Jean-Claude Trichet: Financial markets integration in Europe: the ECB's view

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the 9th European Financial Markets Convention Federation of European Securities Exchanges, Brussels, 26 May 2005.

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Introduction

Ladies and gentlemen,

I accepted with great pleasure your invitation to speak this evening at the 9th European Financial Markets Convention.

I have to say that I particularly like the fact that tonight's dinner is being held here in the CBBD (Centre Belge de la Bande Dessinée) as it is a remarkable place in two respects. First, it is a fascinating art nouveau building that was built by Victor Horta in 1903. Second, it was here that I had confirmation that the first expedition to the moon was not engineered by Americans, but by Belgian citizens. There is a model here of the rocket that Belgium's intrepid heros, Tintin et Milou, Tintin and Snowy, used to go to the moon well before Armstrong.

The title of this year's Convention is "Towards true integration by 2009". Given that the integration of the financial system in Europe, in particular in the euro area, is of utmost importance to the ECB, I would like to present our views on the process of European financial integration.

I will start by highlighting the economic benefits of financial integration. I will then briefly summarise the state of financial integration in Europe, paying particular attention, given the specific event, to recent developments in the EU securities markets, especially in the field of securities regulation. Finally, I will outline prospects for the future, taking into account the recent publication of the European Commission's Green Paper on Financial Services Policy in 2005-2010.

The economic benefits of financial integration

The Lisbon strategy was defined in 2000 to enhance structural reforms, which Europe urgently needs. Structural reforms raise the growth potential of the European economy. And one such structural reform is the process of European financial integration.

It is generally accepted that financial integration fosters financial development, which in turn creates potential for higher economic growth. In a nutshell, the link is as follows. Financial integration enables the realisation of economies of scale and increases the supply of funds for investment opportunities. The actual integration process also stimulates competition and the expansion of markets, thereby leading to further financial development. In turn, financial development can result in a more efficient allocation of capital as well as a reduction in the cost of capital. In other words, the European economy grows more, the more integrated its financial system is. For example, according to a study (London Economics, 2002)[1] additional growth – resulting from financial integration of the European bond and equity markets – of 1.1% over a period of ten years is estimated.

It is against this background that the ECB strongly supports the Commission's policy of pushing forward the Lisbon strategy by focusing reform efforts, at the national level and the European level, on "delivering stronger, lasting growth, and creating more and better jobs".

One of the ECB's most effective contributions to these efforts is to continue to act as a strong and reliable anchor for safeguarding monetary stability, thus providing a vital element for promoting sustainable output growth.

However, the relationship between monetary policy and structural reforms like European financial integration is reciprocal, in the sense that the elements are mutually beneficial. Most importantly, an integrated financial system promotes the smooth and effective transmission of monetary policy throughout the euro area.

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[1] London Economics (2002), "Quantification of the macro-economic impact of integration of EU financial markets", Report to the European Commission.

Furthermore, I would like to mention that the integration of the financial system is highly relevant to our task of maintaining financial stability. Deeper financial integration, on one hand, has a higher capacity to absorb economic shocks than individual countries. It can also offer more possibilities for financial institutions to manage and diversify their relevant risks and realise economies of scale, which leads to greater efficiency of the financial system. On the other hand, deeper financial integration is transforming the nature of the risks all over Europe, particular attention being given to systemic risk stemming from contagion through intensified cross-border links (for instance infrastructure, interbank exposures, shareholdings and participation) and to moral hazard issues resulting from much larger institutions posing as a consequence much larger risks in case of failure. Therefore, the interaction between financial integration and financial stability deserves thorough analysis and consideration.

Having discussed the economic benefits of financial integration, let me now talk about the actors involved as well as the state of financial integration in Europe.

The actors involved and the state of financial integration in Europe

The main actors involved in the process of financial integration are the public authorities and the private sector.

Financial integration is a prime objective of the general economic policies of the European Union. Charlie McCreevy, the European Commissioner for Internal Market and Services, has explained the Commission's proposed line of action, as contained in the recent Green Paper on the priorities of the so-called post-FSAP strategy. The ECB will certainly give its advice on the main priorities to be pursued in order to complete the Single Market for financial services, and I will mention some of the core aspects of this later on.

However, although the public authorities can, and must, provide an adequate framework conducive to financial integration, financial integration is ultimately a process driven by market forces and decisions taken by the private sector. In my view, policies relating to the regulatory and supervisory framework should also be complemented by and closely coordinated with other policies relevant to financial services, in particular competition policy.

Let me turn to the role of the ECB in fostering financial integration. We generally distinguish between four types of activities. First, as I have just said, the ECB can act as a catalyst for collective private sector initiatives. We assist, if you like, Adam Smith's invisible hand of the private market in order to achieve financial integration. This function is particularly important in the European context as private market participants still need to develop further the coordination of their joint interests, for example in the setting of standards. In this regard, I would like to mention the Short-Term European Paper (STEP) initiative as well as the Single Euro Payments Area (SEPA) project, both of which we support by acting as a catalyst for private sector activities.

The second type of activity involves the provision of central banking services. Whereas the main purpose of this activity is related to the basic tasks of central banking, the specification of these services can also be conducive to fostering financial integration. The most prominent example of this is probably the TARGET system and its current consolidation into TARGET2. Today, TARGET represents around 90% of the total traffic in large-value payments in euro. And with EUR 1.7 trillion settled every day, TARGET is one of the two largest wholesale payment systems in the world, alongside Fedwire in the United States. Moreover, TARGET2, due to got live in 2007, will foster financial integration even more. It will be based on a single technical platform, it will increase the cost effectiveness and it will put in place a single price structure for domestic and cross-border payments. We expect TARGET2 to be one of the most efficient and sophisticated payment systems in the world.

Thirdly, we provide advice on the shaping of the legislative and regulatory framework of the financial system. At this juncture, I would mention, in particular, the views we provided on the design and implementation of the Lamfalussy approach as well as on specific draft Community legislation such as the four directives relating to the securities markets (Markets in Financial Instruments Directive (MiFID), Prospectus, Market Abuse, and Transparency).

The fourth major activity concerns the research we conduct on all aspects of European financial integration and our monitoring – in collaboration with the European Commission – of the financial integration process by means of quantitative and qualitative indicators. Through this, it is our aim to raise awareness of the need for financial integration and the means by which it can be achieved.

This leads me to give a brief overview of the state of integration in the European financial markets. Generally speaking, the degree of integration differs quite significantly between the market segments, and it is greater the nearer the respective financial market segment is to the single monetary policy. As a broad assessment of the level of integration in the wholesale markets, I would say that it is almost perfect in the money market, including its related interest rate derivatives markets, very well advanced in the government bond market, fairly high in the corporate bond market, and least advanced, but increasing, in the equity market. As concerns the securitisation markets in Europe, there still exist obstacles to cross-border securitisation.

Finally, as regards banking markets, integration is fairly well advanced in wholesale (or interbank) and capital market-related activities, including trading and sales, asset management, agency services and syndicated lending. In retail banking, however, it is clearly lagging behind. In its Green Paper on the post-FSAP strategy, the European Commission identified this area as one requiring initiatives to foster integration, and it plans to issue this summer a separate Green Paper on integration of European mortgage markets.

But before turning to the broader subject of the post-FSAP strategy, let me focus for a while on the field of securities markets and regulation.

Development of EU securities markets and securities regulation

I surely do not have to remind you of the significance of securities markets from the ECB’s point of view. Efficient securities trading platforms and clearing and settlement institutions are of fundamental importance for the functioning of the financial market. In addition, the ECB has a specific interest in integrated securities markets and infrastructures because all central banking credit operations need to be fully collateralised.

Tonight, I would like to talk about developments in the EU securities markets and about what I believe the role of regulation should be.

As a general feature of the euro area’s financial system structure, non-bank intermediated and market-based instruments have become more important in the past decades. Indeed, firms in continental Europe are increasingly turning to the capital markets to fulfil their external funding needs. As for the corporate bond market, growth has been very robust since the launch of the euro. In terms of issues by non-financial corporations, the average annual growth rate in the euro area between January 1999 and December 2003 was around 10 percentage points higher than in the United States, which is the converse of the situation prevailing before the introduction of the euro. Nonetheless, corporate bond markets in the euro area are still comparatively small, as, for example, the outstanding volume of bonds issued by non-financial corporations is around EUR 600 billion in the euro area compared to USD 2.9 trillion in the United States.

The euro area stock market capitalisation also has increased perceptibly over the last years, namely from 21% of GDP at the end of 1990 to 45% of GDP at the end of 2003. Furthermore, the number of listed companies in the euro area grew from around 4,300 at the end of 1990 to around 6,700 at the end of 2003. There are also clear signs that integration in the European markets will accelerate in the future and that further consolidation of European trading and the post- trading infrastructure is on its way.

The factors that have stimulated the growth of financial markets are manifold. These include, among other things, advancements in technology, deregulation, increasing wealth and demographic changes that boosted the demand for private pension schemes. In addition, the launch of the euro further bolstered capital market growth in the euro area, mainly through substantially improved market liquidity. Technological and regulatory changes also aid the removal of barriers to the cross-border provision of services and create the right conditions for consolidation of market infrastructure. I believe that this growth in the EU financial markets has been spurred by the increased efforts to strengthen the legal and regulatory framework at the EU and the national level, particularly through the launch of the Financial Services Action Plan (FSAP).

Indeed, the FSAP has addressed those parts of the EU regulatory framework that needed to be upgraded in the light of new developments in the markets, or the newly perceived need to tackle the regulatory barriers to cross-border services. Examples of such changes include the MiFID and the Prospectus Directive. In addition, existing lacunae in the EU framework have been addressed, for example with the Market Abuse Directive, which has introduced a new EU regime for combating market manipulation. The Commission and the Committee of European Securities Regulators (CESR) are currently finalising the complex layout of Level 2 measures and the European Securities Committee will be very busy over the coming months with the implementing measures of the MiFID. As always, “the devil is in the details” and careful drafting is highly important. The ECB, which participates in the meetings of the European Securities Committee, will provide its technical input on those matters deemed within its interest.

I have just mentioned that recent research has shown how important securities regulation and well-functioning legal systems are for the development of equity markets.[2] The basic idea is that well-functioning legal systems protect outside investors which in turn should improve firms’ ability to raise external finance and to exploit growth opportunities. We should not forget here the importance of initiatives for improving corporate governance mechanisms and the protection of shareholders. This conference rightly does not only cover securities regulation as it will also host a corporate governance session tomorrow. Following recent corporate scandal, a number of initiatives are on the way at the European and the international level.[3] Of key importance is in my view the existence of a continuous dialogue among all regulatory authorities to promote a better mutual understanding and to reduce the risk of duplication of requirements.

Regulation, however, is not a panacea and action by regulators cannot suffice on its own. The correct behaviour of market participants is also crucial to the efficiency of the securities markets. Institutional investors, auditors, analysts and rating agencies also play a key role in that they interpret disclosed information and assess the value of companies. In addition, they help solve the collective action problems of investors by researching and overcoming informational asymmetries. Particularly in the EU context regulation should remove the barriers to cross-border services and ensure that nothing hinders the full implementation of the Single Market.

Prospects for the future

We are at a particularly crucial stage in terms of the regulation of EU securities markets and more in general financial regulation. When approaching a crossroad, it is natural to feel slightly uneasy before it becomes clear which road to take. This is especially the case when the crossroad is badly lit and there are no signs to indicate the way. In this case, however, I think that the crossroad is very well illuminated and there is no reason to worry.

The Commission started to prepare the post-FSAP strategy in a transparent manner, timely involving all interested subjects and it has now published a Green Paper for public consultation in order to encourage debate on the post-FSAP strategy.

The ECB will reply in detail to this consultation. For now, let me make a number of preliminary suggestions as to what I believe to be amongst the main challenges ahead of us.

First of all, I share the focus of the Green Paper on the consolidation of existing legislation, entailing that a rigorous “better regulation” approach will be applied and measures that do not deliver the intended benefits have to be amended or repealed. Regulation is a fundamental tool for correcting market failures and overcoming barriers to the realisation of the Single Market. And I call upon all participants to deliver responses to the consultation that will highlight areas in which the public authorities can really help to overcome the coordination problems that remain between market participants.

Second, I can fully support the notion underlying the whole Green Paper that every effort should be made to promote a more consistent implementation at the national level of existing Community legislation. In this context, I recall the position expressed by the Eurosystem in relation to the review of the Lamfalussy process.[4] The Lamfalussy approach has enormous potentialities to favour further convergence of national regulations that still have to be fully exploited. More specifically, Level 2 should provide the main set of technical rules to which financial institutions would be able to refer to. In

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[2] See inter alia R. La Porta, F. Lopez de Silanes, A. Shleifer, and R. Vishny (1998), “Law and Finance”, Journal of Political Economy, 106, pp. 1113-55.

[3] For an overview, see ECB, “The evolving framework for corporate governance”, in ECB Monthly Bulletin, May 2005, pp. 89 – 100.

[4] See http://www.ecb.int/pub/pdf/other/lamfalussy-reviewen.pdf.

the same vein, I very strongly support the proposal in the Green Paper to launch a feasibility study on whether all rules at the national and the European level can be fused into a single body of consistent law, a “Financial services rulebook”. The “Financial services rulebook” would be the proof that we have a single market in the financial services and simultaneously a very efficient mean to deepen it.

Finally, I think that a lot of attention should be addressed to achieve the objective of supervisory convergence which the Level 3 Committees have to deliver. This objective is crucial for reducing the compliance costs for financial institutions operating on a cross-border basis. It is also relevant for promoting convergence towards best supervisory practices. The success of the supervisory committees will be very largely measured in terms of their capability of actually delivering the objective concerned.

Concluding remarks

Ladies and gentlemen,

Let me, in conclusion, repeat my main messages as concisely as possible.

First, now a new period begins with less emphasis on new regulation and much more emphasis on transposition and enforcement of existing measures.

Second, the implementation of the Lamfalussy framework is a unique opportunity to achieve consistency in the regulatory and supervisory framework across Member States and therefore to have an effective level playing field for financial services.

Third, the working of a “Financial services rulebook” is warmly and strongly supported by the ECB.

And fourth, we will continue, as far as we are concerned, to work closely with the Commission, policy makers and market participants and will continue to play the role of catalyst of private sector initiatives where it appears appropriate.

Thank you very much for your attention.