Nicholas C Garganas: The European financial marketplace

Speech by Mr Nicholas C Garganas, Governor of the Bank of Greece, at The Economist Conference: Private Banking and Asset Management, Athens, 22 October 2002.

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Ladies and gentlemen,

Let me start and by thanking The Economist for inviting me to speak at this conference.

In recent years, there has been a visible acceleration in the development and integration of EU financial markets. In what follows, I will discuss, first, why financial integration is desirable, second, why it has occurred, third, trends toward financial integration in the EU, and fourth, the role of public policy in supporting integration.

Why is financial integration desirable? I think it fair to say that the main function of the financial system is to serve the needs of the real economy, encouraging productive investments, allowing risks to be diversified, mobilising savings, monitoring firms' use of funds, etc. To this end, the development of both markets and sound financial institutions plays a key role. To the extent that increased financial integration allows the tasks of markets and institutions to be completed more efficiently, it will bring about greater benefits through two main channels: increased capital accumulation and higher productivity of capital. Through these two channels, the greater efficiency of an integrated EU financial system will lead to increased economic growth and a higher standard of living for EU citizens.

Three main interrelated factors have underpinned the acceleration of integration of EU financial markets. The first factor is globalisation. The integration of financial markets in Europe is part of a wider global development. Globalisation has many dimensions, all of which have been stimulated by the decline in costs of communication, transportation, data processing, and transactions. The second factor is the advances in creating a common regulatory framework across the EU as part of the effort to complete the Internal Market in financial services. The adoption of a common EU policy has been accompanied by liberalisation of financial markets in the Member States. As I will discuss shortly, however, there is still some distance to travel in this respect.

The third factor is the adoption of the euro. Before January 1999, the need to operate in many national currencies was a major obstacle to financial integration in the Union. The presence of a sizeable exchange risk limited the attractiveness of cross-border investment, reduced the incentive to proceed with regulatory harmonisation at the EU level, and dampened competitive pressures in Member States' home markets.

The introduction of a common currency for twelve Member States has altered this situation dramatically. The euro has eliminated exchange risk as a source of fragmentation in the EU financial system. It has also increased price transparency, stimulating competition. As a result, deeper integration has led to more homogeneous markets, a wave of consolidation among intermediaries and exchanges, and the emergence of new and innovative products and techniques.

The introduction of a common currency –the euro-- has perhaps had its biggest impact on the unsecured money market, that is the interbank deposit market. There is now virtually full convergence in interest rates across the euro area with little or no differences in the rates wherever the funds are exchanged. This outcome is, to a significant extent, a consequence of monetary union as all the regional money markets existing before EMU formed a large euro area money market. The ability to move funds across the euro area enabled the emergence of a deep, liquid and homogeneous money market.

Despite recent progress, however, the EU financial system remains fragmented. Member-State financial structures have evolved over time under the influence of specific national preferences with regard to legal and regulatory frameworks. For example, progress in integrating the secured money market, that is, the market in which money is exchanged for collateral and repos, or repurchase transactions, and which includes the markets for T-bills and CDs, has been hampered by differences in national rules about collateral, settlement and matters concerning the handling of insolvency. Nonetheless, a large increase in gross issues in euros by monetary financing institutions, non-monetary financial corporations and nonfinancial corporations has occurred (see Figures 1-3). Whilst the levels of monthly issues differ across groups (reflecting the fairly recent recourse by nonfinancial corporations in Europe to short-term securities markets in contrast to banks' use of the CD market to raise funds), there is no doubt that the advent of the euro has contributed to a marked change.

Bond markets, both government and corporate, remain even less integrated. In the former case, yields have converged significantly, with remaining differences reflecting either credit risk or liquidity risk. In particular, smaller countries often have difficulties in generating deep markets across the whole maturity spectrum. One solution that has been proposed is greater coordination of debt issues. This proposal, however, has met with some resistance, not least because national debt issuance is affected strongly by national-specific fiscal characteristics. With regard to markets for corporate debt, the lack of integration reflects the fact that euro-area companies have traditionally relied much less on debt raised in financial markets than have their Anglo-Saxon counterparts. Financial intermediaries play a much more important role in the euro-area than in Anglo-Saxon financial systems.

Finally, equity markets remain fragmented despite several mergers between exchanges, the increased use of electronic trading and higher positive correlations between share price movements across exchanges. The current, bearish climate in equity markets appears to be delaying further integration through the creation of integrated networks which can facilitate cross-border trading.

The introduction of the euro is also providing new impetus to competition between financial institutions. Wholesale banking markets have been integrated for some time now, but retail markets remain fragmented. Banks have tended to concentrate on domestic consolidation and have expanded cross-border by signing agreements with banks in other countries so as to facilitate the supply of services to their largely domestic customers.

Since some EU financial markets remain fragmented despite the benefits of financial integration, let me now turn to actions that can be taken to create an integrated EU financial market. In this regard, what is the role of public policy?

In my view, there are two major areas where public policy action can contribute to more-effective financial integration. The first relates to the need to remove remaining legal or regulatory barriers. The second involves responding appropriately to the new challenges raised by a more financially-integrated environment.

Regarding the need to remove existing barriers, the need of action in this area has been recognised at the highest political level. Successive European Councils have declared the integration of EU financial markets as a high priority of economic reform in the EU. This priority is reflected in a coherent policy strategy at the EU level and in the urgency which has been attributed to its implementation. The issue is being addressed mainly within the context of the Commission's Risk Capital Action Plan (RCAP) and the Financial Services Action Plan (FSAP).

The RCAP focuses on improving the provision of finance to new enterprises, often working in high technology, high risk areas. These firms often cite a lack of external finance as a major impediment to their expansion. Given the dynamism they provide to an economy, measures to alleviate the shortage of finance are crucial in meeting the wider goals of the EU member states, namely increasing employment, productivity and growth. At the Cardiff European Council in June 1998, financial services were given a high profile and the European Commission was asked to prepare a framework for action. The result was the Financial Services Action Plan, a package of 42 policy initiatives aimed at improving the functioning of the EU financial system by 2005. Among the objectives underlying the plan are the creation of a single wholesale financial market in the EU and open and secure retail markets. In general, the emphasis is on promoting financial markets, which are considered to be underdeveloped in Europe. Although more than half of the FSAP initiatives have been adopted or finalised, much work remains as agreement is proving difficult in some areas. One such area is that of methods of corporate governance. A wide variety of systems exists at present, varying, in part, according to the role of banks versus markets in corporate governance and the extent to which corporate governance mechanisms associated with growth of financial markets can co-exist with other methods based on institutions. The EU is sensitive to such differences. However, the greater development of markets necessitates the implementation of rules to regulate market behaviour, for example, in the areas of takeovers and takeover bids. Such differences need to be overcome quickly if the aim of implementing the FSAP by end-2005 (and the RCAP by end-2003) is to be realized. In this connection, the recent adoption by the Commission of a Directive on Prospectuses will introduce a truly single passport for issuers. Also, a Commission Regulation has recently been adopted on the application of International Accounting Standards (IAS) in the EU. It requires that all EU listed companies prepare their consolidated accounts in accordance with IAS from 2005 onwards.

Aside from the stumbling blocks in specific areas, there is also the more general question of the extent to which the infrastructure required for the smooth operation of a cross-border financial system will tend to emerge naturally through the operation of market forces and the extent to which it needs to be actively promoted by the authorities. I am inclined to think that a more proactive role for the authorities is needed to encourage the development of pan-European settlement and clearing systems, securities depositories, etc. Market forces may be impeded by the existence of strong national interests (existing national organisations often have strong monopoly powers which operate to prevent change) and/or the presence of diverse regulatory and legal environments (if a pan-European institution has to observe many different national regulations, depending on the nature of the transaction, then little will be gained by such an institution's existence).

Further financial integration brings not just benefits, but also challenges in terms of the measures needed to secure financial stability and to protect consumer and investor interests. A number of the measures in the FSAP address issues such as liquidation of financial institutions, the capital adequacy of banks and the question of how to deal with financial conglomerates. The EU has long been involved in strengthening cross-border cooperation among the member states in the area of supervision. The first two Brouwer reports, published in 2000 and 2001, examined supervisory procedures in some detail. In the second report, emphasis was placed on the need to coordinate supervision across sectors (banking, insurance, securities) in the face of the creation of large financial conglomerates. A third Brouwer report was published in September of this year which, inter alia, suggested recommendations for the procedures by which Community regulation is agreed, drawn up and adopted in an attempt to speed the presently rather cumbersome process.

Financial markets cannot function properly cross-border without a co-ordinated regulation and supervision for banking, insurance and securities markets as well as across these markets. The current set of committees is structured by sector and includes committees for discussion, advisory committees and committees with regulatory powers. Following the introduction of the Lamfalussy decision-making process in the securities markets, the current structure of committees came under scrutiny. In this connection, the Lamfalussy process, which was originally designed to establish a unified regulatory and supervisory framework for the securities' sector, is to be extended to cover banks, insurance companies, and financial conglomerates. This framework will lead to closer coordination of supervisory practices.

In conclusion, I think it fair to say that European financial integration has come a long way. Yet, the process is far from complete. EU financial integration is one of the cornerstones of the effort to boost the dynamism of the European economy. A more efficient and integrated EU financial system will increase the availability of capital and increase the productivity of capital, with positive knock-on effects on output growth and employment creation.