

The European Free Trade Association and the European Community**

The hypothesized economic gains from European Community (EC) integration have supported the apparent political and wider attractions (like greater economic efficiency and improved access to bigger markets) of completing the EC internal market. The well-known Cecchini study¹ produced quantitative estimates of the possible order of these economic gains for EC countries. These alleged gains were considerable, but they have been strongly debated and, in some cases, hotly disputed. Within the Cecchini study the estimated gains flowing from the financial sectors were seen as particularly important, and a key part of the Cecchini research exercise was the microeconomic study of the financial services sectors. The prospects for closer EC and European Free Trade Association (EFTA) cooperation have been very much on the agenda for some time.² In 1989, EFTA commissioned the Institute of European Finance (IEF) to study the possible impact of the EC internal market on EFTA financial sectors using the Cecchini methodology. This article reports on some of these findings. To begin, the report sets the scene by examining the broader aspects of EFTA and EC cooperation.

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**Parts of this article are to be published shortly as an EFTA Occasional Paper.

1. COMMISSION OF THE EUROPEAN COMMUNITIES, EUROPEAN ECONOMY: THE ECONOMICS OF 1992 (1988).

2. See, e.g., P. KRUGMAN, EFTA AND 1992 (EFTA Occasional Paper No. 23, 1988); H. WALLACE & W. WESSELS, TOWARDS A NEW PARTNERSHIP: THE EC AND EFTA IN THE WIDER WESTERN EUROPE (EFTA Occasional Paper No. 28, 1989).

I. EFTA and the EC

A. BACKGROUND

EFTA comprises an association of advanced European economies that, for a variety of political and economic reasons, decided initially not to join the European Economic Community (EEC). The EFTA countries,³ Austria, Finland, Iceland, Norway, Sweden, and Switzerland, are generally small; in total they comprise an economy that is only around half the size of West Germany's. The EC and EFTA combined represent a market of some 353 million people, producing nearly 26 percent of World Gross National Product (GNP). This compares with a U.S. market of 239 million (35.3 percent of World GNP) and a Japanese market of 121 million (11.8 percent of World GNP). The six EFTA countries (EFTA-6), on average, enjoy a greater proportionate share of this wealth than their eight EC counterparts (EC-8), but they are considerably smaller (31 million and 3.3 percent of World GNP). Table 1 compares and ranks for 1986 the EC-8 countries studied by Price Waterhouse Management Consultants (Dublin) (PW) and the EFTA-6, using Gross Domestic Product (GDP) per head of population.

The second general comparative feature concerns the structure of EFTA's real production and trade. Table 1 has already highlighted the relative size of the EFTA countries: collectively, they are very small in relation to the EC. This implies that the EC is more important to EFTA than vice versa. During 1987, the EC accounted for over 60 percent of EFTA imports and took over 55 percent of EFTA exports.⁴ Within EFTA, with one important exception, intra-EFTA trade is practically insignificant compared with that between individual EFTA countries and the EC. There is very little trade between the Alpine EFTA (Austria and Switzerland) and Nordic EFTA (Finland, Iceland, Norway, and Sweden). Although intra-Nordic trade is more important than intra-Alpine trade—around six times more trade with the EC compared with ten times, respectively—intra-Nordic trade is still much less important than the corresponding trade with the EC.⁵

Norman suggests that these characteristics imply that the effects of interaction between EFTA countries can be ignored when examining the effects of 1992 on real trade and production.⁶ This conclusion allows attention to be focused on the bilateral interaction between individual EFTA countries and the EC. The one exception to this pattern is Sweden. Intra-Nordic trade is dominated by flows between Sweden and

3. The founding members of EFTA were Austria, Denmark, Norway, Portugal, Sweden, Switzerland, and the United Kingdom. In the spring of 1961 Finland became an associate member. The future EFTA governments came together in 1959, and in January 1960 they signed the so-called Stockholm Convention.

4. See A. SKALNIK, *HOW WILL 1992 AFFECT THE REST OF THE WORLD? THE REACTIONS OF SOME MAJOR COUNTRIES AND TRADE BLOCKS TOWARDS EC INTEGRATION* 13 (Bank of Finland Discussion Paper 24/88, 1988).

5. See Norman, *EFTA and the Internal European Market*, *ECON. POL'Y*, at 424, 427-28 (Oct. 1989).

6. *Id.* at 428.

TABLE 1
EC AND EFTA COUNTRIES RANKED BY GDP PER
HEAD OF POPULATION 1986

	Population (millions)	GDP (ECU billions)	GDP/Population (ECU)	Rank
<i>EC-8</i>				
Belgium (B)	9.91	117.5	11856.7	11
West Germany (D)	61.05	913.7	14966.4	6
Spain (E)	38.70	211.85	5474.2	14
France (F)	55.39	741.51	13387.0	8
Italy (I)	57.22	617.08	10784.3	12
Luxemburg (L)	0.37	5.76	15567.6	4
Netherlands (NL)	14.56	178.98	12292.6	10
United Kingdom (UK)	56.76	562.41	9908.4	13
<i>EFTA-6</i>				
Austria (A)	7.56	96.3	12738.0	9
Finland (Fin)	4.92	72.1	14654.5	7
Iceland (Ice)	0.24	3.7	15416.7	5
Norway (N)	4.17	69.44	16652.2	2
Sweden (Swe)	8.37	134.1	16021.5	3
Switzerland (Swi)	6.50	139.2	21415.4	1
Subtotals:				
EFTA-6	31.76	514.84		
EC-8	293.96	3348.79		
Total	325.72	3863.63		

Source: INTERNATIONAL MONETARY FUND, INTERNATIONAL FINANCIAL STATISTICS (1987).

Finland and, especially, between Sweden and Norway. The implication from this analysis is that the effects of interaction cannot be ignored when analyzing the possible effects of 1992 on the real sectors of Sweden or Norway.

The EFTA countries have generally faced different economic conditions and developments throughout the 1970s and 1980s, and these have helped to condition regulatory and associated trends in the corresponding financial sectors. Select macrosectoral data provide a broad indicator of some of these different conditions. Table 2, for example, summarizes comparative data on the annual growth of EFTA GDPs, current account balances, and year-by-year inflation. Although Iceland appears an obvious outlier for much of the data comparisons—like annual growth of GDP and inflation—there are other outliers year-by-year.

Table 3 shows the variability of broad monetary growth in five EFTA countries for the two periods studied by Bingham.⁷ Once again, there is some heterogeneity in these data, both on a cross-sectional and time-series basis. For the period 1976 to 1982, for example, Sweden appears an outlier. Both Sweden and Switzerland show marked differences (and in the opposite directions) in the variability of their respective broad money growths between the two periods summarized in Table 3.

7. T. BINGHAM, BANKING AND MONETARY POLICY (1985).

TABLE 2
MACROECONOMIC INDICATORS FOR THE EFTA COUNTRIES

	1980	1981	1982	1983	1984	1985	1986	1987	1988
<i>Annual Growth of GDP</i> (in percent)									
Austria	3.0	-0.1	1.1	2.2	1.3	2.6	1.4	1.6	4.2
Finland	5.4	1.6	3.6	3.0	3.3	3.5	2.3	3.7	4.8
Germany (Fed. Rep. of)	1.5	0.0	-1.0	1.9	3.3	1.9	2.3	1.8	3.4
Iceland	5.7	4.3	2.3	-4.1	3.5	3.4	6.3	8.4	-1.5
Norway	4.2	0.9	0.3	4.6	5.7	5.3	4.2	3.6	1.5
Sweden	1.7	-0.3	0.8	2.4	4.0	2.1	1.1	2.3	1.9
Switzerland	4.6	1.5	-1.1	0.7	1.8	4.1	2.8	2.6	2.8
EC	1.2	0.1	0.8	1.7	2.5	2.4	2.6	2.8	3.5
<i>Current Account</i> (in percent)									
Austria	-2.2	-2.0	1.1	0.3	-0.3	-0.2	0.3	-0.2	-0.4
Finland	-2.7	-0.8	-1.6	-1.9	0.0	-1.3	-1.1	-2.3	-2.9
Germany (Fed. Rep. of)	-1.7	-0.5	0.8	0.8	1.6	2.6	4.4	4.0	4.0
Iceland	-2.1	-4.1	-8.3	-2.0	-4.7	-4.1	0.5	-3.2	-3.7
Norway	1.9	3.8	1.1	3.6	5.3	5.3	-6.4	-4.9	-4.1
Sweden	-3.5	-2.6	-3.7	-1.0	0.4	-1.2	0.6	-0.6	-1.4
Switzerland	-0.5	3.0	4.2	4.0	4.8	5.6	5.0	4.2	3.3
EC	-1.3	-0.7	-0.6	0.2	0.5	0.7	1.5	0.9	0.4
<i>Inflation*</i> (annual percentage change)									
Austria	6.4	6.8	5.4	3.3	5.6	3.2	1.7	0.9	1.5
Finland	11.6	12.0	9.6	8.3	7.1	5.9	2.9	4.1	4.4
Germany (Fed. Rep. of)	5.5	6.3	5.3	3.3	2.4	2.2	-0.2	0.6	1.3
Iceland	57.5	51.6	49.1	86.5	30.9	31.9	22.2	16.8	25.4
Norway	10.9	13.7	11.3	8.4	6.2	5.7	7.2	7.6	5.9
Sweden	13.7	12.1	8.6	8.9	8.0	7.4	4.3	5.5	6.0
Switzerland	4.0	6.5	5.6	3.0	3.0	3.4	0.7	1.5	2.0
EC	12.8	11.7	10.4	8.0	6.8	5.8	3.3	3.1	3.4

Source: EFTA, CONSEQUENCES AND PROBLEMS OF LIBERALIZING CAPITAL MOVEMENTS IN THE EFTA COUNTRIES (EFTA Economic Committee, Working Group on Liberalization of Capital Movements, Final Report, EFTA/EC7/89), annex V (July 4, 1989).

Note: *1980-1986 based on consumer prices, 1987-1988 based on the private consumption deflator.

TABLE 3
VARIABILITY OF BROAD MONEY GROWTH IN OECD COUNTRIES¹

Country	Period	
	1965-1975	1976-1982
<i>Countries Using Broad Monetary Aggregates</i>		
Australia	6.16	2.75
France	4.40	2.13
Germany	2.40	2.91
Japan	4.00	2.60
Spain	4.25	1.65
United Kingdom	6.00	4.10
United States	2.61	2.36
<i>Countries Not Using Broad Monetary Aggregates</i>		
Austria	2.61	3.36
Belgium	3.57	3.06
Canada	4.59	4.48
Denmark	5.63	1.99
Finland	3.76	3.21
Greece	4.18	4.51
Ireland	5.29	5.19
Italy	4.09	5.46
New Zealand	12.72	5.10
Norway	2.22	2.41
Portugal	5.73	7.22
Sweden	2.96	4.64
Switzerland	4.37	2.13
Turkey	5.31	22.59

Source: T. BINGHAM, *supra* note 7, Table 3.2, at 57.

Note: 1. Standard deviation of annual growth of broad money.

Generally speaking, though, there has been a shift in emphasis in most OECD (and EFTA) countries away from selectivity in monetary policy. One of the main reasons for this shift is the changes that have taken place in banking and financial systems. Selective policy, on the grounds that the market is not capable of satisfying legitimate demands on reasonable terms, becomes less sustainable as market imperfections are reduced. At the same time, these developments facilitate the creation of offsetting flows or channels of intermediation that lessen the impact of particular kinds of regulations. This kind of regulation-avoidance (the so-called "regulatory dialectic model") behavior has been an important explanation, for example, of much active financial innovation.

Despite the different economic conditions that have faced many EFTA countries, there are other noteworthy similarities in institutional characteristics and social preferences. The movement towards a greater market orientation in the financial sector is one such common feature. The increasing liberalization of financial markets, growth of capital markets, and increased competition are

common to many EFTA countries. These trends have been particularly noteworthy in wholesale financial sectors and sectors exposed to strong international competition. Other common institutional and social preferences exist. Since the early 1980s, for example, private savings ratios of the Nordic countries have fallen sharply. Although financial markets are, to varying degrees, different among the Nordic countries, reforms in these markets have been closely related.⁸ Several factors have contributed to recent household savings behavior patterns in the Nordic countries, including financial market liberalization, high marginal income rates, and appreciation in equities and house values.

B. FINANCIAL SERVICES SECTORS, CECCHINI AND EFTA OPTIONS

The financial services sectors were confirmed as particularly important within Cecchini's computation of the overall gains from completing the internal market. Up to one-third of the growth expected from the Single European Market during the first six years will flow, directly and indirectly, from the expansion of financial services. The financial services sectors are of increasing importance within the EC economy, producing around 6.5 percent of total value-added and employing about 3 percent of the total workforce (see Table 4). Integration of the financial services sectors of the eight countries⁹ studied by Cecchini, the EC-8, was estimated to produce economic gains of the order of ECU 22 billion. The PW/Cecchini study focused on the eight EC countries shown in Table 4. All of the following aggregated EC data reported in this paper relate to the EC-8, unless otherwise stated or obvious.

These data in Table 4 illustrate why Cecchini and the EC directed particular attention towards the financial services sectors. The efficiency of the sectors also impacts on the efficiency of the other nonfinancial sectors that use the financial system. Macroeconomic policy is influenced as well by the development of the financial system. For all these reasons the EC financial services sectors are especially important in the context of Europe, 1992, and the European Economic Space (EES); the latter comprises the EC and EFTA countries combined.

The Cecchini study has been subject to criticisms.¹⁰ There has been particular concern and debate about the advantages and disadvantages of the single market for financial institutions. For the moment, however, such criticisms and doubts will be set aside, although they are discussed later. At the very least the Cecchini exercise was a useful quantitative exercise, despite its flaws, in comparative competitive conditions within EC financial services sectors. It also explored the

8. See Lehmuusaari, *Financial Deregulation and Saving Behavior in the Nordic Countries*, 2 KANSALLIS ECON. REV. 11, 12 (1989).

9. These comprise Belgium, West Germany, Spain, France, Italy, Luxembourg, the Netherlands, and the United Kingdom.

10. See e.g., CENTER FOR BUSINESS STRATEGY, 1992: MYTHS AND REALITIES (1989); X. VIVES, BANKING COMPETITION AND EUROPEAN INTEGRATION (Center for Economic Policy Research Discussion Paper No. 373, 1990).

TABLE 4
ECONOMIC ASPECTS OF THE EUROPEAN
FINANCIAL SERVICES SECTOR, 1985¹

	Gross value-added as a % of GDP ²	Employment as a % of total employment ³	Compensation of employees as a % of total for the economy
Belgium	5.7	3.8	6.3
Germany	5.4	3.0	4.4
France	4.3	2.8	3.8
Italy	4.9	1.8	5.6
Luxembourg ⁴	14.9	5.7	12.2
Netherlands	5.2	3.7	4.9
Spain	6.4	2.8	6.7
United Kingdom	11.8	3.7	8.5
EC-8 ⁵	6.4	2.9	6.2

Source: COMMISSION OF THE EUROPEAN COMMUNITIES, *supra* note 1, Table 5.1.1, at 87.

Notes: 1. Defined in the narrow sense as credit and insurance institutions.

2. Including net interest payments.

3. Employees in employment plus the self-employed.

4. 1982.

5. This aggregate accounted for 95 percent of total Community GDP in 1985.

mechanisms and directions of some important economic effects that seem likely (and on which there is a wide consensus) to result from the 1992 program.

The importance of the Cecchini exercise to EFTA is reflected at one level in the apparent growing signs that the EC is committed to ever closer cooperation with EFTA. The historic joint declaration of the concept of EES in 1984¹¹ indicated the EC commitment to stronger relations with EFTA. A joint meeting of EFTA ministers with the EC Vice-President, Henning Christopherson, in June 1989 restated the commitment of both blocs to EES.¹² During the same period the Austrian socialist party (the senior partner in the coalition government) published a position paper on its intention to press for EC membership in the summer of 1989.¹³ Most recently, on June 20, 1990, negotiations between the EC and EFTA started, and these were based on a mandate adopted by the EC Council a few days earlier. Officials hoped to reach broad and comprehensive agreements on the EES by the end of 1990.

Another feature of this recent period has been the apparent strengthening of EFTA itself as it has sought to attain a common negotiating position.¹⁴ EFTA has

11. Following the Luxembourg meeting, the Commission submitted an action program to the Council implementing the declaration and enunciating three main principles: community integration comes first, the autonomy of community decision making must be preserved, and there must be a balance between benefits and obligations.

12. See EFTA BULL. No. 3, at 18-20 (1989).

13. See *Fin. Times*, Apr. 5, 1989, at 2.

14. See *Fin. Times*, June 15, 1989, at 2.

certainly received much attention from the European media over recent months; the issue of EC and EFTA cooperation itself seems to have acted as a spur to greater cooperation between the EFTA countries. However, differences among EFTA members still persist. These internal EFTA differences, coupled with requests for exceptions from EC rules, could make for strenuous debate between the two groups on economic cooperation and related agreements. EC Commission President, Jaques Delors, urged in January 1989 that EFTA's structure should be reinforced to make negotiations between the two blocs easier. EFTA has already taken several positive steps in this regard.

These kinds of development support a belief that at least three possible economic alternatives appear open to EFTA members at the present time: accession to the EC, closer cooperation with the EC, or an integrated EFTA that remains outside the EC. These alternatives are not, of course, mutually exclusive, but for present purposes they substantiate EFTA's interest in the Cecchini study on EC financial services sectors. In each or any collection of these alternatives, the singular importance of the financial services sectors has already been substantiated by the Cecchini study.

C. SELECT FINANCIAL SECTOR COMPARISONS

Table 5 (which may be compared with Table 4) shows gross value-added as a percentage of GDP for the EFTA countries. Finland, Norway, and Sweden are all below the bottom of the range figure (4.3 percent) for the EC-8 countries covered by Cecchini. Excluding outliers (Luxembourg, 14.9 percent; United Kingdom, 11.8 percent; and Switzerland, 10.4 percent), Austria and Iceland both have comparatively large financial sectors using the Table 5 GDP indicator.

TABLE 5
SHARE OF THE FINANCIAL SERVICES SECTOR IN GDP, 1985

Gross value-added as a % of GDP	
Austria	6.2
Finland	3.4
Iceland	6.1
Norway	3.2
Sweden	3.8
Switzerland	10.4

Sources: INTERNATIONAL FINANCIAL STATISTICS; E. Gardener & J. Teppett, *The Economic Impact of 1992 on the Norwegian Financial Services Sector: A Select Replication Exercise Using the Price Waterhouse (PW)/Cecchini Methodology* (Draft Confidential Report, Ministry of Finance, Oslo) [hereinafter Gardener & Teppett, Norway]; E. GARDENER & J. TEPPETT, *THE IMPACT OF 1992 ON THE FINANCIAL SERVICES SECTORS OF EFTA COUNTRIES: A SELECT REPLICATION EXERCISE* (EFTA Occasional Paper No. 33, 1990) [hereinafter GARDENER & TEPPETT, EFTA]; *EFTA Statistical Survey*,¹ in GARDENER & TEPPETT, EFTA.

Note: 1. This refers to a statistical survey carried out by Gardener and Teppett, with the help of EFTA, under the project commissioned by EFTA from the Institute of European Finance (IEF), referred to in the introduction to this article.

Table 6 shows the economic dimensions of the main financial services branches for EFTA and the EC-8 countries as a percentage of GDP. A comparison of the EFTA range of insurance premiums (4.0 percent to 13.8 percent) with that of the EC (2.2 percent to 8.1 percent) emphasizes the comparative importance of insurance (in terms of GDP) to EFTA. In terms of bank loans, Finland, Iceland, and Sweden are all below the bottom end of the corresponding EC range (93 percent for France); apart from Luxembourg (an outlier at 6916 percent), Austria, Norway, and Switzerland are comparable with the other EC countries. In terms of stock market capitalization, however, only Switzerland is comparable with (and generally exceeds) the EC-8 range. The range (excluding Luxembourg at 11125 percent) for the EC countries is 75 percent to 165 percent.

Table 7 summarizes EC and EFTA data on employment in banking and insurance for 1985. Four out of six EFTA countries (Austria, Iceland, Finland, and Norway) are roughly congruent with the EC simple average of 3.5 percent (percent of all employment). Both Sweden (1.9 percent) and Switzerland (4.9

TABLE 6
ECONOMIC DIMENSIONS OF THE MAIN FINANCIAL SERVICES BRANCHES:
INSURANCE PREMIUMS, BANK LOANS OUTSTANDING, AND STOCK
MARKET CAPITALIZATION, AS % OF GDP

	Insurance Premiums ¹	Bank Loans ²	Stock Market Capitalization ³
<i>EC-8</i>			
Belgium	3.9	142 ⁴	92
France	4.3	93 ⁴	85
Germany	6.6	139	89
Italy	2.2	96	75
Luxembourg	3.1	6916	11125
Netherlands	6.1	130	165
Spain	2.5	99	69
United Kingdom	8.1	208	149
<i>EFTA-6</i>			
Austria	4.1	107	57
Finland	5.8	58	42
Iceland	3.6	30	N/A ⁵
Norway	4.0	126	46
Sweden	4.3	43	56 ⁶
Switzerland	13.8	135	487
EC-8 ⁷	5.2	142	116

Sources: COMMISSION OF THE EUROPEAN COMMUNITIES, *supra* note 1, Table 5.1.2, at 87; Gardener & Teppett, Norway, *supra* Table 5; GARDENER & TEPPETT, EFTA, *supra* Table 5.

Notes: 1. Average.

2. 1984.

3. End 1985.

4. 1982.

5. Described as "undeveloped" by our expert contacts.

6. Represents capitalization of equity shares only—bond data unavailable.

7. Weighted average.

TABLE 7
EMPLOYMENT IN BANKING AND INSURANCE BY COUNTRY, 1985

Country	(1) Banking	(2) Insurance	(3) (1) + (2)	(4) % of (3)	(5) % of all Employment
Austria	68	30	98	2.7	3.5
Belgium	89	30	119	3.3	3.9
Finland	56	14	70	1.9	3.5
France	448	154	602	16.5	3.4
Germany	604	230	834	22.9	3.7
Iceland	3.7	0.6	4.3	0.1	3.5
Italy			379	10.4	2.5
Luxembourg	9.9	0.9	11	0.3	7.7
Netherlands	111	42	153	4.2	3.5
Norway	47	15	62	1.7	3.5
Spain			292	8.0	3.9
Sweden	61	22	82	2.3	1.9
Switzerland	110	51	161	4.4	4.9
United Kingdom	527	245	772	22.1	3.6
Total			3639	100.0	

Sources: Price Waterhouse, *infra* note 15; Gardener & Teppett, Norway, *supra* Table 5; GARDENER & TEPPETT, EFTA, *supra* Table 5; EFTA Statistical Survey, *supra* Table 5.

Note: Figures in columns 1, 2, and 3 are expressed in thousands.

percent) appear significantly different from these data. The high figure for Switzerland reflects its importance as an international financial center, while the comparatively low figure for Sweden is probably the result of many factors, although quantitative restrictions on various aspects of financial sector development are particularly significant.

These select comparisons indicate the marked heterogeneity within both EFTA and EC financial sectors. Within EFTA the comparative importance of the financial sectors (in terms of value added as a percent of GDP) of Austria and Switzerland, the so-called Alpine-EFTA, is emphasized in Table 5; 1983 and 1985 value-added data were employed *inter alia* in the Cecchini computation of the economic gains from completing the internal market. Nevertheless, all of these comparative data should be treated with caution. In producing these data, the IEF followed closely the approach used by Cecchini, and this part of Cecchini's work is concerned with their microeconomic study of the EC financial sectors. In this exercise Cecchini employed Price Waterhouse Management Consultants (Dublin) to undertake this assignment.¹⁵

II. EFTA Financial Sectors and the Gains from Integration

A. THE IEF AND CECCHINI EXERCISE

The primary aim of the IEF study is to assess the economic impact of 1992 on the financial services sectors in the EFTA-6 under the assumption that prices

15. See Price Waterhouse, *The "Cost of Non-Europe" in Financial Services*, in 1 RESEARCH ON THE "COST OF NON-EUROPE," BASIC FINDINGS 259 (1988).

move towards a common level, the so-called law of one price prevails, or at least the mechanism (direction of change) implied by this economic law obtains. The latter "law" implies that after the internal market is completed, the price of each financial service will settle to a common (assumed to be lower by Cecchini) price, with the result that a mortgage, for example, will cost the same in all the countries covered by the internal market globalization (or integration) process. Economic impact in this context will reflect the economic gains from EC integration, and for this purpose the EFTA-6 are treated as if they were EC members and a part of the 1992 "globalization" process. Furthermore, the study uses the same methodology, data, and timeframe employed in the PW/Cecchini exercise. In short, the IEF research attempts to replicate the results for EFTA that PW might have generated in its EC exercise had PW assumed at that time that EFTA countries were EC members. The IEF brief from EFTA was to replicate as faithfully as possible the microeconomic methodology (the price difference exercise) used by PW in their input to the Cecchini study.

The core part of the PW study focussed on comparative price differences (obtained largely by field survey) of sixteen financial products or services, spread over the three basic financial sectors (or subsectors): banking, insurance, and securities (or brokerage). PW alleged that this dataset was broadly representative of the three financial sectors, and Table 8 summarizes the standard financial services or products PW surveyed. The hypothesized price falls on these are the basis of the computation of economic gains, the consumer surplus (CS) results. The latter is the economist's concept of consumer gains resulting from the simultaneous occurrence of lowered prices and increased output of each financial service that resulted from completing the internal market (freeing-up competition across the EC).

The empirical basis of the PW exercise is the survey of prices for the sixteen-product dataset of Table 8. The price survey data relate to 1987 (the PW/Cecchini survey was undertaken in July 1987), and it was necessary (for the IEF research brief) to collect similar (in terms of products and timeframe) data for the EFTA financial sectors. Under the law of one price assumption used by PW, the price of each financial product is assumed to have settled to a low reference level price (LRLP), which is computed as the average of the four lowest prices surveyed for each respective financial product.

The results of the PW price difference (PD) exercise using these assumptions are shown in Table 9.¹⁶ These data at least provide a "snapshot view" of comparative competitive conditions. A positive PD in Table 9 corresponds to an assumed price fall under the law of one price assumption. In the case of consumer credit, for example, Belgium is hypothesized to experience a price rise (negative PD) of 41 percent and Germany the highest price fall (a positive PD) of 136 percent.

¹⁶ The Price Differences (PDs) in part 1 of Table 9 are expressed as a percentage of the corresponding low reference level prices (LRLPs).

TABLE 8
LIST OF STANDARD FINANCIAL SERVICES OR PRODUCTS SURVEYED

Name of Standard Service	Description of Standard Service
Banking Services	
1. Consumer credit	Annual cost of consumer loan of 500 ECU. Excess interest rate over money market rates.
2. Credit cards	Annual cost assuming 500 ECU debit. Excess interest rate over money market rates.
3. Mortgages	Annual cost of home loan of 25,000 ECU. Excess interest rate over money market rates.
4. Letters of Credit	Cost of letter of credit of 50,000 ECU for three months.
5. Foreign exchange drafts	Cost to a large commercial client of purchasing a commercial draft for 30,000 ECU.
6. Travellers checks	Cost for a private consumer of purchasing 500 ECU worth of travellers checks.
7. Commercial loans	Annual cost (including commissions and charges) to a medium-sized firm of a commercial loan of 250,000 ECU.
Insurance Services	
1. Life insurance	Average annual cost of term (life) insurance.
2. Home insurance	Annual cost of fire and theft coverage for house valued at 70,000 ECU with 28,000 ECU contents.
3. Motor insurance	Annual cost of comprehensive insurance, 1.6 litre car, driver 10 years experience, no claims bonus.
4. Commercial fire and theft	Annual coverage for premises valued at 387,240 ECU and stock valued at 232,344 ECU.
5. Public liability coverage	Annual premium for engineering company with 20 employees and annual turnover of 1.29 million ECU.
Brokerage Services	
1. Private equity transactions	Commission costs of cash bargain of 1,440 ECU.
2. Private gilt transactions	Commission costs of cash bargain of 14,000 ECU.
3. Institutional equity transactions	Commission costs of cash bargain of 288,000 ECU.
4. Institutional gilt transactions	Commission costs of cash bargain of 7.2 million ECU.

Source: COMMISSION OF THE EUROPEAN COMMUNITIES, *supra* note 1, Table 5.1.4, at 91.

TABLE 9
ESTIMATE OF POTENTIAL FALLS IN FINANCIAL PRODUCT PRICES AS A
RESULT OF COMPLETING THE INTERNAL MARKET

	B	D	E	F	I	L	NL	UK
1. Percentage differences in prices of financial products compared with the average of the four lowest observations								
<i>Banking</i>								
Consumer Credit	-41	136	39	105	¹	-26	31	121
Credit cards	79	60	26	-30	89	-12	43	16
Mortgages	31	57	118	78	-4	¹	-6	-20
Letters of credit	22	-10	59	-7	9	27	17	8
Foreign exchange	6	31	196	56	23	33	-46	16
Travellers checks	35	-7	30	39	22	-7	33	-7
Commercial loans	-5	6	19	-7	9	6	43	46
<i>Insurance</i>								
Life	78	5	37	33	83	66	-9	-30
Home	-16	3	-4	39	81	57	17	90
Motor	30	15	100	9	148	77	-7	-17
Commercial fire, theft	-9	43	24	153	245	-15	-1	27
Public liability	13	47	60	117	77	9	-16	-7
<i>Securities</i>								
Private equity	36	7	65	-13	-3	7	114	123
Private gilts	14	90	217	21	-63	27	161	36
Institutional equity	26	69	153	-5	47	68	26	-47
Institutional gilts	284	-4	60	57	92	-36	21	¹
2. Theoretical, potential price reductions								
Banking	15	33	34	25	18	16	10	18
Insurance	31	10	32	24	51	37	1	4
Securities	32	11	44	23	33	9	18	12
Total	23	25	34	24	29	17	9	13
3. Indicative price reductions								
<i>All financial services</i>								
Range	6-16	5-15	16-26	7-17	9-19	3-13	0-9	2-12
Center of Range	11	10	21	12	14	8	4	7

Source: COMMISSION ON THE EUROPEAN COMMUNITIES, *supra* note 1, Table 5.1.4, at 91.

Note: 1. Observations for consumer credit in Italy and mortgages in Luxembourg and institutional gilts in the United Kingdom were manufactured. Price Waterhouse Management Consultants (Dublin), Cost of "Non-Europe" in Financial Services: Final Report (Confidential Report, Price Waterhouse Management Consultants, Dublin).

Our preliminary findings in this paper report EFTA PDs compared with the EC-8 PDs using PW's LRLP. We also model the following two cases:

1. PDs using a LRLP derived from the PW and EFTA datasets combined; and
2. PDs for EFTA countries alone using EFTA survey-derived LRLPs.

These three PD scenarios correspond respectively to the three possible scenarios for EFTA financial sectors discussed earlier:

Scenario A: EFTA countries are outside the EC, and EFTA financial sectors are fragmented (nonglobalized) within EFTA, but each EFTA financial sector becomes globalized (for example, with a strong cooperation agreement) bilaterally with the EC from 1992.

Scenario B: EFTA countries' financial sectors are globalized and become fully integrated within the EC.

Scenario C: EFTA remains outside the EC, EFTA and EC financial sectors are fragmented bilaterally, but EFTA financial sectors become integrated (or globalized) within EFTA.

This paper focuses on Scenario A above. An "economic justification" for simulating A is that each EFTA country financial sector, viewed alone, is unlikely to affect the LRLP used by PW because of the comparative size of the EC financial sector. A more pragmatic justification is contained within our research brief; it is the scenario that is initially the "most comparative" with the PW exercise. It is "most comparative" because it does not entail altering any of the PW dataset, and it is not always clear exactly how PW derived some of their data and results.

Part 2 of Table 9 shows the weighted averages of the theoretical potential price fall¹⁷ for each subsector, and part 3 summarizes the so-called indicative price falls. The latter represent a "scaling down" of the theoretical potential price reductions depicted in part 2 of Table 9. This exercise, based on PW's comparative studies and case study work, is supposed to represent the extent to which the theoretical, hypothesized, competitive, and integrated conditions will not be achieved.

The price falls computed by PW in part 3 of Table 9 are used to model the impact on value-added (a proxy for output) and the gain in consumer surplus (CS) that are hypothesized to result from the law of one price assumption. Table 10 summarizes the PW results. In using published data, PW generally used the latest available data at the time: this was usually 1986, although 1985 and 1983 value-added data were employed. Our basic research aims are to extend Tables 9 and 10 to include the EFTA-6.

¹⁷ It may be noted that parts 2 and 3 (unlike part 1) of Table 9 summarize hypothesized price falls.

TABLE 10
ESTIMATED GAINS RESULTING FROM THE INDICATIVE
PRICE REDUCTIONS FOR FINANCIAL SECTORS

	Average indicative price reduction %	Direct impact on value-added for financial services		Gain in consumer surplus as a result of average indicative price reduction ¹	
		Mn ECU	% of GDP	Mn ECU	% of GDP
Belgium	11	656	0.6	685	0.7
France	12	3513	0.5	3683	0.5
Italy	14	3780	0.7	3996	0.7
Luxemburg	8	43	1.2	44	1.2
Netherlands	4	341	0.2	347	0.2
Spain	21	2925	1.4	3189	1.5
United Kingdom	7	4917	0.8	5051	0.8
W. Germany	10	4442	0.5	4619	0.6
EUR - 8	10	20617	0.7	21614	0.7

Source: COMMISSION OF THE EUROPEAN COMMUNITIES, *supra* note 1, Table 5.1.5, at 92.

Note: 1. Based on the assumption that the elasticity of demand for financial services is 0.75.

B. EFTA GAINS FROM INTEGRATION

Table 11 summarizes the price survey results for EFTA and the EC-8 under Scenario A; it will be recalled that these PDs are computed using PW's original LRLP for each financial product. A positive result indicates the percentage amount of price reduction hypothesized under the law of one price assumption. Several of the EFTA results in Table 11 appear extreme compared with their EC-8 counterparts. Within the banking products, for example, credit cards and mortgages are obvious cases. The credit card results for Finland, Iceland, and Norway seem especially extreme; the mortgage results for Austria, Finland, Iceland, and Norway also group as outliers in the European Financial Sector Space (EFSS), and Iceland produced more extreme results consistently for several financial products.

Of course, the comparability of financial products in different countries is often open to serious question. Several survey respondents expressed particular doubts about the comparability of insurance products. These concerns related to differences in locational factors (like salaries and weather conditions) and to the packaged nature of many products. Some financial products in Table 11 also had to be "engineered" in order to increase comparability. Although these points highlight some of the main product comparability practical difficulties encountered in the survey, they are also a more general warning of the practical difficulties that arise in comparing financial product characteristics and prices in different countries. Many of the products surveyed, for example, are almost certainly characterized by different implicit and explicit cross-subsidization features. These data, therefore, are best regarded as broadly indicative rather than specific and exact.

TABLE 11
ESTIMATE OF POTENTIAL PRICE FALLS IN FINANCIAL PRODUCT
PRICES AS A RESULT OF COMPLETING THE EC INTERNAL MARKET: BILATERAL INTEGRATION

	A	B	D	E	F	Fin ¹	I	Ice	L	N	NI	Swe	Swi	UK
Banking														
Consumer credit ²	91	-41	136	38	105	-97	121	-174	-28	276	31	11	103	121
Credit cards	35	79	60	26	-30	127	89	208	-12	3	43	181	28	16
Mortgages ³	260	31	57	119	78	-328	-4	-476	37	-92	-6	80	49	-21
Letters of credit	33	22	-10	59	-8	-20	9	12	27	59	17	59	59	8
Foreign exchange (commercial draft)	363	6	31	196	56	22	23	198	33	75	-46	-90	48	16
Travellers checks	-25	35	-7	30	39	29	22	-66	-7	17	33	26	-81	-7
Commercial loans	255	-5	6	19	-7	67	9	37	6	26	43	79	233	46
Insurance ⁴														
Term insurance	50	78	5	37	33	85	79	59	67	34	-9	73	95	-30
House insurance	-35	-16	3	-4	39	7	80	-52	57	30	17	-7	291	90
Motor insurance	12	30	15	100	9	-7	148	167	77	67	-7	-36	-40	-17
Commercial fire and theft	45	-9	43	24	153	30	245	21	-15	38	-1	-7	48	27
Public liability	77	13	47	60	117	104	77	70	9	102	-16	-75	108	-7
Securities ⁵														
Institutional gilts	413	284	-4	60	57	541	92	541	-36	49	-17	287	28	-47
Private gilts	89	14	89	216	21	153	-63	153	26	140	161	14	51	36
Institutional equity	49	26	68	153	-5	111	47	5	68	44	26	-28	14	-47
Private equity	76	36	7	66	-12	37	-2	40	7	23	115	-32	17	124

Sources: Price Waterhouse, *supra* note 15; GARDNER & TEPPELT, *EFTA, supra* Table 5; *EFTA, Statistical Survey supra* Table 5.

- Notes: 1. Finland credit card, foreign exchange, and travellers checks prices referred to current prices.
- 2. The cost of consumer credit in Italy is assumed to be equal to the average for Germany, France, and the United Kingdom.
- 3. Mortgages in Luxembourg are assumed to be priced at the average of the other EC countries. The Norwegian rate is a proxy (see text) rate.
- 4. The prices of Austrian term, fire and theft, and public liabilities insurance were assumed equal to the average of German and Swiss prices.
- 5. Indicative commission charges for stock exchange transactions were obtained from FIBV publications, with the exception of Iceland.

The PDs in Table 11 are converted (using a weighing system) into average indicative price reductions. The PW/Cecchini results for the EC-8 were summarized earlier in Table 9 (parts 2 and 3). Table 12 summarizes our results for EFTA, and these may be compared directly with the Table 10 results. It is clear that the estimated CS gains (as a percentage of GDP) are highly significant for all the EFTA countries. The estimated gains for Austria (1.8 percent) and Switzerland (2.4 percent) are considerably higher than for the top two EC-8 countries, Spain (1.5 percent) and Luxembourg (1.2 percent). The EFTA range of these results is also considerably wider (at 1.9 percent) compared with the EC-8 (1.3 percent); the respective EFTA mean gain is 1.1 percent compared with an EC-8 mean of 0.7 percent. It is interesting to note again that, within EFTA, the Alpine-EFTA countries are at the very top of this range.

TABLE 12
ESTIMATED GAINS RESULTING FROM THE INDICATIVE PRICE
REDUCTIONS FOR FINANCIAL SECTORS

Country	Average indicative price reductions %	Direct impact on value-added for financial sector		Gain in CS as a result of average indicative price reductions	
		MN ECU	% of GDP 1986	MN	% of GDP 1986
Bilateral Integration					
Austria	29	1580	1.6	1789	1.8
Finland	15	359	0.5	381	0.5
Iceland	13	22	0.6	23	0.6
Norway	18	442	0.6	476	0.7
Sweden	20	976	0.7	1059	0.8
Switzerland	24	3038	2.2	3356	2.4

Sources: COMMISSION OF THE EUROPEAN COMMUNITIES, *supra* note 1; EFTA Statistical Survey, *supra* Table 5.

C. A CRITICAL EVALUATION

The microeconomic gains from completing the internal market are hypothesized to result from the elimination of barriers to trade and the increased stimulus to competition. They include cost reductions, increased efficiency in financial sectors, a higher rate of financial innovation, and generally, increased competition. These, in their turn, are predicted to have resultant, positive influences on important EC macroeconomic variables. All in all an extremely positive, practically irresistible picture of advantage for 1992 is painted. Our concern here is with that part of the picture that relates to the microeconomic methodology employed in the financial sector. Use of that methodology raises broader questions about the appropriateness of the microeconomic methodology in general

and more specific questions about any special features of the financial sector that warrant special treatment compared with other sectors.

A recent study by the Center for Business Strategy¹⁸ argued that trade liberalization of the kind envisaged for 1992 has its primary effects on supply and not demand. This study cautions that the scale economy argument is far from unambiguous. The study observes: "It is puzzling that economies of scale are so widely touted as a source of competitive advantage when there is so little evidence of their significance."¹⁹ And it suggests: "Successful operators in an integrated financial market will be those who correctly exploit the scale and scope economies that do exist without sacrificing the specialization that can also be very important."²⁰ Although specialization is undoubtedly important in various aspects of financial sector business, one must be careful in dismissing the economies of scale (EOS) thesis.

In fact the theoretical and empirical literature in banking is not altogether clear on the EOS issue. Recent work in this field has suggested that scale economies exist in banking, but these are apparently limited to smaller institutions, and that the average cost curve for the production of the main products of banking (loans and deposits) is U-shaped.²¹ Humphrey's later work²² on cost dispersion in banking drew particular attention to the wider cost differences between smaller banks compared with larger ones. Revell's comprehensive study cautioned about generalizations in the context of size and efficiency in banking.²³ He emphasized, *inter alia*, that there is no such thing as optimum size in banking and that EOS exists in some aspects of the operations of all banks, but economies of scope "are even more important, especially for large banks."²⁴

The work by PW has some undesirable "upward bias" in its interpretation of economic gains. For example, PW excluded hypothesized price rises (those negative-signed PDs in Table 9) from their "law of one price scenario," but this exclusion assumption is debatable. When credit rationing exists for a financial product, it is likely that price increases will result when the market mechanism is liberated. The case study used by PW—London's Big Bang and its impact on the cost of stock market transactions—also illustrated the price rises (in this case on small, private trades) that can occur after deregulation.

In a more general context it has been argued that PW chose the wrong case study on which to base much of its reasoning and hypothesized estimates.²⁵ The

18. CENTER FOR BUSINESS STRATEGY, *supra* note 10, at 2.

19. *Id.* at 104.

20. *Id.*

21. See Humphrey, *Cost and Scale Economics in Bank Intermediation*, in HANDBOOK FOR BANKING STRATEGY 745 (1985).

22. Humphrey, *Cost Dispersion and the Measurement of Economies in Banking*, ECON. REV., at 24 (May-June 1987).

23. J. REVELL, *MERGERS AND THE ROLE OF LARGE BANKS* 91 (Institute of European Finance Research Monograph in Banking and Finance No. 2, 1987).

24. *Id.* at 92.

25. See Neuberger, referred to in CLIFFORD CHANCE, *INVESTMENT SERVICES 1992* (1989).

reasoning here is that the PW study was concluded before the subsequent post-crash (1987) shakeout in the City of London, before the full consequences of this kind of deregulation were realized. The same study suggested that the EC textile industry would have been a better general model. The industry is considered to have benefitted already from the removal of EC internal barriers, but it is interesting to note that an EC-wide clothing or textile industry does not exist.

Another criticism of PW is their downgrading of the hypothesized producer losses that occur when consumers gain. One estimate²⁶ is that the short-term drop in profits for firms may have more negative economic effects than were emphasized by PW or Cecchini. In the United Kingdom, for example, it has been suggested that the profits of investment firms could fall by up to a quarter. Increased competition in these kinds of financial sector markets, where profit margins are already thin, may increase concentration and lead to monopolistic and less efficient prices.

The fundamental point, however, is that our knowledge of the economics of financial sector integration and the behavior of financial institutions and markets is still imperfect. Although the PW/Cecchini price-reduction mechanism is undeniably important, it may be particularly oversimplified in the case of the financial sector. In these markets factors like joint demand, reputation, asymmetric information, access to delivery systems, and specialization are especially important in particular segments. Barriers to entry may often be the result of factors other than regulation. Nevertheless, regulation is an area that is particularly relevant to the financial sector.

PW and Cecchini focused on the welfare impact of a particular kind of deregulation process, which we may label structural deregulation. Structural deregulation simply refers to the means by which financial institutions and markets are enabled to compete more freely. 1992 is the latest milestone along a deregulatory path that started over two decades ago. In this sense 1992 is not unique. What is unique is the remarkable commitment of governments to the process of deregulation over the period leading up to 1992. The other unique aspect of this process is that it has been accompanied by an additional collection of countervailing regulatory trends. In particular, there has been a process of supervisory (prudential regulation) re-regulation, investor protection, and conduct of business rules that also have increased in complexity, detail, and scope. PW/Cecchini did not analyze this area in any detail.

Nevertheless, it is undeniable that 1992 is likely to be associated with increased competition in the financial sector, but that this degree of competition will not be homogenous across all financial product markets and within each country. A useful starting point here is to distinguish between retail and wholesale financial markets. The higher segments of the latter have already globalized largely independently of 1992, although 1992 itself is likely to have positive

26. *See id.*

competitive effects on investment banking and related industries. It is in the retail and middle segments of the wholesale financial sector that we may expect, at least in theory, to see significant competitive effects flowing directly from 1992.

However, these (especially the retail) market segments are those where proximity, national and cultural preferences, and branch networks are especially relevant. Experiences in Europe have already demonstrated the problems facing foreign institutions who wish to penetrate national retail market segments.²⁷ The need for branch networks may make many retail product/markets restricted in their contestability. However, the new alliances and sharing arrangements that are developing across Europe are indicative of what might happen. It also seems likely that the main merger activity in the run up to 1992 will take place within individual countries. Retail and home markets are also more likely to be "defended" in various ways by national governments, and 1992 is unlikely to eliminate completely or quickly all of these defensive propensities or opportunities. As price competition intensifies, explicit pricing, quality of service, and access to existing and new delivery systems will become more important. We may expect specialized and highly focused financial institutions, in particular, to demonstrate increasingly their ability to undercut the larger financial firms that cross-subsidize parts of their customer base.

III. Conclusions and Implications

Many of the implicit changes hypothesized in this research are now considerably advanced in many EFTA countries. In the Nordic-EFTA countries, for example, major regulatory changes took place after 1987. At the domestic level there has been a strong (structural) deregulatory trend towards market-oriented financial systems. Financial sectors in these countries have also been exposed to greater international competition by gradually removing regulations governing capital movements. In Switzerland the domestic financial market has been highly cartelized, but during the past year (1989/90) the Swiss authorities have taken action to introduce more competition into the domestic market. All of these developments indicate that the kind of economic adjustments implied by the preceding survey and simulations have already started. Contemporary trends indicate that this movement may be about to accelerate in some EFTA and other non-EC European countries.

There have been strong criticisms of the PW/Cecchini microeconomic methodology, and it is undoubtedly oversimplified in many important respects in the case of the financial sector. The previous section outlined some of these weaknesses. Nevertheless, the PW/Cecchini work is important not only for the debate

27. See E. GARDENER & P. MOLYNEUX, *CHANGES IN WESTERN EUROPEAN BANKING* chs. 6 & 8 (1990).

that has ensued, but also because the empirical analysis did produce some useful evidence on comparative competitive conditions. At the very least, PW/Cecchini provided a partial, "snapshot view" of competitive differences in some important financial product sectors.

At one level, it is in this context that the potential gains to EFTA should be assessed, and our results suggest these are relatively high. In CS terms, EFTA (especially the Alpine-EFTA) stands to achieve considerable CS gains. The danger is that this kind of partial and static analysis ignores the potential, wider implications of opening up domestic markets to highly competitive predators. High CS gains computed in this way imply *ceteris paribus* comparatively less competitive financial sectors in many instances. This suggests an urgent policy priority of strengthening these sectors as a prelude to increased competition. Since the significant CS returns from 1992 are envisaged to entail concentration in the most efficient producers, employment losses and other secondary, redistributive effects may be particularly acute in those countries where comparative efficiency is low.

