Willem F Duisenberg: The transformation of the European financial system

Welcome speech by Dr Willem F Duisenberg, President of the European Central Bank, at the Second ECB Central Banking Conference, 24-25 October 2002, Frankfurt am Main, 24 October 2002.

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Ladies and Gentlemen,

I am pleased to welcome you to Frankfurt, to the second ECB Central Banking Conference, entitled "The transformation of the European Financial System". This event is the largest and most important open ECB conference and is held every two years.

The first ECB Central Banking Conference took place in November 2000. It focused on price stability, which is the ECB's primary objective, and that of many other central banks worldwide. It was a successful event, and I am convinced that this year's conference will be too.

Indeed, looking around, I am happy to see that this second conference has evidently aroused much interest and attracted researchers from leading institutions, officials from most of the major central banks, from ministries of finance, various European and international bodies and the media. In view of this year's topic, we also decided to invite representatives from commercial financial institutions and from supervisory authorities. I should like to extend a special welcome to the representatives of the central banks of the countries that are negotiating to join the European Union; these negotiations will hopefully be concluded fairly soon. I should, of course, also like to thank the speakers, discussants, panellists and chairpersons of the sessions.

Since the early days of the ECB and the first ECB Central Banking Conference, sufficient time has passed for us to assess whether we at the ECB have made an effective contribution to the relationship we have with the academic world. The academics here today should be the first to be asked this question. From our side, I am inclined to say that we have been effective. I am in particular referring to the success of our Graduate Research and Visitors Programme. In this context, I should like to announce the establishment of five fellowships for young researchers working in top-priority fields within the Financial Research Network. The Executive Board has decided to call these fellowships the 'Lamfalussy Fellowships', in honour of the first President of the European Monetary Institute (EMI), who has made an impressive contribution to the process of European monetary and financial integration.

Another example of successful co-operation and exchanges of information between the academic world and the ECB is the launching of a series of conferences and research networks. Of these, the ECB-CFS research network on "Capital markets and financial integration in Europe" has the closest ties to the theme of this year's conference – the transformation of the European financial system. Some of you may have attended the initial workshop here in Frankfurt last April. It's a European initiative; future workshops are to be held at the Bank of Finland in Helsinki, in March next year, and at the Bank of Greece next November. Also related to the present theme is the Eurosystem monetary transmission mechanism network.

Why have we chosen the transformation of the European financial system as our subject on this occasion?

The establishment of Economic and Monetary Union (EMU), almost four years ago, and the introduction of the euro banknotes and coins were real milestones. In respect of the Maastricht Treaty, they appear to mark the completion of the process of monetary integration in Europe. But we shouldn't regard Monetary Union as an end in itself. The introduction of the euro will have – and already has had – a powerful influence on the development of financial markets in Europe and their integration, as we will learn and discuss today.

The implications of these developments are manifold and profound, in particular for central bankers, but also for other policy-makers. Let me mention a few examples.

First and foremost, the transformation of the financial system has an impact on the conduct of monetary policy. For example, the emergence of new financial instruments and changes in the use of existing ones affect the choice, behaviour and interpretation of forward-looking financial indicators of underlying economic variables, such as consumer price inflation and GDP growth. Moreover, the implications for the transmission mechanism of monetary policy are of supreme importance to the

ECB. But I'll say no more on this matter now, as my colleague Otmar Issing will cover it in greater depth in his dinner speech this evening.

Second, financial system transformation affects the implementation of monetary policy. I will give you an example. Our weekly main refinancing operations with money market counterparties are conducted on the basis of repurchase agreements ("repos"). This requires a list of eligible collateral for such operations. In a changing financial environment, a central bank has to ensure that eligible collateral allows market participants to have efficient and equal access to central bank liquidity.

My third example of the importance of financial system transformation to central banks relates to the payment systems function. Most central banks in industrialised countries run a large-value payment system and are involved in the oversight of other payment and securities settlement systems. For reasons of efficient liquidity management by private banks, the Eurosystem's TARGET system allows for intra-day overdrafts that are fully collateralised. For TARGET to perform efficiently, it is therefore very important that securities settlement systems are interlinked or consolidated in a way which allows a smooth flow of collateral across the euro area.

Fourth, past experience has shown that structural change in financial systems may have an impact on financial stability. Hence, the structure and modus operandi of the authorities responsible for supervising financial markets and institutions must be designed to prevent any instability from arising. This is, as you are aware, quite a topical issue in the European Union. Central banks have a genuine interest in this issue, which clearly has its origins in the Treaty on European Union. The Treaty states that the European System of Central Banks (ESCB) shall "contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system". These and related issues will be considered in tomorrow's policy panel discussion, which will start off on the basis of a paper contributed by my colleague Tommaso Padoa-Schioppa.

Structural change in the financial system is important not only to central bankers but to other policy-makers as well. For instance, all policy-makers should have a clear interest in a further integration of European financial markets. The economic literature tells us that an integration of financial markets is very likely to contribute to economic growth by making the allocation of capital more efficient. The paper by Jean-Pierre Danthine in our third session tomorrow will address this issue. This is why the freedom of capital flows is one of the "four freedoms" at the heart of the Europe's single market. Indeed, increasing financial integration has always been a major item on the European political agenda. In this context, also the establishment of Economic and Monetary Union should be regarded as giving an important impetus to European financial integration. As things stand now, it is clear that full integration of European financial markets, to the extent possible of course, has not been achieved yet, despite the introduction of the euro. Although in some areas, such as the unsecured money market or the bond market, the euro seems to have boosted market integration, in other areas, such as repo and equity markets, the impact has been much weaker. The need for further efforts in this direction is fully recognised by many institutions, including the ECB, and is at the heart of the European Union's initiative to create a truly integrated market for financial services. The Vice-President will address this issue tomorrow in his summing-up.

The second ECB Central Banking Conference is structured very much like the first one. Today and tomorrow, there will be three sessions covering a number of issues related to the general theme of this conference, and based on research papers and contributions from discussants. A policy panel will follow these sessions.

The first session will deal with developments in European banking. The paper by Jean Dermine takes a look at how the European banking system has changed since the Treaty of Rome in 1957. It then asks a provocative question: how "real" is the single banking licence? The second session, tomorrow morning, will address the changing character of European finance, and in particular consider to what extent Europe is shifting from bank financing to market financing. In their paper, Luigi Zingales and Raghu Rajan will assess recent developments in this respect, and impediments to a further shift to a more market-based financial system. Our speaker in the third session, Jean-Pierre Danthine, will illustrate the benefits from the discipline that economic theory can impose on our thinking when analysing European equity market integration. He will also present a generalised approach to estimating the importance of country and sector effects in portfolio allocations. One of his discussants, Bruce Carnegie-Brown, will draw on his experience as a market expert to interpret for us recent developments in bond markets. Finally, as already mentioned, the policy panel, which will be the final session of the conference, will discuss the role of central banks in the maintenance of financial stability against the background of the transformation of the European financial system. I am particularly pleased to see that we have been able to bring together such highly esteemed policy-makers and academics for this purpose.

Ladies and gentlemen, I should like to finish at this point and hand over to our first speaker. I sincerely thank you again for coming here today. I wish you a very interesting and stimulating discussion, and I look forward to hearing about the results of the second ECB Central Banking Conference.