The EU's Financial Sector Mercantilism Will Lead to Weakness, Not Strength

By Eric Grover

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The best way to have open, strong, and resilient financial markets and payment systems is not to commit to central planning.

AMERICANS don't give much thought to the European Union. EU elites, however, obsess over America.

Embodying that obsession, European Commission president Ursula von der Leyen's "geopolitical Commission," aims to enhance the EU's role on the world stage, by boosting the importance of the euro — the currency shared by most of its members — along with its capital markets, banks, and payment systems not only within the EU, but beyond it. The Commission (the "EC") is keen to create EU champions, and to take King Dollar, Anglo-American capital markets, and banks, as well as credit-card networks, such as Mastercard and Visa, down a peg or two. The EC's January 19th manifesto titled, "The European economic and financial system: fostering openness, strength and resilience," captures the dirigiste and mercantilist spirit driving its project. Brussels has retail payments and digital-finance strategies, is developing a sustainable-finance strategy, and plans to bolster "the euro as the default currency for the denomination of sustainable financial products."

The eurocracy's bias toward dirigisme and its determination to press on with building an "ever closer Europe" show few signs of having been shaken by, say, its mishandling of the procurement and roll-out of COVID-19 vaccines, the repudiation that Brexit represented, or the euro-zone crisis and its aftermath. And then there is the anti-Americanism. Many of the EU's leadership resent the EU's dependence on — and the primacy of — the U.S. dollar, banks, payment systems, tech giants, and, if more ambiguously, American hard power.

The Commission declares that it wants to strengthen “the EU’s open strategic autonomy” — a disingenuous construct. The best way to be open is to be open. The best way to have a strong and resilient economy is to support liberal economic policies and to maintain a transparent, apolitical, and light regulatory and legal regime, low taxes, sound currency, and vigorously competitive private markets. That, however, is not what Brussels has in mind.

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For all the talk of economic efficiency, the euro was primarily designed as a means to further political integration, and to serve as a competitor to the U.S. dollar. Currencies enjoy powerful network effects. King Dollar reigns worldwide. In the third quarter of 2020, 57 percent of the world’s foreign-exchange reserves were in dollars versus 19 percent in euros. In 2019, 64 percent and 22 percent of outstanding international debt securities were in dollars and euros, respectively. That the euro is a distant No. 2 chafes EU chauvinists. It’s perhaps telling that one area — at least for now — in which the euro decisively beats the dollar is in the issuance of “Green” bonds, which underscores — again, at least for now — the more overtly political flavor of EU financial markets. We can leave the question of central-bank intervention, on either side of the Atlantic, for another time.

The EC believes that “there is scope to promote the use of the euro in the context of EU trade agreements,” and plans to reach out to “third-country partners to promote the use of the euro, euro-denominated instruments, and benchmarks . . . and to foster its status as an international reference currency in the energy and commodities sectors.”

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The Global Financial Centres’ index of financial-center competitiveness ranked New York City first, London second, and Zurich ninth. Frankfurt and Paris ranked tenth and 23rd, respectively.

In its January 2021 report, the EC decried an “overreliance on non-EU banking,” which is a thinly veiled call for protecting and promoting EU banks. U.S., British, and Swiss banks play outsized roles in Europe’s capital markets. In 2020, the top ten European IPO bookrunners were American or British. Of the top ten European equity capital-market bookrunners, five were American, two British, two Swiss, and only one from the EU (Sweden). Of the top ten European debt capital-market bookrunners, five were American or British and five were from the EU.

The EC wants to promote EU capital markets. But London and New York City are the world's financial capitals because they enjoy relatively transparent and apolitical regulation, are open, cosmopolitan, English-speaking, and benefit from the network effects of a critical mass of financial-service providers, market makers, and investors. In addition, New York benefits from an immense domestic capital market. However much Brussels might try, these are advantages that will be difficult to reproduce in, say, Paris or Frankfurt. That said, the EU will use the regulatory opportunity presented by Brexit to try to increase the amount of financial business conducted within its borders, at London's expense.

Politics affect financial services. In a presentation at the Federal Reserve Bank of Atlanta's 2013 Financial Markets conference economist Charles Calomiris observed that "the decisive influences for determining whether credit is abundant or scarce, and whether banking crises will be likely to occur are political." In *Fragile by Design*, Calomiris and political scientist Stephen Haber discuss the range of political bargains that banking industries in various countries make with their governments and regulators, and the implications for credit and financial-system stability. These can include reduced financial-services innovation and distorted credit markets with all the adverse effects than can flow from that. To take one notorious instance: Washington pressured Fannie Mae, Freddie Mac, and banks more generally to weaken mortgage credit standards, with results that contributed substantially to the U.S. financial crisis. Part of the EU's bargain is that banks must be good Europeans and allocate capital and resources to autarkic projects in the name of deeper EU integration.
Payment Services Directive 2 provides one example of this. Under it, banks have been forced to allocate capital to support fee-free payments within the EU. The mandate for inter-bank SEPA credits and debits is yet another example. And a similar approach can be seen when it comes to payment systems.

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At one level the EPI is merely intended to create a smoother EU payments system, but there has been no attempt to conceal the importance that politics has played in its creation.

In July 2020, the ECB put it this way (my emphasis added):

In November 2019 the Eurosystem [the ECB and the national central banks within the euro zone] relaunched its retail payments strategy, calling for increased collaboration between European stakeholders to provide payment services that meet the needs of European customers *and strengthen the autonomy of the European retail payments market . . .*

The Eurosystem will continue to support private initiatives for retail payments provided that they fulfill five key objectives: pan-European reach, customer friendliness, cost efficiency, safety and security, European identity and governance, and, in the long-run*, global reach*. In this connection, it was interesting to read the comments by Wolf Kunisch, the head of strategy, public and regulatory affairs at Europe's largest payment processor, Worldline. Speaking at the Merchant Payments Ecosystem (Europe's largest merchant payment processing conference), Kunisch observed that using American payment systems doesn't "feel right."

A recent *Financial Times* report included comments that were, if anything, blunter still (my emphasis added):

More than 30 of Europe's largest banks and credit card processors are trying to create a payments giant capable of shattering a US-dominated "oligopoly" . . .

"The idea is to build a European payment champion that can take on PayPal, Mastercard, Visa, Google and Apple," said Joachim Schmalzl, the chair of the European Payment Initiative.

The banks and acquirers behind the initiative include Deutsche Bank, BNP Paribas, ING, UniCredit and Santander and currently process more than half of all payments in Europe. The project has the backing of the European Commission as well as the euro area's financial regulators.

EPI has so far received more than €30m from its backers, said Schmalzl. He is also a board member of the German Savings Banks Association, the country's biggest retail banking group and staunch supporter of the initiative . . .

Burkhard Balz, a Bundesbank board member, said that Germany's central bank supported the EPI, which "would strengthen *the strategic autonomy* of the EU in the payments market, enhance competition and thus improve consumer choice". The ECB has also welcomed the initiative . . .
Card payments in Europe are predominantly processed by US-based companies. Four in five transactions in Europe are handled by Mastercard and Visa, according to EuroCommerce, a lobby group of European retailers. Schmalzl warned that such a dominant market share could hurt consumers and merchants — pointing to relatively high fees as well as questions over data protection. "We want to offer an alternative to this oligopoly and give merchants and consumers in Europe a real choice," he said . . .

A Deutsche Bank spokesperson said that a European payment scheme was needed "*to remain independent",* and that Germany's largest lender had joined the initiative "to support this joint effort of European financial institutions".

As mentioned above, the EU wishes to enhance its position on the world stage, something that cannot, of course, be detached from foreign policy. The EU has long been interested in supplanting its member-states' foreign-policy prerogatives, and has gone some way in achieving this. Thus it has a "foreign minister" (the High Representative of the Union for Foreign Affairs and Security Policy) and its own diplomatic service, the European External Action Section. But its most effective way of taking this further may well be to use its existing powers within the regulatory and economic area as (effectively) an instrument of foreign policy — something that the bloc's size enables it to do and something that it has not hesitated to do.

Meanwhile, the EC excoriates an unnamed U.S for taking its "unfair and abusive practices" — i.e., for its liberal use of financial sanctions against rogue states that I referred to above. It wants to "shield EU operators in the event a third country [the U.S.] compels EU-based financial-market infrastructures to comply with unilaterally adopted sanctions." Unilateral is code for U.S. policy that Brussels has not blessed.

In 2018 Germany's foreign minister Heiko Mass called for the EU to build a system to bypass SWIFT and dollar-denominated payments to enable trade with Iran. Toward that end payments in 2019, Paris-based payments clearinghouse INSTEX was established. It is owned by nine European governments (including, interestingly, the U.K.). Yet INSTEX may not have made much of an impact; it had, reported Bloomberg in January, "only moved small amounts of capital for a few medical shipments, which are technically exempt from sanctions." Indeed, the Iranians complained about how ineffective it had been. Nevertheless, the thought behind it, which owed more to a determination to assert Europe's right to go its own way, is striking enough, even if that meant (potentially) helping out Tehran.

The EC has a retail-payments strategy, a digital-finance strategy, and, acting through the ECB, is promising a sustainable (green) finance strategy.

However, central planning won't foster innovation or create great companies or vibrant economies. France's and Germany's effort to build a European Google, Quaero, failed. This report from *The Economist* 15 years ago on a "Franco-German internet-search engine, to be called Quaero (Latin for 'I seek')" makes interesting reading, not least this:

Quaero's chief aims are cultural and political, rather than commercial. Alexander Waibel, a research leader at the University of Karlsruhe who sits on Quaero's steering committee, offers an emotional justification too. "Europe wants to secure access that does not have to be channelled through American technology," he said. And an official close to Mr. Chirac adds that "the goal surpasses by far the industrial stakes."

We know now how that worked out, not that it should have been too much of a surprise. Under the circumstances, it is not unreasonable to think that EPI too is likely to fail. No central planners in Washington anticipated, much less planned Mastercard, PayPal, Visa, Google, Microsoft, Apple, Facebook, or Amazon.

The EC wants more financial-system resiliency. But the emphasis it is placing on "strategic autonomy," not to speak of its bias toward command-and-control and distrust of self-correcting markets, promote system fragility. In *AntiFragile: Things That Gain From Disorder*, New York University professor of risk engineering Nassim Taleb observes that "fragile" systems fail when sufficiently stressed while anti-fragile systems like our immune system and muscles become stronger. Centrally directed and highly concentrated industries are inherently fragile. Markets with many competing players pursuing different strategies are anti-fragile. Markets become more resilient and less fragile, with more players, none of which would pose systemic risk were they to fail individually.

The best way to have open, strong, and resilient financial markets and payment systems — and thereby a stronger (and thus inherently more independent) economy — would be for the EU to play the role of the nightwatchman rather than mercantilist central planner. Europeans in and outside the EU and, for that matter, Americans too, would be better off if Brussels took a more liberal tack.

Eric Grover is the principal at Intrepid Ventures, providing corporate development and strategy consulting to financial-services, payment-network, and processing businesses, principally in North America and Europe.