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Deutsch-Französisches Wirtschaftspolitisches Forum

# Trade Rules and Global Governance: A Long Term Agenda. The Future of Banking.

Working Paper

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## Forum Economique Franco-Allemand

## Deutsch-Französisches Wirtschaftspolitisches Forum

Together with other members of the European Union, France and Germany embarked on an unprecedented cooperative venture. To be successful, Economic and Monetary Union requires a very high degree of mutual understanding among the policymakers of the participating countries. It also requires upgrading the dialogue between those who contribute to shaping the policy debates on both sides of the Rhine.

France and Germany have a long tradition of high-level dialogue and cooperation in the framework of bilateral and European institutions. But the dialogue between their civil societies does not match this spirit of cooperation. Economists and those involved in practical economic policy making from both countries in particular rarely talk to each other to find out why they may have differing visions of the functioning of Economic and Monetary Union and of the associated challenges, and even more rarely try to narrow the divergence of their views. This lack of dialogue contributes to keeping alive entrenched prejudices on the other country's supposedly hidden policy agenda.

Yet, an Economic and Monetary Union in which policy debates with a bearing on European policy choices remain confined within national boundaries would be prone to instability, because disagreements about policies would tend to end up in dispute between countries. It is, therefore, of utmost importance to foster the emergence of a genuine *European* professional discussion on major economic policy issues.

The purpose of the *Deutsch-Französisches Wirtschaftspolitische Forum/Forum économique franco-allemand* is to contribute to this discussion through the organisation of a series of informal meetings between French and German economists.

The Forum assembles professional economists from academia, business and the public sector. As a non-partisan institution, the Forum brings together participants from all strands of thinking about economic policy with the aim of stimulating fruitful debate. Each meeting is devoted to one or two major policy issues. The Forum commissions papers to provide an informed basis for the discussion, but the focus will be on debate and the exchange of views, starting with reactions from discussants whose role will be to present alternative views and to frame the key issues for the debate.

The proceedings of each meeting are published in policy paper format. With the present brochure, we present papers of the discussion from the Forum's seventh meeting on July 3 - 4, 2000 in Paris. We hope that this will be a useful input into an emerging public debate on Europe's economic policies in our two countries and beyond.

Jürgen von Hagen

Jean Pisani-Ferry

# *Trade Rules and Global Governance: A Long Term Agenda*[1]

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In 1999-2000, global governance issues have received widespread attention and have recurrently come to the fore of international news reports. But, save for welcome exceptions, this was not because attempts at organising collective action were producing results. Instead, the two features that came out most strongly were the failure or disappointing results of some highly visible meetings, such as the WTO ministerial in Seattle in December, 1999, or the Environmental Conference in The Hague in November, 2000, and the emerging tradition of vivid demonstrations that have accompanied high level international meetings, often brilliantly orchestrated by newly famous NGOs. To be sure, this combination of discontent and failure dates back some way to earlier unhappy initiatives, such as the failed MAI (Multilateral Agreement on Investment) project negotiated at the OECD. But Seattle gave it a new potency.

Many have been tempted to attribute the failure of Seattle to the demonstrators in the street. In fact, they may well have got the causality wrong. Seattle exposed a profound lack of shared vision and agreement on objectives among participating governments, unable to bridge their differences in due time and in the context of poor preparatory work. Ex post, therefore, it is apparent that Seattle was bound to fail, even if NGOs had not been present outside the meeting rooms. And, in fact, the failure of Seattle contributed to the success and media coverage of the NGOs. It exposed disagreements between major players on how to proceed, has now made life even more complex for negotiators by introducing a new set of actors from the “civil society”, and does leave the whole system without a sense of direction, even if past commitments guarantee that negotiations will still be going on in Geneva for the foreseeable future.

Some observers, scholars and opinion leaders are bound in denial : anti-globalisers, they argue, have it all wrong, do not understand what globalisation and multilateral institutions are about or yet are moved by unrelenting ideology. “Basically ignore, condescend to explain, and go back to work” could be their motto.

Our purpose in this paper is to argue that there is much more in the current anti-globalisation crusade than the sheer amplification of anti-capitalist ideologies through media coverage and the Internet. We interpret the recent, incipient backlash against globalisation as a symptom of policy failure, as policy makers not only have provided partial responses at best to legitimate concerns linked to globalisation, but also have failed to grasp the challenges of collective action at the multilateral level. We argue that the time is now ripe to seriously address central issues related to global governance well beyond the remit of the WTO and that failure to do so could result in the progressive demise of the multilateral system that has been so effective in underpinning economic prosperity in the second half of the 20th century. But recent experience suggests that there is a two-fold challenge : how to enlist the civil society in the discussion (1st challenge)? what guiding principles should underpin global governance efforts (2nd challenge)?

In a first section, we revisit the context of multilateral trade negotiations, because international trade has been at the core of multilateral co-operation, and because the WTO has been a constant target of anti-globalisation NGOs. We then move on to discuss, in a second section, various strategic options to restore the momentum of collective action in the

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[1] This is a much revised version of a paper presented at the 7th French-German Economic Forum, Paris, 4 July 2000. We thank our discussants, André Sapir and Hartwig Berghaus, and the participants for useful comments. We also benefited from in-depth discussions with Marie-Anne Frison-Roche. The usual disclaimer applies.

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trade area. A third section tentatively highlights some of the constitutive elements of a long term global governance agenda from the vantage point of the link between trade and other governance issues. Section 4 returns to more immediate concerns and briefly outline how to build a bridge between long term visions and short term issues.

## *1. TRADE RULES AND THE WTO: WHAT IS AT STAKE ?*

If anything, the Seattle fiasco has shown that the *degree of misunderstanding*[2] of the WTO and of multilateral trade negotiations, by the public opinion and by the NGOs claiming to represent civil society, is absolutely staggering. With its 500 person staff and its SwF 128 million budget, the WTO is a very small multilateral organisation by any standard. It nonetheless came to be depicted as an excessively powerful institution pursuing its own agenda and trying to govern the world in an undemocratic way. Its fully intergovernmental nature, where decision emerges from consensus among its 138 members, has been consistently ignored. It is tempting to argue that protesters had it all wrong. They pointed to excessive and overwhelming government from the WTO while the central problem is insufficient governance by the international community at large. The difficulty is that once such misperception has started to pervade many sectors of the public opinion everywhere, it is very difficult to redress.

Beyond a patent misunderstanding of the organisation, there is also a deep misunderstanding of the process itself. The purpose of establishing rules of the game in the field of trade in goods and services is not appreciated, while the image that surfaces is that of a trade system dominated by the powerful and by multinationals. There is a confusion between ex ante negotiating pressures and lobbying, which indeed is a game of power and pressures, and the ex post result, which is precisely to contain the power of actors through enforcing multilaterally agreed rules.

This is where the WTO has real teeth. One of the most significant innovations of the Uruguay Round was the considerable strengthening of the dispute settlement mechanism. Dispute settlement, based on the Dispute Settlement Body (DSB) and the Appellate Body is one of the very strong features of the organisation, and has already been extensively used in its first five years. It is a very powerful mechanism, because it subjects all member countries to a quasi-judicial order that can legitimate a resort to trade sanctions if countries do not live up to their commitments. But the DSB does not decide on the extent of liberalisation.

This misrepresentation is also a challenge to communication. And the task of proper communication does not only fall on the WTO shoulder. Governments have generally fared poorly in trying to explain the WTO: either they minimise its role and become vulnerable to the charge that it leaves the interests of the more powerful among states and firms rule unchecked; or they emphasise the power of the Dispute Settlement Body and feed the criticism that the WTO is all powerful. Member countries, most notably the Quad countries, are also largely responsible because their broad attitudes to the WTO, their negotiating postures, and their domestic debates, often characterised by strong misgivings about globalisation, do not adequately reflect the nature and purpose of the multilateral negotiating exercise. The reality is that the WTO is two different things at the same time, as we develop below: a secretariat in charge of multilateral trade rules, and an institution that has already made some inroad toward the governance of globalisation, albeit limited in scope, whose functioning requires focus and attention.

In refining the argument, it is useful to assess the relevance of the current framework of trade rules administered by the WTO against the three important criteria of efficiency, equity and legitimacy[3]. In these three important respects, the current system has over time faired fairly well, but increasingly exhibits serious flaws that need to be attended.

[2] Misunderstanding is not limited to outsiders. In fact, the shift from the GATT to the WTO is a change of regime whose significance has so far received too little attention. See Ostry (2000).

[3] They were at the core of a Harvard Kennedy School conference on “Trade at the Millenium” on June 1-2, 2000. Conference papers are available at http://www.ksg.harvard.edu/cbg/trade/papers.html

Efficiency

The GATT/WTO framework has produced two major achievements: trade liberalisation, and an effective rules-based multilateral trade system whose credibility is enhanced by a unique dispute settlement mechanism. Both contribute to economic efficiency: trade liberalisation through the benefits from trade; and the rules-based system through the settlement of conflicts as a way to prevent escalation of trade wars and to limit unilateralism and non co-operative behaviour, such as free riding. Credible rules of the game also enhance the predictability of market access, thus lowering investment uncertainty and bolstering economic growth and prosperity.

Postwar economic growth, as well as the current economic expansion in the United States and in Europe, are testimonies to the benefits from trade. The classical view, based on comparative advantage, focuses on the efficient resource allocation allowed by specialisation in a perfect competition, fixed technology framework. Consumers also benefit from greater choice and cheaper goods and services. Even more important, there are also dynamic efficiency gains from competition, through innovation, best practice benchmarking, technology transfers and other channels. As the degree of actual globalisation is actually much smaller than the ongoing debate suggests and our countries, however open, remain largely centred on themselves, gains from further trade liberalisation are probably quite large[4].

More recent trade theory, however, highlights some of the shortfalls in the classical theory: as imperfect competition, asymmetric information, increasing returns to scale, and technical change, rather than static technology and perfect competition, are the normal state of affairs, there are gains from trade through larger markets and economies of scale, but there is also room for efficiency-enhancing, market supporting government intervention. For example, markets can work even when information and competition are imperfect, but we all know that more often than not, they don't work well and some kind of regulatory support is called for.

But this gives no support whatsoever for unilateral protective measures : not only is protection seldom appropriate to deal with market failures, but it is also politically vulnerable to capture by parochial interest groups, and it is furthermore likely to invite costly retaliation from trade partners. This highlights some of the central benefits to be expected from a multilateral, rules-based system geared toward liberalisation : it legitimates the use of government measures and codifies codes of conduct – all of which is a far cry from "free trade" – while submitting them, through liberalisation efforts, to the test of efficiency and to the constant need to adapt to economic and technical change. Liberalisation should be thought of not as a quest for free trade, but as a "Schumpeterian" process of creative destruction of obsolete regulations that need to be replaced by more appropriate and efficient ones. Moreover, the multilateral arena is the right place to discuss the proper mix – and the subsidiarity - of market and government regulations, that is needed to make the market system more effective.

This suggests that the WTO and multilateral trade negotiations should no longer be posited as an elusive and rather misleading quest for "free trade". The true quest is for efficient trade and markets, and that requires hard thinking on the kind of regulatory framework and government policies, both at the national level and internationally, that are likely to promote market efficiency. It is a question of policy design, rather than policy irrelevance. The liberalisation drive helps to evince costly protectionist policies, but the task of policy construction remains largely unchartered. It is important that the nature of the exercise be properly recognised. This dimension can only grow with the development of the "new economy"; whose features more than often challenge the standard assumptions of competitive markets.

There is another, important dimension to efficiency. It refers to the maximisation of the value produced from a given resource input. One usually tends to measure value from statistics

[4] Frankel (2000) discusses the extent of openness ; Messerlin (1999) documents the costs of remaining protection in Europe.

about GDPs and growth rates. But, of course, value is a much broader concept, and the welfare function of an individual or a society is not restricted to the level of income or the rate of growth. Access to public services, for example as regards education, cultural diversity, income distribution, the sense of security, including food safety, and the quality of the environment are also intrinsic parts of welfare. Moreover, there are important and legitimate differences in the way various societies think of their collective welfare. Collective preferences differ between countries. For example, less developed countries may care less about environmental damage than richer countries, and it is well known that the early stages of industrialisation bring environmental damage. Or different societies might have different attitudes towards risk: a case in point is the difference in attitudes of the US and Europe vis-à-vis GMOs, which is not rooted in attitudes toward trade but rather in the societies' collective memories and in their conception of the role of the State.

It would indeed be unreasonable to think of international trade rules as instruments to promote these other values; but, certainly, trade has impacts, positive and negative, that ought to be taken into account. Here again, a dogmatic approach to "free trade" is not an appropriate response. Rather, what the world ought to be looking for is something like liberalisation accompanied with "efficient protection"[5].

Equity

Not only are there gains from trade, but there are also "pains from trade"[6]. And pains often come in the short term, while gains are more likely to materialise over the longer term, which helps explain why the widespread allegiance to the gains from trade from so many governments does not easily translate into single-headed liberalisation. In particular, in our societies, as theory predicts, unskilled workers have borne the brunt of the costs of adjustment to trade and technological change[7] and that also explains why we all struggle with an incipient backlash to globalisation. Globalisation will not be socially sustainable or morally acceptable if part of the gains are not redirected through appropriate distributive policies to those who suffer from job displacement or loss of income. Indeed, social policies are a key component of governments' pro-globalisation policies. The scope and nature of redistribution, as well as the pace of transition, will depend on national preferences and do not require full global harmonisation. But increased factor mobility restricts the ability of governments to undertake tax-based redistribution. The standard answer from trade specialists that such policies should be recognised as necessary complements to trade liberalisation is basically correct but cannot be considered sufficient to put an end to the issue.

Equity also comes out as a deep concern with regard to the situation of many developing countries. It is urgent to recognise the shortfalls of convergence alongside its successes. While a growing "middle class" of emerging countries has succeeded in escaping poverty and catching up with industrialised nations, a widening gap has developed between the top end and the bottom end of world income distribution. Contrary to what classical economists would have predicted, worldwide convergence between the rich and the poor simply does not take place spontaneously. It is increasingly clear that globalisation may also act as a force of exclusion, and that risk is further enhanced by the emergence of the so-called "digital divide" that introduces another innovation-based discrimination among countries[8]. This is a central challenge for world governance, calling for reform both in the way existing multilateral institutions conceive development aid and conditionality, but also in the bilateral aid policies of individual countries. It is also a matter for consideration by the WTO itself, especially in the aftermath of Seattle, where one could argue that a new North-South rift has

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[5] Sykes (2000) discusses " efficient protection ".

[6] Too often ignored in the standard economic advocacy of the benefits from trade. See Sapir (2000) for a useful discussion.

[7] Most studies emphasise the much stronger impact of technology as opposed to foreign trade, but evidence is growing that the impact of trade should not be neglected.

[8] Sachs (1999) argues that the post-cold war world is once again divided in three " worlds " : those able to innovate, those unable to innovate but able to use innovation, and those excluded from innovation altogether.

been in the making. It has become apparent that the desire to enlist the South in restoring the multilateral momentum faces a number of obstacles.
First, most developing countries simply do not have the resources to be present in Geneva, to take part in the discussions, to conduct the necessary studies crucial to a definition of their own policies with respect to trade and opening. Hence the growing feeling that the WTO is a closed club of rich countries that does not include new members on an equal basis, with the United States and Europe deciding – or procrastinating - for all the rest, and developing countries not being able to air their own objectives and concerns. A better integration of developing countries in the process of multilateral negotiations is therefore a priority task[9].
Second, the Uruguay Round, for the first time, fully integrated developing countries as "normal" members tied by the whole series of WTO commitments. As they are faced with the task of implementing these commitments, they discover the costs, and are yet unsure about the benefits. Developing countries find it notably costly to live up to their commitments with respect to the protection of trade related intellectual property (TRIPs agreement). They fear that in many crucial areas, such as health, these commitments might conflict head on with their national interests. Needless to say, a multiplication of conflicts of interpretation around the TRIPs agreement would significantly alter its credibility.
Third, developing countries' access to industrial countries' markets has become a real issue. The credibility of our message about the benefits from openness is crucially dented by our unwillingness to recognise them ourselves when our sensitive sectors are concerned. True, the Uruguay Round has made some progress with respect to the opening of markets for textiles and apparel, since it provides for a gradual dismantling of Multi-Fiber Agreement quotas. But no such progress has taken place in agriculture[10], and rich countries have backloaded the "gradual" dismantling of the MFA and have too easily succumbed to the temptation of invoking anti-dumping compensation. Hence the feeling in many developing countries that they are asked to deliver faster liberalisation while some of the provisions of the Uruguay Round have simply not been implemented by developed countries yet.
Finally, it is important to refine the message that we send developing countries about the benefits from openness. There have now been a wealth of empirical studies arguing that openness is over time a key contributor to development and prosperity. Openness thus empirically emerges as a *necessary* condition for take-off and sustainable growth. But there is a leap of faith in going from that reality to the mantra of liberalisation: "open, it's good for you". This motto implicitly postures openness as a *sufficient* condition for growth. This, however, is not supported by facts and has in fact already met with stringent denials: the Asian crisis, a story about mismanaged liberalization of capital inflows, amply demonstrates the point. Openness is a key objective, but it must be managed and accompanied by structural and institutional adjustments, that are difficult and costly to implement in the short term and will provide benefits only over time. In societies where market institutions, including the financial system, work poorly, unchecked openness may actually compound the problem. With the Uruguay Round, developing countries have increasingly lost their exceptional treatment and become full participants in the WTO agreements. It is, however, necessary to revive some differential treatment, not in terms of the extent of the eventual opening effort, but in terms both of the transition period necessary to phase in such effort and of the assistance needed to strengthen their institutions and modernise their policies (including social policies).

More often than not, however, the purpose of negotiations is set in terms of results. However, process, practices and principles matter more than results. Moreover, the quest for "results" is often hostage to pressure from powerful lobbies looking for increased market access. While this is legitimate from their parochial point of view, this may distract from the

[9] Which has started receiving a lot of attention. Many now consider that the time has come for a " development round ". Worthwhile efforts have also taken place through the joint WTO/World Bank co-operation (Cattaneo, 2000 check)
[10] Further agriculture liberalisation by itself would do little for development in LDCs; but the lack of it seriously affects our own credibility in invoking the mantra of the benefits from globalisation.

central purpose: to progressively develop a framework for a more prosperous, less unequal world and a better international economic governance. The time dimension, in this respect, is crucial. To maintain the negotiating momentum, one does need deadlines, and this is what a round is about, as opposed to ongoing negotiations that face no time constraint (and this is why the current built-in agenda negotiations that have started on time at the WTO will have a hard time converging on any meaningful agreement short of the start of a new round).

Legitimacy

Equity considerations naturally translate into legitimacy problems. There are really two separate issues to address in order to assess whether an action is legitimate: first, "procedural legitimacy", dealing with the way the action has been conducted; second, the value of the results, i.e. whether the action was effective and how.

Much of the discontent at Seattle targeted the lack of democratic accountability of the WTO, in other words procedural legitimacy. Indeed, as already suggested, several NGOs missed the point by not recognising the fully intergovernmental nature of the WTO process. Nationally elected governments have delegated authority to representative officials to negotiate at the WTO and delegation is part of the democratic process. But, of course, there is more to democracy than elections. Transparency is a key requirement, to allow the public to have all the relevant information before judging with their ballots. But debate is also crucial, provided it is not captured by single, parochial groups. Governments should take responsibility more clearly for major strategic choices as regards world trade and finance.

However, as already argued above, it is important to recognise that values may legitimately differ between countries, and these differences need to be explicitly recognised instead of being immediately suspect as signalling protectionist impulse. Existing agreements do include specific allowances for such differences. The outcome, should a conflict arise, will depend both on the modalities through which such differences feed into domestic policies and whether such modalities respect the general principles underlying the WTO commitments (such as non discrimination), and on the ability to build a convincing case: aptly seasoned lawyers become a crucial asset.

But we must also find ways to associate representatives of civil societies in the preparatory work before actual negotiations. In doing so, it is necessary to acknowledge the diversity of representation and the transparency of the groups that are invited to take part. Involving NGOs, however, is likely to become another point of North-South contention. For many developing countries, NGOs have no legitimacy to enter the debate, and are in fact agents of rich countries, representing special groups' interests that conflict head-on with their own interests, such as labour rights or environment protection and that eventually disguise a protectionist motive.

To the extent that liberalisation advances efficiency, it might seem that multilateral trade negotiations targeting further liberalisation are naturally legitimate in that they provide valuable results. The effectiveness of an action, however, is partly a relative concept: what do we get from a specific course of action, in comparison with the alternatives? This is where, as some NGOs also pointed out, the WTO also faces a problem of legitimacy. The success of the multilateral trade order building on GATT and then the WTO and the relative power of the dispute settlement mechanism establish an implicit hierarchy of norms in which trade issues are perceived as dominating other concerns. Clearly, one of the messages heard in Seattle is that such hierarchy needs to be seriously questioned, as no equivalent hierarchy exists *within* countries between the principles of, say, free enterprise, and, say, workers or consumers protection. Revolt against the trade order arises in large part from this perception that international [trade] laws are based on a set of values that differs from the set of values underlying domestic laws.

Indeed, some of the messages sent out in Seattle were that the public at large cares for more than simply trade. It is therefore not legitimate to respond by focusing the international action only on trade issues. What is questioned, therefore, is the implicit or explicit hierarchy of norms that have formed the basis of international negotiations. In the view of the protesters in Seattle, the focus on the WTO meant that an international trade order was established with a clear remit and the power to enforce the rules of trade. But it also implied that an imbalance was created between the trade order and the lack of a parallel international order in other fields of international relations. The fact that the WTO is the only multilateral institution where the negotiating process is sufficiently formalised and where results can be implemented, notably through the workings of the Dispute Settlement Procedure provides no justification. Legitimacy also requires that all the other issues be addressed by the international community, from labour rights to environment, to crime and money laundering, to food safety and to health protection, in a proper and effective framework.

## *2. BEYOND SEATTLE: WHAT WAY FORWARD?*

One of the most worrying features of the current multilateral environment has been the patent deficit of global leadership. Post world-war II liberalisation and the gradual emergence of a multilateral world economy owe much to US leadership. It was part of a generous, outward oriented vision, but also reflected a perception of US economic interests, and even more of core foreign policy concerns from the economic and political hegemon of the Western world confronted with the need to bolster alliance prosperity as an antidote to the Soviet model. Such leadership today proves more difficult to assume by the US alone, and this is not due only to short-term electoral considerations. The US Administration remains strongly committed to multilateralism, but the domestic debate increasingly reflects the views of those who narrowly consider that the US does not need multilateralism anymore, and that its power and success allow it to pursue its own domestic interests through a series of bilateral or regional arrangements without submitting them to international commitments. Moreover, despite a resounding economic prosperity, the American public is among the most concerned about globalisation, in particular because the dynamism of job creation has been matched by that of job destruction, putting job displacement, rather than unemployment, at the centre of the concerns of many individuals. This also tends to weaken any multilateral commitment.

Europe’s interests and vision are not identical. It would have more to lose than the US in a demise of multilateralism, if only because as a grouping of countries, the concept of an international law is at the core of its own culture. The European Union should thus capitalize on the failure in Seattle to seize the window of opportunity thus opened and fill the gap of leadership in multilateral trade negotiations. Europe is uniquely placed for this task, precisely because during the run-up to Seattle, it has already taken an ambitious stance for a broad round that would have included new issues central to market access such as direct investment and competition policy. But it must now back up its ambitious WTO strategy with an unambiguous signal that it has a clear vision of its strategic interests in international trade negotiations. However, short term political costs, such as those arising from liberalising to developing and emerging countries exports, and from reforming the common agricultural policy, tend to overshadow longer term considerations. For Europe’s voice to be heard and listened to, a more strategic approach and a more forthcoming attitude with respect to the reform of farm support policies are important prerequisites.

### Possible strategies

Since the failure at Seattle, there has been much debate on how to restore the momentum of the multilateral trade negotiations in Geneva. Such debate typically amounts to examining four scenarios:

***Business as usual.*** Many trade specialists[11] dismiss what happened in the streets of Seattle and any reference to a new North-South rift and they focus instead on the process of intergovernmental cooperation. With a new US administration taking charge, the argument

[11] Including Hartwig Berghaus, who was discussant of a previous version of this paper presented at the French-German Economic Forum on 4 July 2000.

goes, talks could be resumed and a new round launched. Thanks to careful preparation, obstacles could be overcome and the Seattle setback could pave the way for a success. We regard this strategy as potentially risky, as it overlooks the problems emphasised above and may invite a serious backlash, with potentially much more severe consequences that those experienced so far. Besides, those who support such a scenario have yet to explain why governments who could not share a common vision all along the way to preparing Seattle would suddenly achieve it through a “business as usual” method.

***A pause.*** Many otherwise pro-globalisation observers have argued in the aftermath of Seattle that the time has come to pause and avoid any activism in multilateral trade negotiations: why not first take on board previous Uruguay round achievements and postpone further liberalisation? Some even go as far as to argue that governments should slow down globalisation, so as to allow citizens around the world time to adjust to some of its harsh realities. While these reactions have the merit of recognising both adjustment costs and the temporal dimension of adaptation to change, they broadly speaking miss the point. The pace of change is largely driven by technological progress and private sector initiatives, and a ‘hands off’ approach would certainly neither slow it down nor appease controversies. Henceforth, the choice is not between more globalisation and less globalisation, but between a “spontaneous”, market driven, response or a constructed global order tackling the problems of efficiency, equity and legitimacy which arise with liberalisation.

***A minimalist approach***. According to the so-called bicycle theory, motion is more important than speed (provided it does not slow down below a certain threshold). In order to keep trade negotiation alive and to restore success, the minimalist view proposes to concentrate at least initially on a limited number of issues, mostly those included in the built-in agenda. Good work has been accomplished by the WTO secretariat and there are a number of issues on which useful, efficiency-enhancing agreements could be reached. That includes among others the further liberalisation of trade in agriculture and services, and a reassessment of the TRIPs and TRIMs agreements. Among the “minimalists”, some would want to initiate a modest round, while others would prefer the alternative route of incremental, subject-by-subject negotiations. But none of these would solve the problems that came into the open in Seattle and, in the short term, the lack of support for trade negotiations would not be reversed. Restricting the range of issues to be negotiated might even compound lack of support, especially if these issues are to be addressed in an incremental manner, as negotiation on each of them would increasingly appear as a political zero sum game between “winners” and “losers”, as already developed.

***The trade <u>and</u> approach.*** In contrast to the previous, conservative approaches, an alternative would be to attempt at taking on board the issues that were at the core of the Seattle controversy, and to push for an ambitious trade round that would result both in significant liberalisation and in concrete steps towards linking trade topics with other issues such as labour standards and the environment. Broadly speaking, the strategy would be for governments in developed economies to get the consent of developing countries through market access concessions and to appease controversies at home through addressing some of the concerns of the anti-WTO activists. Trade commissioner Pascal Lamy has indicated sympathy for this approach, and we agree with him that all these issues must receive a proper, global response. But the risk we see is that the trade <u>and</u> approach would be opposed from all quarters : anti-WTO militants would criticise the predominance of trade rules, while trade specialists and developing countries would oppose blurring trade principles with heterogeneous considerations. Furthermore, the “trade and” approach introduces a bias in the consideration of non-trade issues such as environment or labour standards, since it would address them only in so far as their relation with trade is concerned. At best, this would thus offer a partial response only to the broader concerns of our public opinions.

While we thus tend to discard the first three approaches as unfit for the challenges discussed above, we also think that the fourth one only goes half-way towards addressing the core issues and chooses a dangerous course for achieving this half-baked result. While the attempt at broadening the scope of discussions is a sensible one, it lacks organising principles for linking trade issues with other issues. If it is to be made both intellectually respectable and politically viable, it must be made part of a still broader approach aiming at developing global rules and institutions for a global economy. Such a global approach cannot rest on the WTO alone. Ways need to be found to tackle the question of global governance. This means thinking about the architecture, namely the nature, role, number and interaction of the multilateral institutions.

This may sound like a *fuite en avant*. This would indeed be the case if we had claimed that solving the problems of global governance is a prerequisite for addressing the already daunting trade controversies. But our claim is different. Namely, without a vision of the end-goal – how world governance should be organised in a globalised economy –, we would lack basic principles to think about the more immediate trade and issues. We know that progress can only be very modest and incremental. But moves, however modest, should be made in a clear direction[12]. This is why governments should now discuss the general principles needed to underpin gradual progress toward a global architecture of globalisation.

[12] This is true for the trade and debate, but also for a number of other discussions. For example, when IMF managing director Michel Camdessus attempted to involve the Fund in poverty alleviation, he was to some extent following what could be called a finance and approach. This attempt was strongly rebuffed by US academics and policymakers who criticised a "mission creep" and advocated instead a more focussed IMF, and it was essentially ended by his successor Horst Köhler. This is an indication that concrete discussions can to a large extent be influenced by controversies about first principles.

**First principles**

The reason why the WTO naturally leads to thinking about the architecture of world governance stems from its twofold role:

It is, first, the secretariat in charge of a particular set of international rules governing a specific type of economic interdependence between countries, called trade, which arises from the movement of goods and services; and

Second, it is also the closest thing to an institution in charge of globalisation, as exemplified by its Dispute Settlement Body (DSB), which, in its sector, is close to having the remit of an international economic court of justice[13].

It should thus come as no surprise that trade negotiators, for whom the WTO is only in charge of merely one aspect of economic interdependence (trade alongside money, finance, migration, environmental spill-overs, etc.) have difficulties finding a common language with demonstrators for whom it is a powerful institution in charge of the whole world economy, if not more.

Both groups have a point. Trade specialists are right to resist the temptation of overloading negotiations with issues which have little to do with international commerce, but environmentalists and trade unionists are right to point out that it would be hard to justify a world in which pursuing free trade was ranked higher than preserving the welfare of future generations, or enforcing a working person's fundamental freedoms and rights.

This contradiction is increasingly recognised and this is why some trade experts advocate returning to the pre-WTO scheme, in which the GATT was basically the secretariat of international trade negotiations. This would however represent a step away from the construction of effective and legitimate international rules and institutions, and a step backward from the useful move toward a much more effective dispute settlement mechanism that sanctioned the transformation of the GATT into the WTO.

The key issues can be summarised in three questions:

How valid is the principle of specialisation which governs the present arrangement of international institutions?

Absent a world government that would have both the legitimacy and the ability to embark on political arbitration between say, trade and environmental concerns, how could cross-sectoral disputes be settled?

How should specialised institutions be governed in order to ensure legitimacy and transparency, and how could civil society be listened to in decision-making?

***Governance and specialisation.*** Specialisation is a founding principle of the existing arrangements. International governance is currently based upon an array of specialised institutions such as the WTO, the IMF, the ILO, etc.., each of which was given authority over a specific subset of issues by specific international treaties and has to that end developed specific legal instruments (or, in the case of weak institutions, has not). In spite of repeated calls for more "consistency", for example between the WTO and the IMF as regards linkages between trade and exchange rates, or between the WTO and the ILO as regards linkages between trade and labour, or between the IMF and the ILO as regards the social effects of Fund programmes, linkages remain weak and, furthermore, no political authority exists that would be able to provide arbitration in case of conflict. This arrangement thus strikingly contrasts with what exists within countries, where (i) specialised ministerial departments do exist, but are controlled by or accountable to an overall political authority (which can be the head of government or the parliament), and (ii) specialised laws do exist, but take place within the framework of a broader legal system, and draw legitimacy from being voted by a single parliamentary institution.

[13] Of course, the DSB is more like an arbitration body that assesses the evidence of bilateral trade restrictions and may authorise retaliatory measures. It is not entitled to make decisions or impose sanctions. It thus behaves like a civil but not a criminal court.

In a democracy, the specialisation of ministerial departments is merely a technical, efficiency-enhancing arrangement. It may increase transparency and foster accountability, but does not impact on the government's legitimacy, which is based upon the (opposite) premise that voters have chosen men and women and have given them overall responsibility over a wide number of issues. But in the international system, which has neither a government nor a parliament, institutional specialisation is essential both to the legitimacy of institutions which precisely draw authority from the focussed mandate they have received from the international community, and to their accountability since their performance can only be assessed on the basis of that focussed mandate. The specialisation principle, therefore, is essential in the international sphere, and that infringements to this principle should be kept minimal.

***Solving cross-sectoral disputes.*** Absent political arbitration, there are only a few solutions in addressing cross-sectoral disputes. One is to give prominence to an institution or, equivalently, to a subset of principles. Unequal institutional developments push in this direction, and it is very much the road followed de facto by the WTO when addressing issues which are outside the pure trade remit (for example, when WTO panels have to settle cases involving environmental dimensions). However, there is no real basis for such an approach, because the implicit presumption in a system based upon specialisation is that no subset of law and no institution should be given prominence lest decisions could be taken on partial premises and challenged on legitimacy grounds.

As a crucial corollary of institutional specialisation, therefore, symmetry should prevail in the way specific laws and institutions should be treated when a conflict arises. This means that horizontal conflict settlement procedures should give the same weight to, say, environmental and trade concerns, and that they should not be systematically dealt with by one specialised institution. To the extent that cross-sectoral disputes cannot be solved through such horizontal procedures, this also means that arbitration should be provided by a neutral institution.

***Principles for multi-agency governance.*** International institutions have in common that their authority stems from international treaties that provide the legal basis for their action, but they differ widely in their governance structure, both as regards the effectiveness of control by their shareholders and as regards the voting rules. The IMF, for example, is governed by a board of directors appointed by member countries, who meet several times a week and whose votes are weighted according to a country's population and economic weight. But other institutions have much weaker governing structure, with infrequent meetings and a one country-one vote rule which in practice leads to government by consensus.

While it would be beneficial to make the weakest institutions stronger, this diversity is here to stay. But it is desirable, as a rule, to make the institutions more accountable to their shareholders and to let the shareholders bear more responsibility for the decisions that are taken. This is a strong prerequisite for enhancing the legitimacy of those decisions and for avoiding that governments free-ride on policies for which they should share responsibility. This may seem obvious, but a basic response to those who are challenging the legitimacy of international institutions is to tighten shareholders' control. The case for it goes beyond the standard principal-agent argument, as responsibility for the overall consistency of the international system can only rest with national governments. Loose governance could only lead institutions to develop an agenda of their own and to overlap with each-other, with potentially disastrous consequences for legitimacy and accountability, as well as for operational consistency.

But a lesson from recent events is that whatever the quality of the governance structure, legitimacy cannot be based on delegated authority alone. Institutions are also increasingly required to be transparent vis-à-vis public opinion and what has been called Global Social Movements (GSMs), and several of them have embarked on a dialogue with specialised NGOs. There is certainly much to gain from this process, provided no confusion arises between an institution's responsibility vis-à-vis and accountability to its shareholders, and the requirements of transparency towards public opinion and dialogue with NGOs. An analogy with central banks may help understanding what we mean : central banks certainly must develop a close relationship with the financial community, which may involve efforts towards transparency and a frequent dialogue, but they remain accountable to their shareholders, i.e. to parliaments and / or governments.

**Toward a Blueprint**

The conclusions we draw from our analysis is that proposals for reforming the existing international architecture must (i) be compatible with the specialisation principle, (ii) develop procedures to settle cross-sectoral disputes, while avoiding to create explicit or implicit hierarchies between different domains of international integration, (iii) foster both accountability to the ultimate shareholders and transparency vis-à-vis public opinion and the NGOs, without creating a confusion between those requirements.

The current institutional set-up clearly does not meet these prerequisites. Specialisation prevails, but an implicit hierarchy exists between domains, the extent of which can be gauged using various criteria (such as legal means, decision-making mechanisms, enforcement ability, etc..). Cross-sectoral dispute settlement mechanisms hardly exist, and there has been a tendency to respond to claims that institutions narrowly focus on the topics for which are responsible (freer trade for the WTO, macro-economic financial stability for the IMF, etc…) through internalising other concerns within the remit of each institution, which ultimately leads to contradict the specialisation principle. Finally, the governance structure is frequently weak, and accountability is deficient. Significant progress has been made towards transparency, but street protests highlight that more needs to be done vis-à-vis public opinion.

What would a structure that meets our requirements look like? Ideally, we would think of an array of specialised institutions, each governing specific aspects of interdependence - call them the WxOs, where x stands for trade, finance, development, nuclear safety, food safety, labour, health, environment, tradable permits, etc... According to the specialisation principle, each institution should have a clear and focussed mandate. Each should be in charge of establishing and enforcing commonly agreed rules and/or codes of conduct for the sector for which it has responsibility, and, when relevant, specialised Dispute Settlement Bodies would provide arbitration in bilateral disputes and engage in effective surveillance of the implementation of members' commitments. This would be done on the basis of specific sectoral rules.

Within this framework, each institution should respect the principles and procedures of the other institutions and resist the temptation to blur the frontiers. Consequently, social or environmental clauses would have no future in trade law. Equally, other bodies should resist the temptation to call for trade restrictions as a natural means of action. In areas like labour or the environment, there is a whole array of other available instruments, from codes of conduct and peer pressure to public recommendations and sanctions, which should be explored in full before trade measures are contemplated.

Any blueprint needs to address at least four crucial questions: How should cross-sectoral issues be addressed? How would decisions be enforced? How could the NGOs be involved? How would political guidance be provided?

***Cross-sectoral disputes***. This is a key issue Efficiency calls for an horizontal approach, in which specialised institutions would find ways to settle the cases bilaterally. The core concept should be that each institution recognises the legitimacy and the expertise of the others in their own field. There is already a basis for such an approach since, for example the WTO, recognises the legitimacy of recommendations by the *codex alimentarius* and bases its own decisions on these recommendations. This approach could be expanded to tackle the many cross-sectoral issues that are likely to arise, especially for measures affecting trade. The principle should be that whenever the settlement of a trade dispute involves non-trade issues, the WTO DSB should have to request the "informed opinion" from the relevant specialised institution. It would then be bound either to follow that opinion, or to explicitly motivate its decision not to follow it. This would preserve the privilege of each institution to make legally based decisions in its own domain, but would create procedural constraints that would foster transparency and time consistency, and would also respect the desirable parallelism of standards.

Obviously, an appeal procedure would be needed, for example in the case an institution makes a decision involving issues outside its own remit without requesting an outside opinion, or if it decides not to follow an opinion after having requested it. Ideally, therefore, the next step should be to consider establishing a two-level system, with level 2 consisting of a sort of "Super-DSB" which would act as a court of appeal for unresolved cross-sectoral disputes. What is key is that this Super-DSB would not be biased towards giving prominence to any specific set of concerns. It would not have preference for trade laws over environmental principles, nor vice-versa. It should thus be entrusted with the legitimacy that the WTO is missing when dealing with issues outside the narrow realm of trade.

***Enforcement***. Trade is more than just one channel of interdependence. Whatever their (limited) effectiveness, trade sanctions are often resorted to because of the virtually universal character of international commerce. They have historically been used for political purposes, for example against South Africa during apartheid, or more recently against Iraq, and they can more generally be used as a retaliation against reprehensible behaviour in sectors which have no direct relationship to trade.

There is, however, a clear distinction between relying on trade sanctions as an instrument of international law and making trade liberalisation conditional upon the adoption of different attitudes towards child labour or the environment. In the scheme we have outlined, the extent of trade liberalisation would be determined by a strict framework of trade negotiations. Trade sanctions could be used only in the case of genuine deviations from international law, subject to the authorisation or the decision of an international organisation in which all countries participate on an equal footing. There would thus be no room for covert protectionism. Just like the present DSB, this Super-DSB would be entitled to authorise proportionate retaliation by countries suffering a loss, but more importantly also to recommend and possibly impose multilateral sanctions against a country whose behaviour violated international law and represented a threat to the international community.

The assumption that to rely on trade sanction is the best possible ways to enforce decisions by the international community is furthermore questionable. First, there is, as already stated, a wide array of alternative channels of graduated pressure, that each institution could implement before considering trade sanctions. Second, financial penalties can in some cases be at least as effective than trade penalties, as recently demonstrated in the international community initiative against non-cooperative offshore financial centres. The reason why they have not been frequently used has more to do with the fact that the effectiveness of those sanctions depends on their multilateral character and on the availability of generally agreed procedures for decision and implementation[14] (ore the lack thereof) than with their comparative effectiveness. There is thus a case for enlarging the panoply of possible sanctions the international community can rely on.

NGOs. ***We have stressed above that the dialogue which has begun between NGOs and international institutions was a positive development and that there was much to gain in pursuing it further. However, it would be paradoxical to limit the involvement of the NGOs to a series of bilateral dialogues with the specialised institutions, while the very same NGOs are vocally criticising the international institutional architecture for its neglect of cross-sectoral issues. The question then becomes : how to involve the NGOs in the settlement of cross-sectoral issues.***

We recommend that NGOs be allowed to express their views on the occasion of the settlement of cross-sectoral issues[15]. While the parties would in most cases be states (or groupings of states such as the EU), there is no reason why NGOs should not be allowed to formally present their views to sectoral or cross-sectoral arbitration bodies. And if a case a brought to the Super-DSB, they should be able to make themselves from that body. The

[14] For example, the IMF does sanction member countries for not complying with its programmes, but not for other motives.

[15] We have in mind, here, the “ interested third party ” model (in French, le “ tiers-intéressé ”)

only condition we would consider, however, would be to require from candidate NGOs the kind of transparency that they demand from governments and multilateral institutions : they would have to comply with specified transparency requirements.

***Political guidance*.** To be workable, the system we have outlined would require that states are willing to abide by international law. Significant progress would thus be required. However, the traditional structure of trade discussions does not facilitate conceptual breakthroughs. Permanent political guidance will thus be required. The G7 would be a natural candidate, but it only represents major industrialised countries and its legitimacy can only decline as time passes. It should thus liase with the G20[16], a wider group that could well serve as an operational structure for North-South discussions. A significant objection would be that poorer countries, especially from Africa, are not represented in the G20, but they are not the most vocal in international discussions either, and they would in any case be represented in negotiations.

## *3. HOW DO WE GET FROM HERE TO THERE?*

Whatever the precise design of the long-term goal, practical first steps can only be modest, because we are obviously far from any consensus on a blueprint, and because mutual trust cannot be created from scratch. What is required for the immediate future is a practical agenda that would make the resumption of trade talks possible by offering a method for taking on board the concerns of the various players. This could be achieved by focusing on four practical conditions.

***Discussion***. A serious discussion is needed on how the international architecture should be reformed, much in the same way as was done for international finance. It should be conducted in an open way, with the participation of academic experts and representatives of the civil society from a wide range of countries. It should also start immediately in order to bring results by the time a new US administration takes office and prepares its agenda in spring 2001. This discussion will no doubt develop in a number of fora, but to give a signal, the G20 could commission a high-level study group to make proposals by summer 2001.

***Significant liberalisation***. Industrialised countries, and especially the European Union, should follow up their demand for a more comprehensive approach to trade issues with action. They should clearly stand ready to offer significant unilateral trade liberalisation in return for acceptance by emerging and developing countries of discussions on environment and labour issues in appropriate fora.

***Parallelism***. The trade <u>and</u> approach has failed, because of the developing countries' distrust of industrialised countries. The alternative should be to move in parallel on different fronts without linking the corresponding issues in the negotiations but with an overall political endeavour to move ahead on all those fronts within a given time period. Most of the burden of making this collective commitment credible - which is obviously key for the success of the approach we are suggesting – would fall on the G7/G20. What we have in mind basically amounts to start a modest “global round” rather than a new, however ambitious, trade round.

***Gradualism***. The choice of first steps should aim at providing test cases for the new approach that could convince us of its validity. As Jean Monnet did for the EC, preference should be given to a combination of a long-term vision and modest improvements from which general lessons can be drawn.

This brings us back to what should be done within the WTO. As we have argued, restoring momentum in Geneva hinges on our ability to make substantive progress on other issues that it would not be reasonable to burden the WTO with. This will not solve the current deadlock with the millenium round, but it will facilitate the work of those who currently try to

[16] The G20 was created in September 1999 under an initiative of the G7. Together with G7 countries, and a representative of the EU and one for both the IMF and the World Bank,  it includes eleven other countries : Argentina, Australia, Brazil, China, India, Korea, Mexico, Russia, Saudi Arabia, South Africa and Turkey.

revive the momentum. As for the content of any new round, we believe that the EU position is right: first, the round needs to be broad enough to provide both consistency (market access requires that direct investment and competition policy overtime become part of the set of multilateral rules on trade), and legitimacy (in the sense that everyone would find areas in which benefits can be expected); second, it needs to focus on the long-term process, rather than on short-term results. What matter is the gradual emergence of a system of rules that covers all major dimensions of market access through trade and movements of factors. That this requires time does not mean that we should not explicitly set it as a goal.

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**ANNEX**

Example of a multi-agency, cross-sectoral dispute settlement

To figure out how the system would work, consider the following example :

nothing would change in dealing with a pure trade dispute between country A and country B. It would be brought to the trade DSB, which would make a decision on the basis of rules governing trade and of these rules only; appeal would be possibility undertaken as usual;

in the case country A would ban a certain categories of products on, say, food safety grounds, while country B would claim to be hurt as a producer of those products, the WTO would have the responsibility of assessing whether the ban is implemented in an discriminatory way, but it would not have the competence to assess whether country A has a valid case for introducing the ban (unlike under current arrangements, since the SPS agreement recognises the right of countries to take protective measures but also establishes a number of conditions that such measures must verify). It would thus rely on the opinion of, say, the World Food Safety Organisation, which would have to assess whether evidence on the existence of risks or other motives may justify country A decision. Having received this opinion, the WTO would have the possibility not to follow it, but it would then have to state its motives explicitly (and to take responsibility for that decision vis-à-vis the international community). Its decision could be challenged by country A, in which case the dispute would be brought to the Super-DSB.

In practice, it is likely that a large number of disputes would be settled at the horizontal level without having recourse to the Super-DSB, since specialised institutions would have both expertise and legitimacy in their own field.

Alternative examples could be found outside the trade area :

assume that country A suffered direct loss through breach of environmental codes of conduct by country B. Country A would then take country B to the environmental DSB, which would make a ruling on the basis of environmental rules only. If country B complied with the ruling, the process would stop there. If not, country A would be able to appeal to the Super-DSB, which could then allow it recourse to proportionate bilateral sanctions against country B;

assume that, in spite of repeated recommendations by the relevant world organisation, country C's behaviour as regards nuclear safety represents a threat to the international community at large. The nuclear safety organisation would take the matter to the Super-DSB, which could decide to impose multilateral sanctions on country C.

# The Future of Banking in Europe [17]

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(First version June 2000;this version March 2001)

## I. Introduction

### 1. The general problem of economic predictions

The problem in writing this paper is that I am not a clairvoyant. I simply do not know what the future of banking in general, and banking in Europe in particular, will be – and indeed, nobody can rightly claim to know this. The future is uncertain, it unfolds as time goes by. One important source of uncertainty is innovation, which is inherently unpredictable. But apart from the nature and effects of innovations, one can identify certain general classes of factors which will shape the future of banking (in Europe) and which at the same time give cause for uncertainty with regard to this future. It is useful to distinguish between two general sources of uncertainty: Firstly, external factors relevant to the development of banking may change in ways that may be surprising. Secondly, banks and their managers as well as their competitors, regulators, policy makers and the clients of banks act on the basis of their expectations about the changing external factors, and each of them reacts to the consequences which they expect others to draw from the changes which they anticipate. The actions and reactions of the "players" in the banking world can be just as surprising as the external factors.

These two classes of determinants of the future and causes of uncertainty with respect to the future are not independent of each other. Economic agents hold beliefs about the future and have strong economic incentives to take these expectations into account when they determine how to act and to react, even though these beliefs may be quite vague. By acting and reacting as rationally as possible, the economic agents jointly create the future which they individually try to anticipate. Thus an economic prediction of the future (of banking in Europe or any other comparable issue) can only be a speculation about possible paths of development which are, however, constrained by the fact that agents act in anticipation of, and in response to, external developments, the strategies chosen by other economic agents, and their relevant beliefs.

The necessity of taking into account the interrelationships between the object of a prediction and the expectations and actions of those who jointly shape this object is the essence of the concept of a rational expectations equilibrium. In essence, economic evolution is an uncertain equilibrium path over time. Thus simply extrapolating currently observable trends would not be enough and might indeed lead to inappropriate conclusions.[19] Any attempt by an economist to predict the future (of banking in Europe) should make use of this concept.

However, I should not take my inability to predict the future of banking in Europe too seriously. As the concept of rational expectations suggests, I share this inability with those

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[17] Revised version of a paper presented at the 7th German-French Economic Forum, Paris, July 4, 2000. The format of a lecture is maintained in the present text. The paper draws heavily on joint work with Marcel Tyrell and Andreas Hackethal. For advice and support in the preparation of the paper, I owe a great debt to these two collaborators as well as to Falko Fecht and Christian Pfeil. Of course, none of them bears any responsibility for the views expressed here, nor for any errors or omissions.

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[19] See Grossman (1981). It should be kept in mind that this concept of rational expectations neither has to assume the unlimited rationality of all agents, nor does it abstract from uncertainty.

who shape this future through their decisions and actions within banks and outside of banks. It may therefore even be helpful to put myself in their shoes.

**2. The focus of the paper**

There are many questions which one might want to ask concerning the future of banking in Europe. It would, of course, be impossible to address all of them here.[20] My choice of a specific question to focus on is dictated by my current research interests. To me at least, the most interesting question is whether the considerable differences between the financial and banking systems of EU member countries will remain or whether banking in Europe will converge – either to a position located somewhere between the present systems, or to a system that is in effect modelled on the Anglo-Saxon system.[21] I therefore want to focus on the future of the typical features of banking in much of *continental* Europe. These peculiarities are, or at least have been until quite recently, the following:

(1) Not strictly profit-oriented types of banks, such as savings banks and financial co-operatives, play an important role.
(2) Relationship banking is the dominant or at least the most characteristic model of banking.
(3) Universal banks are the prevailing type of banking organisations.
(4) The main function of banks is to act as intermediaries between depositors or savers and borrowers.
(5) Financial systems are bank-dominated and not capital market-dominated.
(6) Finally, there are considerable "structural" differences between the financial systems of different countries in Europe.

Many competent observers in the academic world and in the banking and business community seem to be convinced these days that financial and banking systems are likely to change and also to become more similar in the near future – both worldwide and particularly in European countries. Typically, they expect all financial systems to adapt to the Anglo-Saxon model, which is capital market-dominated and in which banks still play a role, but one that is different and much more limited than their traditional role in continental Europe.[22] More specifically, these observers do not see much of a future for traditional banking in the sense of financial intermediation; for relationship banking as the dominant model of banking; for non-profit banking or more specifically, banks which are not strictly profit oriented; for the dominance of banks in the respective financial systems; and finally for important "structural" differences between national financial and banking systems.

**3. The structure and methodology of the paper**

The attempt to shed some light on the question whether these expectations can be sustained, i.e., whether the six peculiarities of banking in Europe listed above are indeed likely to disappear soon, or whether they are in fact more likely to remain, determines the structure of this paper. Before embarking on an attempt to predict the future of banking in (continental) Europe from the point of view and under the provisos outlined above, I take a brief look at the past and the present – or rather the quite recent past – of the financial systems of three major European economies in order to provide a basis for comparison. I

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[20] For a different selection of aspects of the same general theme, see the book by Danthine et al. (1999).

[21] Relevant recent work concerning this issue is summarised in Schmidt et al. (2001).

[22] See Rajan/Zingales (1999) and, with a more moderate position, Danthine et al. (1999) and Danthine et al. (2000) as important sources from the academic world. One source from the banking community, though certainly a very significant and influential one, is Rolf-E. Breuer, the CEO of Deutsche Bank. Over the years, Mr. Breuer has regularly made statements to the effect that a convergence to the Anglo-Saxon type of financial system is to be expected. The most recent of these statements can be found in Deutsche Bank (2001). See also the collection of interviews with chief operators within the banking industry in Engler/Essinger (2000). An article by David Roche (2000) entitled "The 'Global' World is Anglo-Saxon" in the Wall Street Journal Europe perfectly summarises this view and indicates how widespread it is. The opposing view that there will be a convergence towards a position which incorporates "the best features" of the Anglo-Saxon and the German financial systems can be found in OECD (1995, p. 119).

will then discuss three sets of external or exogenous factors which most observers would consider to be highly relevant to the future development of banking in Europe. These factors are

(1) deregulation and liberalisation,
(2) dramatic advances in the field of information technology (IT), and
(3) the progressive economic and financial integration of Europe and the advent of the Euro.[23]

One of the main problems with predicting the future of banking in Europe consists in knowing how these exogenous factors can be linked to the "observable" specific characteristics of (continental) European financial and banking systems, which may or may not be likely to persist. As the opening paragraph tried to make clear, there seems to be only one way of establishing a relationship between them. It consists of taking into account the fact that the way in which the development of the external factors influences the observable features of the European banking system, or systems, depends on the strategies chosen by the economic agents, mainly the banks themselves. But bank strategies are not the only "intermediary variable".[24] In addition to bank strategies, the intermediary variables also include the nature of competition in the various segments of the market for financial and banking services, and the structure of the banking industry in the individual countries and in Europe as a whole. Thus bank strategies, competition and banking structures serve as conceptual bridges linking external developments to an assessment of whether the main characteristics of continental European banking systems are likely to disappear or to remain.

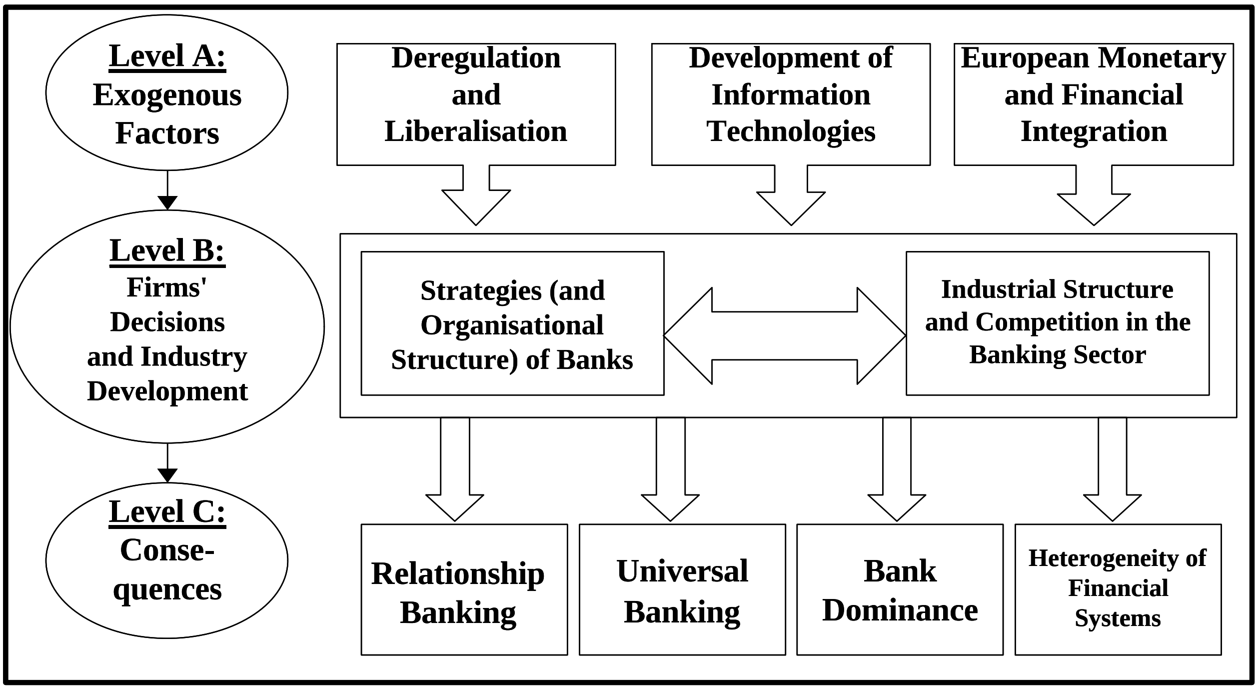


**Figure 1: Structure of the Argument**

The approach taken in this paper is therefore to outline an informal microeconomic framework or model, which is inspired by the concept of rational expectations, for the future of continental European banking. Its structure is summarised in Figure 1. Besides being informal and incomplete, this model has some additional weaknesses. Firstly, to a certain extent the intermediary variables are themselves features of banking systems which are partially observable. Secondly, they are not independent of one another. Furthermore, the lists of external factors, of intermediary variables and of observable attributes are

[23] References to the relevant literature will be provided in section III.1 below.

[24] The term "intermediary variable" may be unfamiliar to some readers. It corresponds to the term "intervening variable" used in the psychological literature to designate unobservable elements (such as perception or cognition) which create a (causal) link between observable inputs (stimulus) and outputs (behaviour).

incomplete; and last but certainly not least, our knowledge of the links between the elements is incomplete and highly speculative. Nevertheless, I hope that this framework will serve the purpose of providing a conceptual structure for this paper and for answering the questions addressed in it.

## II. The Past and "Present" of Financial Systems in Europe

National banking systems are a part of national financial systems. They can only be understood properly if one takes this "embeddedness" into account.[25] When we study the financial systems of Germany, France and the United Kingdom (UK) as they were 15 to 20 years ago, i.e. before the wave of deregulation and liberalisation of the mid 1980s, before the start of European financial integration and before the revolutionary advances in IT of the past few years, and then look again at these three financial systems as they presented themselves in the recent past – say two years ago[26] – then the following picture emerges.

1. In the early 1980s, the German financial system was bank-dominated. Banks were very important financial intermediaries, and intermediation was the main function of the banking system. Corporate finance was mainly provided by banks. Banks also played a strong role in the "insider-controlled" governance systems of the large non-financial firms. Close relationships between banks and their customers – or in the case of firms, "housebank relationships" – were a fact. Financial markets were relatively underdeveloped. Non-bank financial intermediaries and capital markets were strongly influenced by the banks. The German banking sector was fragmented into different subsectors, and the market share of not strictly profit-oriented banks was high. The dominant, and certainly the most prominent, type of banking organisation was the integrated universal bank. It would seem that, contrary to the view conveyed in the popular and financial press, these fundamental characteristics of the German financial and banking systems did not change until very recently.[27]

2. The British financial system was the polar opposite. It was capital market-dominated. Banks played a limited role in providing long-term financing to firms. The typical bank in the UK was much more specialised than its German counterpart; bank-customer relations were "at arm's length". Bank concentration was higher, and the degree to which the banks could rightly be called universal banks was lower than in Germany. As far as corporate governance systems are concerned, the UK had an "outsider-controlled" system, and the banks had hardly any role in it. The development of capital markets was already at that time more advanced; and non-bank financial intermediaries (NBFIs) and capital markets were much less dependent on banks than in Germany. The different roles of banks, NBFIs and capital markets, in comparison to Germany, are reflected in different levels of intermediation and different patterns of corporate finance. Again, when we look at the data referring to the late 1990s, we can recognise the same structural features. Thus the British financial and banking system has also not changed fundamentally.[28]

3. The case of France is more difficult, as it does not offer such a clear picture. At the beginning of the 1980s, state influence played a very prominent role in the French financial system; banks dominated the financial sector; at least the large firms were "generously" financed by banks which in turn were refinanced by central public institutions, notably "le

[25] The concept of "embeddedness" goes back to Granovetter (1985), a theoretical sociologist, and plays an important role in many academic discussions of all kinds of social systems.
[26] Limiting the considerations in this paper to the quite recent past – instead of "the present" – is motivated by the concern that the developments of the last two years are too complex to permit an assessment at present. This concern will be taken up again in the concluding section.
[27] Surprising as it may seem, very little has been written in English on the German financial system. The best-known source addressing the financial system as a whole is still Edwards/Fischer (1994). Many individual elements of the German financial system are covered extensively in Obst/Hintner (2000). For the proposition that the general character of the German financial system has not changed substantially in the past two decades, see the reference in note 5 *supra* and the articles summarised there.
[28] Among the best references concerning the British financial system are Buckle/Thompson (1998) and Bain (1992).

trésor". Banking regulation was pervasive and oppressive, and irrespective of their legal status and ownership structure, banks were mainly instruments of government policy. Financial markets were *cloissonnés* and unimportant for all but the government; access to them was very restricted. All this changed dramatically in the following years. The banks have lost their traditional burdens and privileges – and they have in the meantime suffered greatly from the consequences of *libéralisation, banalisation, marchéisation* etc. If one looks at purely quantitative measures, such as bank-related intermediation ratios and financing patterns, it seems that France and its financial system have made a huge step from being "more German than the Germans" – or from having a strongly bank-dominated system – to being "more British than the British". However, in contrast to British banks, which seem to know well what their specific strengths are and can exploit these strengths, it appears that French banks have at least for a long time been searching in vain for an orientation and a profitable strategy in their new environment.[29]

The upshot of all of this is firstly that these three financial systems differed greatly at the beginning of the 1980s, and they were still very different at the end of the 1990s. In fact, with the possible exception of France,[30] there does not seem to have been much convergence on a fundamental or structural level during this time span. This must come as a surprise, as the convergence of regulation in Europe, advances in IT and financial integration following the single market initiative have led many to expect that there would even be a "fundamental" convergence of the three systems.

## III. An attempt to predict the future of banking in Europe

As indicated in the introduction, I want to present a framework or an informal model of the future of banking in continental Europe. Thus in much of what follows, I exclude the UK banking system from the set of empirical references, because it clearly represents a different type than those of continental Europe and one towards which others might develop.

### 1. External factors and their impact on bank strategies and competition

a) The development of the exogenous factors

The exogenous factors and developments (level A in figure 1) which will probably continue to have an *indirect* influence on the observable peculiarities of banking in Europe (level C) and a *direct* influence on the strategies pursued by banks, on the nature of the competition in the market for banking services and on the structure of the banking industry (the intermediary variables at level B) are: regulation, mainly deregulation and liberalisation, but also reregulation; advances in IT; and economic, financial and monetary integration in Europe.

*Regulation*: The dominant trend in the area of banking and financial regulation has been, and will continue to be in the future, that of deregulation and liberalisation. In most European countries banks are now allowed a much freer choice in the ways they conduct their business (conduct deregulation), and they may now engage in lines of business which had previously been barred to them. At the same time, others may now enter fields of economic activity which had formerly been reserved for banks (structural deregulation). Thus in terms of what they do, the distinction between banks and other financial service providers has become blurred, and this process is likely to continue. The degree to which deregulation has taken place in recent years differs greatly from country to country, which mainly reflects different degrees of restrictive regulation at the beginning of this process after 1980.[31]

But there is also a trend towards the introduction of other forms of regulation, notably capital requirements, as a substitute for the outdated instruments, conduct and structural

[29] On the transformation of the French financial system in general see Bertero (1994), Faugère/Voisin (1994) and Zerah (1993), and specifically on the changes in the banking system, Plihon (1999).
[30] See Schmidt/Hackethal/Tyrell (2001) on the special case of France.
[31] One of the best sources on the impact of deregulation on banking in various European countries is Gual/Neven (1993); see also Gual (1999) and Engler/Essinger (2000)

regulation. These requirements are currently under discussion, and it can be safely predicted that they will change in the near future when the "new capital adequacy framework" of the Basle Committee becomes effective; European banks will certainly be affected by this development.

*Information technology*: The incredible advances in information technology and its application in banking range from the computerisation of many back-office functions to ATMs and most recently to electronic banking. One of the most important IT-related developments is that it is now technically feasible to have computerised securities trading systems with almost unlimited remote access, which is having a profound effect on the efficiency, and thus the overall attractiveness, of organised capital markets. As a result, capital markets will become deeper, more liquid and thus ultimately more attractive.[32] This development has a historic parallel in the invention of the railroad, which reduced transportation costs, increased the size of markets and completely changed the structure of many industries.[33]

*Financial and monetary integration*: Partially as an immediate consequence of the political decision of 1986 to create a single market in Europe by the end of 1992, and partially as a consequence of its implementation, the complete mobility of capital and people as well as banking and many other financial services within the European Union became a reality in the early 1990s. The general model of financial integration in Europe is that of the "single passport". This concept combines minimum harmonisation, mutual recognition and home country control for banks and other important groups of financial service providers. The process of financial integration has gone a long way, but it is still not complete. By eliminating the exchange rate risk within the Euro zone, the recent introduction of the Euro as a common currency in most member countries of the EU has given this process an additional push.[34]

b) Their implications for bank strategies

The term "strategy" refers to the way in which a firm tries to establish and maintain competitive advantage. It includes many aspects, such as the determination of markets or fields of activity in which a given firm operates, its market entry and exit decisions, pricing, product design and organisational design. Strategies are a reflection of external factors and of the competitive situation in the industry under consideration. Competition is itself the outcome of the strategies which the market participants choose and implement. Thus strategies and competition determine each other mutually and are jointly determined by external factors.

In what follows, I want to briefly sketch the likely implications of the aforementioned external factors for the strategies of banks and their main competitors. A certain degree of overlap and, moreover, interaction between the effects which the three external factors have on bank competition is unavoidable. In the next subsection, the arguments pertaining to competition are briefly summarised.

*Effects of (de-)regulation on bank strategies*

(a) Banks in many countries will broaden their range of products; at the same time, bank products are now also available from non-bank financial intermediaries, and NBFIs will probably play an even more extensive role as suppliers of these products in the future. Therefore, banks will face stiffer competition, which will put

cost-containment

the entry into, and exit from, specific market segments,

and alliances, acquisitions and mergers

on the strategic agenda of all banks. Cost-containment appears possible in principle by exploiting economies of scale through internal growth and external growth via acquisitions

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[32] See Biais (1999) and Seiffert et al. (2000).

[33] See Merton (1995), Mishkin/Strahan (1999) and again the interviews in Engler/Essinger (2000) on the impact of IT on banking and finance.

[34] As a selection from the literature on this issue, see ECB (1999), Danthine et al. (2000) and Walter/Smith (2000).

and mergers, and by reducing branch networks, which is often a motive for horizontal mergers within countries. Market entry and exit strategies manifest themselves for instance in the attempt to leave the field of retail banking, which is considered to be unprofitable in some countries, and to enter specific areas in the broad field of investment banking.
(b) The traditional forms of bundling together different banking products, of following integrated pricing strategies and cross-selling and cross-subsidising, which has been one of the pillars of universal banking and also of relationship banking in the past, may become less attractive or even no longer feasible as a consequence of the new forms of competition from market entrants and the increasing intensity of competition.
(c) Strategies in the credit business are likely to change as a consequence of the new capital adequacy regulation. This new regulation will benefit large borrowers with external ratings, and big or network-affiliated lenders that possess sophisticated internal rating and risk-management systems, or can more easily bear the cost of setting them up. It is likely that some strictly profit-oriented banks, and particularly small profit-oriented banks, will withdraw altogether from lending to small and medium-sized businesses and non-rated firms. This opens up new opportunities for savings banks and co-operative banks, which are typically affiliated to networks and can therefore share the set-up costs of rating and risk management systems. Thus in the future banks will differ much more than during the past two decades with respect to how much, in which forms and to whom they lend.
(d) Although deregulation and liberalisation make mergers and acquisitions easier within countries and also across borders, strategies of external growth will differ greatly between banks which focus on retail banking and those which are mainly involved in investment banking.
All in all, de- and re-regulation offer opportunities to gain competitive advantage by adopting differentiating strategies.[35] A one-size-fits-all approach, which seems to have dominated bank strategies in past decades and whose adoption may have been inspired by certain notions of "best practice", does not seem advisable for the future and will probably not shape the emerging new banking scene in Europe.

### *(2) Effects of information technology on bank strategies*

The overall effects of IT-related advances are twofold: IT reduces the costs of providing banking services in general; and it changes the cost structure in such a way that fixed costs increase while variable costs decline sharply. These effects apply to banks, to non-bank financial intermediaries and to securities markets, though probably not with equal force. Banks should take these effects into account in their strategies; and the greater flexibility they now have as a consequence of recent deregulation makes it more likely that these effects will indeed be incorporated into banks' strategies in the future.
(a) The most dramatic effects of IT are probably on the internal processes and structures of banks. An obvious example is the opportunity to reduce costs by installing ATMs and by concentrating and relocating back-office functions. IT also changes the balance between the centralisation and the decentralisation of decision-making authority. Decentralised decision making combined with centralised monitoring and performance measurement has become much easier in recent years; and the full implications of this trend are yet to be seen. Banks which make full use of the potential to reduce costs and to increase flexibility are more competitive. As this applies to all or most banks, there will be more competition, to which banks will have to react by lowering their costs. This can be done by reducing staff and increasing flexibility via decentralising the organisations and trimming administrative hierarchies.

[35] This is one of the core strategies in the classification system devised by Michael Porter (1980); specifically for the field of banking, see Smith/Walter (1997), Chapter 14, and Canals (1993).

(b) Although econometric research suggests that economies of scale or the benefits of sheer size are limited in banking in general and commercial banking in particular,[36] one can nevertheless expect that IT-related developments increase the minimum efficient firm size in the banking industry and therefore encourage mergers in retail banking. Most of all, domestic mergers and acquisitions appear to be a way of reducing superfluous retail capacity. In spite of the failure of the recent attempted mergers between BNP and Societé Générale in France and between Deutsche Bank and Dresdner Bank and Dresdner Bank and Commerzbank in Germany, there are numerous examples of large bank mergers which have been successfully completed recently. Almost all of these have taken place within national borders, while cross border mergers of commercial banks are extremely rare.[37] This suggests that their main motive may indeed have been to cut costs. The potential for closing costly branches would be limited in the case of a merger between Deutsche Bank and Societé Générale.

(c) IT is changing the balance between banks, NBFIs and capital markets, i.e. banks have tended to lose ground to their competitors. Especially as far as lending to big corporations is concerned, capital markets have for quite some time been cutting into the traditional business of banks. At least for certain types of borrowers, disintermediation seems to be a reality.[38] Many banks are in fact reacting to this presumed trend by shifting their focus to fee-earning and investment-related services. Germany's biggest bank, Deutsche Bank, provides a good example of this strategy. The advances which NBFIs have made during the last decade in the area of savings mobilisation, which represent a second type of disintermediation, are also largely due to the fact that in the era of the Internet branch networks become less important for providing financial services than they used to be.

(d) Given that IT seems to benefit capital markets at the expense of financial intermediation, banks can react strategically by giving up territory they cannot defend anyway, such as lending to multinationals, or by withdrawing from retail banking, or by becoming allies and handsomely rewarded servants of the winning competitor, i.e. the capital market, providing capital market-related services. But there are still fields of activity in which banks retain a competitive and genuinely strategic advantage. These are quite traditional banking functions such as providing liquidity insurance, lending in difficult-to-monitor cases and providing all-round advice and services. For offering these services and for serving the clients who need them and are willing to pay for them, especially small and medium-sized firms, the traditional approach of relationship banking – possibly also provided in the traditional organisational form of a universal bank – seems very well suited.[39] Banks should, and successful banks will, be able to benefit from this strength. Furthermore, better communications technology makes it easier for banks to provide this comprehensive set of services to far-away clients. Thus it appears inappropriate to predict that the advent of IT leads to a complete "breaking up (of) the bank"[40] or, more precisely, of the value chains whose combination under one roof has been the hallmark of the traditional bank.

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[36] For a summary of this line of research, see Berger (2000), and specifically for Europe Molyneux et al. (1996) and Berger et al. (2000).

[37] In a recent study, the ECB (2000) reports that out of the 2,153 M&As in the banking industry in Europe between 1995 and the middle of 2000, only 16% had at least one aspect of a cross-border transaction; the rest were purely internal mergers and acquisitions.

[38] While this applies to certain groups of former bank borrowers, notably large corporations, empirical arguments provided in Schmidt et al. (1999) cast doubt on the widespread assumption that disintermediation is a general trend. On this, see also Hackethal (2000 and 2001) and Hackethal/Schmidt (2000b).

[39] Empirical evidence concerning the persistence of relationship banking in Germany is provided in Elsas/Krahnen (1998). See also Elsas/Krahnen (2000).

[40] This is the title of a book by Lowell Bryan, a consultant with McKinsey, published in 1988. Similar assessments are also found in the more academically oriented literature; see e.g. Miller (1998).

***(3) Effects of economic, financial and monetary integration on bank strategies***

Among managers of large banks and some of their professional advisers, there seems to be a widespread conviction that – in addition to the general trend towards globalisation – the "single market programme", and much more so the introduction of the Euro, have indeed already led, or will soon lead, to the emergence of one single market, in which rivalry between existing banks is so fierce that only the strongest competitors can survive. As strength is often assumed to come mainly from size, all one has to do in order to survive is to consolidate either actively or passively, that is, to acquire or to be acquired or to merge. At least in its generality, this prediction is not warranted. There is a need to differentiate between commercial and retail banking on the one side, and investment and wholesale banking on the other. The strategic implications of financial and monetary integration are different for these different lines of business. The fact that in continental Europe these different markets have typically not been served by different groups of banks makes it difficult to draw practical conclusions from this general insight.[41]

(a) We do not see much evidence of foreign banks' entering the retail markets of other countries through geographical expansion or cross-border mergers and acquisitions. Retail banking, which makes up the larger part of commercial banking, is a local and at best regional industry, and it is likely to remain so in spite of the Euro. Economies of scale are probably not easy to achieve in this industry, and if they are achievable, then mainly through cost reduction by eliminating branches, which is only feasible within countries. Thus cross-border consolidation is not a source of increased competition in retail commercial banking.

(b) However, increased competition for commercial banks results from the benefits which financial and monetary integration in Europe offers for capital markets. This is a strategic threat to commercial banks, or to the commercial banking divisions of universal banks, as corporations are now in a better position to fund themselves through capital markets. The corporate bond market in Europe has seen a virtual explosion since the introduction of the Euro. Stock market activity has also increased considerably. The growing importance of securities markets may reduce the demand for bank loans by – a less narrowly defined group of – large corporations, and certainly makes a strategic shift of banks towards investment and wholesale banking attractive.[42]

(c) An additional push in this direction comes from the fact that European integration stimulates mergers of non-financial firms. Banks will try to benefit from this business opportunity. Investment banking is to be a pan-European and in many segments even a global industry in which only "big players" can compete successfully. Some of these are American investment banks. Attempts to match their size and prowess will lead to additional mergers and acquisitions among European banks with a strong investment banking orientation and even the emergence of a "league" of big European investment-oriented banks. This trend is likely to find some support from national governments who want their "national champions" to be part of this "champions' league".

(d) The increasing importance of investment and wholesale banking poses a strategic challenge to most banks in Europe. In the past, most banks were essentially commercial banks. Now this situation is changing. At least in some banks, investment banking can no longer be treated as a useful addition to the main business, i.e. commercial banking. These banks face the difficulty that commercial (and retail) banking on the one side, and investment (and wholesale) banking on the other side require vastly different organisational designs. For instance, optimal pay structures and career paths are different for these two types of banks. Thus European integration challenges, indirectly at least, the conventional

[41] One of the most competent sources on the effect of the single market and the advent of the Euro on the banking system, or banking systems, in Europe is Walter/Smith (2000). See also Danthine et al. (1999).
[42] For new empirical data, which support this assessment, see ECB (2001).

concept of a universal bank.[43] Banks will have to decide to what extent they want to be "real" investment banks and how they adjust the rest of their business to accommodate this decision. As a consequence we are likely to see more specialisation of European banks in the future.

(e) The deepening of European stock markets, to a large extent caused by financial integration in Europe, also leads to growing pressure on privately owned and publicly held banks to create value for their shareholders and to improve their financial performance. One can speculate that the pressure to create shareholder value might prevent some banks from undertaking mergers and acquisitions which would mainly increase the prestige and power of the top management of the respective banks.

(f) Financial integration should make cross-border mergers and acquisitions in the banking industry easier in principle, and there are at least certain advantages to a strategy which entails elements of a pan-European expansion. Nevertheless, cross-border M&A activity in Europe has been very limited in recent years. One reason for this seems to be that the banking industry is shaped by national cultures and national idiosyncrasies. It seems highly unlikely that a "merger of equals" between two big banks from different European countries would "work". The same can be expected for straight takeovers. Alliances and other forms of co-operation might be more acceptable to the people who create value in the banks. However, their success is strongly dependent on the partners' willingness and lasting ability to respect each others' interests. Given the pressures under which they find themselves now, big privately owned and publicly traded banks and their top managers may not find that easy, and are therefore not likely to restrict their desire to dominate their foreign partners.[44] In this respect, not strictly profit-oriented banks might be in a better position; they may appear to be, and indeed may really be, more reliable partners in pan-European alliances.

In summing up, one can say that the effects of financial and monetary integration are different for mainly retail-oriented commercial banks than for more wholesale-oriented banks or for primarily investment banks. We are not likely to see a fully integrated European banking market except in wholesale and investment banking.[45]

c) Implications for competition

In the last subsection, three external factors were discussed at some length in an attempt to describe their isolated impact on the strategies of banks. Obviously, though, the three exogenous, or external, factors are interdependent in their influence on bank strategies. Therefore, a logical next step would be to analyse how these factors interact in shaping bank strategies. At the moment there does not seem to be enough theoretical and empirical research evidence to permit more than the "informed guess" that the three factors tend to reinforce each other in terms of what they imply for bank strategies.

One implication of the three external factors and their interaction is that we can expect competition in banking to intensify in the near future as a general tendency.[46] Competition between existing competitors is likely to become stronger, mainly because of the effects of IT on the cost structures of banks. The efforts of banks to spread their higher fixed costs over a larger volume of business will induce them to compete for market shares, and this typically leads to a general pressure on bank profitability. Non-banks and near-banks and organised capital markets are likely to enter markets which were formerly reserved for banks of a given country. Market entry of various types of new competitors from other countries has now become at least a realistic possibility.

The strategic implications of this for an individual bank are very specific to the situation of the bank. All one can say on a general level is that each bank must react to the increasing

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[43] In early 2001 the "big three" traditional German *Grossbanken* adjusted their general organisational structures. A divisional structure has now replaced the older client-oriented structures. This tends to make German banks more similar to British banks which have for a long time been organised along similar lines.

[44] The implicit allusion to the Daimler-Chrysler case is not accidental, see *Der Spiegel*, 26.2.2001, pp. 96-109.

[45] This is also the view expressed and supported at great length in Walter/Smith (2000).

[46] See also Remsperger (2000) who identifies the EMU as the single most important factor and refers to the 1999 all-time low of the interest margins of German banks at 1.28% as strong empirical support.

competitive pressure by selecting very carefully the fields of activity it wants to focus on in the future, and then by adapting all of its internal processes and structures to the requirements of the market segment or segments in which it wants to compete. These segments can be defined by type of service provided, by type of client, and by geographic scope. Given that, obviously, not all banks will select similar strategies, we are likely to see more specialisation of banks in the future. Some will become mainly investment banks, some will remain mainly commercial banks; some will have a local or regional focus, while others will have a broader geographic outreach. Clearly, the strategic selection of product focus, client focus and geographical scope has to take into account that some combinations are less attractive than others. It would be nice to be able to make general statements concerning the nature of competition in the commercial banking and the investment banking segments. But this is not possible; in order to make such statements, the broad categories of commercial and investment banking would have to be broken down into much smaller segments.

There is a counterforce to the trend of increasing competitive pressure. The strategic reaction of individual banks to increased competition can take one of two forms. Either they can try to gain a competitive advantage by growth, including mergers and acquisitions, in order to exploit economies of scale; or alternatively they can specialise in certain market segments. Given that economies of scale are difficult to achieve and that cross-border mergers and acquisitions may be very difficult to negotiate, and even more difficult to implement successfully, the specialisation alternative would seem to have a lot in its favour. If many banks decide to specialise more in the future, this will reduce the number of competitors in most market segments; and to the extent that competitive pressure is a function of the number of market participants, the widespread adoption of strategies emphasising specialisation could counter the competition-increasing forces listed above. However, in banking the relationship between the number of competitors and the intensity of competition is ambiguous. It is therefore impossible to state with precision whether the intensity of competition will generally increase in the future. Nevertheless, as a general tendency this appears highly likely.

Even though I have not been able to provide a detailed analysis of competition in the various parts of the market for banking services, it seems to me that the above consideration of bank strategies is not inconsistent with the sketch I have offered in this subsection: the strategic implications of the external factors do not need to be completely rewritten when one takes into account that the banks' strategies must also be a function of the prevailing and expected competitive situation, which is itself an outgrowth of the strategies adopted by the banks.

## 2. The development of banking structure(s) in Europe

There will be a process of consolidation in European banking. The number of banks will go down. Some banks will be unable to adapt and therefore will simply disappear, be bought up or merge. Whether this also implies a higher level of concentration depends on the specific market segment and the extent of new market entry into this segment.

a) The future of different segments of the banking market

*(1) Commercial and retail banking:* It seems safe to expect that, mainly as a consequence of IT and of the declining importance of traditional lending to corporations, concentration in national retail markets will go up. But it is unclear how far this process of consolidation and concentration will go. National peculiarities are strong in this area. It is hard to measure and to compare concentration levels between countries because of the different roles of the network-affiliated savings and co-operative banks in different countries. Not least because of these networks, which are traditionally important in Europe, the patterns of consolidation and concentration will differ greatly between countries. As explained above, large privately owned listed banks with a clear international focus might decide to leave the retail market. The example of Deutsche Bank and Dresdner Bank supports this proposition. But big British banks are moving in precisely the opposite direction. Smaller privately owned banks can be

expected to reduce their lending activity or even to give it up completely. Many of them have already taken this step.
As market entry by foreign banks is relatively unlikely in the retail market, the commercial and retail banking markets of the individual countries will in the future still be relatively closed to foreign market entrants and more concentrated than in the past. They will be dominated by a small group of banks or bank networks. Even though banks which are not strictly profit-oriented may be successful in building up transnational pan-European networks, the European market for retail banking will remain a patchwork of national markets.
*(2) Investment banking:* In several subcategories of investment banking, international focus and size are important, because size helps to attract high-calibre staff and to establish and use reputation. Both of these arguments also suggest that it is attractive for an investment banking firm to cover several areas in which valuable human capital and reputational capital can be used. As far as the relationship with customers is concerned, national borders are relatively unimportant for most parts of the investment banking business. We will therefore see an increasing trend towards concentration and consolidation in the investment banking industry on a European level. For reasons which are internal to the banking organisations it appears plausible that the European banks that will succeed in this market will still retain a distinct national identity. As the number of truly big banks in Europe (with a national flavour) is probably not great we might see the market dominated by one or two big financial institutions from each country. However some highly specialised small "boutiques" with a good reputation will be able to defend their positions.
b) The future of different types of banks
*(1) Big banks:* One of the interesting questions about a new banking structure is which role the really big national banks will play in the future. Today, most of them are national universal banks providing a large array of services to many groups of clients. In the past, some of them seem to have envisaged playing a similar role in several countries, that is, becoming truly European universal banks. But this now seems to be neither achievable nor attractive.[47] The costs of internal growth would simply be too high even for the largest banks; external growth seems very difficult because national banking cultures differ too much, and the benefits of being present in all market segments do not seem sufficiently great. So what we can expect to see is a number of big national banks remaining universal banks in their home countries but at the same time pursuing selective strategies in other countries, such as concentrating on specific businesses or specific types of client. Their number will probably decrease further as a consequence of domestic mergers.
*(2) Not strictly profit-oriented banks:* Co-operative and savings banks have in the past played an important role in many European banking systems. It is therefore natural to ask whether they will be able to maintain their positions in a future European banking system.[48] The prospects appear good for various reasons. One is that at least in some countries the big privately owned commercial banks are retreating from the domain in which the co-operative and savings banks have their strongest position, namely the local and regional retail market. The business clients of co-operative and savings banks are not likely to migrate to the capital markets. The networks to which these banks belong provide a balance of scale and flexibility and enable them to defend their traditional turf without having to forgo the opportunities which deregulation, IT and financial integration might offer them. They might even be particularly well placed to benefit from the option of financial integration. As was explained above, their tradition of being part of networks or federations and the limited performance pressure to which they are exposed because of their specific ownership and governance structures may make them more trustworthy partners in pan-European alliances than big, acquisition-hungry, strictly profit-oriented banks. However, whether the co-operative and savings banks can exploit this potential is open to question because of their unclear and, at least in the view of some observers, deficient ownership and governance

[47] See Büschgen (1993) and various contributions in Saunders/Walter (1996).
[48] See White (1998) for empirical data, and the theoretical argument in Allen/Gale (2000), Chapter 3.

systems. Moreover there is at least a possibility that the European Commission will break up the governmental support and ownership of these institutions. It is too early to say what this would imply for the savings banks; the answer will largely depend on the strategies chosen by the big banks. If they withdraw from the retail market, as some big German banks seem to be contemplating, then the prospects for semi-privatised savings banks could remain good.

## IV. Is banking in Europe likely to retain its specific features in the future?

In the introduction, six features were listed which are at least to a certain extent specific to the banking and financial systems of continental Europe. As was said there, many competent observers claim that in the process of modernisation and integration, these features might be lost and that, moreover, the banking and financial systems in continental Europe are likely to converge to the Anglo-Saxon type of financial and banking system.

The question which this paper addresses is whether these expectations are correct. In this final section, an answer is sketched. The results of the preceding analysis will prove useful for this undertaking, but they are certainly not sufficient on their own, and additional considerations must be taken into account. It should also be remembered that history plays an important role in shaping economic phenomena such as banking systems.

*(1) The important role played by not strictly profit-oriented types of banks*

Savings banks and co-operative banks have played, and to this day continue to play an important role in the banking systems of many European countries, and they clearly differ from other banks. The analysis shows that, for various reasons, co-operative and savings banks are not likely to be eliminated by market pressures. Their specific feature of not being strictly profit-oriented even has some advantages in the new environment. They may benefit from the retreat of other banks from the retail banking segment; and they could generate successful pan-European alliances in the future. This assessment can be supported by empirical evidence which shows that these banks have survived the recent turmoil in the financial markets better than many private banks. And indeed, there are theoretical considerations which would have led to predictions that this would be the case.[49]

*(2) Relationship banking as the dominant mode of banking*

Relationship banking will remain an important feature of banking in Europe. But it is questionable whether it will remain the dominant model for all companies. Big and even not-so-big corporations have begun to use capital markets to a much larger extent than they used to, and many banks have shifted to investment banking. In this context, the scope for relationship banking is limited. Relationship banking will remain important or even increase in importance for small and medium-sized firms and thus also for the savings and co-operative banks which will specialise, to an even greater extent than they have in the past, in serving these clients if, or because, private banks turn away from them.[50]

*(3) Universal banks as the prevailing type of banking organisations*

In the past, the term universal bank was used in a broad sense to designate a bank which provides *all* kinds of banking services to *all* kinds of clients. Universal banks in this sense may continue to exist, but they are certainly no longer the prevailing form of banks even within national banking systems. The need to specialise is so great that banks will not want to remain universal banks in this broad sense. *A fortiori*, we will not have universal banks of this type covering several European countries. However, one can also speak of universal banks in the sense of banks which provide many services to *specific* groups of clients. Universal banks in this narrower sense are here to stay and may even gain in importance in

[49] See Allen/Gale (2000), Chapter 6.

[50] Indirect evidence for this conjecture is provided by data from the Deutsche Bundesbank (1992, 1998): Lartge firms with turnover greater than DM 100 million have decreased the share of bank loans in total liabilities below 10%, whereas small firms with turnover below DM 10 million have increased this ratio to almost 40%. See also Starrk for a confirmation of the significance of relationship lending for German SMEs, as well as Canals (1993) and the references provided in note 23 *supra*.

catering for specific, but economically significance, groups of clients such as small and medium-sized firms. They are the appropriate organisational form for relationship banking.[51]

*(4) The important role played by traditional banking and bank-based financial intermediation*

Financial intermediation, i.e. the combination of deposit mobilisation and lending, was once the essence of banking. The decline of financial intermediation in general, and of intermediation by banks in particular, has been predicted for quite some time. Recent empirical research indicates that this prediction was wrong at least until the late 1990s and as far as it was applied to the entire financial system of a country.[52] Bank intermediation ratios have remained stable in many large industrial countries, notably Germany and the UK. However, this might well have changed recently. The growth of securities market activity in the years 1999 and 2000 points in this direction; and some banks, in particular some big private banks, are eager to react to this situation by curtailing their involvement in traditional banking operations. But I do not expect this to be a general tendency.

(5) The dominance of banks, as opposed to capital markets, in the respective national financial systems

The importance of banks relative to capital markets will decline in the future. However, this does not imply that the financial systems in continental European countries will soon change their general character and become capital market-dominated. Whether a financial system can be considered bank-dominated or capital market-dominated depends on many more aspects than merely the level of capital market activity. I do not have the space to describe the other aspects here, but if I did, my description would not support the proposition that the financial systems of continental Europe are on their way to becoming capital market-dominated. In spite of all the changes, banks seem able to maintain their strategic position in a financial system if this position has traditionally been strong. Bank dominance might however disappear in countries like France, in which the formerly strong, or even dominant, role of banks was mainly a consequence of regulation and government policy.[53]

(6) Considerable differences between the financial systems of different countries

Even though the banking system in Europe will remain fragmented along national lines to a certain extent, banking markets and even capital markets are in the process of becoming more and more integrated. However, this alone will not eliminate the profound or "structural" differences which still exist between some financial systems in Europe. A financial system is a configuration of several elements which complement each other. This feature makes coherent financial systems resistant to "structural" change and thus also to forces which could be assumed to lead to a *gradual* convergence. Increasing similarity with respect to one or a few elements is not sufficient to change the fundamental structure of a given financial system and therefore does not lead to a convergence of entire financial systems. However, it is an open question whether the recent and the foreseeable developments – mainly in 1999 and 2000, the era of the stock market rally and the wave of new issues in many European countries including Germany – are important enough to undermine the coherence of the individual financial systems in Europe and thereby destabilise them, and whether they will converge after having been "sufficiently destabilised".[54]

[51] For similar assessments see Walter (1997) and Doerig (1996).
[52] See the references in note 24 *supra*.
[53] See Schmidt et al. (2001).
[54] See Hackethal/Schmidt (2000a) and Schmidt/Spindler (2001).

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