Jean-Claude Trichet: The state of European financial integration

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the third euro fixed income forum, Euromoney Conferences, Paris, 28 November 2005.

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1. Introduction

Ladies and gentlemen,

I would like to thank the organisers of Euromoney Conferences for inviting me to speak to you today on the occasion of the Third euro fixed income forum.

I am impressed by the wide range of topics that you will deal with in the course of this event, addressing developments in financial markets and financial infrastructures as well as EU policy issues. The conference also addresses in a comprehensive manner past and future developments and geographical comparisons between the euro area market and the US market.

In my speech today, I will assess the state of European financial integration. I will therefore not only deal with a subject matter that is of primary interest to the ECB, but at the same time touch upon several of the conference themes that will be discussed in workshops and round tables.

2. Why European financial integration is important

Financial integration is directly relevant for the ECB's tasks. A well-integrated financial system is important as it enhances the smooth and effective transmission of monetary policy impulses throughout the euro area. The financial system is composed of financial markets and their related infrastructures, and of the financial institutions that are active on these markets. We can be very proud of the euro money market, in particular the unsecured interbank market that has been almost perfectly integrated since shortly after the introduction of the euro in 1999. Our TARGET system, the large-value payment system that has been operational since the first day of Monetary Union as a platform for balancing liquidity surplus and deficits within the euro area, has been instrumental in this respect. A financial market also needs an integrated market infrastructure in order to achieve full integration. The Eurosystem helps in this respect by providing central banking services that are conducive to fostering financial integration. Our decision to move to TARGET2, where the launch of the single shared platform is planned for November 2007[1], is a clear example of this.

Furthermore, financial integration has implications for our task of safeguarding financial stability, for which the Eurosystem's contribution has been called upon by the Treaty establishing the European Community. Being aware of the links between financial integration and financial stability is therefore of the essence. As we know, on the one hand, more integrated financial markets offer better opportunities for financing and risk diversification, and thus help to improve the capacity of economies to absorb shocks. On the other hand, the structural transformation of the financial system through enhanced financial integration, including the creation of intensified cross-border financial links, necessitates that we closely follow the process of financial integration.

But we should also bear in mind that financial integration is relevant for all of us, for financial market professionals and for all citizens of Europe alike, because of the economic benefits that arise from financial integration. In fact, financial integration is a key factor in the development and modernisation of the financial system, which, in turn, increases the potential for greater and more sustained non-inflationary economic growth. I will give here a direct answer to the question you posed in the first round table discussion this morning concerning the possibilities of enhancing sustained economic growth in Europe.

It is generally accepted that financial integration fosters financial development and, ultimately, economic growth. Financial integration allows for economies of scale and increases the supply of funds for investment opportunities. It also fosters competition and the expansion of intermediation and

[1] See Second progress report on TARGET2, ECB press release dated 21 October 2005, available from the ECB website.

markets. This financial development in turn leads to a more efficient allocation of capital and thus increases the potential for higher economic growth.

We can also note the interesting development with regard to the theory of optimal currency areas, where it has been put forward that the optimality of a currency area is not necessarily something that needs to be achieved fully before monetary union takes place but rather is the result of monetary union itself. In fact, the euro acted as a major catalyst for the integration of the euro financial markets.

Still, we are also aware that the degree of integration differs between market segments, with integration being more advanced in those market segments that are closer to the single monetary policy, above all the money market. Integration could still be enhanced for other segments.

In this context, it is interesting to look at studies that quantify and estimate the economic benefits of financial integration. By way of example, let me mention a study that estimates the potential resulting from the integration of European bond and equity markets in terms of additional GDP growth, which is predicted to be around 1 % over a ten-year period, or around EUR 100 billion.[2]

Coming back to the question of the possibilities for enhancing sustained economic growth in Europe, I would like to stress the importance of realising the potential inherent in European financial integration in order to reap its economic benefits in full.

3. Measuring the state of European financial integration

In order to realise the existing potential of financial integration for economic growth, the immediate question to ask is: where is such potential to be found, in which parts of the financial system is financial integration more advanced, where is it still lagging behind? In sum: what is the state of play of financial integration in Europe?

A prerequisite for any action is the analysis of the state of financial integration in the euro area and the monitoring of the progress of financial integration over time. Because the relevant arguments in discussions on this topic are often of a qualitative nature, the ECB sought to devise a way to capture, in quantitative terms, the state of financial integration in the euro area. Two months ago, the ECB published, for the first time, a set of indicators regarding the state of integration of euro area financial and banking markets. With the accompanying explanatory report, which we will publish on an annual basis, the ECB aims to measure and monitor financial integration in the euro area over time.[3]

I will now describe, on the basis of several of the 20 indicators published, the state of financial integration in the main euro financial market segments, namely the money market, the government bond market, the corporate bond market, the equity market and banking markets.

Money market

As I mentioned earlier, we have good reason to speak of success when we look at the degree of integration of the money market, in particular the unsecured interbank market and the repo market.

Our indicators measure financial integration of the euro money market based on the dispersion of lending rates for actual transactions or rates offered by EONIA, EURIBOR and EUREPO panel banks.[4]

When we recall that only one year before the start of Monetary Union, in January 1998, the cross-country standard deviation of the average overnight lending rates among euro area countries was higher than 130 basis points, it is impressive that this indicator was as low as three basis points in early 1999 and has since decreased even further to just one basis point.

Indicators for the one-month and 12-month maturities also consistently show a highly integrated unsecured money market. While the respective cross-country standard deviation of EURIBOR lending

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

[3] The ECB's report and the statistics underlying the financial integration indicators can be accessed under Statistics > Indicators of financial integration on the ECB's website. The financial integration indicators will be updated semi-annually.

[4] Data referring to the time before the introduction of EONIA and EURIBOR are average overnight, one-month, 12-month rates, respectively, of euro area countries.

rates among euro area countries stood at more than 100 basis points for the one-month maturity, and at around 50 basis points for the 12-month rates in January 1998, since early 1999 both of these indicators have shown values not higher than, and normally below, one basis point.

Last but not least, our indicators also confirm a high degree of integration for the repo market. The EUREPO index was launched in March 2002, and since then, the euro area cross-country standard deviation of the one-month EUREPO rates has been around, and normally below, one basis point. The indicator for the 12-month maturity shows a standard deviation of around, and normally below, two basis points.

The absolutely decisive role of the euro in enhancing financial market integration is also visible in the interest rate derivatives markets. Let me highlight the success of the euro overnight index swap market. As an example of a market that came into existence after the launch of the euro and having been integrated from the outset, this relatively young market is not covered by our initial set of indicators – which does not exclude the fact that we may add it at some stage. But what is sure is that it is a successful market – as also attested by the launch of the EONIA Swap Index in June this year.

Later in this conference the issue of what the euro area market does better than the US market will be addressed. One such example is the euro interest rate swap market, which is the largest interest rate swap market in the world – about one third larger than the equivalent US dollar segment.[5]

But we know that there are also examples where the euro area market lags behind the US market. The least integrated money market segment is the short-term securities market. Compared with the equivalent US commercial paper market, which has an outstanding amount of around EUR 1.3 trillion and which is indeed integrated, the aggregate size of the commercial paper and certificates of deposit markets in Europe is around EUR 0.8 trillion. Furthermore, these markets remain segmented within Europe. Here, I expect that the Short-Term European Paper (STEP) initiative, which aims to promote the convergence of standards and practices, will provide an impulse towards integration, thereby increasing the depth and liquidity of this market in Europe. The Eurosystem supports this market-led initiative. I would like to express my appreciation to the promoters of the STEP exercise and would like to encourage them to keep up the momentum for the last stage, as the first STEP-labelled programme is expected in early 2006.

Government bond market

Let me now turn to the bond markets, where I would like to begin with the government bond market.

Government bond markets have achieved a very high degree of integration, mainly due to the disappearance of intra-euro area exchange rate risk. Since then, government bond yields in different euro area countries have been driven exclusively by euro area-wide factors and news, and by the appreciation of the risk inherent to the various signatures of the Governments concerned.

Our indicators of the integration in government bond markets encompass the standard deviation of government bond yield spreads, measures based on regressions, such as the evolution of beta coefficients, and variance ratios. They point to a very high degree of integration of the euro area government bond market.

Corporate bond market

Noteworthy is the emergence of a euro corporate bond market, which has grown considerably since 1999. While this market had been predominantly open to the highest quality credits in that year, the market has since broadened to facilitate the funding needs of riskier issuers. In general, a maturing euro corporate bond market adds to the diversification of corporate financing and leads to greater benefits from having multiple avenues of corporate finance. The gap with the US market is, however, still large in terms of absolute size, with the outstanding volume of bonds issued by non-financial corporations of around EUR 2.5 trillion in the United States being around three times larger than in the euro area.

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5 The euro interest rate swap market has a daily turnover of almost EUR 250 billion, while the equivalent US dollar segment is around EUR 160 billion. See BIS Triennial Central Bank Survey - Foreign exchange and derivatives market activity in 2004 (March 2005).

The reasonably high degree of integration of the euro corporate bond market is, however, positive. The yield on a corporate bond depends typically on a number of factors, such as the credit rating, time-to-maturity, liquidity and cash flow structure. Our indicators for the state of integration of the euro corporate bond market are based on (econometric) model estimation, investigating whether or not risk-adjusted yield spreads have a systematic country component. In an integrated market, the proportion of the total yield spread variance attributable to country effects should be close to zero. Our studies suggest that this market segment is fairly integrated in the sense that the country of issuance is only of marginal importance in explaining yield differentials.

Equity market

Other market segments have even more potential for further advances in the level of integration. In fact, the euro area equity markets are still quite fragmented, but a gradual integration process is ongoing.

For example, our indicators show that stock prices across the euro area increasingly react to euro area-wide factors and news. Another indicator to measure the degree of integration in euro area equity markets is the relative importance of sector versus country-based investment strategies. The indicator is derived by calculating and comparing the cross-sector dispersion with the cross-country dispersion of equity returns. The more integrated the euro area equity market is, the greater the pertinence of spreading investments across sectors as opposed to country-based equity investment strategies. Our statistics show that the elimination of intra-euro area currency risk has encouraged integration in the sense that the “home bias” in the equity holdings of institutional investors has been significantly reduced. For the first time since 1973, the concept of sector diversification has, since January 2001, surpassed geographical diversification among euro area countries. Nevertheless, the importance of the country effect is still too great for it to be concluded that the equity market is fully integrated at the level of the single currency area.

Banking markets

A further example where integration is generally lagging behind is banking markets, whereby the degree of integration is also different for the types of banking activities, i.e. capital market-related activities, interbank (or wholesale) activities, and retail banking.

Cross-border interbank loans and holdings of securities have, in relative terms, experienced substantial growth. While securities issued by non-monetary financial institutions of another euro area country accounted for only 16% of the securities held by euro area monetary financial institutions (MFIs) at the end of 1997, this share has now reached almost 40%, pointing to a higher degree of capital market integration in the euro area. And although loans granted between domestic MFIs still account for more than 50% of the total EU MFI loans, the respective euro area cross-border activity has increased from only 15% at the end of 1997 to around 23% at present.

Last but not least, integration in retail banking has, by contrast, not progressed to any great extent, as shown by both price and quantity-based indicators.

For example, while the share of euro area cross-border MFI loans granted to non-MFIs stood at 2% at the end of 1997, this figure has risen to no more than 3.5% today. Also, taking a price-based indicator, the cross-country standard deviation of interest rates on consumer credit has been rather high and constant, on average 0.9% over the last three years. And, to give a last indicator for the level of retail banking integration, the cross-country dispersion of interest rates on lending for house purchase amounts to, on average, 0.5% over the last three years, with no clear declining trend visible as yet, thereby confirming the picture of hesitant euro area credit market integration.

Before I conclude on the state of financial integration in the main euro financial market segments, I will mention that, after having produced the first publication of indicators of financial integration this year, the coverage of our indicators will be further enhanced next year, in particular by adding indicators relating to the integration of financial institutions and financial market infrastructures.

4. The role of EU policies to foster financial integration and the Eurosystem's contribution

I would like first to stress that the provision laid down in the Treaty that the Eurosystem acts in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, also determines the Eurosystem's view that financial integration is first and foremost a market-driven process.

In addition, we see it as a basic task of public authorities to create a framework conducive to fostering financial integration. This framework should be such that, generally speaking, all potential market participants in a given financial instruments or services market are subject to a single set of rules when they decide to deal with those financial instruments or services, have equal access to this set of financial instruments or services and are treated equally when they operate in the market. If the opportunities thus created have been exploited by market forces, true financial integration will have been achieved and its benefits can be reaped.

Let me now turn to the European Commission's agenda for the financial services policy over the coming years. Incidentally, I have also made a contribution in this respect to the Euromoney Yearbooks "European Single Financial Market 2005/2006", published at the start of October.[6] This contribution is to be seen within the context of the Eurosystem's response, provided in August, to the European Commission's consultation on the priorities for financial services policies over the next five years.[7] As we explained, the Eurosystem supports the key policy orientation of the Commission's Green Paper. Let me give a brief summary of what we deem to be some basics for the further shaping of the regulatory and supervisory framework of the European financial system in order to foster financial integration. I would like to highlight two points.

First, there is a need to proceed with the adoption of the remaining measures envisaged in the Financial Services Action Plan (FSAP) in order to complete the regulatory framework, and hence, with the effective implementation and enforcement of such measures at national level. The field of securities clearing and settlement is an area in which further integration is needed to exploit in full the benefits arising from a pan-European securities market. A recently published paper by ECB staff summarised the situation of the integration of securities market infrastructures in the euro area.[8] The Eurosystem supports the Commission's intention to put forward a proposal for a Directive on securities clearing and settlement to complement the market-led removal of the "Giovannini barriers".

Second, we agree with the Commission's proposal for "better regulation" based on open, transparent and evidence-based policy-making, including an ex ante evaluation of possible costs and benefits. In its Green Paper, the Commission in particular put forward retail financial services and asset management as areas where such efforts could potentially be made. In the case of retail financial services, I mentioned earlier our assessment based on quantitative indicators that integration is generally lagging behind in the field of retail markets. In the case of asset management, I would like to mention the Eurosystem's recent contribution in response to the Commission's public consultation regarding the enhancement of the EU framework for investment funds.[9] The Eurosystem fully endorses the Commission's reflections to assess the possible need for further Community initiatives in the area of asset management. We also stand ready to support any further work the Commission may undertake in this field. By way of example, I would like to mention that we advised the Council on amendments to the UCITS Directive, and stand ready to advise it on any future legislative initiative in the field. Furthermore, the ECB is developing harmonised and comprehensive statistics about investment funds which may also be helpful to the Commission in its further work.

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6 See "European Single Financial Market 2005/2006", Euromoney Yearbooks, 1 October 2005, p. 1-4 (Foreword).

7 "Eurosystem contribution to the public consultation by the European Commission on the Green Paper on Financial Services Policy (2005-2010)" dated 1 August 2005, 72 kb en. See the ECB's website under Publications > Publications by activity > Financial stability and supervision.

8 See "Integration of securities market infrastructures in the euro area", H. Schmiedel and A. Schönenberger, ECB Occasional Paper No 33, July 2005.

9 "Green paper on the enhancement of the EU framework for investment funds. Eurosystem contribution to the Commission's public consultation" dated 17 November 2005, 76 kb en. See the ECB's website under Publications > Publications by activity > Financial stability and supervision.

With regard to the supervisory framework, the policy objectives are twofold. First, in order to realise economies of scale and scope, the framework should facilitate the development of cross-border consolidation of financial institutions and the cross-border exchange of services and products. The second objective is to maintain the effectiveness of supervisory standards and action in a more integrated financial system. The current institutional set-up, and in particular the Lamfalussy framework, provide the appropriate structure for achieving these broad policy objectives, if it is used to the maximum extent possible. This entails pursuing two operational goals.

First, to achieve supervisory convergence by the Level 3 committees which should deliver supervisory action that is consistent on a cross-border basis. The experience thus far is encouraging.

Second, to achieve a strengthening of the cooperation between home and host authorities for the supervision of financial groups operating across borders. This is essential for reconciling the interests of supervisory authorities and the financial sector. A lack of progress could fuel demands to revise the current institutional set-up, as the financial industry occasionally points out.

The work of the Level 3 committees is expected to strongly promote supervisory convergence and cooperation. Further developments in financial integration, especially the increasing prominence of both complex cross-border institutions spanning several Member States and large foreign establishments in host countries, may pose challenges to the current arrangements. Furthermore, financial integration calls for increased supervisory cooperation across financial sectors. In this respect, I recall that the three Level 3 committees, i.e. the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR), signed last Thursday a joint protocol that aims to foster cooperation and coordination in their tasks of common interest.[10]

As I already mentioned, the Eurosystem is of the view that the potential of the existing framework should be fully exploited. Furthermore, the review of the Lamfalussy approach due by the end of 2007 should provide the opportunity to form a comprehensive judgement about the progress made.

I have now discussed EU policies and have spoken about the Eurosystem's view on shaping the regulatory and legislative framework. We see the provision of such advice as one contribution we can make to support the process of financial integration. It is also in line with the Treaty provision in Article 105 that the Eurosystem shall support, without prejudice to the objective of price stability, the general economic policies in the Community, of which financial integration is a priority objective.

Lastly, I would like to mention another contribution the Eurosystem can make to foster financial integration, which is for the central bank to act as a catalyst for collective private-sector activities. This is a straightforward illustration for the joint effort undertaken by market participants and public authorities, like the Eurosystem, to foster financial integration. Since competition among private financial agents is also necessary, coordination of interests can be facilitated with the aid of a catalyst. Being a central bank, we are also a market participant, having both the necessary knowledge and the numerous contacts with market participants. I would just like to mention the two most important catalyst activities that are ongoing at present, namely the Short-Term European Paper (STEP) initiative as well as the Single Euro Payments Area (SEPA) project.

In fact, the STEP initiative, which I mentioned earlier in my assessment of the degree of integration of the money market, was first discussed at the meetings of the ECB Money Market Contact Group by ACI – The Financial Markets Association, which has led the initiative since then. The Eurosystem's support, together with that of the European Commission, for the banking industry's initiative to create the Single Euro Payments Area (SEPA) is another case in point. By 2008 we expect European citizens to be able to make payments throughout the euro area from a single bank account, using a single set of payment instruments, as easily and safely as in the national context today.

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[10] See "Banking, insurance and securities supervisors enhance EU wide cooperation", press release dated 24 November 2005, at www.c-ebs.org, www.ceiops.org, www.cesr-eu.org.

5. Concluding remarks

Ladies and gentlemen, it was a pleasure to give you our assessment of the state of European financial integration as well of the various contributions that the ECB, and the Eurosystem as a whole, make in fostering this process.

Let me put today's theme in the context of the Lisbon strategy to which the ECB is inflexibly attached. Creating well functioning, competitive and efficient markets is a key aspect of the Lisbon goals. The benefits from the internal market in terms of growth and employment, the two clear objectives on which the Lisbon strategy focuses, are still to be fully exploited. Financial integration is one tool with which to achieve these benefits. The ECB, for its part, will continue to make its contribution. Thank you for your attention.