

EUROPEAN ECONOMIC COMMUNITY

Commission

The Development of a European Capital Market

Report of a Group of experts
appointed by the EEC Commission

BRUSSELS, NOVEMBER 1966

Foreword

Article 67 of the Treaty establishing the European Economic Community provides that during the transitional period the Member States shall gradually remove restrictions and abolish discriminatory treatment affecting capital movements between them, to the extent necessary for the proper functioning of the Common Market.

This, then, was the aim of two directives, issued in 1960 and 1962 by the EEC Council on proposals from the Commission, which, for certain important categories of transaction, eliminated exchange restrictions that hindered the free movement of capital within the Community. However, because of the faster advance towards economic integration and agreement on common policies, the rates of progress in the various sectors soon got out of phase and it became evident that there would have to be a new drive to develop a European capital market.

Discussions within various Community bodies, in particular the Monetary Committee, had shown that the measures likely to encourage such progress would gain in effectiveness if worked out with the aid of a clear picture of the objectives, conditions and implications of integration in this field. The Commission therefore decided to entrust a group of independent experts with a study of the problems confronting the capital markets of the Community as a result of implementation of the Treaty.

The Group of experts consisted of the following members:

- Dr. A. BATENBURG, Managing Director, Algemene Bank Nederland, Amsterdam;
- Prof. J. L. BLONDEEL, President, Kredietbank S. A., Luxembourg;
- Prof. G. DELLA PORTA, Director, Research Department, Banco di Roma, Rome;
- Prof. A. FERRARI, Director-General, Banca Nazionale del Lavoro, Rome;
- M. R. FRANCK, Director, Banque Internationale, Luxembourg;
- Dr. L. GLESKE, Chairman, Landeszentralbank, Bremen;
- M. J. GUYOT, Partner, Messrs Lazard Frères & Co, Paris;
- M. A. LAMFALUSSY, Director and member of the Executive Committee, Banque de Bruxelles, Maître de Conférences in the University of Louvain;
- Prof. Dr. H. MÖLLER, University of Munich, Director of the Institut für internationale Wirtschaftsbeziehungen, Munich;
- M. G. PLESCOFF, Director, Caisse des Dépôts et Consignations, Paris;
- Prof. C. SEGRÉ, Director for Studies, Directorate-General for Economic and Financial Affairs of the EEC Commission;
- Prof. P. TABATONI, of the Faculty of Law and Economics, Paris.

Other experts closely associated with the work of the Group were:

- M. P. BARRE, Director, Research Department, European Investment Bank;
- M. R. BERTRAND, Director of Payments, OECD;
- M. E. ISRAEL, of the Banque Internationale, Luxembourg;
- M. G. SERTOLI, Director, Finance and Treasury Department, European Investment Bank;
- M. A. THEUNISSEN, Director-General for Credit and Investment, ECSC High Authority;
- M. P. WERTHAUER, Head of Division, Directorate-General for Credit and Investment, ECSC High Authority.

The chairmanship of the Group was entrusted to the representative of the Commission, Prof. Claudio SEGRÉ, who also supervised the preparation of the report.

The Group of experts presented the report which follows. The Commission wishes to express its thanks and appreciation to the Group for the important and valuable work it has performed. Though the report does not of course in any way prejudge the position the Commission will take on the problems examined, the Commission regards it as an excellent basis for the accomplishment of its tasks in this field.

Brussels, November 1966.

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INTRODUCTION

Terms of reference for the Group's study

1. The terms of reference laid down by the Commission for the Group's study assigned five basic tasks which may be summarized as follows:

a) To establish and specify what needs to be done to develop a European capital market, having regard, on the one hand, to the aims of the Treaty of Rome — particularly in its financial clauses — and, on the other, to the scope for evolving joint solutions from the efforts currently being made by the various Member States to improve the functioning of the markets;

b) To analyse present differences of market organization in the Member States, to assess the implications of these differences and thus ascertain the factors responsible for the present fragmentation of markets;

c) To take stock of intra-Community capital flows during the current stage of fragmented capital markets, in order to assess what would be the significance of broadening the market on a European scale;

d) To endeavour to establish what impact the establishment of a European capital market would have on the Member States' pursuit of economic policies based mainly on the use of financial instruments;

e) To consider how the structure and the working of the financial institutions would have to be adapted so that the markets could be integrated.

The Group was invited to put forward specific recommendations on the above points in its report, which was later to form the basis for concrete measures to be taken by the Community authorities.

Scope of the study

2. In accordance with explanatory notes appended to its terms of reference, the Group so far as possible left purely descriptive themes outside the range of its studies. True, it has at times felt it necessary to describe some special aspect of the structure of a capital market, some special technique used by one particular intermediary or some fiscal or other regulation in force in a Member State. Such passages have, however, been introduced into the report only when they threw light on the precise nature of the obstacles to integration or the scope of the recommendations put forward.

No systematic analysis of national capital markets has therefore been undertaken. An analysis of this kind would at best have been of only limited value since papers

on the situation and problems of the capital market had already been prepared by certain Member States and international organizations. The OECD Committee for Invisible Transactions has for instance been invited to make a "Study on the Improvement of Capital Markets", the results of which are to be published shortly.

In addition, the underlying purpose of the Group's work differs from what was aimed at in most of these other studies, which set out to reveal certain deficiencies in the structure or functioning of the capital markets and to seek remedies exclusively at national level. The OECD study, too, although it has a wider scope as it ranges over several markets, endeavours to bring out the problems common to certain markets but does not tackle the question of their integration. The special feature of the Group's approach lies in the fact that it adopts from the outset a Community outlook and makes its analysis with an eye to the conditions, methods and probable implications of setting up a European capital market and the obstacles that will be encountered.

The Group's study covers the main financial flows and channels and devotes special attention to certain categories of institution. The specific problems of other categories of institution or financial intermediary have not been discussed in detail: this applies for example to the agricultural credit institutions, to professional or co-operative credit or social insurance institutions and to stock-brokers and stock exchange intermediaries. This does not mean that the problems connected with these financial intermediaries were regarded by the Group as being of secondary importance: in fact, the principles emerging in this report for the solution of the problems of the particular categories of institution considered are in many ways equally applicable to these financial intermediaries as well.

The Group also realized that it would not be possible, within the limited scope of the present report, to provide solutions to all the many problems posed by such a vast operation to be completed gradually over a period of years. It hopes nevertheless that its work may throw light on the path to be followed and thus make a useful contribution to the preparation of the various measures to be considered with this end in view.

Plan of the study

3. For the presentation of its study, the Group has adopted a plan centred around five main themes.

a) In Part I an attempt is made both to define the bases and conditions for developing a European capital market and to pinpoint the problems of structure common to the markets of the Six, together with the scope of the financial links that have already come into being within the Community.

b) In Part II the study sets out to show how the establishment of a European capital market can be facilitated by certain adjustments in the way the economic policies of the Member States are applied.

c) Part III contains the Group's recommendations for widening the scope of the supply of medium- and long-term credit for industrial equipment and of lending to the housing sector and to local authorities.

d) Part IV studies the conditions in which securities markets can be integrated and their contribution to the financing of investments increased.

e) Part V deals with the various obstacles, basically of a technical nature, which may impede the balanced development of a European capital market, whether in the form of differences in the ways the financial institutions are regulated or in the form of obstacles that stem from exchange risks and disparities in the system of taxation.

Organization of the work

4. The care taken to balance the number of experts drawn from public and private financial institutions, from the academic world and from various international organizations illustrates the main concern of the Group in its approach to the problems: to carry out a study which, while dealing exhaustively with the matters being examined, still had the primary aim of indicating definite action to be taken.

The Group held in all twelve meetings of two days each. At the first of these meetings a programme was drawn up and working methods were decided upon. For each meeting one or two members of the Group or the Secretariat were invited — as rapporteurs — to prepare a paper on the subject to be dealt with and to open the discussion. Subjects were determined in accordance with a general outline for the final report, drawn up when work first began.

Members of the Group invited to submit a paper were assisted by the Secretariat, one of whose tasks was to produce background documents for the Group's discussions. After each meeting the Secretariat wrote up an account of the discussions showing the points that had emerged.

For the preparation of the final report, it was thought advisable to have the editorial work carried out by the Chairman and the Secretariat, who prepared a draft and submitted it to the Group; constant contacts with the various experts made it possible, however, to give the work a collective character.

The Secretariat of the Group was composed of M. R. Bistolfi, M. P. A. Rutsaert, M. M. Sarmet and M. H. Stoller, of the Directorate for Studies in the Directorate-General for Economic and Financial Affairs of the EEC Commission; the statistics for the report were prepared by M. L. Tanter, M. B. Taquet and M. F. Turli.

The following independent experts also helped with the examination of special problems: M. G. Gelders, Director at the Commission Bancaire, Brussels, M. M. Grosfils, Head of the Research Department of the Banque de Bruxelles, M. L. Jeorger, Inspecteur des Finances, Paris, M. J. G. Lieberherr, Messrs Lazard Frères & C^o, Paris, and M. J. Truquet, Banque de France, Paris.

The report was approved by the Group at its meeting of 14, 15 and 16 September. The approval given by the members in their individual capacities applies to the report as a whole and not to each of its separate proposals taken out of context.

SUMMARY OF THE REPORT

Chapter 1: A European capital market: its foundations and the conditions for its development

1. Less progress has been made with the development of a European capital market than with the other elements of the economic union being established in the Community. Today, the reforms already under consideration to improve the functioning of the capital markets in certain member countries offer a chance of laying the foundations of a wider market; the focusing of effort on this wider market seems indeed to be a condition for the success of these reforms, as the present shortcomings of the capital markets are due not so much to insufficient savings as to the impossibility of adjusting correctly supply and demand on markets that are too narrow (secs. 1 and 2).

2. Market mechanism contribute best to economic growth and to the equilibrium of the economy when they operate within the framework of policies reflecting the long-term goals set for the economic and social systems. It is also an accepted fact that some methods by which financial policy is implemented in each country are more compatible than others with the gradual development of capital markets that are more open to the outside world.

In all the Member States the financing of economic growth is coming to depend more and more on the capital market, and the establishment of wider markets and close co-ordination of economic policies would facilitate this growth by:

- i) Offering enterprises new and more varied opportunities of obtaining from outside sources the financial resources that can help them expand to the size needed for efficient operation in the common market;
- ii) Bringing more into line the conditions on which finance can be obtained in the Community, and so reducing the distortions in competition due to present differences;
- iii) Increasing the supply of capital as financial savings are attracted to the market by the wider range of investment outlets;
- iv) Intensifying financial flows and so lessening the risk of the disturbances that are characteristic of excessively narrow markets (secs. 3-7).

3. A European capital market would facilitate the implementation of the common policies introduced in various sectors. Also, while there can be no monetary union in the Community without such a market, its creation is already indispensable if the present payments system, based on fixed rates of exchange and complete freedom for current transactions, is to work smoothly (secs. 8-11).

4. Though a European capital market ought to be the result of spontaneous developments, it will none the less require constructive efforts on the part of governments and financial institutions. The adjustments that the public authorities will have to make are concerned primarily with closer co-ordination of their national economic policies and shifts in the importance attached to the various instruments they normally use: their objectives, however, need not necessarily be affected.

The following points in particular deserve a thorough re-examination:

- i) The tax regimes applying respectively to home and to foreign investment, and differences in the tax treatment of the various forms of investment or of the channels utilized by the investors;
- ii) The rules applicable to certain financial mechanisms, so as to reduce the fragmentation of markets at present split up into a number of separate channels;
- iii) The eligibility rules for institutional investors which at present severely restrict their freedom of choice both on national and on external markets;
- iv) The exchange control regulations governing capital movements (secs. 12-15).

5. As these adjustments are carried out by the public authorities, the financial institutions that are currently most active in international operations will be able to set the pace for the rest of the market:

- i) Certain financial techniques not at present familiar in all member countries will come to be more widely used, with the result that the range of available investment outlets and resources will be broadened;
- ii) Financial institutions will tend to be less narrowly specialized, and this will help to restore effective competition;
- iii) At the same time the links between these institutions will be strengthened: they will set up joint services and be able to improve the allocation of their resources in the broader framework as it emerges (secs. 16 and 17).

6. The European market that stems from these developments will take the form of a network of transactions which, if at first limited, will gradually be extended to cover all the categories of financial flows. Within the Community it will not imply the supremacy of any single centre, and this evolution will help intensify rather than hinder the existing relationships with the capital markets of non-member countries (sec. 18).

7. The progress made in establishing an integrated capital market will depend first and foremost on the general stability of currencies and on the extent to which public finances are correctly managed. Only in these circumstances will it be possible to ensure the steady expansion of savings and to avoid setbacks due to conflicting measures taken by the public authorities in their endeavours to re-establish equilibrium in price trends and in external payments.

Chapter 2: Structural problems common to the markets of the EEC Member States

1. The prospect of the integration of capital markets which have hitherto been more or less isolated raises the question of the effects of possible disparities in the savings rates and in the conditions under which saving-investment equilibrium is achieved in the various Member States. Although the rates of saving differ appreciably from one country to another in the Community, they are in fact high and are unlikely to pose problems for the working of a future European capital market. On the other hand, the ways in which the financial surpluses of certain sectors of the economies are adjusted to the financial deficits of others vary fairly sharply from country to country; this fact has a direct impact on the working of the domestic capital markets and thus on the process of integration of these markets (secs. 1-19).

2. The contribution made by the capital markets to the financing of gross domestic capital formation appears to be similar and remarkably constant in most member countries. The average for the Community as a whole is close to the corresponding figures for the United Kingdom and the United States (secs. 10-13).

3. An examination of the demand for capital shows that the business sector's needs have been growing rapidly as profit margins have been squeezed by rising wages, by keener competition and, in some cases, by price freezes, while the calls emanating from the public authorities have also been increasing. This overall rise in demand for capital must, in short, be seen in the light of twin requirements which have to be faced by the Member States: their economic potential must be further developed in order to cope more successfully with foreign competition, while certain urgent steps to improve the social and economic infrastructures cannot be postponed (secs. 14-18).

4. The way available resources are distributed between the various sectors, and particularly between the public authorities, public enterprises, private business and housing, depends essentially on decisions taken by the authorities. The scale of public investment, the major role played by official financial intermediaries, and the dominant position on the market held by the public authorities leave only a relatively small area in which the play of traditional market forces can determine the allocation of resources (sec. 19).

5. The way in which financing requirements are met depends to a large extent on the composition of the funds available. It is this composition rather than a shortage of savings which explains the structural imbalance to be seen in certain sections of the capital markets in the Member States. The supply of funds reaching these markets reflects primarily the following points:

i) Savers generally prefer to hold cash or short-term assets and it would be difficult to alter this liquidity preference radically in the short term;

ii) Savings which take the form of deposits will remain a major factor in the supply of capital. The financial institutions which collect this form of savings should therefore be able to offer medium- and long-term loans and to use their funds on the capital market;

iii) Saving through institutional investors, particularly contractual saving, is inadequate in all member countries except the Netherlands. This inadequacy in part explains why markets are not able to function satisfactorily (secs. 20-27).

6. This state of affairs does not seem likely to undergo a spontaneous change, especially now that income redistribution to the advantage of wage-earners has raised the savings potential of social classes still unprepared to take a direct interest in the capital market. Consequently, several Member States are stimulating the consolidation of savings and the various forms of contractual saving (sec. 28).

7. In addition to government intervention, there are two sets of mechanisms which are of particular importance in adapting supply to demand on the European capital markets: the redistribution of long-term savings (secs. 29-33) and "transformation", i.e. the use of short-term funds for longer-term financing (secs. 34-37). These operations are carried out both by private institutions and by specialized financial intermediaries set up or supervised by the authorities.

8. The optimum utilization of available funds demands an easier flow of capital from one financial channel to another, alignment of the tax systems affecting the various types of investment, enlargement of the opportunities for savings institutions to employ the funds they collect and, lastly, markets wide enough to ensure in practice greater liquidity of investments. Savings entrusted to financial institutions exceed by far the sums directly invested by individuals on the securities markets. The key to improvements in the financing of productive investment and social infrastructure lies therefore in better adaptation of these institutions to their functions (secs. 38-40).

Chapter 3: Existing links between the capital markets

1. In the period 1960-1965 the net import of private medium- and long-term capital by the Community amounted to slightly more than \$6 500 million; this balance was more or less offset by net export of official capital and short-term funds. Intra-Community movements of medium- and long-term capital were relatively modest: Germany and France imported capital from the Benelux countries and probably from Italy. Financial transactions were mainly in the form of portfolio investment in the Netherlands and in Germany, and of direct investment in France and Italy (secs. 1-4).

2. The volume of international borrowing by bond issues has increased sharply, particularly since 1963, when Euro-bond issues started to expand. On the other hand issues abroad denominated in the currency of the country of issue have not shown a comparable rise. Borrowing by Community residents on the markets of non-member countries — including the Euro-bond market — was several times higher than borrowing by residents of non-member countries or by international organizations on the markets of Member States, the balance amounting to more than \$570 million for the period 1961-65 (sec. 5).

3. The official data available give a very incomplete picture of the real geographical breakdown of capital movements because of the redistribution effected through

international financial institutions, certain financial centres and the Euro-bond market. Consequently, financial relations with markets in non-member countries are over-estimated compared with those between the markets in the Member States; the true degree of integration already attained in the Community is therefore difficult to assess (secs. 6-8).

4. Intra-Community capital movements are governed by reciprocal obligations assumed by the Member States in accordance with the Rome Treaty; these are appreciably stricter than those in the OECD "Code of Liberalization of Capital Movements". Two directives have already been adopted to implement Article 67 of the Treaty. They provide for total freedom of movement of capital in the fields of direct investment, operations in listed securities, investment in real estate, transactions of a personal nature and short- and medium-term credits linked with commercial transactions or with the supply of services. For other categories of transaction, such as the issue of securities, financial loans and short-term capital movements of a purely financial nature, restrictions continue to exist in certain Member States; an outline of these restrictions is given in the annex. A proposed third directive, at present under discussion, is intended to establish a better balance between the liberalization measures taken by the various Member States in accordance with the previous directives, and at the same time to remove a number of obstacles not arising from exchange control regulations but of equally fundamental importance (secs. 9-11).

5. The exchange restrictions still in force seem to be maintained for reasons other than those for which they were originally adopted; they are now intended rather to ensure the autonomy of domestic monetary policies than to safeguard the balance of international payments. This trend, however, involves a risk of Member States moving further and further away from convertibility (secs. 11 and 12).

Chapter 4: Policies for control of aggregate monetary demand and regulation of the capital market

1. Radical changes in the circumstances influencing the implementation of policies for regulating aggregate monetary demand have been brought about by the increase in international trade and capital movements: the establishment of a European capital market will add impetus to this trend. A reappraisal of the extent to which the various instruments of short-term economic policy can still be used in the light of the changes that are occurring is urgently required if the essential objectives of this policy are to be maintained (secs. 1-7).

2. Now that enterprises enjoy increased facilities for obtaining capital abroad and links have been forged between the markets for short-term commercial credit, the range of domestic monetary policies is more narrowly circumscribed. This limitation becomes particularly evident when different economic trends lead Member States to adopt basically divergent policies. Yet until co-ordination has been carried further and certain harmonization measures have taken effect, it is natural that monetary authorities will feel concern when they see certain capital movements running counter to the objectives which they are pursuing (secs. 8-14).

3. There seems to be a need for greater speed in coping with cyclical imbalances and for more flexible and more systematic use of the instruments of fiscal policy. As a restrictive budget policy bears directly on aggregate demand and does not concentrate on the investment demand of enterprises, it is in fact less likely to engender compensatory capital movements. With this in view:

i) The public authorities should establish greater flexibility in their current expenditure on goods and services and in their transfer payments, but should at the same time take steps to ensure that their investment programmes could, if necessary, be employed more effectively in smoothing out the business cycle;

ii) The authorities should have powers of immediate action, in the interest of stabilization, by varying — within previously established limits — both direct and indirect taxes and depreciation allowances (secs. 15-19).

4. Credit policy would, however, retain a key role both in countering undesirable fluctuations in international payments and, by bolstering budget policy, in controlling aggregate monetary demand. Credit policy would be made more effective by lessening the differences that still exist between the circumstances in which it can operate in the various Member States and between the instruments by which it is applied (secs. 20-22).

5. Official intervention on the capital market and the establishment of a “queue” to avoid short-term fluctuations due to bad timing of issues could, if necessary, be co-ordinated. Meetings of representatives of the authorities supervising the capital markets could be held at regular intervals and provide the institutional framework for such co-ordination. Whatever is done in this connection, the trend of rates on the various capital markets should be kept in mind and there should be no discrimination in the “queue” against non-residents wishing to float issues (secs. 24-26).

6. The use of the “queue” for the purpose of channelling capital towards the financing of priority investments might — as will be shown in the next chapter — be replaced by other methods more likely to prove effective in the context of financial integration (sec. 27).

Chapter 5: Policies for stimulation of saving and direction of capital investment

1. In all member countries the authorities provide selective encouragement for certain types of investment, and accord priority to the mobilization of funds for specific sectors and regions (secs. 1-4). Some of the instruments used result in the fragmentation of each market into separate sectors and hamper the international mobility of capital. A co-ordinated adjustment of the techniques used, without necessarily endangering the objectives pursued, would therefore appear to be desirable (secs. 5-16).

2. Savings incentives which form part of social policy or represent counter-cyclical measures can readily be adjusted to render them more “neutral”: such advantages must be secured for the saver no matter where he makes his investment or what type of outlet he chooses (secs. 17-18).

3. Incentives which tend to confine saving within specific channels can be justified only if there are serious structural imbalances — the housing sector in some countries might be quoted as an example — and on condition that additional saving is elicited by these incentives (sec. 19).

4. The development of long-term forms of financial saving is sought by most of the Member States. The incentives used, however, need to be harmonized in order that:

i) The institutions collecting privileged savings have greater latitude in investing them outside the domestic market;

ii) Inducements to put money into the securities markets apply to foreign and domestic securities alike;

iii) The development of contractual savings — in particular those linked with employment contracts — is given top priority (sec. 20).

5. Measures intended to steer investment in a given direction should in principle be applied by means of instruments which influence entrepreneurs' demand for capital — such as tax advantages, investment allowances, interest subsidies and credit guarantees — rather than through direct action on the allocation of funds (secs. 22 and 23). The only condition that would have to be met if an investment is to benefit under these measures is that it should be in line with regional and sectoral objectives: administration of the funds set aside by the authorities to finance some of these incentives should not be left exclusively in the hands of one particular type of institution (sec. 25).

6. It would hardly be possible, however, to limit these instruments to those that act on the demand for capital, since such action will be of little value if the necessary funds are not available on the market. Direct government lending and, even more, lending by specialized credit institutions would not appear to be incompatible with financial integration provided that — where the necessary funds are collected by means of a loan issue — the Government and the intermediaries concerned resort to the market on conditions comparable to those that apply to other issuers (secs. 24 and 26).

7. Closer co-ordination of regional and sectoral policies within the Community should enable the High Authority of the ECSC and the European Investment Bank to make a more active contribution to these policies (sec. 29). But if action by these bodies is to be effective while remaining compatible with the operational requirements of a European capital market:

i) Their access to the capital markets of Member States should be facilitated by governments;

ii) The conditions governing their recourse to the various markets should be aligned on those applicable to comparable borrowers resident in the country concerned;

iii) The granting of interest subsidies to recipients of ECSC and EIB loans should be allowed in specific circumstances (secs. 30-32).

Chapter 6: Finance policies of public authorities and public enterprises

1. The insufficiency of the savings realized by public authorities when compared with their planned capital expenditure used to be characteristic of certain member countries only, but is now becoming more general and leading these authorities to make increasing calls on the capital market (secs. 4-6). The fixing of "political" prices for certain public services means that the enterprises supplying them are not able to finance any significant portion of their investment out of retained earnings — sometimes indeed not even to meet their operating costs — and accounts essentially for their large-scale recourse to outside borrowing (secs. 7-9).

2. The advantages enjoyed by the authorities and public enterprises on the capital market often exceed those that derive naturally from the type and size of the borrower. These special advantages include the favoured position reserved for their issues in the portfolios of institutional investors, various tax exemptions, preferential treatment in the timing of issues, and low rates of commission and other issue charges (secs. 10-12).

3. An increase in the financing requirements of the public sector in one Member State may result in extra pressure being felt directly or indirectly in other capital markets of the Community. Inelasticity of demand makes it unlikely that equilibrium will be achieved by the interplay of market forces alone. The decision as to whether or not priority should be given to calls on the capital market by the public sector is of a political nature and cannot be guided by any general rules. In the present state of the economy, however, with all member countries vitally concerned in maintaining equilibrium, it seems that the public sector will have to bear the brunt of the adjustments to be made in aggregate demand (secs. 13-17).

4. An adjustment of the financing terms accorded to authorities and public enterprises would make it possible to contain the pressure which the public and the private sectors exert on each market within the limits and forms compatible with the progress of financial integration. It would be helpful, first of all, if a higher proportion of public investment were financed by tax receipts. Greater autonomy for local authorities in tax matters would mean, among other things, that they would be better able to adapt their income to their needs. Any additional calls on the capital market could be made under conditions less likely to disturb its balance if budgetary planning were extended to cover a period of years, and if the borrowing operations of local authorities were co-ordinated — either on a permanent basis or merely at periods when markets came under pressure — by a special institution whose calls on the market could be better timed (secs. 18-24).

5. Rates charged for public services must be adapted to cover, at the very least, operating costs and renewal of the plant and machinery of production enterprises. If certain public enterprises were unable to achieve, in addition to the above, the profitability required for a normal degree of self-financing, contributions should be made from public funds, financed out of taxation, in order to avoid excessive calls being made on the capital market. In any event, these calls would be more effective and less likely to upset the market if greater diversity in the types of security offered by public enterprises enabled them to avoid weighing only on the bond markets. Possible solutions would be the issue of ordinary shares, preference shares or "participating" bonds (secs. 25-29).

6. Direct access by public authorities to the capital market of another member country is governed by Article 68(3) of the Treaty, which however contains procedural provisions only. The criteria to be applied in practice can only be worked out gradually. Nevertheless, strict limits on the special advantages to be offered with loans floated abroad by public authorities could be laid down here and now, while the conditions under which the authorities in each member country have recourse to their home markets ought also to be progressively harmonized (secs. 30 and 31).

Chapter 7: Medium- and long-term credit to industry

1. Industrial investment is financed under widely differing conditions from one Community country to the next: in all of them, however, the specialization of credit institutions is tending to diminish, and the differences can therefore be expected to grow smaller. This will help to broaden the flow of medium- and long-term credit in Europe, though progress in this direction will be largely dependent on the adjustments made in the techniques by which the public authorities intervene (secs. 1-7).

2. The establishment of a European market in this field may result from an increase in the volume of direct international lending, from the interconnection of banking systems, and from international refinancing of national credit institutions (secs. 8 and 9).

3. The grant of direct international credits presupposes the removal of the exchange control restrictions now in force and a greater willingness on the part of borrowers to assume the risks attendant upon engagements expressed in foreign currencies, though these risks are themselves tending to fade (secs. 10 and 19).

4. On the institutional plane there are certain specialized public credit institutions which will probably be able to Europeanize their activities only by means of refinancing operations. Banking institutions could, however, more easily develop their foreign business, as some of them are already quite active in the field of short-term credit; an expansion of their activities might, however, raise problems of competition (secs. 11-14).

5. The problems relating to the use in international operations of the guarantees and sureties now used internally must be examined. The backing of a credit institution in the borrower's own country would facilitate his access to external sources of finance, and no obstacles should therefore be placed in the way of giving such guarantees. With regard to real estate charges, the general adoption of a uniform and flexible surety such as the German *Grundschuldbrief* (land charge deed) is to be recommended (secs. 15-17).

6. It is essential that the activities of "central risk offices" should be co-ordinated so as to increase the exchange of information on borrowing by companies (sec. 18). Finally, in the tax field, arrangements ought to be made to eliminate double taxation of interest on loans to borrowers abroad (secs. 20 and 21).

7. Apart from granting direct international loans, banks could extend their operations to other member countries by setting up subsidiaries or branches and by collaborating more closely with institutions in these countries. It would appear, however, that the founding of subsidiaries and branches is not likely to be undertaken on any great scale in the near future, even if notable advances are made with harmonization of the rules on right of establishment (secs. 22-24). On the other hand, the flexible ties provided by co-operation among financial institutions in various countries seem both better adapted to the situation today and more appropriate for extension in the future (sec. 25).

8. Refinancing by medium- and long-term credit institutions on the European market would enable these institutions to increase their "stable" resources by recourse to traditional techniques — such as public and private placing of bonds — and by employing new techniques such as European refinancing consortia or cross-frontier mobilization of medium-term paper (sec. 27).

9. Such bond flotations abroad would be facilitated if tax discrimination were eliminated and if the rules governing the operations of institutional investors were gradually relaxed. Consideration should also be given to the quotation on the exchanges of other member countries of domestic loans issued by institutions specializing in medium- and long-term credit (secs. 28 and 29).

10. The introduction of medium-term refinancing techniques, through the establishment of European bank consortia to issue securities with appropriate maturities and tailored to the preferences of the various markets, and also through the establishment of systems for mobilizing medium-term instruments of indebtedness, would help to provide financial institutions with new resources (secs. 30-34).

Chapter 8: Credit for housing and local authorities' capital expenditure

1. Because of the scale of the expenditure involved, the financing of housing and of investment undertaken by local authorities has a particular impact on the functioning of the capital market in each member country and consequently on the relationships that may be built up between them (secs. 1 and 2).

2. Subsidies given by Member States to the housing sector are granted either in support of the investment itself, thus reducing the cost to the builder, or to stimulate saving that will be applied to housing, or direct to the user, thus reducing the rent or the cost of acquiring the property (secs. 4 and 5).

3. Direct subsidizing of users seems preferable to the other forms of State aid, since this method does not involve any distortions in the choice of sources of finance and does not impede a return to a free housing market. In countries which are still experiencing a housing shortage, however, other forms of encouragement may be necessary. It would be best if subsidies which stimulate investment and saving simultaneously were used, thus preventing artificial movements of capital between the member countries. Methods such as subsidized loans financed out of public sector savings, and subsidies paid to the saver on condition that he really builds, would meet the case (secs. 4-9).

4. In certain member countries it would be difficult, in view of their nature, for institutions specializing in finance for housing and local authority works to operate outside their own country; refinancing is, therefore, the only means whereby they could be fitted into a European capital market. Although the situation is different for institutions in other member countries, the fact that they can normally accept only guarantees and sureties originating in their own country constitutes a major obstacle to the extension of their activities. A first move towards greater flexibility would consist in giving these institutions freedom, within the limits of their capital and reserves, to grant loans covered by sureties from other member countries (secs. 10-14).

5. Savings banks, their central institutions, building societies and life assurance companies also contribute — to a varying but always considerable degree — to the financing of housing and/or public works undertaken by local authorities. Greater freedom of action could be accorded the savings banks: they could be given authority to undertake in other member countries — within the limits of a small percentage of their funds — the same types of investment they undertake at home. The central institutions of these savings banks should be freed of most of the restrictions on their external investments, and flexible co-operation arrangements, especially on projects of interest to more than one country, should be established (secs. 15-18).

6. The obstacles to international refinancing are doubtless easier to overcome than those hampering the granting of credit across frontiers. In addition to the floating of loans abroad, this refinancing could be effected indirectly by allowing non-residents to invest in securities issued on the domestic market. Such purchases would be facilitated if:

- i) These securities (ordinary bonds, mortgage bonds, communal bonds) were quoted on the stock exchanges of other member countries;
- ii) Co-operation was established between the financial establishments dealing with “tap” issues;
- iii) Terms and conditions of issues were harmonized and the restrictions on advertising made less severe.

The shares of real estate companies and “property trust certificates” (*certificats immobiliers*) are particularly effective instruments for building up the international mobility of capital in this sector. The obstacles — particularly tax barriers — to the circulation of these securities should be eliminated.

Finally, the establishment of an international arrangement for mobilization of paper drawn in respect of medium-term credit might also be helpful. The technical problems — and consequently possible solutions — are substantially the same as would be encountered in a similar arrangement for industrial credit (secs. 19-25).

Chapter 9: Structure of fixed-interest-securities markets

I. The conditions in which the markets in fixed-interest securities operate are more or less strictly regulated in all Member States. The equilibrium of these markets is supervised by the public authorities in the interest of the saver and,

in certain cases, in order to ensure that what are regarded as priority needs are satisfied. It should, however, be possible to integrate these markets without prejudice to these aims (secs. 1 and 2).

2. On the supply side, better balance on the fixed-interest-securities markets would be helped by making them less isolated from each other. One way of achieving this result would be by adjusting the rules which govern the operations of institutional investors in such a way that:

a) The differences in the treatment of industrial bonds and public-sector securities would be reduced to the minimum consonant with the nature of the risks involved;

b) The bonds issued by borrowers in other member countries would be on the same footing as domestic securities provided they presented similar features and were quoted on a stock exchange in the lender's home country (sec. 3).

3. Insurance companies, social security organizations and local savings banks should, under the conditions set out in the preceding chapter, be authorized to invest a percentage of their available funds even in bonds quoted only on foreign stock exchanges. This percentage, which should be modest at first, could be raised gradually. The central organizations of savings banks, savings banks with a centralized structure and banks in general could already be given wider powers of this sort (secs. 4-7).

4. Encouragement should be given to the development of investment companies specializing in fixed-interest portfolios and to the distribution of their shares or certificates throughout the Community (sec. 8).

5. As yield considerations play a vital part in the choice of fixed-interest investments, disparities in the taxation of bond interest artificially affect international capital flows on the markets in fixed-interest securities and impede the integration of these markets. The abolition of double taxation of income is a priority aim: because of its urgency, an effort should be made to find solutions that will be more effective and quicker to apply than bilateral agreements. Withholding taxes should be abolished or standardized at a level not likely to distort capital flows. Internally, any tax advantages accorded to bond income should be part and parcel of measures to stimulate long-term saving and should apply to any investment exceeding a given minimum period (secs. 9-13).

6. From the point of view of demand for capital, differences in size or structure of the fixed-interest-securities markets in the Member States cannot by themselves be a reason for limiting the access of foreign borrowers to these markets. Nor, as and when these differences are reduced, can divergences in yield on the various markets be invoked to justify the maintenance of restrictions. At most there will be a transitional problem, and this could be solved by opening up the markets gradually and by making certain adjustments of a technical nature (secs. 14 and 15).

7. Existing exchange control restrictions could be removed by authorizing other member countries to place issues within limits that would be fixed on the basis of objective criteria and gradually raised (secs. 16-18).

8. Laws and regulations which discriminate against issues by the residents of other member countries should be amended and the criteria according to which the supervisory authorities intervene to even out the flow of issues should be defined objectively. By means of regular meetings between representatives of these authorities in the various countries it should be possible to co-ordinate their supervision of and action on the markets (secs. 19 and 20).

9. Even if all the restrictions hampering free, reciprocal access to the bond markets of Member States are abolished, issuers will benefit from the increased opportunities only to the extent that the material conditions for loan flotations are improved. This presupposes that:

a) Greater use is made of certain effective and inexpensive techniques (private placing of bonds, selection by tender of the syndicate to manage the issues, etc.);

b) The problems of competition with tap issues in the various countries can be solved;

c) Placing of securities with institutional investors is facilitated, for instance by enabling foreign subscribers to a domestic loan to apply for bonds expressed in their own currency;

d) The employment of techniques having special characteristics — index-linked bonds, “participating” bonds, convertible bonds or premium bonds — is standardized at Community level (secs. 21-25).

10. Although the interpenetration of markets has been relatively slow among member countries, the Euro-bond market, which has developed more rapidly, fulfils a number of functions that should be the province of a European market in fixed-interest securities; taxation factors and special circumstances linked with the policies of the public authorities in certain countries have contributed to its success. These Euro-bonds have brought additional funds into the market and provided financial institutions inside and outside the Community with an opportunity for fruitful co-operation (secs. 27-32).

11. In the past a certain instability has been noticeable on the secondary market, in part because some of the securities in circulation were financed with funds borrowed at short term and in part because institutional investors were not showing much interest. A lack of clarity concerning the operation of the secondary markets and insufficient arbitrage have also contributed to this instability. These weaknesses could be corrected to a certain extent by having the securities concerned officially quoted in several exchanges and creating broadly based issue syndicates interested in the maintenance of equilibrium on the secondary markets (secs. 33-36).

Chapter 10: Structure of the equity markets

1. In several Community countries, the equity markets are suffering both from a shortage of available capital and from a rather unsatisfactory pattern of business demand for capital, as reflected in the types of security and the terms offered. Consequently, business firms often find it hard to obtain risk capital and at the same

time the investing public does not always find attractive opportunities on the market (sec. 1).

2. Expansion of the supply of capital on equity markets should in the first instance be sought by enhancing the role played by institutional investors on these markets. For this purpose, the rules governing the activities of these investors should be amended (sec. 2).

3. The remaining limitations on purchases of foreign securities by investment companies should be removed along with the restrictions on the acquisition of their shares or certificates by residents of other Community countries. Greater alignment of the rules on management, information for the public and supervision of these companies and funds would help them to expand their business by doing away with the uncertainties caused by the the present diversity of rules affecting the distribution of income and the terms on which these shares or certificates are bought and sold. Tax arrangements at the national and international levels should be so devised that income passing through these institutions should not be penalized (secs. 3-7).

4. In several member countries, insurance and provident institutions, particularly life assurance companies, still have their choice of investments in equities restricted by rules which are no longer entirely consonant with the interests of the saver. The contribution which these institutions make to the equity market could be made more substantial if they were allowed to offer — in addition to current types of contract — policies linked with investments in shares or certificates of investment companies. All discrimination between investment in national securities and investment in the securities of other member countries listed on a stock exchange in the country where the insurance or provident institutions are established could be abolished forthwith (secs. 8-10).

5. The savings banks could participate more actively in the equity market if certain adjustments were made in the regulations which apply to them. In this connection the recommendation already made to the effect that local savings banks be authorized to earmark a fraction of their assets for investment in other member countries would also promote investment in shares. A greater degree of freedom should be granted here and now to the central organizations and to savings banks with a centralized structure. The right — already enjoyed by savings banks in certain member countries — to set up open-end investment funds and facilitate investments by their customers in shares should now be extended (secs. 11 and 12).

6. The participation of banks in stock market transactions is subject in the Member States to laws and regulations often based on radically divergent principles. Although credit institutions could undoubtedly make an active contribution to the broadening of these markets at the European level and to the improvement of the supply of risk capital to private enterprise, the possibility that operations of this kind could lead to conflicts of interest should not be overlooked. It is therefore not possible without detailed study to express an opinion on the advisability of extending — or reducing — the right of banks to take participations and hold share portfolios (secs. 13-16).

7. Certain investors may have been turned away from the equity markets of the Community owing to the low yields offered. The tax incentives to which some Member States have resorted in order to increase such yields to the investor may, in principle, improve the flow of risk capital to the market; however, the fact that these tax reliefs are confined to residents or holders of domestic shares — and even more the combination of these two conditions — tends to keep the domestic markets separate and, in the end, lessens the efficacy of the measures themselves. Shareholders residing in other member countries should therefore receive advantages equivalent to the “tax credit” enjoyed by residents (secs. 17-21).

8. For a number of reasons, business firms prefer to seek loans rather than raise additional share capital. Improvement of the structural balance of the capital market calls, *inter alia*, for greater diversity in the forms of recourse to the market and better techniques for the placing of securities (sec. 23).

9. Greater recourse to preference shares with limited voting rights and, under certain conditions, to shares carrying more than one vote should enable management groups anxious to retain their controlling interest to overcome their distaste for share issues. However, a strict balance should be maintained between changes in voting rights and the advantages or restrictions involved for the shareholders. Any steps taken to deal with this problem should be harmonized at Community level (secs. 24-26).

10. The issue of convertible bonds often enables enterprises to obtain capital on better terms than by an issue of ordinary shares. Holders of convertible bonds can benefit if a company's shares rise in value, while they are protected against a possible decline in prices and assured of a satisfactory yield. Such bonds are an ideal instrument for a first approach to the markets of other member countries and also make it easier to interest institutional investors, who are not allowed to invest in foreign shares. Here too the statutory rules on this type of issue should be harmonized (sec. 27).

11. In order to provide the saver with better protection and improve the financial structure of enterprises, the public authorities should not facilitate borrowing by firms in cases where it appears that their capital and reserves position needs strengthening; decisions in this field should be based on objective criteria laid down in advance (sec. 28).

12. Financing through the issue of shares would be made easier if for tax purposes firms were, for a given period, allowed to treat dividends on newly issued shares in the same way as interest on bonds by deducting them from taxable profits. Also, the distribution of stock dividends would satisfy both the need of companies to increase their own capital and the desire of shareholders to be remunerated in a tangible form that can easily be converted into cash (secs. 29-31).

13. The improvement of distribution networks might reduce the difficulty and cost of new issues. If specialized intermediaries are to operate effectively, however, the market must be correspondingly large and they must be able to count on a substantial contribution from institutional investors: these are conditions which can more easily be achieved in the framework of a European capital market (sec. 32).

Chapter 11: Operation of a European securities market: Information for the public, dealing in and movement of securities

1. Structural changes in the supply of and demand for capital on the securities markets constitute one of a number of conditions that must be fulfilled if these markets are to be properly integrated. The quality and quantity of information made available to the public should also be improved, while for the negotiation and movement of securities of other member countries conditions similar to those obtaining on the domestic market should be established (sec. 1).

2. The problem of ensuring that full information is available to investors is a particularly important aspect of the development of a European securities market. Measures designed to familiarize the public with investment in securities and with the stock exchange mechanisms appear to be necessary; so also is the laying down of rules to ensure — apart from the annual publication of accounts — a continuous flow of information on company operations. More detailed information should be published when securities are issued or quoted on a stock exchange. Although it has been noted in recent years that the information supplied by companies has improved, entirely voluntary arrangements will probably not be sufficient to ensure further progress in this direction: for this reason several reform schemes, already adopted or still under study, seek to lay down prescribed standards in this field (secs. 2-10).

3. The content and scope of the disclosure and information rules relating to new issues and to applications for quotation on a stock exchange should be harmonized in the various member countries and given the same legal status: the model prospectus proposed in the annex to this chapter might be a suitable basis for such harmonization (secs. 11-15).

4. The institutional arrangements for independent control of the information supplied should not be neglected either; work on their harmonization could begin forthwith in a committee bringing together representatives of the various categories of institutions concerned and of the supervisory authorities. If the legal requirements and procedures used were more closely aligned in the Member States, co-operation in this field could later be given a more organic basis and its scope could be widened. The advisability of setting up at Community level an organization similar to the Belgian *Commission bancaire* or the American Securities and Exchange Commission should also be considered (secs. 16-23).

5. On account of their narrowness, the securities markets in the EEC countries are all beset with similar operating problems. These can be solved only by providing institutional investors with opportunities for expanding their operations on the capital market, by transacting on the stock exchanges business that is at present done outside the exchanges, and by establishing closer communications between the markets of the various countries. The latter aim could be pursued by listing a greater number of foreign securities and by developing international arbitrage (secs. 26-32).

6. Listing the securities of other member countries on the various exchanges would facilitate dealings in these securities and reduce costs. For this purpose, the discriminatory rulings which in certain countries make it more difficult or more

costly to secure the quotation of foreign securities than that of domestic securities should be eliminated. Requirements concerning information for the public and procedures for admission to quotation should also be harmonized (secs. 34-38).

7. The securities of other member countries could also be quoted in larger numbers on those markets which have simpler admission procedures (*marché hors cote, ventes publiques supplémentaires, Freiverkehr, mercato ristretto*). They should be admitted without formality if they are already officially quoted on a stock exchange in their country of origin. Simplification and harmonization of the techniques of establishing and presenting quotations would increase knowledge of the markets of other member countries and would encourage arbitrage (secs. 39-41).

8. In order to facilitate the movement of and dealing in securities, certain technical adjustments could also be made. These include:

i) The institution of European clearing arrangements for securities;

ii) The adoption of tax measures designed to encourage the release of shares at present frozen in company portfolios, together with the reduction of indirect taxes on stock exchange transactions;

iii) Harmonization of the rules governing credit institutions as intermediaries in transactions involving securities, and the search for answers to the problems raised by the operations of directors or executives dealing in the securities of their own companies ("insider trading");

iv) Amendment of the measures which, in certain countries, hamper dealings in blocks of shares, so as to ensure that these operations can be carried out with a comparable degree of efficiency and safety in the various member countries (secs. 42-48).

Chapter 12: Disparities in the working and supervision of the financial institutions

1. Active participation by the various types of financial institution in the creation of a European capital market may be hampered by the rules under which they operate and the supervisory controls to which they are subjected. The differences in these rules and controls are, moreover, liable to distort competition and therefore constitute an obstacle to the process of integration (secs. 1-9).

2. The main difficulty facing the banks in the task of attracting funds is the diversity of the regulations on the rates of interest they may offer on deposits. As regards employment of the funds, the differences concern not so much interest rate regulations as the obligatory minimum and maximum holdings of certain types of asset (secs. 10-17).

3. The need to achieve a certain balance between the rules on management of a bank's liabilities and those dealing with the assets it may hold makes harmonization even more necessary: the diversity of the existing systems could, if it were not

reduced, create between the banks of different countries competition problems analogous to those which have already arisen between different institutions within the same country (sec. 18).

4. No change in the working rules of specialized credit institutions can be recommended until the activity of each institution has been examined individually, for only in this way can allowance be made for its special role in the economic and financial system of the country in which it is located. The general principle, however, could be laid down that any special advantages granted to these institutions are justified only in relation to specific burdens or obligations imposed upon them. These advantages should therefore be extended to all institutions subject to similar restrictions and obligations (secs. 19-23).

5. Owing to the size of their resources and their wide network of branches, savings banks cannot be considered to be purely local institutions: they have an essential role to play in the development of a European capital market. To this end the first step in harmonizing their investment rules should, as already pointed out in Chapters 8, 9 and 10, be to broaden their authorized range of operations. Whereas the local savings banks would — up to a specified percentage of their funds — be allowed to make exactly the same investments in other member countries as those open to them at home, the central organizations and the savings banks with a centralized structure could here and now be granted greater freedom of action for operations in other member countries (secs. 24-30).

6. The principles for harmonizing the investment rules of life assurance companies have already been set forth; one particular proposal put forward was that the eligibility requirements as far as listed securities are concerned should be liberalized. Also the rules preventing subsidiaries or branches of life assurance companies from entrusting all or part of their technical reserves to their parent companies in other member countries should gradually be relaxed (secs. 31-35).

7. The right to conclude life assurance contracts directly with non-residents could effectively promote the expansion of capital flows between Community countries. The administrative obstacles to the direct writing of contracts across frontiers and to advertising and canvassing by companies in other Member States should be removed. To prevent these developments giving rise to problems of competition between the companies of different countries certain steps would be necessary:

- i) Indirect taxes on life assurance premiums should be abolished in those Member States where they are still levied;
- ii) Any fiscal advantages granted to insured persons should be the same, irrespective of whether contracts are concluded with domestic companies or those of other member countries;
- iii) The problem of the "separation" of the various branches of insurance should be solved;
- iv) The current principles underlying control of investment should be harmonized: in the long run, the greatest possible freedom should be sought in this field, while strict requirements ought to be imposed for the information to be made available to the public (secs. 36-38).

Chapter 13: The exchange risk — an obstacle to transactions

1. Although it will gradually lessen as a European capital market develops, the exchange risk will not disappear completely until formal monetary union has been achieved. Intra-Community financial transactions will still be affected by this risk during the transitional period (sec. 1).

2. This obstacle is particularly serious for institutional investors such as savings banks and insurance companies and — in connection with medium- and long-term operations which cannot be covered by forward foreign exchange transactions — for the commercial banks as well (secs. 2 and 3).

3. The seriousness of the exchange risk has already decreased for borrowers as the variety of currencies making up their receipts has increased; as for the financial intermediaries, where they cannot themselves shoulder this risk, they can often arrange to pass it on to the ultimate borrower or to a public authority not directly party to the contract (secs. 2-4).

4. The cautious liberalization of the rules for institutional investors recommended in the preceding chapters could include authorizing them, within specified limits, to purchase securities expressed in foreign currencies, perhaps through instruments such as investment companies, that enable risks to be spread. These investors could as of now be given the freedom to purchase any foreign securities listed on the stock exchanges in their own country (sec. 5).

5. The unification of these foreign exchange markets where a distinction is still made between an “official” rate for current transactions and a “free” rate for capital transactions appears to be feasible and would be decidedly beneficial. In the longer term, the narrow margins within which the Member States’ currencies are at present allowed to fluctuate with respect to one another might even be eliminated altogether (secs. 6 and 7).

6. In international loan issues, the conditions governing distribution of the exchange risk between borrowers and lenders merit close examination; this applies in particular to loans which contain a currency option (sec. 9), those denominated in the currency of the market on which the issue is made (sec. 10), loans expressed in units of account (secs. 11 and 12) and loans denominated in a “third” currency (sec. 13).

7. Experience has been helpful in diversifying the investment outlets available to savers through the adoption of forms that meet their preferences; at the same time, the ease with which capital can flow across frontiers has increased. However, the disappearance of the exchange risk should in future make it unnecessary to fall back on such currency clauses (sec. 14).

Chapter 14: Tax obstacles

1. The setting up and smooth working of a European capital market require that the systems of taxation should not militate against the creation of conditions analogous to those obtaining on a domestic market. The requisite neutrality will have been achieved when the tax system no longer affects the choice of the place

where the investment is made or the transaction carried out and does not influence the saver's choice between making the investment direct or relying on an intermediary acting as a collector of savings. This kind of neutrality also presupposes greater uniformity in the tax incentives given to various types of investment and methods of financing (secs. 1-7).

2. At present the main obstacles in the way of this neutrality are as follows:

- i) International double taxation of income from securities (secs. 8-10);
- ii) The existence of tax advantages or charges applying selectively to investments made in certain countries (sec. 11);
- iii) The different attitudes of the Member States in connection with the tax treatment of income from securities accruing to non-residents or to persons who do not file an income tax return. (secs. 12 and 13).

In order to minimize these obstacles, certain adjustments in the tax systems of the member countries are necessary.

3. Where international agreements for avoidance of double taxation do not exist or, if they exist, do not apply to income from securities or are no longer suited to present systems of taxation, fresh solutions should be sought through multilateral agreement or through the simultaneous adoption of appropriate measures by all Member States. It could, for instance, be agreed to tax these incomes only in one of the two countries concerned; or it might be preferred to share the tax revenue by imposing a withholding tax in the source country and making systematic allowance for it in the beneficiary's country (secs. 10 and 14-19).

4. As noted in Chapter 10, certain countries grant, to their residents only, a "tax credit" on the dividends of companies incorporated in that country; in fact this is a refund of part of the corporate income tax. This means a disparity of treatment between income from shares of companies incorporated in the country concerned and income from shares of companies incorporated abroad, and also discrimination between residents and non-residents. To avoid such discrimination the authorities might consider granting the same tax credit on the dividends paid by foreign companies. A solution more in keeping with the required efficient working of the market would be to establish appropriate procedures to credit non-residents with a sum equal to the "tax credit": this solution would have the same effect as the current German arrangement under which tax is levied at a reduced rate on the distributed portion of company profits (secs. 20-24).

5. Harmonization of the different types of tax treatment of income from securities accruing to non-residents or to persons who do not file an income tax return is especially important for the bond market, owing to the direct influence of yields on the choice of fixed-interest investments. This harmonization might lead to complete abolition of withholding taxes on bond interest or to the introduction of a uniform tax in all Member States. In any case, it would be advisable to examine carefully the problems which might occur when the change is made to a harmonized system of this kind, so that the introduction of these reforms should not cause disturbances on the market or distortions in the flow of capital (secs. 25-31).

6. The problem of how to refund or "credit" tax withheld in a foreign country is sometimes even less satisfactorily solved for institutional investors (insurance companies and pension funds) than for individuals. None the less, the basic difficulties are the same and in general terms the same solutions should be adopted (secs. 32-34).

7. The tax disadvantages at present attaching to investments made in other member countries through the intermediary of financial institutions, notably investment companies, should be eliminated. What solutions prove to be possible will depend on the basic choices made by the Member States concerning taxation of income from foreign securities. Furthermore, owing to the complexity of the legal relationships between the various parties involved in such investments, it will probably be possible to attain an entirely satisfactory degree of fiscal "transparency" only within the framework of a multilateral convention for avoidance of double taxation which explicitly caters for the special case of investment companies (secs. 35-44).

8. The indirect taxes which now most directly hinder the setting up of a European market are those levied on the collection and transfer of capital.

These obstacles could be removed either by abolishing the taxes in question or by all countries adopting uniform rates, the other conditions being harmonized in such a way as to avoid any double taxation.

Under a draft directive now before the Council, stamp duty on the issue of securities and on their admission to quotation on a stock exchange is to be abolished and is not to be replaced by any other tax; the draft also provides for a uniform low duty on the initial capital of companies or on any subsequent increase in their capital (secs. 45-48).

PART ONE

THE ELEMENTS OF THE PROBLEM

For the reader's guidance in studying the problem examined in this Report, a word must first be said concerning the nature of the needs felt at the present time, the approach recommended by the Group of experts for meeting them and the data without which it would not be possible to understand the initial situation in which action will be taken to develop a European capital market. Such is the purpose of Part I of the Report. Because of its introductory nature, this first part, unlike the others, contains no specific recommendations; it is none the less essential that the Report should contain a definition of the principles on which the Group of experts worked and the Group's assessment of the problems likely to arise from the diversity of the present situation.

CHAPTER 1

A EUROPEAN CAPITAL MARKET: ITS FOUNDATIONS AND THE CONDITIONS FOR ITS DEVELOPMENT

Introduction

1. The carefully balanced provisions of the Treaty of Rome necessitate a measure of parallel development in the realization of its economic objectives. Inevitably, however, the rates of progress made in the different fields have sometimes got temporarily out of phase: the free movement of capital, for instance, has not advanced as rapidly as establishment of the customs union, freedom of movement for person and services, or the introduction of common policies. In fact, the common market for capital is at present little more than a preliminary plan; moreover, the differences in the attitudes adopted by the various Member States regarding the problem of free movement of capital cannot be maintained indefinitely without risk.

If this situation were to continue, it could not but delay or jeopardize the establishment of a true economic union among the Member States. Just as there can be no steady and balanced expansion in a country's economy unless it has the requisite financial machinery, so too the expansion of production and trade within the Community requires a financial system adapted to an economy of European scale.

The problem would doubtless be less acute if the national markets were fully able to meet the financing needs which occur in each country. This is apparently not the case at present, to judge by the efforts being made in all Member States to improve the efficiency of their markets and so to cope with the new situation that is developing.

2. This situation can be approached from two entirely different points of view. It can be argued that the shortcomings of the national markets are an obstacle to the establishment of a Community capital market that will be difficult to overcome. Or this purely negative attitude can be rejected, and it can be argued that the reforms being planned or already put in hand by the various Governments make this an appropriate moment at which to lay the foundations of a capital market on the European scale, there being no conflict between the wish to improve the efficiency of national markets and the aim of developing a truly European market. In fact, the measures that can help to improve the national market will as a rule be exactly the same as those needed to develop a European market.

A study of the general conditions of economic balance in the Member States shows that the second approach is both feasible and desirable. The rates of saving attained in the various countries of the Common Market compare favourably with those of other countries. The shortcomings of the capital markets in the various member countries are, in reality, due not to any lack of overall savings, but rather to an imbalance between supply and demand for capital, the markets being too narrow and the investors' liquidity preference too strong.

The establishment of a broad European market would mean that the supply of and demand for funds could be equated in competitive conditions and at minimum cost. A more diversified market would offer borrowers and lenders a wide choice of type and period of transaction. Finally, an integrated market would not entail distortion or hindrance of the flow of capital on grounds of the country of residence of the operators.

3. It should not be forgotten that market mechanisms make their contribution to economic growth and balance within the framework of policies reflecting collective preferences and long-term economic and social desiderata. Consequently, a broader capital market should be accompanied by increased facilities for implementing Community economic policy. It cannot be denied, moreover, that some of the instruments of financial policy used in each country are better suited than others to the gradual creation of capital markets that are more open to the outside world. The specific measures which the experts advocate for the development of a European capital market must therefore be such that the financial structures and policies of the Member States can gradually be adapted. In part these measures will be based on a conception of the economic foundations of a European market to be outlined in Part I of this chapter; in part they will depend on the procedure envisaged to achieve this aim — and this will be dealt with in the second part of the chapter.

I. Economic foundations of a European capital market

A. BROADENING OF MARKETS AND ECONOMIC EXPANSION

4. In every Community country the capital market — i.e. the machinery through which resources are collected and channelled towards the financing of investment — is again playing a role which is considerably more significant than in the early postwar years. During the period of reconstruction, recourse to the market was of modest proportions, both the collection of funds and the choice of investment being largely in the hands of the State. The low level of personal savings meant that investment had to be financed either through direct action on the part of the public authorities, or from savings accumulated by the firms themselves. Today the situation is different.

Now that personal saving has come into its own again, the capital market is once more fulfilling its role of intermediary; governments, for their part, have progressively reduced the amount of direct assistance for the financing of enterprises. At the same time the effect of keen competition has been to narrow considerably the margins from which enterprises can find their own finance. Consequently their financing potential, and hence their ability to compete, have come to depend in large measure on how easily and at what cost they can borrow on the market, either directly or with the aid of institutions acting as intermediaries.

Under these circumstances the development of a European market would improve the situation on three main counts.

A) ADVANTAGES TO THE BORROWER

5. Such a capital market would help to meet the increased needs entailed in adapting enterprises to the new demands of the common market. The reorganizations and mergers considered desirable to enable industrial and commercial firms to reach the dimensions needed in the common market do in fact entail greater recourse to outside finance.

The competitive distortions engendered by differences between the member countries or, for that matter, within each country, as regards the supply of business finance could thus be reduced. In the still embryonic stage of international organization of the capital markets, it is in fact only the big companies that can tap foreign markets, often at rates which are more advantageous than those they would have obtained in their own country. These opportunities are for the present almost entirely denied to other companies. One of the main consequences of a greater cross-frontier flow of capital — and of the resultant equalization of the cost of financing — would therefore be the lessening of this disadvantage to the small and medium-sized enterprises, though it could not be expected to eliminate this disadvantage.

B) ADVANTAGES TO THE LENDER

6. Establishment of a European capital market is not the mere aggregation of the markets of the six Member States; the fact of offering the individual saver and institutional investor a wider choice will bring out money which, for lack of a satisfactory investment outlet, has so far been used to purchase consumer goods, to hoard, for speculation or to purchase material assets as a hedge against inflation.

If competition between intermediaries were free throughout the Community, the potential investor would be more effectively courted than before and a greater total of savings would reach the market. This has in fact been happening for some time past and has led to the introduction and development in certain countries of new forms of investment which have subsequently enjoyed great success. This has been the case, for instance, for real estate investment companies, open-end investment funds, and life-assurance policies including indexation clauses and the like. This stimulation of competition among intermediaries and a more sustained savings campaign would indeed figure among the main sources of strength of a future European market.

C) THE ADJUSTMENT OF SUPPLY AND DEMAND FOR CAPITAL

7. In economic terms, it can be said that the purpose of a European capital market would be to provide greater capacity for mutual adaptation of demand and supply than is at present to be found in the capital markets of the individual countries. Today the volume of transactions on these markets is weak, and the circulation of financial instruments is not as smooth as it should be. Consequently any unexpected variation in demand or supply produces disproportionate fluctuations in the cost of capital.

The effects of creating a broad capital market, which will be the more positive in so far as they are backed by close co-ordination of economic and financial policies, can be looked at from two angles, the structural and the cyclical.

First, it has been found that the exchange of certain classes of financial assets for others can improve the balance among various markets. Such is the case, for example, when in a given country a growing preference for liquid assets leads to higher rates on the long-term capital market: this leads to export of securities (and a corresponding inflow of long-term capital) and at the same time accumulation of short-term claims. Market conditions would obviously be subject to more violent disturbances if there were no such possibility of arbitrage, no safety-valve allowing contact with other capital markets. Such exchanges of financial assets are part of the normal activity of a market where dealing is free. There is no difference in character between them and the merchandise trade flows which have evolved since the common market was established — and no one today contests the economic advantage of this latter development.

Fears are, however, frequently expressed that in the present situation the strains that build up inside national markets — often because of their narrowness, of the differences in the way the various types of investment are taxed and of other distortions which have not yet been eliminated — could, as markets are integrated, unleash “perverse” capital movements. Some of these difficulties must be looked on as transitional problems of adjustment to a new situation; the play of the market itself would tend to whittle them away rapidly. Other risks could be reduced if each Member State of the Community were to speed up the improvements being made in the existing machinery, bring investment opportunities more into line with the preferences of savers and eliminate fiscal discrimination, particularly between investment at home and investment in other member countries.

Again from the structural aspect, the creation of an integrated market would also facilitate the balancing of long-term capital supply and demand in another way. In view of the preference shown by savers for liquid investments, this balancing would necessitate the “transformation” of short-term into longer-term investments, through financing institutions, in all member countries. This transformation is, however, limited by the liquidity requirements of the financing institutions responsible for it — requirements that are the more restrictive the smaller the volume of funds to which they apply. The creation of a financial system of European proportions would thus increase the general transformation potential of a given volume of liquid savings, by giving these establishments more scope and by stepping up capital flows from country to country.

The second angle from which the smoother adaptation of supply and demand resulting from integration of capital markets needs to be considered is the cyclical: divergences of economic trend among the various Member States are unlikely to disappear altogether, even when they have gone a long way in harmonizing their policies. This will be directly reflected in the conditions prevailing on the capital markets; the resultant fluctuations could be considerably reduced if the balance between supply and demand were sought not in the framework of national markets, which are in many cases too narrow, but within a broader framework where these trends would tend to cancel each other out.

The practical significance of these two sets of considerations is immediately apparent when the discussion moves to a highly topical problem — that of the steadily mounting cost of money noted both in the Community and in non-member countries.

This phenomenon can hardly be looked upon as something purely cyclical, as it lingers on even when expansion shows signs of levelling off. It would seem therefore to be linked with more fundamental factors such as:

- i) The increased recourse to borrowing to finance the activities of private enterprises and the investment programmes of the public sector;
- ii) Lenders' expectation of higher nominal yields protecting the real yield of their investments against the risks of erosion of the value of money;
- iii) The deliberate raising of interest rates by countries forced, on balance-of-payments grounds, to push rates up to a level that is no longer consonant with the situation at home.

In fact, in almost all the countries there has for some time been a noticeable trend — which forms the backcloth to these developments — to push public and private investment expenditure beyond the limit of available resources. A European-scale widening of the frame within which capital supply and demand are equated would no doubt help to moderate the often undesirable effects of this trend on capital markets.

First, the increase in the supply of funds and the better functioning of the distributive machinery would temper the effects produced on the cost of money by the increasing demand for capital — effects which could be particularly unfortunate if markets continue to be as narrowly circumscribed as they are today.

Secondly, a bidding-up of interest rates on balance-of-payments grounds would become pointless and, indeed, impossible in the Community. The problem of relations with markets outside the Community would of course persist, but it could be more successfully solved by joint action on the part of all Member States than by the sporadic measures taken at present.

B. REALIZATION OF ECONOMIC UNION AMONG MEMBER STATES

8. To these general comments on the assistance an integrated capital market is intended to give to economic expansion in the Community should be added certain observations on particular facets of the economic union being established between Member States. The first of these facets to be considered will be the contribution a European capital market can make to the execution of joint measures. The second question dealt with is how far such a market could improve the working of the international payments system; in this connection, however, no detailed examination has been made of the overall machinery for adjusting the balance of payments, as such a study lies outside the scope of this Report.

A) EXECUTION OF JOINT MEASURES

9. In addition to the budgetary subsidies accorded by governments as part of their regional and agricultural policy, a considerable amount of additional money is collected for these purposes through the capital markets. One need only look at the activities of the various bodies specializing in the financing of the agricultural credit institutions and of the investments made in the less developed regions. At Community level one of the functions of the European Investment Bank is to finance schemes which contribute to the development of such regions; to raise the necessary money it floats loans on the various capital markets.

The common agricultural policy, though financed predominantly by machinery outside the market, must also be able to rely on help from the institutions mentioned. Mobility of capital itself plays an important role in regional policy since, with goods and manpower circulating freely, "compartmentalization" of the capital markets could aggravate rather than mitigate existing imbalances.

Here, the Group feels that it must refute the argument fairly frequently heard that freedom of movement for capital could make the less-favoured regions even poorer because of the pull which more developed regions exert on any money available for investment. Freedom of movement for capital is an essential, but not by itself sufficient condition for the carrying out of a regional development policy; it is clear that regional policy will not be a success unless conditions favourable to investment have been established. Unless this is done nothing can prevent the flight of capital from the regions concerned even in existing circumstances; once however these conditions have been established, the greater ease with which capital can flow in from outside will considerably speed up achievement of the aims of regional policy.

A European capital market should be of great assistance in implementing the common transport policy. A great deal of capital will be needed if the expansion and improvement of infrastructure is to be carried through in co-ordinated fashion in the Community; much of the money will have to be raised by borrowing, as the execution of the programme will undoubtedly involve sums that cannot be found from government budgets. There has moreover been a growing tendency in various member countries to turn to the capital markets for the money needed to finance certain types of public works which were previously considered investments to be paid for from the budget (motorways, pipelines, inland water transport).

Mention should also be made of the financial aid which the Community has pledged to the associated African States and Madagascar, and to Greece and Turkey. This aid is in the main to be drawn from budget appropriations, but to the sums thus made available are added others from the European Investment Bank, which will have to raise the money for its loans on the capital markets.

More important perhaps, so far as relations with non-member countries are concerned, is the burden imposed on the capital markets by the considerable growth of medium- and long-term export credits, and also by financial aid to developing countries, whether this is given direct or through international institutions. In the case of export credit, differences in the conditions offered can distort

the competitive climate, and from this angle it is clear that nothing but a sufficiently far-reaching integration of the markets can re-establish equality of opportunity for those enterprises whose exports depend on the credit terms they can offer to buyers. It is evident too that only a sufficiently broad capital market can make it possible for Member States to export capital in all its forms to the less-developed countries on terms and in quantities consonant with the economic importance of the Community as a whole.

B) IMPROVEMENT OF INTERNATIONAL PAYMENTS RELATIONS

10. It is generally accepted that monetary union will have become a reality once goods, services and persons can move freely, capital movements and current financial transactions are free of all restrictions, and the members of the union have undertaken not to alter existing exchange rates between their currencies. Among these various conditions, the stability of exchange rates has not been the subject of any formal undertaking by the Member States. There are, however, ample grounds for supposing that they already attach far greater importance to the maintenance of existing parities than could have been foreseen when the Treaty came into force. Since 1959 it has been found that exchange rates can be kept stable even in an economic area where major structural changes are occurring; apart from the small revaluation of the mark and of the guilder in 1961 there have been no changes. Despite fears that certain disequilibria could prove to be permanent, these were more a matter of relations with non-member countries than of relations between the Member States. The policy pursued in Italy, for instance, during the difficulties that occurred in 1963-64 seem to show that the authorities are ready to tackle disturbances without resorting to restrictions or to altering the exchange rates. The Member States have in addition agreed that all the other conditions should be met before the end of the transitional period laid down in the Treaty of Rome.

Once freedom of movement for goods and complete mobility of capital have been achieved and the stability of exchange rates assured, it is clear that the supply of and demand for capital in each individual Member State will become very sensitive to changes in interest rates; the capital account in the balance of payments could then easily be nudged in the desired direction by appropriate monetary measures. The need to call on the reserves of central banks as an indirect result of imbalances in intra-Community payments will no longer arise; it can even be said that mobility of capital is one of the conditions for the smooth functioning of a Community economy in which exchange rates are fixed and the freedom of current transactions is absolute. The temporary financing of any imbalances that might occur would thus be arranged through movements of capital.

11. Similar considerations seem to apply to payments between the Community and non-member countries. These have sometimes been seriously affected by the inability of the European markets to meet internal demand in the desired form. Clearly, if there is to be a common monetary policy vis-à-vis non-member countries, the authorities must have at their disposal capital markets which are both efficient and responsive to any stimuli intended to elicit corrective capital movements.

In relations with these countries, it is possible that satisfactory co-ordination of economic policies will not be obtained and that the elimination of taxation disparities and achievement of exchange rate stability will not necessarily be ensured. It has been held that movements of capital can, under such circumstances, constitute an element of imbalance in international payments and it may then be necessary, in the interest of maintaining freedom of current transactions, to impose certain limits on international capital transactions.

The points made in section 7 above have already thrown light on the position which the Group has adopted in this delicate matter; here it should only be added that, where restrictive measures are taken on short-term grounds in face of immediate threats, they must not be part of a policy which systematically places the burden of adjustment on the capital account of the balance of payments. Restrictive measures of this type often take root and grow more severe in the course of time, giving rise to increasing distortions; correction of any such imbalances should therefore be sought through correction of the policies which were in the first place responsible for creating the imbalances.

II. Role of the public authorities and of the financial institutions

12. To the foregoing sketch of the role that an integrated capital market could play in the life of the Community should be added a review of the conditions which must be met by such a market.

The Treaty has done no more than fix the objectives — which, incidentally, are somewhat imprecisely defined — and indicate the procedure to be followed in freeing capital movements and putting an end to discrimination. The gradual construction of a European capital market will, however, prove a success only if certain reforms and adaptations have been made in the techniques used and in the institutional framework. While these changes should be as far as possible spontaneous, it is evident that their speed and effectiveness will depend in part on the conscious efforts made by the Governments of the Member States and by the financial institutions.

A. THE ROLE OF THE AUTHORITIES

13. The public authorities are involved in the creation of a European capital market at two complementary levels. On the one hand, the public authorities determine the conditions under which resources are allocated by the machinery of the market. In the framework of a harmonized economic policy, the “rules of the game” which have to be obeyed by the market institutions should be clarified. The drawing up of a “medium-term economic policy programme” at Community level will make it possible to plan out this framework.

New laws or regulations of various types will be needed to speed the establishment of an integrated European capital market. Their general tenor can be indicated here, fuller details being left to later chapters in this Report.

The reforms advocated by the Group are essentially technical points; they do not call into question the political objectives of governments, but only the choice of economic policy instruments.

A) ADAPTATION OF INSTRUMENTS

14. The adaptations that most urgently need to be made belong to five main fields:

i) In the fiscal field, those measures which at present discriminate between internal investment on the one hand, and investment effected in or by other member countries on the other, will need to be revoked. It will also be necessary to adjust any differences in the tax treatment accorded to the various types of investment and to reduce or abolish certain indirect taxes on the operations by which capital is collected.

ii) The internal segmentation of domestic capital markets will decline in importance as financial channels are broadened on the European scale. The national authorities ought, however, to encourage this trend by reconsidering the arrangements for certain specialized financing channels.

iii) The regulations applicable to institutional investors are often out of date and therefore ill-adapted to current developments; they need to be amended. As investment through this channel is still insufficiently developed in Community countries, action should be taken to make it easier to remove certain obstacles which prevent these institutions from undertaking a wider range of investment operations both in other member countries and at home.

iv) The exchange control regulations governing capital movements ought also to be reviewed, in the light of the full convertibility already achieved for current transactions. On the basis of this review it would be possible to assess, on the one hand, the efficacy of the existing controls, and on the other the gravity of the obstacles which these regulations may place in the way of rational and equitable ordering of financial transactions between countries.

v) There are also certain administrative measures that involve discretionary decisions; by and large these should be replaced by clearly defined operational rules that would make it possible to eliminate any risk — real or imaginary — of discriminatory treatment.

B) HARMONIZATION OF ECONOMIC POLICIES

15. The exigencies and special features of national policies will diminish in importance as experience with Community action produces formulas for co-ordinating and harmonizing these policies, both in the field of short-term measures and in connection with longer-term growth. By pinpointing possible imbalances and spelling out the priorities to be observed, the introduction of a Community programme of medium-term economic policy will clarify the bases of financial policy. It will then be possible to make a sounder assessment of financial needs and of ways and means of meeting them.

This "financial programming" by the public authorities will enable two main objectives to be achieved. At home it will be possible to prevent excessive pressure on the market by borrowers insufficiently sensitive to changes in interest rates — either because profitability considerations do not apply to them or perhaps because their view of development prospects makes them temporarily more imprudent — from upsetting the markets and leading to a system of "rationing by cost" of those applications for finance that would really be more in line with economic policy requirements.

At the same time it will be easier to assess the likely scale and direction of any redistribution of financial resources that may occur among the Member States and, if the redistribution is considered undesirable, to take concerted measures in order to correct it. Nor should it be assumed that the redistribution of resources would be solely within the Community; this problem has already been discussed in section 11 above.

There ought also to be harmonization of the policies behind certain measures by which the public authorities act on the operations of the credit institutions or directly on the capital markets in the broad sense to ensure that funds will be available for priority or privileged borrowers. Such harmonization, which will be discussed in Chapters 5 and 6, is hampered by the difficulty of determining how far the measures taken really affect market conditions and what repercussions they can have abroad.

For this reason and for others of a strictly domestic character, any subsidies that are to be given should be clearly recognizable as such in the budget and should be allocated to the beneficiaries either directly or through approved financial institutions. As the rates of interest ruling on the various markets will then correspond more closely with the real supply and demand situation, one major objection to integration of the markets would lose much of its force. It is not as easy — and here the reasons are political rather than technical — to grant assistance from the budget as it is to intervene in the credit field. It may, however, be wondered if the very ease with which the authorities can influence the supply of credit has not contributed to the maintenance in budgetary systems and, even more, in fiscal systems of certain rigidities which are harmful both from the point of view of fairness and from that of the efficacy of economic policy.

B. THE ROLE OF THE FINANCIAL INSTITUTIONS

A) CHANGES THAT SHOULD BE MADE

16. The financial institutions can adapt their activities to the new situation in three main ways:

i) Certain financial techniques in current use on the markets of one or more countries but unfamiliar in others could be adopted generally; they would extend both the range of investments open to savers and the methods of financing available to borrowers;

ii) Specialization among the various categories of financial intermediary is often excessive; this not only limits their ability to attract funds, but also excludes them from certain types of business that could benefit the economy. The expansion and diversification of their operations — both as borrowers and as lenders — that will ensue once they are part of a wider market will contribute to the establishment of the conditions which are needed for effective competition between financial institutions;

iii) The links between the financial institutions will be reinforced by the establishment of common services covering the entire Community. The widening of financial contacts will incidentally facilitate refinancing by national institutions on the European capital market and, conversely, the temporary investment of surplus funds when supply tends to outrun demand.

As the changes are made, those financial intermediaries which at present have the greatest experience in the field of international operations will set the pace for the rest. The measures taken to stimulate savings must not therefore lead to their being frozen in internal investment; to guard against this possibility, the investment rights and opportunities possessed by institutions collecting these savings should be extended to embrace the markets of other member countries.

The scope for adaptation is not, of course, the same for all types of institution; it is true that there are financial intermediaries, such as investment companies and, within certain limits, insurance companies, which naturally turn to international markets both for the collection of funds and for their investments. This is also true of certain banking institutions such as the *banques d'affaires* and for part of their activities, particularly short-term currency operations, the deposit banks.

Although other institutions may only employ the funds at their disposal within their own country, they can none the less use the refinancing facilities offered by the international market. In certain cases these facilities can be of very great importance: one example is provided by institutions which specialize in the financing of short- and medium-term loans which are re-financed by the issue of bonds on the international market — a practice which is already assuming considerable proportions. Conversely, certain types of intermediary or even "initial" lenders find on the international market opportunities for investing their own money without turning to the market as borrowers.

To sum up, there are only a few institutions which will have difficulties in extending the field of their activities to include direct operations in other Member States. Among those still encountering difficulties are the savings banks and certain insurance and provident institutions, but here too new developments are possible, as will be apparent from Chapters 8 and 12.

B) THE MARKET OF TOMORROW

17. Broader horizons, the impetus given to competition, and the introduction of techniques that are already current practice in other markets will provide the main drive in the changes that will be necessary before an integrated capital market

can be established. It must nevertheless be recognized that this process will not produce a truly single market unless and until it has proved possible to remove one of the material obstacles that is still of vital importance: the exchange risk. Only when monetary union in the true sense has been established will the financial intermediaries, borrowers and lenders be able to operate on the European capital market as if they were dealing on their domestic markets. Steps to reduce the obstacle presented by exchange risks are however possible and several have already been taken. This problem will be examined in Chapter 13.

18. The question arises whether the development of a capital market on a European scale will necessarily involve supremacy of one of the financial centres, with the other markets relegated to the role of satellites. There are two reasons why this is unlikely: in the first place, in an age of increasingly rapid communications, concentration of the institutions in one place is of less significance; secondly, certain domestic financial channels in each member country will retain much of their importance for a very long while to come. The pattern most likely to develop will be a group of financial centres retaining their "national" characters but knit by an increasingly close network of international financial links. In the more distant future this network may well embrace all financial flows and in fact constitute a European market on which more and more institutions, bursting the narrow limits of their domestic markets, will operate.

The Group feels that this clarification should remove any misunderstanding as to the nature of the emergent European market. It is not a question of encroachment by the existing "international market" (Euro-currency and Euro-bond market) on the normal business of the national markets, sapping their strength. On the contrary, as the present markets thrive and as their operations are gradually harmonized and integrated the European market will develop, stimulated by competition from the international market, which will have its place in the European market in process of development.

The tightening of financial links between the Community countries must moreover not be at the expense of the maintenance or development of relations between each of these countries and the capital markets of non-member countries. On the contrary, as was the case in the commercial sector, where the build-up of trade between member countries was accompanied by increased trade with non-member countries, the removal of obstacles to capital movements between the member countries will also encourage financial flows between member countries and non-member countries. In fact, the maintenance of links between the financial centres of the Community and those of non-member countries may even make a useful contribution to the process of integration within the EEC.

As, however, the development of a market involves more than decisions to liberalize, and calls for new organizational measures, particularly measures harmonizing taxes, administrative rules, etc., there is no guarantee that the forging of financial links will progress at the same pace between member countries as between these countries and non-member countries. Should the two developments get out of phase, some "deflection of trade" may occur; but it is reasonable to assume, on the basis of experience gained in the commercial sector, that the "creation of trade" effect will far outweigh any deflection that may occur.

CONCLUSION

19. It has already been pointed out that efforts to develop a European capital market can succeed only if a number of general economic conditions are fulfilled.

For example, the expansion of savings must be sustained and even increased. The means to this end are price stability, which must be maintained, broader markets and, perhaps, official incentives, which should however be more neutral than in the past with regard to the place where the money is invested. As and when the growing volume of savings and their greater mobility help to dispel the impression of a general dearth of capital now prevailing on certain markets (this is in fact evidence only of a lack of balance between sectors and of maladjustment between demand and supply), the authorities will be able to adopt a more liberal attitude, as they will have less reason to fear upheavals when the barriers between the Community countries are removed.

Secondly, the alignment of market conditions in the various financial centres must be pursued. The first moves in this direction were taken under the impetus of liberalization measures already adopted and of the economic integration process in general, and they have already done much to reduce the differentials between interest rates and, on certain markets, between the fees charged for services by the financial institutions. None the less, there are still pronounced disparities: it is reasonable to suppose that the intensification of capital movements will help to narrow them, but there is always a risk that divergent official measures could compromise the progress already made and so give the authorities fresh grounds for seeking to isolate their national markets. Everything must be done, then, to harmonize policy on interest rates.

The third main condition to be met would seem to be that the external payments position of the various Member States should correspond with the long-term balance aimed at by each State (this does not, of course, rule out their being structural exporters or importers of capital): the external payments situation should not constitute an incentive for the authorities to influence the conditions governing long-term international movements of capital between Member States.

20. Throughout this report the Group has endeavoured to define — from the angle of financial techniques — the conditions which it feels must be met if a European capital market is to be developed and the financial links binding the different parts of the Community are to be permanently strengthened. Although it has treated purely political considerations as lying outside its purview, it does feel that governments must keep in mind certain broad principles: if a European capital market is to be developed, vigorous action is required to promote saving, currency and price stability must be maintained and the public finances must be kept in balance.

In an attempt to pinpoint more precisely the action to be taken, the Group has examined the main features of the problems common to the capital markets of the various countries and has assessed the importance of the financial links which have already been forged between the Community countries. This survey of the present situation is contained in the remaining two chapters of Part. I.

CHAPTER 2

STRUCTURAL PROBLEMS COMMON TO THE MARKETS OF THE EEC MEMBER STATES

Introduction

1. This chapter deals with those features of the capital markets which would seem most significant in connection with the development of a European capital market. The aim is not, however, to provide a description — this would lie outside the terms of reference given to the Group — and there is no attempt to give a full account of the structure and working of the Member States' markets. The intention is to bring out the main differences between the markets which might hamper the process of integration.

The analysis will focus on capital markets as defined in Chapter 1 — that is, as the complex of machinery through which funds are collected and channelled towards the financing of productive investment and of economic and social infrastructure. This means essentially the securities markets and medium- and long-term credit machinery; but it does not mean neglecting the movements of short-term capital in so far as they supplement or adjust the balance of saving and investment.

The tables annexed to this Chapter bring out the main characteristics of the capital markets and provide adequate material for assessing the scale of the phenomena under consideration, but they do not allow of detailed comparisons of the institutions or of the machinery, since definitions do not tally in all cases.

The structural problems of the member countries' markets will be examined from four points of view in the different sections of this Chapter:

- I. Savings-investment equilibrium, i.e. the problem of gross capital formation and its financing;
- II. The pattern of demand for funds;
- III. The salient features of the supply of funds;
- IV. The role of financial intermediaries in the adjustment of supply and demand.

I. Gross capital formation and its financing: savings-investment equilibrium

A. THE LEVEL OF SAVING

2. The prospect of integrating capital markets hitherto practically independent of each other raises from the outset the problem posed by the different levels of gross capital formation and the conditions under which saving and investment can be brought into balance.

Theoretically, it might be thought that these macro-economic magnitudes were not directly relevant to a study of the capital flows which will link the various markets

once present obstacles have been eliminated. Indeed, if savings and investment are basically in balance in a given market, whether the balance is at a high or a low level is likely to have only a slight impact on capital flows.

It is only when there is a tendency to disequilibrium on the markets of one or more countries that stimuli — in the form of variations in interest rates and of changes in the level of demand for capital — are generated which encourage an inflow or outflow of capital.

In practice, it is difficult to distinguish between these two cases; statistics show only developments which have taken place and cannot therefore yield direct information on the existence of a tendency to disequilibrium. None the less, certain features can be elicited from Tables 1 and 2, which give details of gross capital formation and its financing. It is a reasonable hypothesis that the rates of investment needed to attain the growth objectives set ought not in principle to differ widely among the Community countries except in Italy and (to a lesser extent) in the Netherlands, where a higher rate of investment may be necessary to help real incomes per head catch up with those in other countries. On this assumption it may be conjectured that countries where the rate of saving is abnormally low are those where there is the greatest likelihood of strain affecting the capital market, particularly in the cases of the two countries mentioned above, where the need for an above-average rate of investment is presumed (conversely, it would be wrong to regard a below-average rate of formation of savings as a probable source of disequilibrium in "mature" economies).

The figures in Tables 1 and 2 show:

i) Rates of saving broadly in line with this assumption, since they are appreciably higher in Italy and the Netherlands than in Belgium and France and, even more, the United Kingdom and the United States, countries with "mature" economies: most remarkable of all is the extremely high rate of saving in Germany, due in part to a high rate of public-sector saving, which however declined considerably in 1965.

ii) A total Community saving, per annum, calculated on the basis of the average of 1962-1964, of about \$59 000 million, compared with \$109 000 million in the United States and \$15 000 million in the United Kingdom. The very size of these figures indicates how important it will be for the development of a European capital market to maintain satisfactory links with the international financial centres outside the Community.

iii) A pattern of Community saving giving Germany pride of place with 44% of the Community total, followed by France with 27%, Italy 16% and Benelux 13%.

B. SAVINGS-INVESTMENT EQUILIBRIUM

3. There are in fact two savings-investment equilibria:

i) In overall terms, the adjustment of gross domestic saving and gross capital formation takes place through the external balance on current account (net financial surplus or deficit of the economy as a whole) (see Tables 1 and 2);

ii) At economic sector level, the "net financial surplus" of some sectors offsets the "net financial deficit" of others.

A) OVERALL EQUILIBRIUM

4. The "net financial surplus or deficit of the economy as a whole" represents the contribution made or received by a given country in its dealings with the rest of the world. This concept differs from what is often known as the "basic balance" in balance-of-payments analysis: neither unrequited transfers of capital to or from the rest of the world nor capital movements properly so called are included. The surplus or deficit does not therefore provide direct information on the impact which dealings with the rest of the world may have had on the capital market of a given country: it simply provides a pointer to the overall financing potentialities or requirements of the economy, with due regard to the levels of saving and of gross domestic capital formation achieved. An examination of the capital account in the balance of payments, which shows more directly the interrelationships between markets, will be made in the next Chapter.

Table 2, in which the above-mentioned surplus or deficit is related firstly to the average gross national product and secondly to average gross capital formation in the years 1962-1964, suggests that, apart from France and the United States, the relative importance of the balance has been small. However, examination of the annual figures corrects this impression slightly, since they reveal that the three-year averages for Italy and the Netherlands are in fact the result of equating relatively high surpluses and deficits.

In general, the evidence suggests that savings-investment equilibrium has been achieved almost wholly at national level: this does not however prevent there already being some degree of interpenetration of markets, as shown by the gross capital movements studied in Chapter 3. Moreover, this situation will change as the greater mobility of capital brings the objective of harmonized growth throughout the Community nearer fruition.

B) EQUILIBRIA BETWEEN SECTORS

5. The financing equilibrium that is established between economic sectors in each country is a result of adjustment between the net financial surpluses and deficits in the several sectors. This equilibrium is not achieved in the same ways in the different member countries. Now, the conditions under which it is achieved are highly relevant to the integration of capital markets: the various savings categories do not have the same fluidity. Public-sector saving is undoubtedly more tied to the country of origin than personal saving and less sensitive to market stimuli; to a lesser degree, this may be true of the saving of enterprises. Thus it may be expected that the countries where saving in the public sector and in enterprises is heavy will prove less well fitted to play the role which they would otherwise fill in view of their relatively high level of overall saving. The converse, of course, applies to the countries in which households account for the bulk of overall saving, even if the total is relatively small.

Another point is that the conditions under which equilibrium between the sectors is achieved have an impact on the rate of overall saving. There is no doubt, for example, that in a period of reconstruction, marked by a shortage of capital, overall saving cannot reach a high level unless the public sector and enterprises save heavily.

(1) *General*

6. The analysis of the adjustment between sectors is normally based on an examination of the financial surpluses or deficits of three distinct sectors: the administrative authorities, enterprises and households. As the boundary between the two latter sectors is drawn differently in the various countries, the two have been aggregated in Tables 1 and 2; in what follows below, however, an attempt will be made to separate the two categories. With regard to the government sector, it should be noted that Tables 1 and 2 indicate net public financial surpluses or deficits before capital transfers to other sectors; this concept is more significant from the economic point of view, since it shows what funds the public authorities would be able to supply to other sectors for financing investments, while the balance after capital transfers to other sectors eliminates some of the overall savings which the authorities could, if they wished, use for investment. For purposes of comparison, the balances before and after capital transfers are shown in Table 3.

This said, an examination must now be made of the general conditions under which the adjustment takes place between the "government" sector and the "enterprises and households" sectors. In the past, it seems, the situation of some countries appears to have been almost diametrically opposed to that of others. In Germany the authorities have had a very large financial surplus; in Belgium, on the other hand, the financial deficit of the public sector has been fairly heavy. In the other member countries, the trends have been less marked. The financial surplus of the public sector has increased steadily from year to year in France, and there has been practically constant equilibrium in the Netherlands. In the United States and United Kingdom fairly wide fluctuations have been observed. The detailed analysis by sector requires the following comments.

(2) *The government sector*

7. Table 3 shows the scale of capital transfers in France, Italy and Germany. In these three countries, there is a substantial difference between the public saving/public investment ratio *before* transfers and the same ratio *after* transfers. The key to this disparity is the importance attaching to the various forms of central government aid, i.e. capital assistance to enterprises — especially grants to public enterprises, support for backward areas, arrangements for compensating special costs incurred and various benefits paid to households.

Consequently, although in all the member countries save Belgium and in the Netherlands since 1963 gross saving in the public sector is more than enough to cover public capital formation, in Italy, the Netherlands (and in France in 1962 and 1963) these transfers have led to a net deficit which has had to be covered by borrowing from the capital market; more recent, incomplete data also indicate a decline in the government's financial surplus in several Member States.

These disparities could seriously hamper the establishment of a European capital market. Those member countries whose public saving is least developed are apparently also those whose overall saving is weakest. They might therefore be

tempted to prefer the contracting of debt on the markets of other Community countries to the budgetary and tax measures which would be needed if the level of public saving were to be brought into line with the volume of public investment. The danger of such action is all the greater since the volume of public investment is tending to increase rapidly in Community countries: in addition to the demands of social policy (the need to improve collective equipment) there is a growing urge to encourage more rapid economic development by improvements in infrastructure, education and research. The Group has therefore set out in Chapter 6 the guidelines which it feels should be followed in the field of public finance if capital markets are to be integrated.

(3) *The enterprises sector*

8. The level and the trend of the net financial deficit of enterprises — i.e. of their calls on the capital surpluses of the other sectors — can only be assessed on very approximate lines. Problems of definition (data available refer sometimes to all enterprises, sometimes exclude farming, or public enterprises, or self-owned businesses, or certain of these) and the varying sizes of the samples used, mean that the figures given in Table 4 can be considered only as orders of magnitude mainly useful for assessing the trend of a given series in recent years. None the less it seems that one general point can be made: the rate of self-financing in all member countries is steadily declining. Another is that there are significant differences between the situation of enterprises in the EEC and in the United States. In the United States, depreciation and the undistributed profits of companies in the private sector cover virtually all fixed investment and stocks formation. Since enterprises' need for capital is in great part met from self-financing, increases in registered capital in the form of fresh money from shareholders are on a small scale (in 1964, 0.3% of market valuation, compared with 5% in France). Consequently, industry makes very little call on the capital market and obtains funds easily from that market in time of need. In Community countries, on the other hand, enterprises run a permanent net financial deficit. It is true that the situation is not equally serious in all member countries. In Germany and Belgium self-financing rates are relatively high, in France and the Netherlands average, but in Italian enterprises they are abnormally low (see Table 4). In terms of national accounting, it is quite clear that the financial deficits of enterprises are offset by surpluses in other sectors, but the difficulties of ensuring a smooth adjustment between these deficits and surpluses are precisely what lie at the root of all the capital market problems.

Moreover, the very concept of self-financing conceals factual situations which vary fairly substantially from one country to another. In this connection, the importance of pension funds constituted within German and Italian companies as a source of the internal financing of enterprises should be stressed. Their contribution is included in statistics on self-financing, and the incomplete figures available show that it is far from negligible; in Germany, pension reserves represent 8.5% of the total of the balance-sheets of the 2 000 enterprises making up the Federal Statistical Office's sample. In Italy, for the group of 233 manufacturing companies analysed by the Banca d'Italia, this item accounted for more than 17% of the gross self-financing of enterprises in the period 1960-1964.

Lastly, to complete the picture, mention must be made of the vital influence which public enterprises in certain countries exert on the financing needs of the company sector. This applies particularly in Italy and in France; not only is the role of public enterprises in the economies of these countries very important, but the available figures for France and the estimates for Italy show that the self-financing rate of public undertakings is substantially lower than that for private enterprises; in France it fell from 30% in 1962 to 25.1% in 1964. The subsidies accorded to public enterprises for plant and machinery or for current operations do not suffice to make good this disparity; consequently, to cover their financial deficits public enterprises make considerable calls on the capital market — calls that seem very high compared with their share in capital formation: in France, in the period 1962-1964, the financial deficit of public enterprises represented 40% of the needs of the entire company sector, whereas their share in capital investment was between 25 and 30%. Similarly, under the Fifth Plan, the investments of the big public service concerns in the period of the Fifth Plan were to be less than half those of the “competitive sector” — and yet their requirements of outside finance (including subsidies) would exceed that sector’s financial requirements.

The deterioration in the financial structure of production units, the divergences in the amounts which enterprises contribute to saving, and the problems raised by the financing of public enterprises are all factors making for disequilibrium in the development of a European capital market. Ways and means of remedying these difficulties will be discussed in the second part of this Report.

(4) *Households sector*

9. It is very difficult to assess accurately the level and trend of the net financial surplus of households. Apart from the difficulty of distinguishing between households and enterprises — a difficulty due largely to the many different ways in which the individual entrepreneur is treated — there is the unreliability or the sheer lack of data on the savings of households invested directly in residential construction, which is in fact the main non-financial use of savings from this source. ⁽¹⁾

For this sector, then the only course open is to draw indirect conclusions from observation of the financing requirements — known to varying degrees of accuracy — of the other sectors. A consideration of the forms of financial investment by households (Section III below) will provide further material for the necessary assessment.

II. Demand for capital

10. The structure of demand for capital is determined by the needs of transactors, the ability of the various sectors of the market to satisfy these needs, and the

(¹) It is not possible just to take the gross saving of households, to subtract the figures in Table 1 which show the scale of residential construction, and so to obtain the financing surplus of this sector. The main reason for this is that the data on residential construction cover not only dwellings acquired through the direct savings of households, but also dwellings financed by administrative authorities and dwellings acquired by households with borrowed money.

play of the various control and regulation devices established by the authorities. The present section is concerned mainly with "final demand" for funds, i.e. that of the transactors who themselves carry out real investment: the role of the intermediary institutions which draw funds from the markets for the purpose of relending is discussed in Section IV of this Chapter. Our first task, then, is to examine the overall volume and the structure of demand in the various sections of the capital market, and an attempt will then be made to elicit some information concerning the calls on the capital market made by the various sectors of the economy.

A. OVERALL SCALE OF THE CAPITAL MARKETS AND RELATIVE IMPORTANCE OF THE VARIOUS SECTIONS

A) SCALE OF THE MARKETS

11. The concept of "capital market" used in Tables 5 and 6 (discussed below) differs from that generally used in the rest of this study, where the capital market is deemed to cover medium- and long-term financing machinery only: in view of the nature of available statistics it has been found necessary to adopt here a wider definition including the short-term credits granted to the various sectors. With this reservation, which of course renders the analysis less satisfactory than if it had been possible to isolate the machinery for financing investment, the overall scale of the capital markets in the Member States will be assessed, first by comparing absolute values, and secondly in relation to gross domestic capital formation.

Table 5 shows that in Germany, France and in the Netherlands the amount of capital supplied by the market seems to have grown fairly consistently over the five years under consideration (1960-1964). In Italy and in Belgium (countries for which, however, the data are not complete) cyclical factors and factors connected with the introduction of new tax arrangements have affected trends, and no such steady expansion is discernible.

The addition of funds obtained on the various national markets is only an indication of what might be the initial scale of a future integrated European market, as has been explained in Chapter I. The funds supplied by the capital markets of the EEC countries have in the aggregate corresponded to approximately 50% of the funds supplied on average over the same period by the American market.

As for the contribution made by the market to the financing of gross domestic capital formation, the rates recorded in Germany, France and the Netherlands, have changed little over the years, and they are much the same in each of the three countries. In Belgium the capital market has made an exceptionally large contribution to the financing of real investment. In this respect, average rates in the United Kingdom and in the United States do not vary much from the average Community rate.

B) RELATIVE IMPORTANCE OF THE VARIOUS SECTIONS

12. Table 6, which analyses the funds supplied by the various sections of the capital market, shows wide disparities within the EEC and also between the member countries on the one hand and the United Kingdom and the United States on the other.

i) Issues of securities by ultimate investors of capital (i.e. excluding intermediary institutions) have been on a relatively modest scale in all the countries except Belgium, where they account for nearly 40% of the funds supplied by the capital market, and to a lesser extent the Netherlands, where the corresponding figure is 23%. This may seem surprising in view of the scale of loans floated on the capital market by the public authorities in most of the countries: the reason is the assumption that — except in Belgium — these loans are in large measure floated by the public authorities in their capacity as “intermediary institutions”. The funds supplied by the public sector are on a considerable scale in France, Germany and, outside the Community, in the United Kingdom.

ii) The banking system accounts for roughly 20 to 40%, according to country, of the financial resources supplied to the economy.

iii) The other financial intermediaries — savings banks, the specialized institutions financing credit for industry and housing, insurance companies and pension funds — supply about half the finance placed at the disposal of businesses and individuals in the Netherlands and in the United States.

C) ANALYSIS OF THE MARKET IN SECURITIES AND IN MEDIUM- AND SHORT-TERM CREDIT

13. To fill in this very broad outline, a more detailed treatment is given below of the various sections of the capital market, particularly of the market in securities and in medium- and long-term credit.

Table 7 gives a picture of the volume of issues on the securities markets (1960-65 averages).⁽¹⁾ A first point to be made in connection with this table concerns the comparison of the absolute figures for all securities issues in the EEC countries and in the United States. The total for the United States is shown as some three and a half times that of the Community total. But this is mainly accounted for by the very great scale of mortgage bond issues in the United States, included in Table 7 under securities issues, although they are not in fact dealt in on the market (on the other hand securities which, from this angle, are somewhat similar, such as the *Schuldscheine* in Germany and the securities representing *onderhandse leningen* in the Netherlands, are not included in the table among “securities” issued on the markets of Community States).

The breakdown between issues of shares and issues of fixed-interest securities differs very substantially from country to country. In the EEC as a whole, issues

⁽¹⁾ These data differ from those given in Table 6 on “Funds supplied by the securities market”, since the latter included only the issues of final investors whereas Table 7 covers all issues, including those of “financial intermediaries”.

of shares are on an appreciably heavier scale than in the United States but are of less importance than in the United Kingdom. This could well be due in the first place to the greater scope for self-financing enjoyed by United States enterprises, since even the absolute volume of issues of shares in the United States seems modest in comparison with the EEC total, and secondly, to the efficiency of United Kingdom machinery for putting on the market the shares of even relatively small companies, a factor which facilitates issuing activity on the United Kingdom market.

Within the EEC countries, it is interesting to note the effort made by French and Italian enterprises to use issues of shares to restore financial structures thrown out of equilibrium in the past by undue recourse to borrowing.

It has already been noted that issues of securities as a way of covering financial deficits are on a comparatively small scale, particularly if only those issues constituting demand of ultimate investors rather than all issues are counted.⁽¹⁾ Whatever the prospects, then, of improving the machinery of the securities markets in the various member countries, the benefit accruing directly to transactors will be relatively small in relation to the advantages they would derive from the expansion and the improved functioning of the intermediary institutions, which provide enterprises with the bulk of the outside finance needed.

B. THE DEMAND FOR FINANCE BY THE VARIOUS SECTORS OF THE ECONOMY

14. Demand for capital may come from the public sector, from enterprises, from households, or from abroad. The last two sectors are not dealt with here: the external financial relations of each of the markets are discussed in the next chapter. The recourse of households to the capital market occurs when they purchase consumer durables on credit or buy a flat or house. There are no detailed financial accounts in this field and it is therefore extremely difficult to analyse these transactions.

The demand for capital by the public sector and by the enterprises sector is discussed below.

A) THE PUBLIC SECTOR

15. The public sector's demand for capital seems to be gaining in importance in the various member countries. The authorities are anxious to make good the inadequacy of social equipment and to improve the collective infrastructure, which is the key to economic growth, and this is leading to an increasingly rapid expansion of public investment, while public saving generally rises more slowly. In addition, even where the financing of these direct investments is covered by public saving, the authorities often play the role of intermediary by borrowing capital to finance economic operations in the form of loans to private enterprise. Calls on the capital

⁽¹⁾ The issues used to amass funds for the granting of credit by financial intermediaries are analysed in Table 8.

market by enterprises directly dependent on or controlled by the public authorities can also be included in the public sector's demand for capital.

Table 9 deals with the bonds which the public sector issues to meet the needs of both central and local governments and of public enterprises. It is difficult to establish exactly where issues for central government purposes end and issues for public enterprises begin, for while certain enterprises — particularly in transport and telecommunications — enjoy financial independence in certain countries, others come directly under the financial administration of central government.

Nor has it been possible to take account in the table of the fact that certain institutions, whose primary function is to finance the public sector, distribute to the company or household sectors part of the funds which they amass. However, in view of the sectors for which the funds they borrow are intended, the intermediate institutions of the public sector are not included in the table; if it were desired to take stock of the public authorities' influence on the market, the activities of these institutions would also have to be taken into account.

In view of the above, it is interesting to look at the percentage of total issues originating in the public sector; in certain member countries this brings to light a problem of balance between the opportunities available on the market to the public sector and those available to enterprises, whose need to borrow is also rising fast. These general problems will be examined in Chapter 6.

The bulk of the financing requirements of the local authorities are covered, in the Netherlands and Germany, by obtaining credit from specialized financial intermediaries which in turn obtain their funds by issues of bonds; direct issues by local authorities are of secondary importance. But there is another source — not shown in the tables — which is very important, particularly in France and Italy: it consists in financing granted by intermediaries which obtain their funds by collecting deposits rather than by issuing bonds (the *Caisse des Dépôts et Consignations* and the *Cassa Depositi e Prestiti*). The demand for funds by local authorities, which in certain countries is a very substantial factor in the capital market, also competes more or less directly with the financing requirements of the company sector.

Similar considerations apply to the use of the market by public enterprises: the factors to be examined below in Chapter 6 (the reduced scope for self-financing resulting from a policy on charges designed to keep prices stable, and the limited opportunities for issuing shares) may mean that the importance of these enterprises on the capital market will increase well beyond their real significance in the economy as a whole. Nor should it be forgotten that the public enterprises often receive direct capital contributions from the Treasury and long-term loans (sometimes combined with special advantages) granted to them by the public authorities or by the specialized credit institutions. They therefore enjoy particularly important advantages over the private enterprises.

B) THE ENTERPRISES SECTOR

16. The net financial deficit which enterprises have to cover by borrowing, and consequently the calls they make on the capital market, have increased sharply of late. There are several reasons for this. A high volume of investment is demanded

by the tempo of technological progress and by the need to adapt to a larger market. The profits available for ploughing back are smaller now that profit margins have been reduced by the pressure on prices due to keener external competition (or, in certain member countries, by price pegging measures forming part of stabilization programmes) and higher costs. The increase in these stems from the higher wages generated by the full employment situation achieved in recent years. The immediate effect of this trend is to cause enterprises to make heavier calls on external sources of finance, at the cost, in the long run, of a deterioration in their financial structure.

Table 10 gives estimates of the pattern of the borrowing by which enterprises have in recent years covered their financial deficits (it has not been possible to separate enterprises in the public sector from enterprises in the private sector).⁽¹⁾

With this reservation, the member countries can be classified in two groups: in the first — France, Italy and Belgium — the issue of securities accounts for more than a quarter of the sums borrowed by enterprises from outside sources. In the second group — Germany and the Netherlands — this method of financing is appreciably less important. The distinction would be sharper if, instead of considering only the funds supplied directly by the securities market to enterprises, account were also taken of the funds which this market supplies indirectly, thanks to the “intermediary” institutions which redistribute as loans the money they raise by borrowing.

This situation demonstrates the relative weakness of the contribution made by the securities markets to the external financing of enterprises and the importance of the role played by the financial institutions; by collecting savings deposits or by issuing bonds, these do much to ensure the financing of enterprises in certain countries. This suggests that the development of a European capital market would be of all the greater value for enterprises if it involved not only an improvement in the working of the securities market but also an improvement in the role played by the intermediary institutions as suppliers of finance.

The pattern of the financing of enterprises as it appears in Tables 10 and 11 is discussed briefly below.

1) *Issues of shares and bonds*

17. The issue of new shares varies in importance from country to country as an external source of financing for enterprises, and the use made of this method reflects circumstances which are peculiar to each of the Member States. In Belgium, where the contribution of share issues to total financing from external

⁽¹⁾ Two series of data are given for all countries except the Netherlands. The first includes residential construction with enterprises, the second excludes it. The second series is probably the more significant: investment in residential construction, which accounts for 20 to 30% of total gross capital formation, is generally financed by machinery differing appreciably from that used to finance productive investment. The inclusion of housing in an analysis of the borrowing by enterprises is liable to give a distorted picture of the scale of medium- and long-term credit, which constitutes the main instrument for financing housing. The problems of this particular sector will be examined in Chapter 8 and no further space is devoted to the subject here.

sources is higher than in any other country of the Community, the situation may be interpreted as a reflection of the difficulties faced by enterprises if they resort to other forms of financing, because of the pressure which the public sector exerts on the bond market. A similar explanation may well apply to France, where financing through the issue of shares is carried out on a considerable scale and fluctuates remarkably little. In Germany and in Italy, on the other hand, enterprises were at the beginning of the period under consideration procuring almost a quarter of the funds required from the capital market through the issue of shares, but here the situation has deteriorated rapidly, owing very probably to the unfavourable climate on the stock exchanges. The Netherlands is a special case, since the scale of year-to-year fluctuations in the relative importance of financing through the issue of shares is almost certainly to be attributed to variations in the calls on the market made each year by the big international companies with headquarters in that country.

It appears (as the more detailed analysis in Chapter 10 will confirm) that the supply of risk capital in the Community countries is hampered by difficulties which, added to the problem of reduced scope for self-financing, are liable to undermine seriously the financial structure of enterprises.

Table 11 shows that for a relatively early year, 1963, the structure of German, French and Italian enterprises was markedly inferior to that of enterprises in the United States or the United Kingdom.

Other evidence suggests that the disparity grew still wider from 1960 to 1964: while the indices that show the financial soundness of enterprises were unchanged in the United States and in the United Kingdom, they developed unfavourably in the three EEC countries mentioned. The ratios of debt to fixed assets, to own resources and cash flow show that the tendency for indebtedness to increase is gathering momentum: if this tendency were to continue, it would be bound to cause concern.

The issue of bonds by non-financial enterprises also varies very widely in scale from member country to member country.

In Germany and the Netherlands — in the former country mainly for tax reasons which were valid in the past, in the latter because of the lower cost and the flexibility of this form of financing — enterprises have tended to prefer private loans against borrowers' notes (*Schuldscheindarlehen* in Germany and *onderbandse leningen* in the Netherlands) to public issues of bonds. The large resources at the disposal of banks, savings institutions and institutional investors have enabled this form of financing to develop considerably, and the need for public issues has been reduced accordingly.

In Italy the specialized credit institutions, which have authority to issue bonds on privileged terms, are in a position to lend at medium and at long term on more favourable terms than those which enterprises would obtain directly on the fixed-interest securities market, given the heavier incidence of taxation on the issue of industrial bonds. The latter therefore play a subordinate role.

In France and in Belgium it is likely that two factors — regulation of access to the market by financial authorities anxious to assure priority for public or semi-public issues and the reticence of the public, who may be induced by tax incentives and investing habits to buy public-sector paper or paper guaranteed by the government — account for the relatively modest growth of bond issues by private enterprises. In the case of Belgium, it should also be said that interest subsidies granted to enterprises may apply only to loans of financing establishments and not to issues of bonds.

These factors which affect the readiness of enterprises to call on the securities market explain why borrowing from the various financial intermediaries provides two-thirds or more of the money enterprises obtain from outside sources. This characteristic — common to all the countries — should not, however, be allowed to mask important differences between the sources and the nature of the credit obtained in the various member countries. On the nature of the credits, it is difficult to say much on the differences to be found between the various countries in the ratio of short-term credit to medium- and long-term credit provided by the credit establishments and by institutional investors. It is, however, certain that in Italy the exceptionally high share of short-term credit in the total sums borrowed by enterprises from outside sources is connected with the Italian bank law which forbids ordinary credit institutions to grant advances for more than one year. Since these institutions dispose of considerable funds, it is not surprising that they grant advances to their customers on current account with no specified date fixed for repayment; these advances in fact play the same role as the formal medium-term credit granted by other institutions and thus contribute to the financing of capital investment.

2) Medium- and long-term credit

18. The bulk of the loans required for plant and equipment in France and in Italy reaches borrowers from public or semi-public institutions granting aid direct or acting as intermediaries. Institutional investors, particularly insurance companies, play only a subordinate role in this field. In Germany, on the other hand, most of this medium-term or long-term credit is accorded by the banks — the powerful network of savings banks being a part of the banking system — with appreciable support from the insurance companies: it is often granted in the form of *Schuldscheindarlehen*, which are roughly comparable with bonds placed privately. In the Netherlands, institutional investors, insurance companies and pension funds are the chief source of direct medium- and long-term loans to enterprises, although the contribution from the banks is far from negligible. In Belgium, lastly, it looks as if the situation is undergoing a complete change since, although semi-public institutions still dominate the field, they have declined in relative importance in recent years now that the banks have shaken off their reserve over granting loans for more than two years.

CONCLUSIONS

19. To conclude this study of the demand for finance, two points of some importance for the rest of the analysis may be made.

In the first place, the distribution of the demand for funds among the various sectors, and notably the administrative authorities, public enterprises, enterprises in the private sector and residential construction, reflects choices made by the public authorities rather than the impact of the machinery of the market in the accepted sense of the term. The study has shown not only the importance of the investments made directly by the public authorities (or under their auspices by public enterprises), but also the role played by the semi-public financial intermediaries. It may be added that intervention by the authorities in the arrangements for issues on the securities markets leaves a relatively small area in which the allocation of resources depends on the play of machinery not directly subject to official control.

Secondly, the point made at the very beginning of this section, i.e. that the way in which financial deficits are covered depends to a large extent on the pattern of the supply of capital to the market, merits special emphasis. Hence the need for an analysis of the supply side of the market; it should yield a more detailed explanation of the origins of the machinery by which financing deficits are covered.

III. The supply of capital

20. This section is concerned not with the volume but with the pattern of the supply of capital. After a summary account of the role of the main contributors to savings formation, an analysis will be made of the composition of their financial investments, and this will be followed by an attempt to bring out clearly the problems raised by the widening of the capital market to European dimensions.

A. THE SOURCES OF SAVINGS

21. Basically the pattern of the supply of capital on the market is determined by that of the sources of savings. The following considerations are helpful to an understanding of the relation between the two:

i) Saving by the public authorities is normally intended for investment without passing through the market, although public saving may in fact sometimes help to make more funds available on the market; this element in saving is relatively immobile in international terms;

ii) Nor is company saving normally likely to boost the supply of capital to the market, although it may do so more than public saving. This is true only for the company sector taken as a whole: investments by enterprises temporarily disposing of idle balances may be of considerable importance. International mobility may also be quite pronounced;

iii) Saving by households remains, however, the major factor to be taken into consideration in any assessment of the potentialities of the capital market of a given country. This is true, of course, only to the extent that non-financial investments

— investments in self-owned businesses and in residential construction — and hoarding do not absorb too high a proportion of household saving.

Subject to the above reservation it can be considered that, with saving by households forming a larger proportion of overall saving in the EEC countries than in the United Kingdom and the United States (where the share is only about 20%), the structure of overall EEC saving is satisfactory from the point of view of normal supply of the capital markets and of mobility of capital across frontiers.

However, something more is needed than this mere general statement. For example, whether public-sector saving passes through the banking system or through independent channels affects the conditions in which the market works. The situation in this respect varies appreciably from Member State to Member State. In the case of enterprises the level of their indebtedness and the nature of their relations with financial institutions also influence their capacity to make a contribution to the capital market.

Lastly and most important, the way saving by households is divided between investments on the market and non-financial investment may have more importance than the actual volume of this saving. In France, for instance, certain deficiencies in the supply of funds to the capital market are probably to be explained by the fact that direct payments for housing absorb a much larger proportion of personal savings in this country than elsewhere. The desire to own one's own home may provide a stimulus to saving, thus increasing its volume without encroaching on financial investment. Beyond a certain limit, however, the scale of the contributions necessary to the financing of construction may become such that a household has to give up any other form of investment, and as a result the capital market will suffer. The same is true where there is an undue tendency to hoard.

In this connection it is, however, important to make a clear distinction between causes and effects, since in many instances it is clear that the growth of hoarding or of investment in housing is in fact due to the inability of the capital markets to offer attractive investment opportunities. This point must be kept in mind in the following analysis of the unsatisfactory distribution of savings between the various forms of investment.

B. THE DISTRIBUTION OF FINANCIAL INVESTMENT

22. The pattern of investments made by the various non-financial sectors of the economy reveals that among the member countries there are marked differences in financing flows; these differences are brought out in Table 12, which deals with financial investment by the non-financial sectors.

A) CASH HOLDINGS

23. The proportion of cash (notes, coin and sight deposits) to all net financial investment by the non-financial sectors differs significantly between France, Italy and Belgium, where it ranges from 20 to 30%, and the Netherlands and Germany,

where it is only 12 to 14%. The difference is even more marked between the Community countries and the United States, where cash holdings account for only 6% of the annual increase in financial investment.

The reasons for the public's strong liquidity preference can be listed here but not analysed in detail. A first point is that the holding of deposits has still not made much headway with households, as is evidenced by the importance they attach to notes and coin. More generally, the tendency to hold ready money may be seen as a corollary of the public's reluctance to commit funds to long-term investments which in the past have entailed considerable losses due to erosion of the currency. The public's reaction to this threat is probably due to a desire to be in a position to cope rapidly with new situations and to take early advantage of speculative opportunities. Tax factors and defects in the working of the capital markets have also almost certainly played a role. In this connection, it may be noted that liquidity preference on this scale suggests a certain indifference among households to considerations of yield.

B) SAVINGS DEPOSITS

24. For an assessment of the scale of deposit saving, some rearrangement of the headings "Savings deposits entrusted to the banking system", "Funds entrusted to savings institutions" and "Funds entrusted to specialized credit institutions" is required, since, in Table 12, the savings banks system is included in the banking system in Germany but among the specialized institutions in France. In the banking system, time deposits are often grouped with savings deposits: but these two sorts of deposit frequently come from rather different sources, since in many cases the time deposits are merely a more profitable way for enterprises to employ their idle balances. None the less, they represent relatively stable resources for the banking sector and can therefore be properly classified with deposit saving.

It may be noted that the scale of deposit saving as a proportion of all net financial investment of the non-financial sectors varies in the several member countries between 25 and 37% and that it therefore constitutes the most important single source of funds for the capital market. It may be added that deposit saving is even more developed in the United States, where it accounts for about 52% of the total.

The item "Other funds entrusted to the banks" must also be taken into account. This item, which is relatively important in Germany and in Belgium, covers funds obtained by the banking system in the form of "credits received" and issues of deposit receipts: from the economic point of view these funds are comparable with time deposits.

If it has been possible to speak of all these funds as contributions to the capital market, this is of course because they are "transformed" into medium- and long-term investments by certain institutions; the process by which this is done will be discussed in the next section of this Chapter.

C) FUNDS ENTRUSTED TO THE PUBLIC SECTOR

25. The "Funds entrusted to the public financial sector" under forms other than the purchase of bonds are of real importance only in France (about 18% of all investment), where the role of the Treasury and of the public financial institutions as collectors of liquid savings is well known. Differences in the definitions of "public financial sector" from country to country must not, however, be overlooked, since they mean that the figures given in this line in Table 12 are not fully comparable. In this respect the importance of the "Miscellaneous" heading for Germany should be noted; it represents in the main the funds which the public sector places at the disposal of firms engaged in residential construction through public financial institutions.

D) THE SECURITIES MARKETS

26. In the Community, the funds invested on the securities markets account for proportions ranging from 15% (France) to 32% (Belgium) of all financial investment: it should, however, be recalled that these figures refer only to direct investment by the non-financial sectors and that investments made by intermediaries on the securities markets are therefore not included.

This also explains the net sales of securities shown in the United Kingdom and — in respect of shares only — in the United States, where, in the years under consideration, the non-financial sectors sold securities which were bought by the financial intermediaries. The tendency in the UK and USA for direct purchases of securities to decline in favour of indirect purchases by savers contrasts with the situation in the EEC, and particularly in Belgium and in Italy, where direct purchases still play a major role: the consequences of this situation will emerge in Chapters 9 and 10.

E) CONTRACTUAL SAVING

27. A similar situation is apparent in very marked differences to be seen in the scale of funds entrusted to pension funds and insurance companies: contractual saving of this kind accounts for scarcely 3% of the total in France, 9 to 10% in Germany and Italy, 15% in Belgium and 39% in the Netherlands. Except in the Netherlands, therefore, this form of saving is much less developed in the Community than in the United States and in the United Kingdom, where it accounts for 20% and 40% respectively of all financial investment. Such a situation calls for more detailed consideration.

The fact that in most of the countries the social insurance institutions have adopted the "assessment" method of assurance means that social security pension reserves are very small. Certain estimates suggest that they represent only about 5% of the total they would reach if the level premium method were used. These reserves represent three to five times the total of annual expenditure in the Benelux countries, are equal to total expenditure in Germany and are actually lower than total expenditure in France and in Italy. It is known that the reserves of life-

assurance companies represent, however, several times their annual expenditure. The adoption of the assessment procedure has had the result of increasing the importance of the social security pension as an instrument for the redistribution of incomes, particularly in the Netherlands and in France. In recent years, however, the current total of social security pension investment has increased in Belgium, Germany and Italy, particularly investment in government bonds and the bonds of public undertakings or of semi-public credit institutions. It should also be noted that the contribution made to the capital market is sometimes more apparent than real, where reserves are invested in public securities while the government subsidizes social security to the same or a greater extent. This is then an internal accounting circuit of the public sector, the only result of which is to swell the volume of public loan paper in circulation, but not that of the real financing resources existing on the market.

Unless changes occur in the existing trends, it seems that in the future the "assessment" method may come to be used even more extensively than at present. If this should happen, there would be little chance of a rise in social-security pension reserves and of the contribution made by social security pension schemes to the capital market. On the contrary, social security pension funds might even call for larger subsidies from the State in order to balance income and expenditure.

This fairly general trend in the Community countries is a result of political and social decisions which the Group is not required to evaluate. The public authorities, however, should be aware of the consequences of these decisions for the capital markets.

Structural factors also account for the modest contribution to the capital market made by various forms of insurance saving linked with the employment contract.

It has been thought advisable to devote special attention, even at this early stage of the report, to the problem of contractual saving, since this is one of the basic prerequisites for the good functioning of the capital market; the situation described reveals marked differences in this respect between the markets of Member States — with the exception of the Netherlands — and the British and American markets. The problem of how to stimulate contractual savings, particularly savings linked with the employment contract, will be examined in greater detail in Chapter 5.

Social insurance saving has developed in various ways in all the member countries: it is designed to ensure a supplementary retirement pension or a form of savings for employees through voluntary payments made by them and a contribution made by employers.

In the interests of the employee and of the capital market, it would be advisable that the funds set aside for the pensions of employees in the enterprise should be available through the capital markets for the financing of enterprises generally rather than being directly invested in the enterprise where they arise: in the latter case, they raise the same problems as does self-financing. To facilitate the mobility of labour, it would also seem preferable that the benefits granted to an employee should not be conditional on his remaining in the same firm until retirement.

It is certain that the various forms of social insurance saving have in any case the basic advantage, since they are voluntary (but advantageous for the employee since

he gains a contribution from the employer as well), of inculcating the habit of saving in social groups which now enjoy higher incomes but whose propensity to save has so far been low.

Structural factors also explain the difference in the extent to which life-assurance companies invest on the capital markets of the various member countries. These companies provide substantial support for the capital market in the Netherlands and in Germany, whereas their contribution is relatively low in France and in Italy, and lies somewhere between the two groups for Belgium. One of the reasons for this is that certain types of contract, particularly annuities and endowment assurance for which the companies have to build up large reserves, have developed in the Netherlands and in Germany, whereas others, like term assurance or whole-life assurance, which involve the constitution of lower reserves, are the most common in France.

C. THE DEVELOPMENT OF A EUROPEAN CAPITAL MARKET: PROBLEMS RAISED BY THE PATTERN OF SUPPLY

28. The main features of the supply of capital on the European capital markets can be summarized as follows:

- i) In several countries savers prefer to hold cash or short-term investments. This preference must be accepted as a fact and cannot be substantially changed just by establishing a European market. The efforts already undertaken to encourage progressive consolidation of personal savings must therefore be stepped up.
- ii) In all member countries, deposit saving is still an essential factor in the supply of funds to the capital market. It would seem necessary, in conjunction with development of the instruments for collecting the funds used by the financial institutions active in this field, to encourage the channelling of deposit savings towards medium- and long-term financing and employment on the capital market.
- iii) Lastly, and most important, the member countries' capital markets are still suffering very seriously from the inadequacy of contractual saving.

The situation on the supply side does not seem to have improved in recent years, and the main reason for this is that the redistribution of incomes to the advantage of wage-earners has increased the opportunities for saving open to social classes relatively ill prepared to play an active role on the capital market.

Aware of the obstacles to the smooth working of the capital markets raised by the nature of the supply of capital, the authorities in most Member States have endeavoured to encourage consolidation of savings and to promote the different forms of contractual saving. The main purpose of measures on these lines, which have assumed some importance in Germany and in the Netherlands and which have just been introduced in France, is to ensure the stability of newly constituted savings for a minimum period and so to help familiarize the saver with the idea of not keeping his funds perfectly liquid. The various measures will be examined in Chapter 5.

Secondly, the Community's first medium-term economic policy programme contains recommendations for a "property policy". Implementation of this policy alongside the incomes policy should encourage households to channel their savings into financial investments. Until this policy is implemented and is producing results, the possibility that savings will be made available in the form needed to cover capital requirements will continue to rest mainly on the work done by the financial intermediaries.

IV. The adjustment of supply and demand on the capital market

29. A useful way of examining the conditions under which the supply of capital is adjusted to demand is to make a broad distinction between the roles played by government intervention, the machinery for the redistribution of long-term saving, and the machinery for "transforming" short-term deposit saving.

A. BALANCE OF THE MARKETS AND GOVERNMENT INTERVENTION

30. In each Community country the supply of capital is adjusted more or less fully to demand with the aid of central government intervention, which supplements and corrects the distribution of funds made by the market machinery. As has just been mentioned, one of the ways in which governments influence the supply of capital is by stimulating saving and guiding it towards privileged channels. Another point that may be mentioned is the scale of the funds supplied by governments either directly or through specialized financial intermediaries; in certain countries these funds represent a substantial contribution to the supply of capital.

However, the most important operations carried out by the public authorities to adjust supply and demand take the form of direct action on investment demand and action on the cost of financing. The main instruments used to influence investment demand are the decisions concerning budgetary expenditure, the control of expenditure by local authorities and nationalized industries, and restrictions on building. The cost of financing can be adjusted by measures (especially subsidies) to affect interest rates and by tax measures.

If all the instruments mentioned above are taken into consideration it would seem that government intervention has assumed relatively greater proportions in France and Italy than in Germany and the Netherlands, with Belgium somewhere in between. But it is of course difficult to assess more accurately the scale of these public operations when they take non-quantifiable forms, such as the control of access to the market through the establishment of a "queue" of issues and by directives to the financial intermediaries.

Alongside government intervention, two types of machinery are of particular importance on the European markets: the machinery for the redistribution of long-term saving and "transformation" machinery, i.e. arrangements enabling short-

term resources to be allocated to longer-term uses. These have been operated by private institutions and by specialized financial intermediaries set up or controlled by governments. On the action taken to adapt these institutions to their functions depends the greater part of the improvements to be hoped for in the financing of productive investment and social infrastructure.

B. MACHINERY FOR REDISTRIBUTING LONG-TERM SAVING

Of the institutions engaged in redistributing long-term saving, the first to be examined here will be those which administer contractual saving, followed by those which redistribute capital collected through the securities market.

A) INSURANCE COMPANIES AND PENSION FUNDS

31. These institutions collect contractual savings directly or indirectly from households and thus dispose of technical reserves which it is their task to administer. In carrying out this task, they redistribute the savings they have collected between various forms of financial and non-financial investment. This operation can to some extent be regarded as a process of "transformation" which affects the nature of the savings since, by entrusting their money to these institutions, subscribers to life-assurance policies or supplementary pension schemes intend to secure for themselves a capital sum at or from a specific date, while the intermediary institutions in fact use this capital in a way which is not determined by the savers themselves.

It is admittedly difficult to compare the exact scale and nature of intervention by social-insurance institutions from one country to another. Certain marked differences in the way these institutions distribute their resources can, however, be discerned. Figures collected by the OECD Committee for Invisible Transactions and referring chiefly to period between 1960 and 1964 show that investments in the form of advances, mainly at medium and long term, account in Germany for about 66% and in the Netherlands for 69% of the increase in the financial assets of insurance companies and independent pension funds, whereas this type of investment accounts for between 1 and 4% of the increase in France, Belgium and the United States, and about 13% in the United Kingdom. The disparities are, however, narrower in reality than these figures might suggest, since they include for Germany and the Netherlands loans against promissory notes — a type of operation which, from the economic point of view, does not differ from the private placing of bonds made in other countries. On the other hand, investment in fixed-interest securities accounts for 63% of the increase in the assets of these organizations in France and 56% in Belgium, compared with only 20% in Germany and 9% in the Netherlands. In the United Kingdom and the United States the corresponding figures are 43% and 37%. In France and Belgium the high proportion of money these organizations put into bonds is due first and foremost to the rules governing their investments, rules which have the effect of channelling most of their funds towards the public sector.

Investment in shares accounted for between 3 and 7% of the increase in the financial assets of these institutions from 1960 to 1963 in Germany, the Netherlands and Belgium, about 20% in France, about 26% in the United States and 37% in the United Kingdom. This shows that, despite the increase in recent years, the social-insurance institutions of the EEC countries apply a relatively small proportion of their resources to risk investment compared with their counterparts in the UK and the USA.

In general, therefore, the contribution of these institutions to the financing of corporate investment in the private sector is much lower in the EEC countries, since their investment in shares is low and their purchases of bonds are mainly confined to government bonds. In addition to the above financial investments, these institutions devote a sometimes considerable portion of their resources to the purchase of real estate, particularly in Italy.

B) THE SPECIALIZED CREDIT INSTITUTIONS

32. The specialized credit institutions fulfil a double role: they carry out technical operations and serve as an instrument of economic policy.

Their economic policy function, which consists in encouraging the financing of investment in certain economic sectors, explains why they more often than not have public or semi-public status and sometimes enjoy certain privileges (special facilities for their loan issues and for dealing with institutional investors, public guarantees, tax benefits).

They also have a purely technical function, which consists in collecting funds on the securities market and redistributing them to certain users of capital (enterprises and public authorities) which have no direct access to the market, or at any rate cannot obtain favourable terms when borrowing in the ordinary way.

Another argument therefore for the above-mentioned advantages which these institutions enjoy in the Community countries is that their operations have the aim of offsetting the handicap faced by these users (for example, small and medium-sized enterprises) when they wish to draw directly on sources of finance. It would seem, in fact, that the technical aspect of the functions of the specialized credit institutions predominates in Germany and in the Netherlands, whereas the policy function is more to the fore in Belgium, Italy and France, where these institutions play a major role in collecting long-term savings or in distributing medium- and long-term credit, or in both.

The scale of their operations is considerable, and the funds they draw from the bond market account for a large proportion of total issues: for 1960 to 1964 the figure was 65% of total net issues in Italy, and more than 50% in Germany; in France, the Netherlands and Belgium it varied from 37 to 45%. This is all the more significant since the use of the funds concerned is narrowly specialized. In Germany, the institutions specializing in the financing of local authorities and residential construction are appreciably more important than those specializing in industrial or agricultural credit. The dominant place of the securities of the

specialized institutions on the market obviously affects the private sector's scope for borrowing against bond issues, and this influence is enhanced by the fact that the securities are available on tap.

C) THE TREASURY

33. In practically all EEC countries, the Treasury also acts as a body redistributing long-term capital by issuing bonds and granting medium- and long-term credit to public or private enterprises either directly or through credit institutions.

The economic policy function is particularly marked in this kind of Treasury operation. To the extent that the Government accords special terms to its own issues, the Treasury is in a position to grant funds on more favourable conditions than those available on the market.

C. MACHINERY FOR "TRANSFORMING" LIQUID FUNDS AND DEPOSIT SAVINGS

34. The financial intermediaries carry out their "transformation" function by adapting the supply of capital to demand from the standpoint of duration of the investment. "Transformation" may be defined as investment for a longer period than that of the deposits received. With a view to integration of the capital markets, this process needs to be examined from three points of view:

- a) Scope,
- b) The institutions involved and the sectors that will benefit,
- c) Its success in adjusting the supply of capital to demand.

A) THE SCOPE OF TRANSFORMATION

35. It is not easy to assess accurately the scope of transformation, and even less easy to compare its relative importance in the financial systems of the various member countries. One reason for this is the absence in three member countries — Belgium, Italy and the Netherlands — of annual accounts covering all financial operations and classifying them according to period. The second reason is that in the other member countries the definitions of "short-term" do not coincide and that in Germany figures on Treasury operations are available. A third factor is that, even if such a standard definition were available, the legal classification of the period for which funds are committed is not a standard by which the stability of deposit saving can be assessed. Lastly, systematic studies on the subject have been carried out only for France, Germany, the United Kingdom and the United States. The comparisons made below must therefore be treated with some caution.

Subject to these reservations, it is clear that transformation of short-term into medium- and long-term funds is carried out on varying scales in the differing financial systems. For the years 1960 to 1963 more than 50% of the long-term capital requirements of business and private borrowers in France were met in this way, compared with less than 30% in Germany; the corresponding figures were 50% for the United States and less than 20% for the United Kingdom ⁽¹⁾.

In some of these countries, in particular Italy, a number of loans shown in balance sheets as "short-term loans" or "advances" are in fact often automatically renewed and this amounts to their transformation by the users of the loans. It would seem that in recent years the volume of funds transformed has tended to increase, at least in France, Germany and in the United States, since the increase in the long-term investment of the non-financial sectors has apparently been smaller than the increase in the long-term capital requirements of the economy.

B) ORIGIN AND APPLICATION OF THE SHORT-TERM FUNDS "TRANSFORMED"

36. In theory transformation can be carried out by any financial intermediary administering sight or short-term funds who is in a position to accept the risk of immobilizing these funds for a period exceeding the period for which the deposit is received; three technical factors make transformation possible:

- i) Sight deposits have a certain foreseeable degree of stability, while time deposits are renewed and here too the extent of renewal can be foreseen;
- ii) New deposits replace withdrawals, so that the institutions have at their disposal a working fund which is to all intents and purposes permanent;
- iii) The volume of deposits increases, so that there is a tendency for this working capital to increase.

In practice, three types of financial intermediary actually carry out transformation: savings institutions, banks and, in certain member countries, the Treasury.

The savings institutions are the most important, since their share in the total of these operations ranges from 60 to 100% in the various member countries. The nature of the resources (almost exclusively savings deposits) accruing to them, as experience shows, with marked regularity diminishes the importance of the liquidity problem, while the public guarantee they enjoy explains why they are particularly well placed to transform short-term funds. Their activity in this direction is also a natural result of the regulations which encourage them to invest in bonds, mortgage claims and long-term loans to public authorities.

The distribution of the saving institutions' resources among the various form of investment is influenced to a great extent by the nature — which varies in liberality from country to country — of the regulations referred to above. In most EEC

⁽¹⁾ Source: "Etude de la transformation des capitaux à court terme en emplois financiers à long terme dans les divers pays" drafted by a Working Party in the Caisse des Dépôts et Consignations, Paris 1966 (unpublished).

countries these funds are channelled mainly towards the financing of housing and public authority investment, and sometimes towards the investments of public undertakings, either in the form of long-term loans or through purchases of bonds. The extent to which the savings institutions assist in the financing of productive investment in the private sector is therefore somewhat limited. The restriction of the funds made available by transformation to certain types of investment sets a serious problem, of course, in the context of a European capital market: on such a market the conditions in which the savings institutions work should vary less from country to country than they do at present.

The banks contribute in smaller measure to total transformation. This is mainly due to the stricter liquidity rules applied to them, particularly in Italy and, until recently, in France. They use the funds derived from transformation mainly to finance private and sometimes public enterprises.

If economic policy considerations, which in certain circumstances may require special liquidity rules to be imposed on banks, are disregarded, it would seem, from the purely technical point of view, that more short-term funds might be transformed by banks in certain member countries where the scope is particularly limited by regulations concerning the employment of funds. More flexible rules would help to increase the volume of transformed funds channelled towards the financing of productive investment.

In the EEC countries the Treasury plays an active part in this transformation process only in France; outside it does so in the United Kingdom and in the United States. But even in France the part played by the Treasury has in fact declined steeply over the last ten years, dropping from 70% of total transformation to only 10%. The funds transformed by the Treasury have been channelled mainly into housing and public enterprises and, at times, to local infrastructure.

C) TRANSFORMATION AND THE SUPPLY AND DEMAND SITUATION ON THE CAPITAL MARKET

37. In what way transformation helps to balance the supply and demand situation on the capital market depends largely on the conditions in which the process takes place. According to whether the transformed funds are applied to investment in securities or to medium- and long-term loans, the equation of demand and supply in one or other of these sections of the capital market is facilitated.

Investment in securities offers the advantage of greater liquidity, but may lead to the security market trend becoming excessively dependent on monetary policy. This risk is all the greater because of the possibility that the institutions carrying out the transformation may find their own liquidity directly affected by decisions of the monetary authorities, and also because they transform resources (sight and time deposits) the trend of which itself reflects changes in monetary policy. On the other hand, transformation has enabled several Member States to make good a temporary shortage in the supply of long-term capital, and has thus come to play an important role in determining the general business trend. In Italy, for example, at a time when the public's interest in bonds had waned, banks invested in them on a large scale.

Investment in medium- and long-term loans has the disadvantage of immobilizing funds for too long, although this disadvantage can be mitigated by the organization of a market or by the existence of mobilization facilities. On the other hand, these investments often have a higher yield than investments in securities.

Thus, if the transformation of short-term funds is to take place in conditions offering the requisite level of liquidity, safety and profitability, a combination of these two types of investment is needed; and there should also be some spread of individual investments among the various sectors of the economy. The development of this machinery in a European capital market would be facilitated if the transformed funds were not tied to specific uses. However, transformation cannot be regarded as an end in itself; it is merely an expedient to counteract the public's undue liquidity preference. It is therefore important that the institutions which transform short-term funds should at the same time encourage the public to make more use of the longer-term forms of investment.

Conclusions

38. To conclude this analysis of the main features and structural problems of the capital markets in the various countries of the Community, it is important to consider the real nature of the defects which, as is generally agreed, hamper the operation of most of these markets.

a) The examination of demand brought out the rapid growth of the financial deficits which enterprises, because of the narrowing of profit margins caused by wage increases, keener competition and — in some cases — frozen prices, have to cover by borrowing. To these requirements of private enterprise must be added the also steadily mounting demand of public authorities. This growing demand for capital is in the last analysis due to the fact that the Member States must rapidly move up to the level of the best-equipped economies with which they are nowadays in direct competition, without being able to put off indefinitely expenditure on social requirements and on economic infrastructure.

b) As for the supply of capital, the inadequacies that have been noted certainly cannot be attributed to any general lack of savings, the growth of which is satisfactory. The fault lies rather in the extent to which and the way in which these savings feed the supply of capital on the market; it is these factors which have caused the structural disequilibria that exist between demand and supply on the capital markets of several Member States.

39. It has already been shown that the supply problems are essentially connected with the excessive bias towards liquidity and the reluctance to engage in risk investment and contractual saving.

It is not certain, however, that these features of saving really reflect the preferences of transactors so much as the nature of present financial structures. It is contrary to the very logic of a market to speak, without amplification, of a "shortage of long-term capital". For this would imply a very marked inelasticity of saving in relation to the terms offered and would suggest that any attempt to restore the

balance by improving the return on long-term saving would have to increase the cost of capital so much that investment would almost certainly be discouraged.

In point of fact, it is not possible to relate elasticity simply to yield; there are a whole series of other factors of importance to the saver (liquidity, ease of investment) which are difficult to quantify and so to express simply as "elasticity".

It would seem, then, that optimum use of available capital depends on four main factors: the mobility of capital from one financial channel to another, greater neutrality as regards fiscal treatment of the various types of investment, improved scope for the collection and employment of funds by the financial institutions which collect and redistribute savings, and, lastly, the development of market techniques which will enable savers to realize their investments more easily.

40. The organization and operation of these markets today is the outcome of a great many factors which emerged from two periods of fundamental imbalance. The first was in the nineteen thirties and led to restriction of competition in the field of credit and to rigid compartmentalization of the various national markets. The second was the reconstruction period after the war, when the dearth of savings in relation to the swollen requirements led the authorities to introduce measures for compulsory direction of available resources.

For the most part, the measures adopted were unavoidable at the time. The problem arises because they still survive though the need for them has largely disappeared.

The present arrangements are therefore being subjected to increasing criticism. The measures taken in the past succeeded in adjusting demand and supply within each market, and the authorities hesitate to abandon machinery which, though it may not be entirely satisfactory, did enable the rapid growth of the European economies to be adequately financed. None the less, a review of these arrangements has in recent years appeared necessary if the markets are to cope with the requirements arising within each of the Member States and to allow for the new circumstances and new prospects opened up by the establishment of the European Economic Community.

CHAPTER 3

EXISTING LINKS BETWEEN CAPITAL MARKETS

1. The existing relations between, on the one hand, the capital markets of the Member States and, on the other, between these markets and those in non-Community countries, will be examined from two main viewpoints.

First an attempt will be made to calculate the scale of those medium- and long-term private capital movements now already well-established between the various countries and to define their principal characteristics.

Secondly, an account will be given of the decisions taken, or about to be taken, by the Governments to facilitate capital movements, in implementation of the principles set out in the Treaty of Rome, and to describe the nature of the remaining obstacles which must be overcome in order to further the progress of financial relations in the European framework.

I. Analysis of movements of private medium- and long-term capital

A. INFORMATION FROM OFFICIAL SOURCES

2. This information is obtained from balance-of-payments statistics and from data provided by the Member States under Article 72 of the Rome Treaty.

A) GENERAL

The official data given in Table 13 provide an overall view of private capital movements from 1960 to 1965 between each member country and other countries; the figures for operations with other Community countries only are also given. The data obtained seem to be satisfactory for three countries; Federal Germany, France and the Netherlands. For Italy the official figures for 1962 and 1963 are greatly distorted by spurious capital movements.⁽¹⁾ The Belgo-Luxembourg Economic Union communicates only the balance of capital operations with foreign countries without details of the movements themselves, except for transactions in securities.

⁽¹⁾ From 1962 to 1964 Italian residents made large transfers in banknotes to Switzerland. These transfers have been estimated to be \$762 million in 1962, \$1 456 million in 1963 and \$557 million in 1964. The bulk of the funds transferred (75% in 1962 and 65% in 1963 according to the Bank of Italy's annual report) was repatriated, by the owners under the cover of Swiss names, to finance portfolio and direct investment in Italy. This procedure greatly increased, in a purely artificial manner, the volume of long-term capital imports recorded in Italian official statistics.

Allowing for these imperfections, the table calls for the following comments:

i) *Overall capital movements with foreign countries*

The official figures for private long-term capital movements reveal that from 1960 to 1965 the EEC countries as a whole were net importers of capital to the tune of \$8 100 million. In fact, if the spurious Italian imports are allowed for, the net figure would almost certainly be no more than some \$6 500 million. But even reduced to this level the figure still looks very high. It must be remembered, however, that it applies only to movements of long-term private capital and that the overall balance of the Community's capital operations also includes movements of public and short-term private capital. If all these movements are taken into account, there remains a net capital import of some \$50 million.

ii) *Capital movements within the Community*

The volume of capital movements between the Community countries is relatively modest. In contrast with commercial trade flows, intra-Community capital movements form only a small proportion of the total capital movements to which each member country is a party. The only exception to the rule is the Netherlands. Dutch residents have exported more capital to Community countries than to non-member countries.

Two countries had a net inflow of private long-term capital: Germany, some \$736 million, and France, a little over \$439 million. Over a third of the total, about \$432 million, came from the Netherlands; in the absence of precise data it may be estimated that the rest was supplied by the Belgo-Luxembourg Economic Union and to a lesser extent by Italy.

3. It is difficult, in conclusion, to discern in capital movements between the Member States and non-member countries trends which may be associated with the process of economic integration in the Community, in particular the development of commercial trade. Nor can the influence be distinguished of certain fundamental economic factors, such as the different degree of economic development in the six Member States; cyclical factors are reflected more clearly, it is true, but still not very clearly.

It would, however, be a mistake to infer that capital movements are the result of purely accidental factors in the economic life of the Member States and that consequently they should be kept in check as far as possible or submitted to controls intended to force them into a given direction. It appears, on the contrary, that this characteristic of capital movements must be attributed first and foremost to the lack of harmony between the policies applied by the Member States in this sphere — total freedom in some and a restrictive attitude in others — and to the effects of certain measures, mainly fiscal or monetary, which on occasion have unleashed heavy movements of capital which were neither foreseen nor perhaps desirable.

It is therefore certain that the trend of capital movements — in the past apparently erratic — would undergo a radical change if the liberalization and harmonization measures recommended in this report were put into effect.

B) ANALYSIS OF THE VARIOUS CATEGORIES OF CAPITAL MOVEMENT

4. Table 14 breaks down by sectors capital transactions made by residents and non-residents. They fall under four headings:

- i) Direct investment;
- ii) Portfolio investments;
- iii) Credits and loans for over one year;
- iv) Sundry (for example, investments in real estate).

The following observations can be made:

- i) For all countries direct and portfolio investments account for the bulk of capital transactions. Portfolio investments are particularly important in the Netherlands and in Germany. In France and Italy direct investments predominate (for the latter country an estimate is made which eliminates the spurious movements already referred to).
- ii) The trend of direct foreign investments, inward or outward, is steadier than that of portfolio investments; in all the countries they have increased regularly, in contrast with the considerable fluctuations in long-term capital transactions as a whole.

Analysis country by country calls for the following comments:

In the Netherlands capital has been imported chiefly in the form of portfolio investments while the operations of Dutch residents have often taken the form of direct investments. This difference reflects both the importance of the Netherlands as an international financial centre and the considerable role played there by certain big international companies.

Non-resident portfolio investment in Germany was very substantial from 1960 to 1963. The movement slackened considerably from April 1964 following the establishment of a 25% withholding tax on the income from German bonds paid to non-residents (*Kuponsteuer*).

In France operations in securities by residents resulted in relatively heavy net disinvestment due to the weakness of new investments and the sale of considerable holdings of securities previously built up abroad.

The incomplete data available for the Belgo-Luxembourg Economic Union concern solely the net purchases of foreign securities by residents and of domestic securities by non-residents. Throughout the period there was a heavy deficit on these transactions.

As mentioned above, official data for Italy do not show the real movements of long-term capital. It must be noted then that while Italy, according to the figures given in Table 2, has been the recipient of a growing volume of direct investment, Italian residents, contrary to the trends indicated by the table, have made relatively substantial portfolio investments abroad.

c) ISSUES OF BONDED LOANS

5. The placing of bonds on foreign markets, which is the traditional instrument for integrating capital markets, has made particular progress in recent years. It has therefore been considered useful to make a special analysis of capital movements under this form. The information available in this field is more complete and more satisfactory than that on other capital transactions.

Two statistical tables have been prepared: Table 15 gives a breakdown year by year of public loan flotations made for foreign account from 1961 to 1965 on the European and American markets; Table 16 breaks down these issues into two main groups: according to the nationality of the borrowers and according to the markets on which the loans are raised.

In order to define the different categories of issue more clearly a distinction has been made in the two tables between "foreign loans in local currency" and "Euro-bond issues". The latter term needs some explanation. By Euro-bond issues are meant issues to be placed mainly on markets other than that of the reference currency (see note at the foot of Table 15 and fuller details in Ch. 9, III). The scale of such issues has increased considerably in recent years and the issue syndicates have made efforts to extend their international clientel constantly. That is why it is extremely difficult to break down issues geographically according to the place of residence of the actual subscribers; it has been found preferable to use the term "Euro-bond issues", which covers loans with very similar conditions governing remuneration. These loans are the beginning of an international market.

Tables 15 and 16 call for the following comments for the EEC countries:

i) *The volume of issues*

The volume of foreign issues has increased sharply since 1963 as a result of the development of Euro-bond issues while "traditional" issues denominated in local currency have not advanced.

Loans issued by Community residents on the markets of non-member countries or on Euro-bond markets have in recent years reached a volume several times greater than that of loans issued by non-member countries or by international organizations (excluding the European Investment Bank and the ECSC, which are counted as borrowers resident in the Community) on the markets of the Member States. The balance in favour of the Community is over \$570 million. This figure, however, must be interpreted with caution in view of the contribution of Community residents to the Euro-bond market, and does not therefore represent net real imports of external capital through foreign issues.

Issues by Community residents — including the EIB and ECSC — on the markets of other member countries have been relatively small. From 1961 to 1965 they totalled \$320 million, or some 6.7% of all foreign loan issues in the period, which totalled nearly \$4 800 million.

ii) *The beneficiaries*

The EIB and ECSC are the leading issuers among Community residents. Loans placed by them represented 35% of all issues by Community residents; Italy, whose share amounted to 18%, was the next largest beneficiary of such loans.

iii) *The main subscribing countries*

If an exception is made for Germany, for which country issues since April 1964 have been included in the total of Euro-bond issues, the Netherlands is the country in which by far the largest volume of foreign issues was placed. It is, moreover, the only country for which loans floated by non-residents exceed those issued by residents in foreign markets.

B. THE INADEQUACY OF OFFICIAL DATA FOR ANALYSIS OF CAPITAL FLOWS

6. The interpretation of official data on international movements of capital sets difficult problems. Statistics account for direct transactions, but provide no information on the part played by redistribution or what may be called the "turntable" role of international financial bodies and certain financial centres. We therefore have a very imperfect knowledge of the geographical distribution of capital movements.

It is also clear that numerous transactions are by-passed by official records, thus making the volume and range of financial relations effectively established seem smaller than they are.

A) THE REDISTRIBUTION ROLE OF INTERNATIONAL FINANCIAL BODIES AND OF THE CAPITAL MARKETS IN NON-MEMBER COUNTRIES

7. From 1954 to 1964 the EIB and the ECSC together granted long-term credit to a total of \$1 000 million and raised nearly \$650 million in loan capital, in addition to the \$250 million making up the EIB's paid-up capital.

Of the loan funds taken up, \$300 million was raised in the markets of non-Community countries, while almost all the credit granted went to beneficiaries residing in the Member States. In this way the two bodies channelled considerable external resources into the Community. In the Community itself they played a very important role in redistributing capital placed at their disposal either by the governments in the shape of capital payments or by subscribers to bonded loans.

The other international financial bodies — the World Bank, the Inter-American Development Bank, the Council of Europe Resettlement Fund, Eurofima — played a similar part as redistributors, but the bulk of the funds lent by them went to non-member countries.

Certain financial centres play a traditional role in the redistribution of capital. This is the case of Switzerland, which figures largely in capital transactions between Community residents and in movements between the residents of Member States and those of non-member countries.

The need to adjust the statistics relating to Italy in view of the movements of notes through the Swiss banks has already been mentioned. It must be added in

this connection that the fraction of Italian funds transferred to Switzerland which amounted to a true export of capital was not used on Swiss territory; actually, much of this money made its way to the markets of non-member countries and to countries in the Community, especially, it seems, Germany and the Netherlands.

The Euro-issues market sets similar problems in connection with the determination of the origin and true geographical destination of the capital passing through it. Table 16 shows that up to the end of 1965 issues totalling about \$1 800 million had been placed on this market. Out of this sum borrowers resident in the EEC obtained nearly \$400 million, of which no less than 40% went to the EIB and ECSC. To this amount must be added at least part of the issues placed by holding companies in order to finance the European subsidiaries of American companies; while such borrowers are not as a rule EEC residents, it is certain that a considerable part of the capital raised in this manner has financed investment in the EEC.

It is impossible to estimate the effective contribution to this market in the shape of subscriptions by EEC residents. It can only be said that the Euro-issues market has played an important role as a centre for the distribution of capital in the Community; but there is no way of determining whether these operations have resulted in a net export or a net import of capital by the EEC countries.

Finally, reference must be made to a further "turntable", which is even more important from the angle of volume, the Euro-currency market. Operations in this market are generally short term and do not fall within the scope of this study. Transfers of funds for more than a year, however, are not unusual and it must be borne in mind that short-term facilities have been systematically renewed by borrowers and must be considered as long-term financing. Estimates have been made by the Bank for International Settlements of contributions and recourse to this market by lenders and borrowers resident in the EEC. The position of the several Member States with regard to this market, however, has varied considerably, particularly where Italy is concerned, a country which has successively appeared on the Euro-currency market as creditor, debtor and again as creditor. This is another important element in the financial relations between the member countries of the Community which does not always appear clearly in official data.

B) DEFECTS OF OFFICIAL DATA

8. Most of the Member States have made notable progress in developing their statistical machinery over the last few years. The situation now appears satisfactory in Germany, France, Italy and the Netherlands. As has been noted, this is not the case for the BLEU. At any rate much remains to be done here in the field of harmonization, especially as regards the distinction between the various types of capital movement and their geographical breakdown.

Another point is that there are many gaps in official statistics which are apparently difficult to eliminate. The most serious are not omissions of a technical nature (minimum amounts, errors of classification) but intentional omissions in the reporting of transactions. The motive is sometimes the desire to avoid red tape, but much more often tax and exchange-control evasion.

II. Measures taken or planned under the Treaty of Rome to facilitate capital movements

9. A brief account will be given here of the reciprocal undertakings agreed to by Member States, or being planned, in order to make capital movements freer. It will hinge on the problems of relaxing exchange control regulations — problems upon the solution of which depends the development of relations between the capital markets of the Member States. Fiscal obstacles will be dealt with in Chapter 14.

A) PRESENT SITUATION

10. At present direct investments, operations in listed securities, investment in real estate, personal transactions and short- and medium-term credits linked with commercial transactions or the rendering of services are all completely free of restrictions. For other categories of transactions, such as the issue of securities on the markets of the other Member States, medium- and long-term “financial” loans (i.e. not connected with commercial transactions), transactions in unlisted securities and movements of short-term “financial” capital, restrictions survive in certain Member States. A brief list of the restrictions in question is given in an annex to this chapter. It must be pointed out, however, that the situation is changing all the time and that now liberalization measures are being planned. They will be examined in section 11.

The measures already adopted to implement the provisions of the Rome Treaty concerning the elimination of exchange restrictions are contained in two directives for the application of Article 67 which were adopted by the Council on proposals from the Commission on 11 May 1960 and 18 December 1962 respectively ⁽¹⁾.

From the technical point of view these directives constitute minimum commitments which the Member States have honoured by changing their domestic legislation. Certain Member States have gone far beyond this. Most of them, furthermore, have extended to non-member countries the liberalization measures adopted to meet Community commitments.

The resulting system of liberalization differs appreciably from that set out in the “Code of Liberalization” for capital movements adopted by the OECD Council on 28 July 1964. The Community commitments are distinctly stricter from the legal angle. A Member State is not free to withdraw the measures of unconditional liberalization established by the Council except in accordance with the safeguard clauses contained in Articles 73 and 109 of the Treaty. These clauses can be invoked only on specific conditions and following Community procedures. In the OECD system, on the other hand, a member state may unilaterally withdraw liberalization measures already adopted “if they result in serious economic or financial disturbance” and may temporarily suspend their application “if the balance of payments position ... develops adversely at a rate and in circumstances which it considers serious ...”

⁽¹⁾ See official gazette of the European Communities, 12 July 1960 and 22 January 1963.

The different forms of capital operations are broken down in the directives referred to into four categories, each subject to different rules:

i) "Unconditional" liberalization, which can be revoked only on the strict conditions set out in Articles 73 and 109 of the Treaty, applies to capital movements listed in the first and second categories. These two categories basically consist of direct investment, operations in listed securities, personal capital movements, investment in real estate and short- and medium-term credits linked with commercial transactions or with the rendering of services.

ii) A "conditional" system of liberalization is in force for the capital movements of the third category: the issue of foreign securities on the capital markets and financial loans and credits. The Member States may apply restrictions to such operations or maintain restrictions existing on the date of entry into force of the directive "if these movements are such as to impede the achievement of the objectives of their economic policy". Three Member States — France, Italy and the Netherlands — have taken advantage of this clause and continue to maintain partial or total restrictions on such capital movements; general licences are, however, granted for transactions for sums and periods not exceeding certain limits fixed in advance (see Annex). For the other Member States, which had already fully liberalized these operations by 11 May 1960, liberalization has become irrevocable unless the safeguard clauses previously referred to are invoked.

iii) For capital movements of the fourth category, which includes short-term financial operations, including the constitution of deposits abroad, no particular obligation regarding liberalization has been laid down and therefore the matter is still open; such operations are in fact fully or almost fully liberalized in three of the Member States.

B) FURTHER PROGRESS

11. As three of the Member States still apply exchange-control restrictions, a third directive under Article 67 has been considered necessary and is at present under discussion. The object is to establish a better balance among the commitments of the various Member States and to eliminate at the same time a number of obstacles which do not arise from exchange control but are of equally fundamental importance.

More specifically, the proposed directive provides for a relaxation of exchange control in France, Italy and the Netherlands, first with regard to the admission of foreign issues on the national markets up to a specific ceiling, and secondly concerning the granting to residents of medium- and long-term financial loans and credits.

The directive is also designed to eliminate laws and regulations discriminating against the access of issuers of other member countries to the several capital markets or against the admission of foreign securities to official quotation on the stock exchanges. It provides, in addition, for the elimination of discrimination with regard to the purchase of foreign securities by financial institutions, a necessary corollary of EEC integration. Liberalization of the rules governing investment by

financial institutions is indispensable if the measures liberalizing foreign issues already in force or proposed in the third directive are to be effective. By allowing financial institutions to buy foreign securities denominated in the domestic currency or free of exchange risks by virtue of special clauses, the directive will help towards building up a sufficiently large market for these issues.

12. The Group would like the regulations impeding the free movement of capital to be removed progressively. Such restrictions as survive seem all the less justified where they appear to be maintained for reasons other than those for which they were originally adopted. Exchange-control restrictions have, as a rule, ceased to be used to safeguard the balance of payments and seem nowadays intended mainly to ensure the autonomy of domestic monetary policies. Besides the traditional exchange control instruments, i.e. the ban on the purchase by non-residents of certain kinds of money market paper and on the contracting by residents of loans abroad, and rules governing time-limits for payments to abroad and the repatriation of foreign currency acquired, measures have been introduced which specifically belong to the domain of monetary policy: they fix limits to the banks' foreign currency holdings, provide for minimum reserve requirements or rediscount ceilings at the central bank depending on the banks' net foreign liabilities, and establish terms — which vary in generosity — governing the swap operations of the banks.

The consequences of this tendency were explained in the 36th Annual Report of the Bank for International Settlements:

“Currency convertibility requires that domestic demand, cost and credit conditions be consistent with balance-of-payments needs. For monetary policy, which is relatively more effective in influencing the particular channels through which funds move than the actual level of expenditure, this normally implies an orientation primarily towards curbing excessive inflows or outflows of capital. By the same token, convertibility induces countries to make greater use of fiscal and incomes policy in trying simultaneously to achieve both domestic and external objectives. In these ways it tends to direct the various policy instruments towards their most efficient uses, thereby contributing to sustainable expansion.

“In practice, however, most countries have been reluctant or unable to accept the discipline inherent in convertibility. Instead, in order to make more use of monetary policy for domestic purposes, they have sought in various ways to weaken the links between domestic credit conditions and external flows of capital. The result has been a gradual drift away from convertibility, confined up to now largely to selective controls over capital transactions”.

Conclusions

13. The present state of knowledge of the extent of integration between the capital markets of Member States is very imperfect. Data are incomplete and definitely underestimate the scale of intra-Community capital movements; the geographical breakdown the figures indicate is radically distorted by a group of factors which tend to overweight financial relations with the markets of non-member countries as compared with those between Community markets.

It is true that measures adopted within the Community to give greater freedom to financial flows have already been appreciable. However, the development of the European capital market requires further progress both in respect of exchange controls and of domestic controls of the machinery of the markets in the several Member States. Such progress can only be achieved if certain adjustments are made to economic policy instruments now in use. The second part of this report is devoted to these adjustments and in it an effort is made to establish the conditions under which economic policy instruments can be made effective in the framework of a capital market extended to European scale.

ANNEX TO CHAPTER 3

Survey of exchange-control systems applicable to the main categories of capital movement between the Member States

GERMANY

Direct investment: unrestricted

Operations in listed securities: unrestricted

Operations in unlisted securities: unrestricted

Issue and placing of securities of a foreign company on the domestic capital market: unrestricted

Issue and placing of securities of a domestic company on a foreign capital market: unrestricted

Investment in real estate: unrestricted

Short- and medium-term credits linked with commercial transactions or with the rendering of services in which a resident participates: unrestricted

Medium- and long-term loans and credits not linked with commercial transactions or the rendering of services: unrestricted

Short-term loans and credits not linked with commercial transactions or the rendering of services: unrestricted

Opening of and transfers to current accounts, deposit accounts and other short-term investments on the money market:

i) By residents on a foreign market: unrestricted

ii) By non-residents on the domestic market: the opening of and transfers to current and deposit accounts are free of restriction; however, German credit institutions are forbidden to pay interest on time deposits held on behalf of non-residents (whether they belong to the banking sector or not), with the exception of saving accounts held by individuals. As for other short-term investments, non-residents may not buy German treasury bonds or similar paper (this rule is designed to prevent the circumvention of the ban on the payment of interest on short-term deposits). Nor may residents buy fixed-interest-bearing domestic stock with a clause providing for redemption at a specified price.

BELGIUM — LUXEMBOURG

Direct investment: unrestricted ⁽¹⁾

Operations in listed securities: unrestricted (For residents settlements for such operations must be made through the free market. For non-residents the settlement may be effected at choice via the official or the free market. In order to transfer abroad the proceeds of a sale of securities it is necessary to go through the free market even if the funds for the purchase had originally been imported into

the country through the official market. The redemption proceeds of B.L.E.U. listed bonds denominated in Belgian or Luxembourg francs may be transferred through the official market. The only formality is a verification procedure).

Operations in unlisted securities: unrestricted (For residents these operations must be effected through the free market. For non-residents they can be effected at choice through the official market or the free market. In order to transfer the sale proceeds abroad the free market must be used even if the funds for the purchase had originally been imported into the country through the official market).

Issue and placing of securities of a foreign company on the domestic capital market: (From the point of view of exchange control, issues on foreign account are unrestricted. However, any public issue of foreign securities or their sale to the public by foreigners is subject to authorization from the Ministry of Finance.)

Issue and placing of securities of a foreign company on a foreign capital market: unrestricted

Investment in real estate: unrestricted ⁽¹⁾

Short- and medium-term credits linked with commercial transactions or with the rendering of services in which a resident participates: unrestricted. ⁽¹⁾ Transfers by non-residents to resident suppliers under the heading of advance payments or the rendering of services must be effected via the official market.

Medium- and long-term loans and credits not linked with commercial transactions or the rendering of services: unrestricted (The corresponding transfers are effected via the free market; for non-residents, transfers may be made via the official market or the free market.)

Short-term loans and credits not linked with commercial transactions or the rendering of services: unrestricted (The corresponding transfers are effected via the free market; for non-residents, the transfers may be made via the official market or the free market.)

Opening and supply of current accounts, deposit accounts and other short-term investments on the money market:

i) By residents on a foreign market: unrestricted (The settlement must be made through the free market);

ii) By non-residents on the domestic market: the opening of current accounts and deposit accounts is unrestricted. Where other short-term investments are concerned, non-residents may not buy Treasury bonds.

⁽¹⁾ Since 1 October 1963, B.L.E.U. residents have been free to effect transfers linked to these operations at their option either via the official market (i.e. at rates established within the limits laid down in the framework of the EMA), or via the free market (i.e. where rates may fluctuate outside these limits). Transfers made via the official market require individual authorization by the Belgo-Luxembourg Exchange Institute; applicants must give reasons for their request and authorizations to transfer via the official market are subject to certain conditions concerning, in particular, the repatriation of income and capital through the official market. For non-residents, transfers linked to these operations may be made via the official market of free market as the investor chooses.

FRANCE

Direct investment: unrestricted

Operations in listed securities: unrestricted apart from operations in the certificates of open-end investment funds.

Operations in unlisted securities:

i) Purchase abroad by residents: unrestricted apart from the certificates of open-end investment funds;

ii) Purchase in France by non-residents: unrestricted apart from foreign securities held on French territory.

Issue and placing of securities of a foreign company on the domestic capital market: special authorization

Issue and placing of securities of a domestic company on a foreign capital market: special authorization

Investment in real estate: unrestricted

Short- and medium-term credits linked with commercial transactions or with the rendering of services in which a resident participates: unrestricted

Medium- and long-term loans and credits not linked with commercial transactions or the rendering of services:

Import: special authorization, except for operations where the amount does not exceed FF 1 000 000, the rate of interest is not higher than 4% per annum, and the life of the loan does not exceed 2 years. The total amount of loans obtained by a resident under the general authorization may not at any moment exceed FF 1 000 000.

Export: special authorization, except for banks, which on their own responsibility may use foreign currency balances held for their account with correspondents abroad for their own investment operations abroad and for all investment operations effected abroad on behalf of non-residents.

Short-term loans and credits not linked with commercial transactions or the rendering of services:

Import: special authorization, except for operations where the amount does not exceed FF 1 000 000 and the interest rate does not exceed 4% per annum. The total amount of loans obtained by a resident under the general authorization may not at any moment exceed FF 1 000 000.

Export: special authorization, except for banks, which on their own responsibility may use foreign currency balances held for their account with correspondents abroad for their own investment operations abroad and for all investment operations abroad effected on behalf of non-residents.

Banks may also, without limit as to amount and whatever the purpose of the operation, grant loans in francs to non-residents in the form of overdrafts on external franc accounts on the sole condition that their commitments do not exceed 6 months (but at the end of the 6-month period there is nothing to prevent a further credit being granted for a further 6 months).

Opening of and transfers to current accounts, deposit accounts and other short-term investments on the money market:

- i) By residents on a foreign market: special authorization, except for banks, which may hold direct balances abroad and use their own foreign currency available with their correspondents abroad;
- ii) By non-residents on the domestic market: the opening of and transfers to current and deposit accounts are unrestricted; French banks, however, are prohibited from paying interest on time deposits held on behalf of non-residents other than central banks and international organizations. Short-term investments are subject to special authorization.

ITALY

Direct investment: unrestricted

Operations in listed securities: unrestricted

Operations in unlisted securities: special authorization

Issue and placing of securities of a foreign company on the domestic capital market: special authorization

Issue and placing of securities of a domestic company on a foreign capital market: special authorization

Investment in real estate: unrestricted

Short- and medium-term credits linked with commercial transactions or with the rendering of services in which a resident participates: unrestricted

Medium- and long-term loans and credits not linked with commercial transactions or with the rendering of services:

Import: special authorization, except for operations where the amount does not exceed Lit. 50 million, the life of the loan does not exceed 5 years and the interest rate does not exceed 6% per annum.

Export: special authorization, except for operations where the amount does not exceed Lit. 50 million and the life of the loan does not exceed 5 years. (Financial institutions may not engage in such operations.)

Short-term loans and credits not linked with commercial transactions or with the rendering of services:

Import: special authorization, except for operations where the amount does not exceed Lit. 50 million and the rate of interest does not exceed 6% per annum;

Export: special authorization, except for operations where the amount does not exceed Lit. 50 million.

Opening of and transfers to current accounts, deposit accounts and other short-term investments on the money market:

- i) By residents on a foreign market: special authorization except for banks;
- ii) By non-residents on the domestic market: unrestricted

NETHERLANDS

Direct investment: unrestricted

Operations in listed securities: unrestricted (Non-residents may buy securities by selling foreign currency on both the official market and on the K-account free market; guilders obtained from the sale of these securities must be credited to K-accounts and may be transferred only via the free market. Residents may buy foreign securities only with currency held in reinvestment accounts or guilders which must be credited to the K-account of a non-resident; on the other hand, foreign currency obtained from the sale of securities is convertible on the official market. There is the possibility of switching between the two categories of account and hence, in practice, there is a single standard rate. Liberalization does not cover bonds listed abroad, denominated in guilders or linked in any other way to the parity of the guilder, which are not listed in the Netherlands.)

Operations in unlisted securities: special authorization

Issue and placing of securities of a foreign company on the domestic capital market: special authorization

Issue and placing of securities of a domestic company on a foreign capital market: special authorization.

Investment in real estate: unrestricted

Short- and medium-term credits linked with commercial transactions or with the rendering of services in which a resident participates: unrestricted

Medium- and long-term loans and credits not linked with commercial transactions or the rendering of services:

Import: special authorization except for an annual total not exceeding Fl 10 000.

Export: special authorization except for an annual total not exceeding Fl 10 000.

For banks: special authorization and on condition that the life of the loan or credit does not exceed 5 years.

Short-term loans and credits not linked with commercial transactions or with the rendering of services:

Import: special authorization except for an annual total not exceeding Fl 10 000.
For banks: unrestricted.

Export: special authorization except for an annual total not exceeding Fl 10 000.
For banks: unrestricted.

Opening of and transfers to current accounts, deposit accounts and other short-term investments on the money market:

- i) By residents on a foreign market: special authorization except for banks;
- ii) By non-residents on the domestic market: unrestricted.