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## **THE EURO AND INTERSTATE BANKING: FALL-OUT HYPOTHESIS EURO - FALLOUT HYPOTHESIS RECONSIDERED**

*Key words: euro, interstate banking, monetary function, community protection, economic growth*

### **ABSTRACT**

*This paper considers the crucial outcome of adopting a single currency within the environment of a multi-state central bank infrastructure in an uncertain money category definition framework.*

*The fallout effects of such a system include the transfer of capitals, the rapid reallocation of resources and the non-homogenous economic development of different regional areas.*

*The recent USA Interstate Banking Act experience, after the Riegle Community Development and Regulatory Improvement Act of 1994, constitutes a valid example of a necessary precondition within the opening of a financial operating infrastructure.*

*The paper focuses on the special condition of the EU community States and the necessity - pending their financial integration - of a special consideration for some likely negative fallout effects in order to implement and advance some appropriate balancing measures.*

*Nevertheless, the role that the globalisation of the economic activity plays, especially in the financial community, is causing a rapid integration of the technology and operating techniques that require critical volumes of trading and rapidly adjusting enterprise dimensions. The latter call for some form of institutional enlarging frameworks where the correct definition of a monetary function and its essence requires a clear and unique common monetary system.*

### **1. EURO - FALLOUT HYPOTHESIS RECONSIDERED**

As a basic preliminary statement, I want to recollect an article of mine that was published in the Italian banking Review *Banche and Banchieri*, number five year 1998, just some days before the Euro parities were finally fixed and disclosed. The title of that article was "The single currency: fall-out hypothesis."

The issue I then expressed was that the currency substantial base has not yet currently been devised, neither through the special drawing rights nor through the ecu issuing efforts.

The Eurodollar had been the only surviving currency during the twentieth century that means all the dollar assets located outside the American banking system both in Europe and elsewhere.

The reason for the Eurodollar success was and still is linked to the tangible real dollar material incorporated base which has changed from the gold consistency adjusted at the Bretton Woods<sup>1</sup> Conference, to the oil standard which has been *de facto* implemented and put into practice in 1973 after the first Arab-Israeli<sup>2</sup> war and after the collapsing of the gold exchange system in August 1971.

Since the price of an oil barrel is listed in US dollars, and the dollars are *the facto* universally exchangeable in the most valuable and demanded homogeneous and universally utilized merchandise, it is understandable that a very close link operates between oil, the fluctuation of its price and the general purchasing power of the US dollars in the USA and all over the world.

We are presently living through a very strange and peculiar phase of great changes and transformations, one of the most relevant of these is the appearing of the second big phase in the world globalisation field,<sup>3</sup> interrupted dramatically by the first world war and the fall of the gold standard with the intense nationalistic and economic isolation phase, consequence of the unfortunate effort to return to the gold standard after the first world war when Keynes was writing his essay about the return to gold and Hawtrey<sup>4</sup> was addressing the Genoa Economic Conference in 1921 supporting and promoting the return to the gold standard. Meanwhile, the Economic consequences of the Peace were already an issue according to Keynes himself.

After two world wars, a dramatic sequence of revolutions and local endemic war, the third millennium is now reconsidering the unsolved fundamental issue of a common currency basic consistent standard and exchange rate's global working system in accordance with the world wide *real time gross settlement systems* in order to avoid the general monetary crisis recently affecting Mexico, Malaysia, continuing in the far East and looming over the Euro system itself nowadays.

The single currency is issued in Europe at the same time as in the USA the Neal and Riegle Banking act in 1994: the *Branching Efficiency Act of 1994*, and the *Riegle Community Development and Regulatory Improvement Act of 1994*, allowing for the first time in the USA history banking activities over the border takes off the limit of the practice of one single State banking, accompanied by a *Community Protection Act*. This rule provides that the savings collected in one single State are allocated in the same State in corresponding percentages – *loan to deposit ratio requirement* – imposing funds to be located as acquired and therefore invested within the same communities creditors with the specific lending bank, both as a community and as a social class<sup>5</sup>.

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- 1 Bretton Woods Conference, popular name of the United Nations Monetary and Financial Conference that took place July 1-22, 1944, at Bretton Woods, a vacation resort in New Hampshire.
  - 2 In 1973 and again in 1978, oil crises occurred when oil production in several Arab countries was disrupted, first during the Arab-Israeli War, and then during the Iranian revolution. Following the 1973 crisis.
  - 3 Field, Cyrus West (1819–92), American financier and trader, in partnership with the other American industrialist Peter Cooper and other partners formed in 1854 the *New York, Newfoundland and London Telegraph Co.*; two years later he organized in England the *Atlantic Telegraph Co.*. Both companies were incorporated in order to lay the first undersea transatlantic cable. The British and American Government support succeeded in starting in July 1866 the first telegraphic communication between Europe and North America.
  - 4 Hawtrey was educated at Eton and the University of Cambridge, graduating with first-class honours in mathematics in 1901. He spent his working life as a civil servant and played a key role in the Genoa Conference of 1922, which attempted to devise arrangements for a stable return to the gold standard. Hawtrey studied economics after leaving Cambridge. He held few academic positions; he taught at Harvard (1928–29) and was Price Professor of International Economics at the Royal Institute of International Affairs (1947–52). He was knighted in 1956.
  - 5 The Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation have issued the enclosed host state loan-to-deposit ratios. The banking agencies will use these ratios to determine compliance with section 109 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Interstate Act). These ratios update the data that was released on September 3, 1999 (see our letter dated September 10, 1999). The Gramm-Leach-Bliley Act expanded the coverage of Section 109 to include any branch of a bank controlled by an out-of-state bank holding company.

The European Union has a split personality: part liberal, part conservative, part nationalist. Europe's century is justifiably seen as a story of the perils of nationalism and of its ugly sister, widespread racism, part Catholic according to the strict observant doctrine, part Reformed according to the spirit of the Protestant capitalistic Ethic as prevailing thesis expressed by Max Weber at the beginning of the nineteenth Century.

Yet it also offers a syndrome about the dismal consequences of *beggar my neighbour, stop the world, I want to get off* economic nationalism.

The history of riches and wealth in Europe still nowadays reflects the morphology of these beliefs and observing the per capita income of the European Union Countries, considering some minor local distortions, one may still see the distribution of the Reform throughout Europe strictly statistically connected to the level of the *per capita* income.

**Table 1 Economic and Demographic Indicators for EU Countries**

	Gross Domestic Product (GDP)			PerCapita GDP, 1999 (U.S. Dollars)	Population, 1999 (Millions)
	1999 (Bill. of U.S. Dollars)	Real GDP Growth Rate			
		1999 Estimate	2000 Estimate		
Denmark	\$178.2	1.6%	1.2%	\$33,547	5.3
Luxembourg	NA	NA	NA	NA	NA
Austria	\$215.8	2.2%	3.3%	\$26,700	8.1
Germany	\$2160.3	2.5%	1.6%	\$26,274	82.2
Sweden	\$231.5	3.8%	3.8%	\$26,097	8.9
Finland	\$130.4	3.5%	5.3%	\$25,256	5.2
France	\$1478.0	2.9%	3.5%	\$25,038	59.0
Belgium	\$253.6	2.6%	3.4%	\$24,810	10.2
Netherlands	\$388.3	3.5%	4.0%	\$24,594	15.8
Un. Kingdom	\$1401.0	2.1%	2.9%	\$23,616	59.3
Ireland	\$85.6	9.1%	8.9%	\$22,911	3.7
Italy	\$1205.4	1.4%	2.8%	\$20,909	57.7
Spain	\$574.9	3.7%	4.4%	\$14,592	39.4
Greece	\$125.4	3.4%	3.5%	\$11,888	10.5
Portugal	\$111.6	3.1%	3.2%	\$11,191	10.0
Total	\$8,539.9	2.3%	3.7%	\$22,754	375.3

Source: WEFA World Economic Outlook.

Twentieth's century *socialism in one country* was a disaster. But so was the *capitalism in one country* that many West Europeans attempted to put into practice after 1914.

History is like a hill, it was once said, the higher you climb the farther you see; it is therefore worthwhile to consider some previous experiences.

After the successful first globalisation stage of the nineteenth century, thanks to the gold standard system, European countries could develop rapidly but were already quite protectionist just before

1914, with high tariffs on imports in France and Germany; and even Britain, once the high priest of free trade, committed apostasy in 1915 starting a huge deglobalisation of its own. But in the 1920s and 1930s, economic nationalism got much worse and became the rule of any single European nation with sensible effect in the oncoming world depression.

One immediate cause of the deep deglobalisation after 1918 was the creation of new countries which gave themselves new tariffs, new import quotas and subsidies both against outsiders and against the formerly integrated global markets they had just left. Another was the creation of the Soviet Union, which raised an ideological and substantial high barrier to trade until its last years, enclosing the socialist Countries within the Comecon trade agreement founded in 1949, and which adopted a formal charter in 1959 and became active in the 1960s when definitely introduced. But France, Germany and Britain too all raised their own barriers especially within the European Communities and the supporting Nato Alliance.

Intra-European conflicts loomed large and wide. So did the notion, arising from the first world war, that self-sufficiency was the only rule for survival as well as to outlive the war periods. But the outside world also played its role. America raised its tariffs in 1921 and 1922, making it harder for the Europeans to export goods in order to repay their war and reconstruction debts to America leading to further preconditions of the great depression.

In 1924, Congress shut off immigration from Eastern and Southern Europe and from Asia, taking away Europe's safety valve. Concern in Europe was growing about new, low-wage rivals in Latin America, Canada, Japan and Australia. And then, in the biggest blow of all, as a consequence of the European effort to return to the gold standard, and the consequent deflationary policies all over Europe, starting in 1925 after the Genoa Conference adopted the Hawtrey formula, fought by Keynes, leading to the general return to the gold up to the pre-war standards and exchange patterns, and the consequent world economic collapse, America in 1930 raised its average tariff to 59%, with the Smoot-Hawley tariff act<sup>6</sup>.

The Europeans retreated into various forms of isolation. Britain, France and the Netherlands settled down with their empires, raising outside tariffs to give preference to imperial trade. Fascist Italy went for corporatism, favouring national firms in alliance with government. Nazi Germany, hit hardest by the depression of the 1930s, went for arms manufacture and barter trade and deficit spending.

Unnatural divisions, as well as the better-known background of war and the Holocaust, is the economic nationalism we need to bear in mind when thinking about the emerging European Union, or Common Market, or European Community, as it has variously been known since it started life with the 1957 Treaty of Rome.

The economic map of Europe in those days was a strange one: not at all the sort of map that nature would have drawn. Normally, a country's neighbours are among its largest trading partners, certainly on a continent such as Europe with close historical and cultural links. Transport costs favour the neighbours, and it is generally likelier that firms physically close to one another will establish the trust and depth of mutual knowledge that favour business transactions.

Yet in the 1930s, France's third biggest trading partner was Algeria. In 1957, Germany's biggest one was America. The natural patterns of trade and personal interchange had been distorted by

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<sup>6</sup> The United States was the worst among the offending countries. As the nation slipped into the grip of the Great Depression, Congress adopted a virulently protectionist trade law. Its name – the 1930 Smooth-Hawley Tariff Act will live forever in the annals of infamous legislation, alongside the Anti-Sedition Act and the post-Civil War Reconstruction Act. Smoot-Hawley raised average tariffs on U.S. imports to over 50 percent

two wars and 50 years of economic nationalism diverting the eighteenth century globalisation phase with 70 millions European reaching North and South America and the huge growth in both communication and transportation sectors.

The European Union can be seen as an attempt to recreate some of those natural patterns, albeit at a time when another political divide, the iron curtain, was cutting the continent in half. It was also, as is usually said, an attempt to stop Europeans fighting one another, to bind France and Germany together. Yet those aims could have been achieved (and were) in other ways. Economic nationalism, too, was being dealt with at other levels, through the trade liberalisation rounds of the GATT<sup>7</sup> and through the establishment of the International Monetary Fund and the World Bank.

But despite those multilateral initiatives, the desire to blunt economic nationalism alone might have been enough to explain the Common Market's creation. After all, if taken at its word, the essence of the European idea, and indeed the Rome treaty itself, is liberal, and goes well beyond the Customs union: the denial of national policies which had seemed individually desirable but which collectively were disastrous; the use of Rome and later treaties to make the renunciation binding and credible; the transfer of sovereignties away from capricious national politicians<sup>8</sup>. What could be more liberal than the unconfined movement of people, goods, capital and services?

Many of the principal achievements of the European Union have indeed been liberal ones: the abolition of internal tariffs (completed among the original six members in 1968) and the transfer of external trade policy to the EU executive body, the European Commission; the outlawing of state subsidies to companies, a process begun in 1983 but not yet completed; the establishment of antitrust policy at a European level, begun in 1990; the outlawing of non-tariff barriers to internal trade, begun by a ruling at the European Court of Justice in 1979 but not properly undertaken until the single-market project of 1985-92; and the most spectacular example, the adoption by 11 countries of a single currency on January 1st 1999, transferring power over monetary policy to an independent European Central Bank.

Yet all those dates, coming long after 1957, carry a powerful clue. It has taken more than 40 years to establish anything like an integrated, "common" market. Only during these years has an integrated financial market begun to develop, thanks to the euro. In many areas—transport, telecommunications and energy, to name but three, the common market is only just beginning to be created. Far from moving too rapidly towards integration, as the EU's British skeptics often claim, the opposite is true: it has moved far too slowly. The reason has been persistent economic nationalism, combined with sharply different views among the member countries about what the Union is for. This is not surprising in a collective effort of six, then nine and now 15 countries. But it has blunted the Union's effectiveness, and makes predictions about its future hazardous.

Most notably, the liberal ideas of unity and free movement have been widely distorted. Subsidies, non-tariff barriers, closed financial systems, national champions: all these have been used by EU members to keep their economies autonomous ever since 1957. At the same time, some countries have sought to divert EU powers and resources to their national benefit.

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7 The General Agreement on Tariffs and Trade (GATT) was first signed in 1947. The agreement was designed to provide an international forum that encouraged free trade between member states by regulating and reducing tariffs on traded goods and by providing a common mechanism for resolving trade disputes. GATT membership now includes more than 110 countries.

8 The WTO's agreements are often called the Final Act of the 1986–1994 Uruguay Round of trade negotiations, although strictly speaking the Final Act is the first of the agreements.

The biggest collective spending policy, the common agricultural policy, under which half the EU budget is devoted to farm subsidies, has become a nationalist feeding mechanism. It is a case study of how a system of subsidies, once created, becomes almost impossible to be dismantled. It is also highly protectionist, impeding poor countries' farm exports. A study by Patrick Messerlin, a French economist, carried out for the Institute for International Economics in Washington, DC, estimated that the total cost to the EU itself of its external protectionism: covering goods and services as well as food—adds up to around 7% of the Union's GDP each year. That is \$600 billion. Regional and structural funds, designed to improve the infrastructure and industrial development of poorer regions within Europe, are another tough issue.

The coal and steel treaty, set up in 1951, was used in the 1970s and 1980s to delay the restructuring of those old industries and to establish a de facto cartel. Countries tried to turn external trade negotiations to the benefit of their local pressure groups. The so-called "social chapter" has in practice sought to protect existing labour legislation in France and Germany against competition from smaller, poorer countries.

A few parties still believe in co-ordinating planning, research, protection or subsidies at a European level. Others believe that, in an economic space much larger than a single country, change can be kept at bay. Yet others think European rules are the only way to make their national politicians act according to external common economic liberal rules.

Others still see all this economic and trade ruling as a price to be paid for the establishment of a unit large enough to bargain on equal terms with the United States and Japan, and to carry foreign-policy common goals. Britain, according to the special relationship with the USA, has always tried to influence events on the continent, though has never really wanted to ally itself to its neighbours wholeheartedly.

It is a muddled, contradictory picture. Recently, with stronger competition enforcement, the single currency and the single-market programme, the liberal tendency has gained ground. As the Union becomes larger, perhaps expanding to 20-30 countries, an activist supranational government is becoming harder to operate. And liberal optimists think the euro will force national governments to free up their own labour and goods markets, in the hope of creating enough jobs to reduce unemployment from its current 10-15% of the workforce.

That more liberal trend looks set for the next few years, during which collective thinkers may well have their minds more on foreign policy co-operation than on economic or social intervention. But it cannot be counted upon to turn the EU into the environment familiar to Hayek's dreams: a Federal Europe whose rules tell its members what not to do, but do not try directly to tell them what they should do. The picture reflects a common party with different dressing attitudes, from hunters to fishermen, from golfers to hikers.

Still, there is little chance of possible break-up. The EU is improving its role, as measured by the desire of more countries to join it. The chances are not, so far, of a sort to pitch nation against nation. The only real candidate for such a fight could arise from the euro and its fall-out hypothesis.

There could be a moment in the depths of a recession in which one government is under pressure to do something about unemployment but finds itself unable to take action on its own. Anti-European emotions could become stirred up from the economic policy allocation in one single central body.

Searching a way to accommodate each member's concerns is both the most maddening thing about the European Union, and its greatest talent for survival. That is also a talent that will be needed in the world's other big, should-be federal but-isn't, country: Communist China.

What is happening in Europe is not a local phenomena but it represents the return of the previous globalisation process with more sophisticated tools and technologies.

Actually the currency problem and the proper base to support the currency circulation is a not yet resolved problem that afflicts the entire world community. The development of the Euro dollar market at the beginning of the sixties was a consequence of the growing assets linked to the oil production and the need of an international liquidity instrument that was not available as was gold during the first globalisation period which marked the gold standard epoch.<sup>9</sup>

What is likely to happen now is:

- a migration of capital and financial resources toward the most developed areas within the EU, especially towards the northern areas linked previously to the German mark and to the Max Weber Calvinist temples of the sophisticated financial markets supplied by the gathering capabilities of the integrating banking sectors and the more efficient financial market and related technologies;
- the absence of any provisions or instrument comparable to the Neal Riegle legislation affecting the allocation of financial resources within the enlarged European open market.

The development of the industrial structures linked to fiscal facilities and lower labour costs may alleviate the side effects of the enlargement but cannot counterbalance the probable concentration of the highly developed areas financial and developed industrial infrastructures and facilities.

The globalisation requires a temporary reshuffling of the economic activities, which could last for several decades before a competitive reallocation process may level off the steep differences emerging out of the first stage unconditional integration. I don't want to enter the confused and complex field of the European facilities provided by the EU legislative bodies which unfortunately just considers very soft regional remedies to the restructuring of the industrial preferences of the European business community linked to the world financial decision making centres.

The solution is lying ahead and implies a very patent and long adjustment process along the Southern Far East Countries development paths, which should avoid the too rapid and inflationary financial strategies like the Thailand, Malaysia, the Philippines and South Korean recent crisis have shown. The unavoidable globalisation process limited to a single geographical contest may lead to endemic and definitive backwardness like the Southern Italy contest, Mexico and most of Southern America where the solidarity and social prevalent patterns have hampered the beneficial effect of a market economy, together with the surviving obsolete agricultural technologies and lack of industrial entrepreneurship.

Conservative estimate suggest that humans were already distinguishable from other primates 2.5 million years ago at the appearance of the *Homo habilis*. Imagine placing a time line corresponding to this 2.5 million year period along the length of a standard football field of about 120 meters, every centimetre would represent 208 years. On this time line, humans were hunters and gatherers

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<sup>9</sup> Liberalisation of financial markets, the growth of free trade, the falling costs of digital technology and the explosion of information have broken down the old order and created a seamless new world in which panic can spread as fast as the latest new idea. That new world is both more integrated and less stable than the old one

until the agricultural revolution, perhaps 10,000 years ago - that is, for the first 119.5 meters of the football field.

The height of the Roman Empire occurs only 10 centimetres from the rightmost goal line, and the Industrial Revolution begins less than 2 centimetres from the field's end. Large, sustained increases in standards of living, our working definition of an industrial revolution, have occurred during a relatively short time - equivalent to the width of half a cigarette before the end of our football field.<sup>10</sup>

Since then, the world population has dramatically increased thanks to the financial system achievements and to the large increase in wealth produced and its distribution.

Especially in the less developed countries, the availability of basic food combined with a lack in alternative resources has focused the value system on the enlargement of the families and growing children has become the essential scope and the sole collectible asset.

Within all the efforts conducted by most of the local governments, the population has steadily increased after elementary food resources have been obtained, mostly through the positive results in the agricultural sector.

Looking to the birth growth rate and to the enlargement of the population, after the first phase of steady and exponential growth, the birth rate is setting itself on a lower path as the standard of living improves and the system of values changes.

To reach this level, a priority system requires and leads to the growth in the population, a trend that may easily be observed through all the available statistical data. These results are reflected in Jones study about the side effects of the industrial revolution that might not be avoided according to the value system ruling the human behaviour since its appearance over the planet Earth. The transition from the nomad to the settler attitude and the development of the agricultural expertise have contributed to the prerequisite essential ground direct cause of the evolution of the economic systems toward the unavoidable industrial revolution and its economic side effects which may be found in the financial markets, the shareholders corporation and the final globalisation processes.

As it appears in the above graphic population growth schedule, the huge increase in the world population stems from the industrial revolution which is a consequence of the capitalistic financial market, the shareholders corporation and the banking activity entering the continental capitalistic model coming out of the XVI century reform, two and half centimetres ago, with a deep restructuring from the previous commercial banking model linked to the financing of trade and foreign exchange activities to the new continental model, bound to support financially the whole range of industrial activities in collecting capital and restructuring firms in transition from family run businesses to public companies.

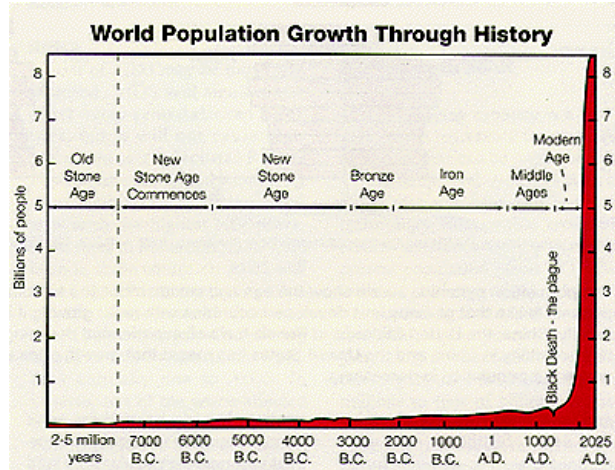
The transition observed is mainly due to the expansion in money circulation due to the enlargement of the gold and silver reserves and the fine tuned gold standard which affected the business community up to the successful first globalisation process.

The following events, mostly linked to the social and military revolutions are well-known up to the issue of the European Euro unit.

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<sup>10</sup> *Was an Industrial Revolution Inevitable? Economic Growth Over the Very Long Run* by Charles I. Jones Stanford University and NBER Chad.Jones@Stanford.edu <http://www.stanford.edu/~> September 28,1999.

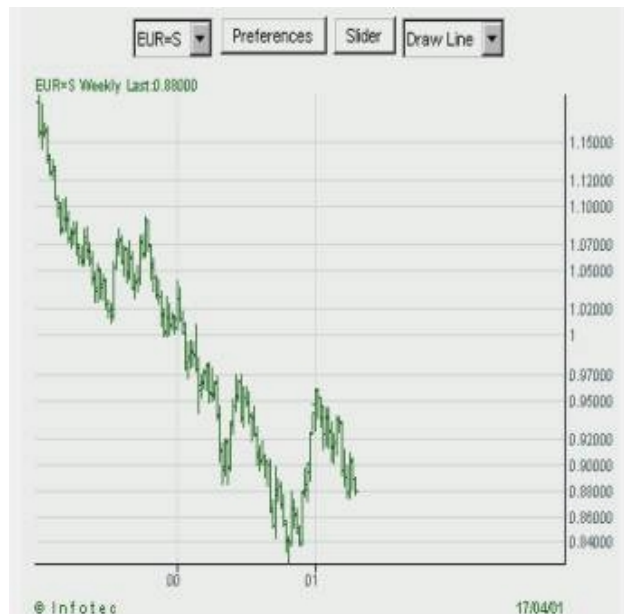




Its success or fall-out effects are strictly linked to the value basis issue and implications which have not yet been fully answered: what is the real future and meaning of money in a cashless and bankless society, when all the transactions are performed through virtual banks and telecommunication process. My personal opinion that this is the main issue and the imbalance between the Euro and the oil supported dollar and the efficiency of the systems based on the principles asserted by Weber is still affecting the exchange markets and the future slope of the dollar-euro rates, together with the capital geographic allocation.

This is already an experience and history after two years and a half of a steady, direct and unflinching declining Euro exchange rate.

**Euro dollar rates through year 2000 and 2001**



The history of the Euro during its first experience as a tenderable currency is that of a declining steady trend, without any possible misunderstanding or plausible explanation diverging from the ones above referred.