Regulation versus Competition on European Financial Markets

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"Competition may be the spice of life, but in economics has been more the main course."
George Stigler

Competition is the mechanism that helps companies, institutions and markets to become more productive and efficient. One of the main obstacles to economic growth is represented by the policies that hinder competition. The European officials' solution to the region's reform is to protect the region against outside competition, while preventing companies from restructuring and making layoffs. But history proved that such a solution will not work, since competition increases productivity and successful organizations are the ones that respond by making the smartest innovations. But this dynamic is more or less absent in Europe. And it should change to face the global challenges. Excessive protection may create a handicap for the European economic system which will have not all the necessary instruments to face the increasing competition between companies, countries, economic regions. The paper aims at analyzing the relationship between regulation, competition and economic performances applied to European capital markets, as opposed to US capital markets. In the case of capital markets, their liberalization is seen as the major source of increased efficiency, which leads to subsequent integration at global level. Nevertheless, existing literature documents the segmentation of European capital markets, which reflects impediments to competition against markets, on one hand, and against investors, on the other hand.

Key words: regulation, competition, capital market, integration

Competition and economic performance – some theoretical considerations

In economics, competition is not a purpose itself, but it is a mean of organizing the economic activity in order to achieve a goal. The economic role of competition is to discipline the different participants to the economic activity in order to provide quality goods and services at low costs. Though the general tendency in economics has always been to consider competition as the opposite of monopoly, there are 2 different approaches of this concept, incorporated in the economic theory:

- A classical – dynamic approach to competition, according to which competition is not conceived as a market structure where the firms react passively to the price, but as an active process that leads to an effective allocation of resources in an economy.
- A static – neo-classical approach that developed and became the basis of industrial economy. In the neo-classical theory, competition is no longer defined as an active process, but rather as a stage in which the process has achieved his limits. This way, competition becomes a market situation which, although it is the result of the free entry for a large number of competitors, has evolved up to the point where no further competition is possible.

The performance of economic entities, no matter how it is measured, is of a complex nature and presents different aspects or dimensions. Therefore, performance in business has numerous dimensions, specifying the fact that these reflect the different functions of firms and the various interconnections with the rest of the economy. The analysis of market performance necessitates, in the first place, identifying the determinants of market performance of an economic entity and the influence of their variation over performance, considering that it is intended not only to know, but also to explain it (Bain, 1968).

Observations, the common sense and the formal theories suggest that there are two main types of performance determinants:

- The organization or structure of an industry (or group of competitive entities). The market structure imposes limits and channels the activities and result of each entity. Variations in the structure can determine variations in performance.
- The behavior of each entity in the market, which represents: policies, practices, plans that are used to adapt at the market conditions.

Within the framework of industrial economy, microeconomic analysis tools have been incorporated in the structure – behavior – performance triad (S-B-P), developed for the first time by E. S. Mason in 1939 at Harvard University and, later on, by his student J. S. Bain in the 50'-60's. (see Table 1).

Table 1. The triad S-B-P

Market structure	Firms' behavior	Industry peformance
➢ Number of competitors ➢ Competitors' dimension ➢ Degree of industrial concentration ➢ Entry barriers ▪ scale economies ▪ initial capital needs ▪ access to distribution channels	➢ Pricing ➢ Product ➢ Promotion ➢ Selection of distribution channels ➢ Cooperation between competitors	➢ In private sense ▪ Competitors' profitability ➢ In social sense ▪ efficient resource allocation ▪ innovation

Source: Civettini, S., *Deux visions pour un modèle synthèse de l'évolution de l'intensité de la concurrence au sein d'une industrie: une application à l'industrie américaine de l'acier*, Doctoral thesis, HEC Montreal, 1995, p. 179

The paradigm of industrial economy underlines the connections between the market structure and the firms' behavior in determining the market performance. In its most simple form, the paradigm suggests that there is a causal connection, starting from the market structure in order to determine the behavior of firms and therefore the performance of the industry. The performance of an industry or market is indicated by factors such as profitability, efficiency or growth. Performance is supposed to be depending on the behavior of each entity as part of the market, and the behavior determines other factors such as: pricing, development and promotion of the product, etc. In all these areas of activity there must be taken into consideration the objectives of each entity, the degree of collusion or competition between the entities and other aspects of the business practice. The market behavior depends, in exchange, on the market structure, which includes elements like: the degree of concentration at the level of a small number of firms, the degree of diversification of the product and the entry barriers for the new competitors. (see Table 2)

Table 2. **S – B – P paradigm elements**

Basic conditions	
↓	▪ Costs
	▪ Demand
	▪ Technology
Market structure	
↓	▪ Degree of concentration
	▪ Product differentiation
	▪ Entry barriers
	▪ Vertical integration
Behavior	
↓	▪ Business objectives
	▪ Business strategy
	▪ Competition practices
Performance	
	▪ Efficiency
	▪ Profitability
	▪ Technical progress
	▪ Creşterea

Source: Clarke, R., *Industrial Economics*, Basil Blackwell Ltd., Oxford, 1987, p. 3

European economic reform, competition and regulation

The political crisis in which Europe stands has as a starting point the problem of the unsatisfactory economic performance: the budget deficit of some member countries, the growth rate of some economies that is low, the high unemployment rate particularly in the young population segment. Addressing such problems is equivalent to discuss the region's economic performance. Although some European leaders favor the restriction of competition, the protection of the economy through rigid regulation, these are incompatible with the concept of dynamic, performing, growing economy. As studies of some prestigious institutes have revealed[1], the low economic growth rates of some European economies do not have as a main cause the lack of technology, but rather the restriction of competition through rigid settlements that determine a decline in efficiency. The example of some European countries[2] engaged in serious economic reform can be relevant for the entire region: these countries have obtained better economic performances, protecting at the same time the European life style, by stimulating economic growth and the reduction of unemployment.

The excessive regulation restricts competition, affecting in negative way efficiency. There are differences of productivity, frequently considerable, between the competitors of the same industry, in many cases the advantage belonging to the American entities in the detriment of the European ones. The studies performed by McKinsey Global Institute point

[1] McKinsey Global Institute (MGI)
[2] Denmark, Ireland, Spain, Sweden, United Kingdom

out a few causes that have led to the impossibility of the European companies to achieve their potential (causes like: structural differences). All these causes are still perceived as symptoms of a much serious problem, namely the lack of competitive pressure.

Competition leads to efficiency growth, considering that the best performing entities are the ones that innovate, extend their market share and create new jobs. This dynamic lacks to the European economies, the main reason being the excessive regulation that leads to the limitation of the new entries in the market, impeding the economic entities to achieve economies of scale and to operate in optimum economic conditions.

Is regulation necessary? Of course it is! Market economies are not able to work without some rules, from the one that protect innovation to the antitrust legislation which looks to enforce fair competition. Regulation however is not that easy to do so that it can be beneficial to the general economic environment. Regulations should be sufficient for its protective role, but not that complicated and stiff to impend innovation and progress. In general, regulation should have as objectives: equal conditions for all competitors in the market; consumers' protection; environment protection.

There are some criteria[3] that should be taken into account in any regulatory process, like:

- *Regulation should be transparent*. The regulatory body should understand not only the way competition is influencing different opinions and interests, but also the social and political consequences.
- *Regulation should be dynamic*. Rules and standards should be changed to reflect the business environment changes.
- *The winners should be designated by the market not by rules and laws*. Regulation should create fair competitive conditions to everybody.
- *All participants should be subject to the same rules*. Nobody should be favored in the detriment of the other players.

Enabling regulations that encourage more than hinder competition and economic growth is more difficult when the economic environment is subject to continuous and rapid technological changes, increasing the economic uncertainties. Regulation becomes more complex and therefore needs to be managed professionally. The main conclusion of MGI's studies on this theme is that a weak regulatory process (either too severe or too relaxed rules) represents the main factor of limited economic growth in the world. In many situations, regulation has a negative effect.

Looking to Europe, our current regulation protects society in the detriment of competition, which in the end turns against the interest of consumers. Protecting society as a whole can be made also without hindering efficiency and economic growth. Economic progress depends on increased efficiency, which in turn depends on a competition undistorted

[3] According to "Regulation that's good for competition", Scott Beardsley, Diana Farrell, The McKinsey Quarterly, No.2, 2005

through excessive regulation. Even if governments are not restricting competition by intend it will have as effect the impossibility of efficient entities to eliminate the inefficient ones, and in this way the economic growth is declining.

One can explain why some countries are rich and others are poor through the differences in productivities and GDPs. Few decades ago, US, Japan and Western Europe were considered to be convergent from the point of view of technologies, capital flows, business practices. Still, there are significant differences between these economies. And the answer is not in the differences in capital markets or labor markets, but in the nature of competition. Competition is the mechanism that helps companies, institutions and markets to become more productive and efficient. In this way, consumers and investors are the ones to benefit.

Excessive protection handicaps the European economic system, leaving it without sensors and instruments to face the challenging global economic environment, in which competition between companies, institutions, markets, countries, and regions becomes stronger. Europe can progress without abandoning its social values. Still, many regulations settled to protect these values, are hindering the European abilities to face competition on global markets. Therefore, taking into account the economic theories that link the degree of competition to economic performance, as well as the empirical evidence that was reflected in many studies made at global level, we can consider that the key factor in reforming the European economy is represented by the stimulation of a competitive behavior.

Capital markets, regulation and competition

A healthy economy is vitally dependent on the efficient transfer of funds from those that are saving to those that need capital to operate the businesses. Economy depends on efficient capital markets. In order to grow companies need capital. The capital they need can come from their reinvested profits. But fast growing companies need more capital than they can generate themselves. Companies can get external funds in different ways: accessing the banking system (which is considered to be an indirect financing), or accessing the capital market (which is considered a direct financing).

Financial markets comprise: *People* – buyers, sellers, intermediaries; *Products* – shares, bonds, derivatives, etc; *Policy* framework – rules of the game; *Platform*s – infrastructure, processes. To function effective and efficient, financial markets should allocate resources efficiently, establish fair prices, have sound risk management and show good corporate governance.Credible capital markets are attractive to those that are looking to find the right place to invest their money. But they are also attractive to those that need capital to finance their businesses. To create credible capital markets it is essential to have a strong regulatory framework. A credible capital market means credible rules and the capacity to enforce the rules to avoid abusing the market in a dishonest, fraudulent way. Financial regulation should influence market behavior that can damage market integrity (market manipulation, inside trading, fraud, etc). This is called conduct regulation.

But financial regulation should take into account also competition regulation (Sheng, 2005). In a market that is highly concentrated (financial intermediaries become larger and more concentrated), competition regulation becomes more relevant. The anti-trust laws look to avoid monopolistic and cartel activities that can harm consumers, investors, competition interests. As markets converge globally, investors and consumers of financial services are looking across borders to find the best financial alternative. This creates competition between players at the global level. Financial regulators have to take into account these global trends and to adapt, one of the objectives of financial regulation being overall financial stability. They have to find a balance between regulation and competition.
„Too much regulation – as well as poorly designed regulation – will make our capital markets unattractive. This will, in turn, add costs to companies looking for capital, reduce investor returns, and result in an overall negative impact on the US economy."[4]. And, as Arlman (2003) puts it: "A strong and modernized EU financial legislation would be beneficial not only for the securities markets but also for the EU economy as a whole. An efficient and integrated securities market is vital to the process of raising the level of competitiveness, ie through the efficient allocation of capital, by mobilizing savings and by disciplining management."

Global financial markets – a changing landscape

Global financial markets have constantly developed in the past twenty years, in terms of transaction volume and diversity of financial assets, reaching a degree of financial depth that is unprecedented – a relevant measure of this would be the fact that the current value of the world's financial assets exceeds global GDP by a factor of three[5]. Deeper financial markets are beneficial for the world's economies, as they generally promote a better resource allocation and provide individuals and businesses with more opportunities for investing and financing.

The importance and positions that various countries and regions play in the global financial markets have changed in the past few years, with Europe gaining more importance. While the United States continue to be the largest financial market in the world and the largest global financial intermediary[6], the eurozone[7] along with the United Kingdom emerge as a powerful player in the global financial landscape. This is observable through the volume of capital inflows and outflows between the eurozone and the rest of the world ($3.2 trillion, of which cross-border capital flows within the eurozone totaled $1.7 trillion, at the end of

[4] National Chamber Foundation Report, "Capital Markets, Corporate Governance, and the Future of the US Economy", February 2006
[5] According to "Mapping the global capital markets, January 2007: Europe Rising", The McKinsey Quarterly, January 2007
[6] The United States' capital inflows and outflows totaled approximately $1.5 trillion in 2005, according to the above-cited McKinsey research.
[7] Austria, Belgium, Finland, France, Germany, Greece, Italy, Ireland, Luxembourg, the Netherlands, Portugal and Spain

2005)[8]. United Kingdom also became an important global player and financial intermediary, particularly for cross-border bank lending (with total inflows and outflows of $1.3 trillion at end of 2005)[9]. By contrast, Japan is noticeably isolated, with recent capital flows smaller than China's, even though the stock of financial assets in China is only one-quarter the size of Japan's. The rise in importance of the eurozone in recent years can be explained by the process of economic integration that EU member states entered into, accompanied by the introduction of the euro as a common currency for these countries. At the same time, the European Commission recognized, at the end of the '80s, the relative competitive disadvantage that European financial markets had against the US market, derived from the diversity of capital markets in the region and the different attributes of countries' financial systems. This diversity is still present, but a number of necessary steps have been taken in order to lead to a higher integration of European financial markets among them and within the larger global financial market. We discuss the degree of financial integration that has been attained at the level of European markets, followed by a critical overview of regulatory measured taken at the European level with intended at providing capital markets with a stimulus for deeper integration.

Financial integration in Europe – the status-quo

The effects of financial integration have been recognized in a quite significant number of research papers, and they can be identified at two levels: a macroeconomic and a microeconomic one. From a macroeconomic perspective, the most important implications of financial integration are observable at the following levels: (1) improved capital allocation within a country and among countries, as the removal of barriers to capital flows allows companies to identify the most efficient manners of investing the available funds and financing their businesses; (2) higher domestic investments, which in turn generates higher growth levels; (3) improvements in the functioning of countries' financial systems; (4) risk sharing with the goal of smoothing consumption inter-temporally, as the wider set of financial instruments available in the market permits a better diversification of the risk that businesses and individuals are exposed to. Nevertheless, the preference of international capital flows for quite a small number of developed countries and, sometimes, a reduced number of emerging countries, combined with a higher volatility of capital flows as compared to foreign direct investments, diminishes to some extent these acknowledged benefits of financial integration. At a microeconomic level, the outcomes of financial integration can be thought of in terms of (1) better portfolio allocations and risk diversification, as the access to foreign assets and institutions improves the range of assets available only on the domestic market; (2) wider opportunities available for financing: and (3) an indirect consequence of a proper functioning financial system.

[8] According to "Mapping the global capital markets, January 2007: Europe Rising", The McKinsey Quarterly, January 2007
[9] According to "Mapping the global capital markets, January 2007: Europe Rising", The McKinsey Quarterly, January 2007

The European Union, as the most successful integration process so far, has been mainly studied in order to observe the presence of these possible effects of financial integration, with general results indicating an increased integration of the capital markets. Beckers (1999) shows that we can observe a statistically significant trend of increased correlations between various industries of countries that are EU members – the most integrated industries seem to be energy, capital markets and, to some extent, utilities. Freimann (1998) studies a number of four macroeconomic variables – GDP growth, inflation, bond yield spreads and changes in exchange rates – to conclude that European countries display a strong integration trend, led by the Netherlands. Fratzcher (2001) analyses the integration process of European equity markets since the 1980s and demonstrates that they became more integrated since 1998, but the euro area has gained considerable importance in world financial markets. This high level of integration between European equity markets can be largely explained by the drive towards the European and Monetary Union, accompanied by the elimination of exchange rate volatility and uncertainty in the process of monetary unification. Adjaoute and Danthine (2004) reassess, in the light of economic and financial theory, the recent evolution of capital markets in the euro area, and conclude that European capital markets are still segmented, which inevitably leads to higher costs for Treasuries and taxpayers, and urge for measures to be taken in favor of a higher integration of these markets. Reszat (2003) evidence that the contribution of the common currency to financial integration has been the stronger the more national markets have in common and the greater the importance of foreign exchange risk as a discriminating factor. On a more advanced level, Baele et al. (2004) present specific measures that can be used with the goal of quantifying the state and evolution of financial integration in the euro area, by considering the money, corporate bond, credit and equity markets. Their results indicate that integration is reasonably high in the government and corporate bond market, as well as in the equity markets. At the same time, Bartram et al. (2005) show that, within the euro area, market dependence increased after the introduction of the common currency only for the large equity markets – France, Germany, Italy, the Netherlands and Spain -, while transaction costs still represent serious barriers to investments and integration of smaller capital markets.

Towards a higher integration of European financial markets

The impediments to the free flows of capital at international level are known and are, despite the trend towards globalization, still persistent in Europe. One major impediment arises from the presence of regulatory restrictions, emerging as a result of the diversity of objectives that companies and financial institutions in Europe have. Related to this impediment, the nature of financial institutions from different countries plays a significant role in market segmentation. From this perspective, with financial institutions that have traditionally paid more attention to the needs of local businesses and investors and much less attention to international capital markets, Europe sees itself at a competitive disadvantage against the United States. The second major impediment to integration arises from the diversity of institutional and cultural attributes of different countries, but this impediment is likely to persist on the long run, as the resistance to change is high, on one hand, and, on the other hand, some of these features are impossible to alter even on the long-run.

Given the limited potential influence over the second impediment mentioned-above, action has been taken at the European level in order to diminish, if not to completely remove, the first impediment, related to the existence of discriminatory rules for domestic and foreign competitors. In 1998, the European Commission launched a Financial Services Action Plan (FSAP), aimed at establishing a deep and liquid single capital market in Europe, with full implementation desired by the end of 2005. The European Council that took place in Lisbon in 2000 saw the FSAP as an integral part of the "Lisbon Agenda", an ambitious plan to transform the European Union into the most dynamic economy of the world by 2010. At the heart of the FSAP resided the acknowledgement that different regulations among EU countries in the field of capital markets represent a real impediment for the integration of markets, as they hinder competition and reduce capital markets' efficiency in allocating capital. The FSAP rules were designed to be restrictive enough to ensure harmonization at the European level, by preserving a certain level of flexibility that would allow financial institutions to adjust to international regulations as well.

The implementation of the FSAP was conducted in two stages: first, each of the measures taken had to be agreed at the European level and afterwards implemented at the national level. A "Committee of Wise Men", chaired by Baron Alexandre Lamfalussy, was handed over the effective implementation of the plan. This committee recommended structuring the FSAP on various levels, as follows: level 1 – "framework principles", which are fundamental principles of the necessary legislation in the form of directives and regulations adopted by the European Council and the European Parliament; level 2 – "implementation measures", that offer the technical details of the directives and regulations; level 3 – uniform implementation of legislation in EU countries; level 4 – compliance with and enforcement of the legislation at the level of member states.

The reports of experts with regard to the FSAP show that it has been a success in promoting integration in banking, insurance and financial securities, both in terms of legislation adoption by member countries and of co-operation between European institutions and market participants. In 2005, the European Commission presented a new strategy for the 2005-2010 period, aiming at exploring the best ways to deliver further benefits of financial integration to businesses and consumers alike. This strategy, which will be supervised through a Financial Integration Monitor, will be developed around five priorities, as follows: (1) the dynamic consolidation of progress in the field of financial services, accompanied by a sound implementation and enforcement of existing regulations; (2) the drive through better regulation principles into all policy making; (3) the enhancement of supervisory convergence; (4) the improvement of competition between service providers; (5) the rise of EU's influence in globalizing capital markets. The European Commission intends to deploy, in this respect, an open, transparent and evidence-based policy-making, based on consultations and impact assessment, in order to ensure that sound rules are implemented, that add value to the EU's financial services industry.

All these measures taken or that are going to be taken at the European Union's level raise the inevitable question of "Is it too much or too less regulation in Europe?". And one can continue by asking "If there is too much regulation, does it have the potential to rather improve or hinder competition?" As current developments suggest, viewed from the perspective of higher financial integration in Europe, the Commission's actions towards the harmonization of regulations in EU has fostered competition, increased efficiency and consolidated EU's role in international financial markets. As long as the process continues and the domains that display higher segmentation at present – retail industries, in particular – will move towards better integration, European financial markets have the potential of competing at the same level with the US capital market, with benefits at both macro- and micro-economic level.

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