Willem F Duisenberg: The integration of Europe's financial markets

Speech by Dr Willem F Duisenberg, President of the European Central Bank, at a gala dinner on the occasion of the 42nd Annual Meeting of the World Federation of Exchanges, Amsterdam, 8 October 2002.

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Introduction

I am delighted to be here to address you this evening, and I should like to start by thanking the World Federation of Exchanges for inviting me to do so. This said, I must first of all confess that my position before you tonight is by no means a comfortable one. Central bankers are supposed to know all the answers to all the questions. However, addressing the stock exchange community at this specific moment in time, I am afraid that it will become all too obvious that we do not possess all the answers. The developments of the past few years in global equity markets have been literally extraordinary. They have raised many more questions than have so far been answered.

However, answers to these questions will have to be provided. Risk is an inherent part of financial investment, but I would regard it as particularly detrimental if the volatility in global stock prices were to result in small savers, in particular, distrusting equity investment. The diversity of the various sources of finance is essential - especially now, at a time when many firms face difficult financing conditions. The “equity culture”, which is still a relatively recent and fragile phenomenon in many European countries, must continue to develop. The same applies to other segments of the financial system, such as the corporate bond market, which have considerably matured since the introduction of the euro.

This faith in markets brings me on to the issue that I wanted to raise with you this evening: the need for further - and complete - integration of the European Union's financial markets. This is a topic that has been in the spotlight more or less since the launch of the euro almost four years ago.

Tonight, I shall try to explain not only *why* we attach so much importance to market integration, but also *what* type of integration the European Central Bank (ECB) favours and to a certain extent *how* it can be achieved, in particular by the private sector itself.

1. *Why* financial integration?

To start with, let me briefly speak about recent events. In the first year following the introduction of the euro, there was some very visible progress in terms of financial integration that could only be applauded. This refers, for instance, to the very quick and safe establishment of the unified unsecured money market in euro. In addition, the simple quotation of all euro area stocks and government bonds in one single currency was seen per se as an immediate step towards integration. More recently, however, there has appeared a certain frustration as - despite all the ongoing efforts and initiatives - observers seem to comment more on the obstacles to progress than on its continuation.

For my part, even though I acknowledge that the current situation is not fully satisfactory, I would not want to take an exaggeratedly negative view on this issue. Progress may at times be slower than the end-users of the market are entitled to expect, but it is still taking place. I believe, however, that the particular market conditions that we are now facing may provide an opportunity for an acceleration of the process. The current pressure for cost-cutting and efficiency gains in the financial sector at this particular moment in time may accelerate the movement of consolidation, in particular in the field of market infrastructure. Stock exchanges are naturally an essential part of this movement.

Integration, however, should not occur only as a reaction to external pressures. It should also be pro-active, motivated by a vision of the optimal organisation and infrastructure of the market that can best serve the interest of all its users. The time and effort spent devising this optimal structure may appear to be intense today, but it can yield considerable returns tomorrow.

But let me remind you why we, at the ECB, put so much emphasis on the integration of financial markets.

One source of interest stems from our tasks as a central bank. This has multiple facets. The implementation of monetary policy clearly requires an efficient and fully-integrated money market. It also requires a high degree of integration of the securities market, because our credit operations are fully collateralised, and therefore rely heavily on the smooth delivery of securities.

Moreover, a homogenous transmission of monetary policy actions across the whole euro area clearly also greatly benefits from efficient and fully-integrated markets.

Furthermore, our interest in market integration also stems, of course, from our statutory duty to promote the efficiency and soundness of payment systems, as well as our responsibility to contribute to the maintenance of financial stability.

Lastly, but in my view most importantly, a well-functioning single market for financial services will benefit economic development within the EU.

2. *What* type of financial integration and *how* (and by whom) can financial integration be furthered?

Stating *why* we want integration gives us a huge clue as to *what type of* integration we want. Integration must be assessed first and foremost through the benefits effectively generated for users of these markets. Integration should result in harmonised access to the market, single technical platforms where appropriate and, of course, fair access to all participants wherever they are located in the euro area. However, it is only when integration results in a genuine increase in competition that it becomes tangible and can provide all these benefits.

I would now like to address the question of how - and by whom - the process of integration of Europe's financial markets can be developed and completed. To do so, I will take in turn the points of view of the three beneficiaries of the integration process: firstly, each individual market participant; secondly, the economy at large; and thirdly, in between these two extremes, the community of participants in each market segment - for instance yourselves, the stock market community - taken as a whole.

Competition

The first beneficiaries of financial integration are and will always be all individual participants in the market. Issuers benefit from access to a broader pool of savings, while investors benefit from access to a more diversified spectrum of investment opportunities. Intermediaries also benefit from more opportunities for business and from economies of scale. Insofar as integration benefits the self-centred interest of each individual participant, it can and should be furthered naturally by the individual participants pushing initiatives as part of an environment of free competition.

Public intervention: legislation and regulation

At the other extreme, as I have already underlined, financial integration benefits the entire economy through the means of externalities from the financial sector to the real sector. This public interest - in the strictest sense - justifies public intervention, in particular as regards the supervision and regulation of the financial markets. A considerable amount of work has been undertaken in this field by the authorities of the European Union, under the head of the EU Council and the Commission, to translate at a pan-European level the public goods role traditionally exercised by markets at national level. In practice a large part of the work has been directed towards the abolition of regulatory, tax and legal barriers to a truly unified financial system. These barriers are for the most part well identified, even though solutions take time to be devised and implemented.

Co-ordination within the private sector

In between competition and public intervention, however, there exists a third possible driver for European integration, and one which I believe has still further scope to be used. This is co-ordination between private market participants and also between private participants and public authorities. I would like to conclude my address with some remarks on this approach.

There are situations where the simple interaction of independent individual solutions cannot achieve an optimal outcome, but where public action is not necessarily warranted. Let me illustrate this point with one example.

One of the most successful examples of development through co-ordination in the euro financial markets since 1999 has been the establishment of the EONIA overnight interest rate swap market. The creation of the EONIA index, which underpins this entire market, is not a legislative or regulatory achievement. Nor could it appear spontaneously as a product of competition; it had to be the object of a co-ordinated agreement by market participants, to which we, at the ECB, have provided our logistical support.

In this particular case, the immediate beneficiary of integration was the community of money market participants as a whole. Accordingly, the appropriate engine for integration was a co-ordinated action within this community.

Let me provide you with another example of a situation where co-ordination could be exploited with benefits for all concerned. We have repeatedly insisted that the integration of the infrastructure of the euro area securities market should be driven by the market itself. However, we have to recognise that the costs associated with building an integrated market infrastructure for securities settlements would not necessarily be borne by those who would benefit the most from it. It may be difficult to devise appropriate mechanisms to compensate those who would bear these costs. In addition, some market participants may actually benefit in the short term from market fragmentation. Even though integration would generate net benefits for the community of market participants, individual incentives to change are missing or are too weak to be effective.

Under these circumstances, one cannot expect competition to achieve the desirable outcome. Yet public action is not a necessity. Rather, co-ordination is needed to foster a sensible private sector solution. In such a situation institutions with a pan-European mandate are well positioned to act as a catalyst, as the ECB did in the example of the EONIA market I mentioned before. However, the initiative has to come from the community of market participants organised for that purpose.

In this context I would like to mention briefly a recent initiative. At the end of the summer, the *ACI,* the *Financial Market Association*, asked us to host on their behalf a public consultation that they are launching on the means to better integrate markets for short-term securities in Europe. We agreed to do so because this is exactly the sort of initiative that I have been describing above. The lack of integration of short-term securities markets, relative to other segments of the money market, was identified some time ago. Competition alone did not allow us to overcome this problem, and while public action may be warranted to remove obstacles to this integration - in particular in the legal field - it cannot achieve it alone. Co-ordinated action by market participants may be the best means to address this issue, and that is why we welcomed the initiative of the ACI and have lent our logistical support to it.

Conclusions

What I conclude from these examples is the following.

There are possible ways, in between pure legislative or regulatory action on the one hand, and sheer competition on the other, for promoting the integration of the financial markets. One such way is co-ordination within the private sector. It is a common experience around the world that where this avenue is used without endangering competition, it can produce the desirable results. Our assessment is that this particular avenue has perhaps not been explored as widely as could have been the case in Europe.

We, at the ECB, are willing to support this co-ordination within the private sector. I insist, however, that initiatives have to come from the market, from you. Our role is to acknowledge and help to bring about your full potential. Yours is to take advantage - both individually and collectively - of the opportunities open to you. Together, we can progress towards a level of market integration that can make EU markets more attractive, more resilient and more effective. This would benefit each market user, it would benefit the financial community as a whole and - even more importantly from my point of view as a central banker - it would help to unleash more growth potential for the European economy.