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Widen the market, narrow the competition : the emergence of supranational governance in EU capital markets

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Publication date
2008

[Link to publication](#)

Citation for published version (APA):

Mügge, D. K. (2008). *Widen the market, narrow the competition : the emergence of supranational governance in EU capital markets.*

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SUMMARY

Financial markets occupy a central place in national economies around the globe. The money flows that they intermediate and the credit that they provide for business, households and the state are indispensable for economic development. Financial markets, in short, provide the life blood of economies, and governments have jealously guarded policymaking in this domain for this reason.

National control over financial markets has not only been a tool for the prevention of crisis and other undesirable excesses, however. It has also allowed governments to tailor financial market policy, and thus markets themselves, to the particular needs of the national economy in question. As countries' economies evolved in different directions and their national 'varieties of capitalism' gained an ever sharper profile, national sovereignty over financial markets proved a crucial asset. For example, Germany could strengthen and fine-tune its bank-based financial system whereas the UK and the US developed, extended and refined their capital markets that seemed to serve these economies' needs so well.

Given this centrality of financial markets to national economic policy, one should assume that governments are loath to ceding control over them. However, that is precisely what has happened in the European Union over the past 20 years. Not only have more than a dozen countries adopted a common currency and given up national monetary policy. Also financial regulation, fundamental to the reproduction of national 'brands' of financial markets, has progressively been transferred to the supranational level. Nowadays, such regulation is no longer designed in national capitals but in Brussels, even if national authorities still play an important role in the process.

Capital markets—as opposed to banking or insurance—have spearheaded this process. In the early 1990s attempts to integrate the market for investment services, as this sector is called in Brussels jargon, still met with serious resistance from national governments. Only with great

difficulty could they agree a framework for common rules, ostensibly meant to facilitate cross-border market access. In fact the Investment Services Directive (ISD), as the 1993 agreement was called, was replete with loopholes that allowed governments to remain in charge and control national financial regulation. A decade later, the situation had changed completely. By then, a successor agreement to the ISD had been negotiated, the Markets in Financial Instruments Directive (MiFID). Instead of the loose framework agreement that the ISD had constituted, the MiFID has harmonized EU capital market rules down to little details. National room for manoeuvre to twist regulation to governments' own preferences has been minimized. With the MiFID, EU capital markets are effectively regulated by one single set of binding rules.

Even more striking, policymaking itself has been supranationalised. With a new procedure known as the Lamfalussy process two new supranational committees have been created that play significant roles in EU capital market governance. The roles of the European Commission and the European Parliament have equally been strengthened. In contrast, the power of national governments in this field has decreased. National parliaments in particular no longer have much say over financial market policy.

It is this emergence of supranational governance in EU capital markets that stands at the heart of this thesis and that it seeks to explain. This thesis argues that commonplace explanations for the growing role of the EU in economic affairs—alleged 'globalization pressures', a concern of governments for their citizens' greater good or the policy entrepreneurialism of the European Commission—all fail to account this shift in governance. Rather, it demonstrates how the interests of the main actors in capital markets, mostly large banks themselves, have been central to the way these markets have evolved. As insiders in small and closed policy-making circles, the largest national banks have been able to inject their preferences into government policies. In the early 1990s negotiations, the net result was a shallow compromise that prevented easy cross-border access for capital market firms. In contrast, a decade later governments approved rules

that effectively allow banks, investment banks and stock exchanges to offer their services freely throughout the EU.

In this thesis, the dynamic underlying this shift is labelled ‘competition politics’. As is true for most firms, the regulatory preferences of banks and other firms in financial services emerge out of their concern with taming (potential) competition. As Adam Smith famously put it in his 1776 *Wealth of Nations*: ‘To widen the market and narrow the competition, is always in the interest of the dealers.’ In the early 1990s, even most large continental banks were wary of competition from the City of London and hence obstructed rules that would have given banks extensive cross-border market access. A decade later, the mood in the industry had changed drastically. By then, a new European ‘champions league’ of firms had emerged, including the likes of ABN Amro, Deutsche Bank and BNP Paribas, which were eager to break into international investment banking and hence in favour of market integration just as much as their London counterparts.

This emerging consensus in the industry itself, so the argument of this thesis, has been central to the changes that have led to the supranational governance that prevails in European capital markets today. The overall process, spanning two decades and cutting right across the domains often labelled ‘economics’ and ‘politics’ was thus driven by the two potentially contradictory firm imperatives that Smith identified: widen the market, and narrow the competition.

This central conceptual argument points to at least two further conclusions, one more abstract, the other more concrete. First, it illustrates how treating political economy processes as one integrated whole is essential to understanding them. The politics of European capital market regulation demonstrate that what happens ‘in’ markets—firms innovating and competing with each other—and what happens ‘outside’ of them—the design of and fights over the regulation that structures markets and market access—are two sides of the same coin. Because of the high stakes that firms have ‘in’ markets, they invest more than any other societal stakeholder to

influence the rules that structure them. After all, the thousands of lobbyists stationed in Brussels are there for a reason.

Second, by putting the politics back into the emergence of EU capital market governance, this thesis opens the space for a critical normative assessment of the shift that the past two decades have seen. To say the least, the global credit crisis that continues to engulf global financial markets at the time of writing and that has precipitated the first European economic contraction in almost a decade is a stern warning sign. It should temper a naïve endorsement of ever-increasing reliance on cross-border capital markets and firms' own preferences as yardsticks for policy. The ultimate consequences of a unified EU capital market policy for national varieties of capitalism and the social compromises they embody remains to be seen. It is difficult to justify, however, that national parliaments as the most developed form of citizen representation have been marginalized to such an extent as they have. The findings of this thesis clearly evidence that the time is ripe for a public debate that explores how financial market policy and democratic deliberation can once again be meaningfully united.