange*, the essential form of foreign exchange in the Middle Ages, were traded at Italian fairs from the twelfth century. Those allowed for the avoidance of the physical transport of precious metals; it was safer to send a courier with bills than to dispatch specie or bullion under the guard of an armed convoy – and it was faster.

- From at least the tenth century, the *contratto di commenda*, a form of limited-liability partnership to share economic risks, whereby people could use their savings to invest in long-distance trade, was in use in Italy. The contratto di commenda (known in Venice as *collegantia*, in Genoa as *societas maris*) is widely regarded as a forerunner of the joint-stock companies.
- Florence and Genoa were the first European cities to mint their own *coins*, the Fiorino and the Genovino, in 1252. The Fiorino and later the Venetian ducat soon replaced the dinar, becoming the 'dollar of the Middle Ages'.
- The earliest surviving *cheque* was drawn in 1365 in Florence to pay a draper for black cloth for a family funeral.
- Genoa and Venice introduced the instrument of *public debt* to finance infrastructure and military projects before 1200 with the first *government bonds* issued in Venice.
- Prototypes of *marine insurance* date back to thirteenth-century Genoa, which remained the centre for this type of activity until the seventeenth century when London took the lead.
- Florence between the twelfth and the fourteenth centuries was the origin of great banking families, such as the Peruzzi, Bardi and Acciaiuoli, and later the Medici, all of whom had large capital stocks and wide *networks* of subsidiaries and relations in western Europe, north Africa, and the Levant.

However, Italians were not the first to have a flourishing money-based economy. The Italian city states owed much of their success to early relations with the Islamic world. There, credit instruments were highly developed before they became known in Europe, social functions such as 'bankers' were much older than the Italian 'benches', and Islamic traders knew sophisticated techniques for pooling capital much earlier than their Italian counterparts. Up to the thirteenth century Italian merchants continued to rely on the gold coins of Constantinople, and later Egypt, which at that time were the preferred specie for international transactions in Europe, the Middle East and India.

The first financial intermediaries in western Europe were *pawnbrokers* and *money changers*. First, the latter largely conducted business in exchange of currencies, with no element of credit involved. Given the great variety of coins in circulation in the Middle Ages, they played an indispensable role in major trading centres. The terms '*banks*' and '*bankers*' first appeared in the twelfth and thirteenth centuries; they are rooted in the benches or 'bancos' Italian merchants established at European trade fairs. *Deposit banking* evolved in reaction to the inconvenience involved in making all payments in specie and to the waste of time involved in counting coin. *Bank money* based on a fractional reserve dates back to the early fourteenth century when money changers discovered that in taking deposits and making payments on behalf of depositors it was not always necessary to keep cash covering the total value of deposits. As a consequence, they began keeping a small fraction of that amount, lending out the rest at interest to third parties or investing it directly in other businesses.

Trade and financial activities among European merchants were largely facilitated by the rise of organised fairs. In the thirteenth century, the *Champagne fairs* became an important financial centre in the European heartland. Located in north-eastern France, they lay midway between the two poles of economic activity in Europe at that time: the Italian cities and the industrially developing textile region of Flanders. Trading in money and foreign exchange became the true specialty of the fairs, but there was a divide between 'local' and international bankers: traditional money changers and local transfer banks in those places usually neither dealt in bills of exchange nor did they have correspondents abroad. This was left to the – mostly Italian – international merchant bankers.

Bill of Exchange

The Bill of Exchange was a contract defining an agreement between a deliverer and a trader by which the *deliverer* advanced a sum of money to the *trader* and, in return, received from him a 'letter missive', the bill of exchange, payable in a distant place and in another currency. Usually, the implementation of the contract required two other parties or agents to be involved in the location where the payment took place. These were the *payor* and the *payee*. The letter would specify the amounts and currencies in which funds were to be received and repaid, as well as the exchange rate and the time at which the bill was to be paid. The latter was known as *usance*.

The length of the usance was not only determined by the time it took to deliver the bill. At a time when financial activities in wide parts of Europe were limited by the *prohibition of usury*, bills of exchange were often used as credit instruments with exchange and re-exchange only concealing an interest-bearing loan (Appendix A). In this, a loophole in the law was exploited: Under a rule endorsed by most scholastic writers, buying and selling bills issued in terms of a foreign currency, and payable in a foreign country, was not considered usury. The practice of using a bill as a credit in disguise helps explain why merchant custom with regard to usance remained practically unchanged for several centuries – long after communication methods had improved considerably.

In the fifteenth century the overall economic supremacy of the Italians came to an end and the centre of financial activities in Europe shifted to the Low Countries, first to *Bruges*, and later to *Antwerp* and *Amsterdam*. They, too, became important centres of financial innovation:

- Among Bruges's wealthiest residents was the van der Beurs family, inn-keepers who allegedly gave their name to the later *bourse* or *stock exchange*.
- Bruges also became known for being the first place to establish *brokers*, called 'makelaer' or 'couretier', as intermediaries as early as the thirteenth century.
- In Antwerp, the *bond*, or *debenture*, was invented, where assets and liabilities were settled by an issuer committing himself to pay an agreed sum at maturity to the owner of a paper that could be sold by the borrower in the meantime.
- Another Flemish invention was the *rentes*, an alternative to loans to governments, which were strongly controversial in the usury debates of the Middle Ages. Antwerp's *Beurs*, founded in 1531, was the first bourse providing a physical presence for such papers.
- Amsterdam largely contributed to the wide acceptance of *stock trading*. The first known share worldwide dates from 1602, and was issued there by the Dutch East India Company (Vereenigte Oost-Indische Compagnie, or VOC). The Amsterdam bourse was Europe's leading securities market for many years.
- Also in Amsterdam, *forward transactions* as a specific form became a common tool of exchange trading.

In the sixteenth and early seventeenth centuries there was a short interlude between Antwerp's supremacy and Amsterdam's reign in which *Genoa* took the lead as Europe's financial centre,

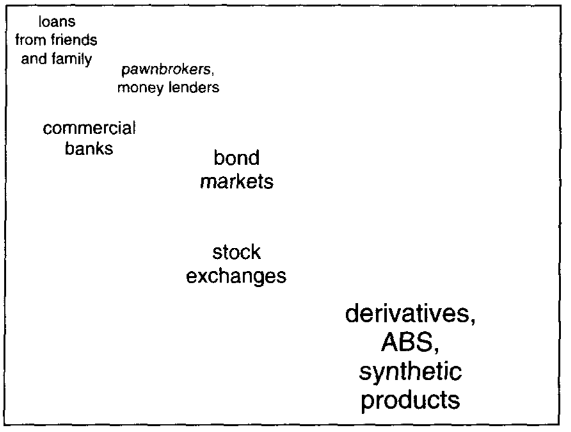

Figure 2.1 Development of finance

following the example of Florence in earlier years with its merchants' wide international networks of subsidiaries and relations. Then, after Amsterdam's decline in the seventeenth and eighteenth centuries, *London* became the financial centre, first of Europe and then of the world, and kept this role until the First World War. It temporarily lost it to New York, only to regain it in the 1960s with the advent of the Euromarkets, and has maintained it ever since.

In literature, financial development is often regarded as a *linear, stepwise process* from simpler to more sophisticated forms. In this view, financial relations start from informal borrowing and lending arrangements with friends and family, followed by a rise of pawnbrokers and professional money lenders, developing into a system dominated mainly by commercial banks in which bond and stock markets slowly play an ever-growing role, with more sophisticated financial services and increasing specialisation emerging still later on (Figure 2.1). While this picture may hold true for countries in an early stage of economic development, it is misleading for the highly advanced economies of western Europe for two reasons at least. On the one hand, in these countries financial products of varying complexity often emerged in parallel in reaction to the needs of trade and commerce. On the other, as the German example demonstrates, even highly advanced economies long made do without a fully developed system. In addition, many examples can be found showing that the process from lower to higher sophistication is *not irreversible*. For instance, this holds true for some of the EU accession countries in eastern Europe such as Poland and Hungary which at the end of the nineteenth century already had well-developed stock markets. The origin of the Budapest Stock Exchange dates back to 1864, and the Warsaw Stock Exchange, which re-opened in April 1991 after half a century of interruption, had first been established in 1817.

Hierarchy also prevails in views of the history of *money* itself. Here, the development started with individual barter and then proceeded from crops and cattle – mankind's 'first working capital asset' (Davis 2002) – to cowrie shells, the world's oldest and most widely spread currency which began to be used in China around 1200 BC and up to the early twentieth century was still accepted in some parts of Africa. The next step was metal coins, then paper currency and, most recently, electronic money (Figure 2.2). But, again, history shows that the process is not irreversible. One example from outside Europe is Japan, where mintage of coins started in the eighth century only to be abandoned again in 958 when the government

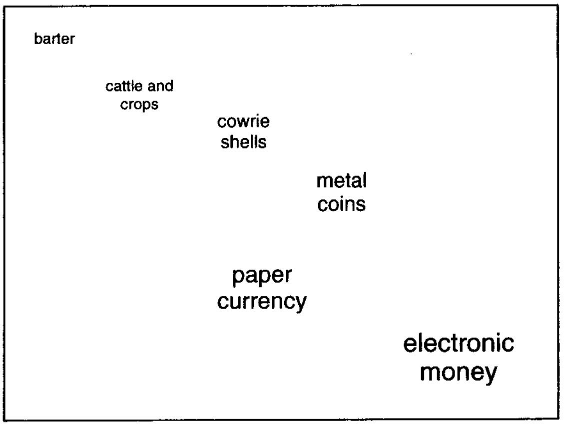

Figure 2.2 Development of money

forbade all circulation of coins after 250 years of mixed success and the country returned to rice and fabrics as mediums of exchange. This situation lasted until merchants and smugglers introduced foreign coins in the twelfth and thirteenth centuries and these soon became widely used and remained the main pillars of the Japanese currency system for the next 500 years.

Regarding the history of *financial centres* in Europe, development was stimulated by many influences. Long-distance trade first created the backbone along which, together with wines, wool and exotic products, money and credit travelled. The high risks involved established the need for inventing cashless means of payment, capital pooling and insurance. Frequent failures as the result of excessive loans to finance wars and other rulers' ambitions, speculative bubbles and the circumvention of the prohibition of usury were other sources of inspiration for financial innovations. Precious metals from the New World found their ways to markets in Europe, reshaping its financial landscape and altering cities' comparative advantage as financial centres, as did the process of industrialisation much later.

There were many reasons why a place became a centre in the world of European finance, why it kept that role for a while, or lost it to other places. *Political and economic influences* played their parts, but so did *natural disasters* and what economists like to call 'historic accident'. The Spanish–Dutch conflict that put an end to Antwerp's supremacy, or the decline of Amsterdam during the French wars, is an example of the first. Economic prosperity is the main explanation for the rise of Italian cities in the Middle Ages. *Institutional influences* help explain the rise and fall of German centres in the eighteenth and nineteenth centuries. Those were rooted in two different developments: in the general market activities of trade fairs in towns like Nuremberg and Augsburg, and in the guilds and merchant cooperatives found in Frankfurt, Cologne, Hamburg, Berlin and elsewhere. Bruges in the early twelfth century is often named as an example for a 'historic accident': when a storm opened a deep channel allowing the navigation of big commercial ships the town became the biggest trading port on the North Sea Coast, a position it held for many years. However, some authors argued convincingly that other influences added to its attractiveness, too.

These days, the financial landscape in Europe is determined both by a fierce *competition* between places like London, Frankfurt, Paris, Zurich and Amsterdam, and by mergers and acquisitions and other efforts to jointly exploit synergies. London is still the Number One among all European centres, although its position is no longer unchallenged. Its rise dates back to the seventeenth and eighteenth centuries when England brought a large part of the transatlantic trade under its flag and foreign commercial and banking families settled in the town as they fled from war on the continent. In later years, the strength of the Bank of England, the range of financial instruments available and the constant flow of financial demand resulting from industrial expansion and government debt became the pillars of the city's success.

Scale Economies and Lock-in

Broadly defined, *scale economies* are benefits arising from a production of more, rather than less, allowing maintenance of a low share of fixed costs per unit. For example, if inventing or adapting a new product or production technique requires significant setup costs, larger firms would perform better than smaller ones. Scale economies may also arise from agglomeration effects and a concentration of activities in one place. A concentration of financial institutions in one location leads to improved information flows, greater liquidity and higher efficiency in organised markets, and a centralisation of support services that all contribute to reducing costs.

Scale economies are special sources of rigidities in an economy giving rise to *path-dependence* and *lock-in*. The former broadly means that history matters. The current international status of a financial place depends on the advantages – and disadvantages – it has acquired in the past and the way in which those have influenced financial firms' location decisions. Lock-in stands for an inflexibility resulting from this process. Even if they offer high incentives for financial institutions to change location, due to long-established bonds and customs newly emerging competitors will find it hard to succeed in challenging the status of the Number One. Lock-in effects may offer one explanation why, despite the fundamental changes of financial systems, structures and techniques that Europe has experienced in recent years, and the introduction of the common currency outside the UK, the European hierarchy of centres with London at the top has remained widely unchanged.

Nowadays, there are additional factors underpinning London's status both in Europe and worldwide. They include

- a concentration of firms with the resulting *scale economies* and *lock-in effects*;
- the existence of *high quality professional and supporting services* such as accounting, actuarial and legal services and IT;
- an efficient *infrastructure* including office accommodation and telecommunications;
- the use of the *English language*.

Compared to other world regions, the spatial pattern of centres and peripheries found in European finance is quite unusual. In America the phenomenon of a financial centre is a very recent one, dating back to the nineteenth century. Even in Asia, the origin of one of the oldest informal money transfer systems (known as *hawala*), until fairly recently there was no need for a city hosting a bourse or fair to serve as a central place for financial activities.

In times of *electronic trading* and the *internet*, in Europe and worldwide, the rationale for financial institutions and activities to 'cluster' in centres seems to be waning. Relations between information technology and financial location are, however, more complex than generally assumed. Unlike in many other sectors, in international finance IT is *not an entirely new phenomenon*. Since the invention of the telegraph in the early nineteenth century, financial services have always been bridging distances using every available new medium and technology, from telephone, telex, video and fax to email and the internet, for speeding up communication and trade. On the other hand, many financial activities continue to require *proximity*. One aspect here is risk considerations and the experience that electronic surveillance is no substitute for human management. Others are the role of *trust building* that is crucial to many financial transactions and the need to become familiar with a special *context* before making financial decisions. Further arguments for an ongoing centralisation are *innovation and networking* and the desire to benefit from the constant presence, exchange and communication with others. In general, the less financial activities require spatial proximity in order to manage risks, gain access to information, establish social contacts or get impulses from the creative milieux of local communities, the greater the scope for dispersion and virtualisation.

Summary

- In contrast to other world regions, the history of finance in Europe is a history of centres and peripheries.
- Long-distance trade and the rise of big merchant empires laid the foundations for the success of cities like Venice, Antwerp, Genoa, Florence, Amsterdam and later London.
- The rise and decline of financial centres was influenced by political and economic developments, but also by what economists call 'historic accident'.
- Organised fairs facilitated early exchange beyond local boundaries with money changers and bankers playing a decisive role for their functioning.
- Financial innovations were stimulated by the risks related to long-distance trade and by the lessons learned from financial failures and speculative bubbles.
- London's present status as the leading financial centre, both in Europe and worldwide, is in part explained by advantages gained from scale economies and lock-in effects rooted in history.
- In the age of electronic trading and the internet, the role of financial centres is weakened, but an ongoing need of proximity to enhance trust building, innovations and networking still provides a rationale for 'clustering'.

Exercises

1. Discuss the reasons why

   - long-distance trade
   - wars and crusades
   - overseas colonies and
   - technological progress

   stimulated financial innovation and the rise of financial centres in history.
2. Explain the following activities and their origins:

   - money changing
   - deposit banking
   - banking based on fractional reserve.