Lucas Papademos: Financial integration, development and stability – lessons from the crisis

Speech by Mr Lucas Papademos, Vice President of the European Central Bank, at the conference "Financial integration and stability: the legacy of the crisis" sponsored and organised by the European Central Bank and the European Commission, Frankfurt am Main, 12 April 2010.

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I. Introduction

Welcome to the European Central Bank! And welcome to this event which has been jointly organised by the European Commission and the ECB. The topic that we have chosen for this conference is the relationship between financial integration and financial stability. The integration of financial markets is an important policy objective of the EU because it fosters economic efficiency and growth. The Commission and the ECB have a common and keen interest in pursuing this objective. The Commission pursues the goal of financial integration in Europe, as part of its Single Market programme. The ECB promotes the integration of financial markets in order to enhance the efficiency of the European economy but also because it facilitates the smooth and balanced transmission of the single monetary policy and increases its effectiveness. Cooperation between European institutions is not always properly recognised or even known. Hence, organising this event jointly has a double aim: first, to advance the European financial integration process by assessing the progress achieved and the policies pursued; and, second, to highlight the extent of cooperation between our two institutions in achieving common objectives.

In my remarks, I would like to address two issues: First, I will highlight the interacting links between financial stability, on the one hand, and financial integration and development, on the other. And I will provide an overview of the effects of the crisis on financial integration and development, as well as of the role of the latter in the emergence of systemic risks. I will consider the processes of financial development and integration together, because, although conceptually they are distinct, they are related in practice and they have interacting links to financial stability. Second, I will focus on a more specific, but important and topical, issue: the impact of the still unfolding crisis on the integration and functioning of the sovereign and corporate bond markets in the euro area.

II. The links between financial stability, integration and development

The crisis has revealed a rather complex set of interdependencies between financial stability, integration and development. In general, an environment of financial stability and the processes of financial integration and development are mutually reinforcing. The stability of the financial system does contribute to its development and integration. This is evident from the experience of the first eight years of EMU that were characterised by financial stability which facilitated a steady and significant progress towards more financial integration and development.

At the same time, and in the opposite direction, a more integrated and innovative financial sector typically enhances competition, facilitates portfolio diversification and access to funding, improves risk-sharing opportunities and increases market liquidity. As a result, the shock-absorbing capacity of the financial system is improved, thereby enhancing financial stability.

However, the crisis demonstrated that a highly integrated and developed financial system does not always and necessarily strengthen financial stability. Under certain conditions, financial integration and certain forms of financial innovation can contribute to the build-up of

vulnerabilities and the emergence of systemic risks. In the years preceding the crisis, as the global financial system evolved at a rapid pace, the proliferation of complex and opaque financial products, the development of innovative securitisation techniques, the emergence of inappropriate incentive structures, the increased interconnectedness of markets and institutions, in an environment of enhanced competitive pressures and excessive credit growth, encouraged risk-creation and risk-taking; and increased the scope for contagion across institutions, markets and borders.

The emergence of systemic risks and the eventual eruption of the crisis were also the consequence of the fact that corporate governance, risk management, market infrastructures for derivative products as well as supervisory practices and regulatory frameworks did not keep up with the rapid transformation of the financial systems.

What has been the impact of the crisis on financial integration and development? The crisis caused severe dysfunctionalities in several financial markets and had adverse effects on development and integration in certain market segments. The issuance and trading in the most complex variants of asset-backed securities – like the CDOs – came virtually to a halt after the crisis broke out and the markets for such products have yet to revive. Even the interbank money market – the most highly integrated one in the euro area – showed signs of segmentation after August 2007, which intensified in September 2008. The ECB Report assesses in detail the impact of the crisis on financial integration and development and it examines, in particular, the extent to which cross-border integration has improved in various markets as they are returning to more normal conditions.

Let me conclude by making two points regarding the policy implications of the crisis for the advancement of financial integration and development. The crisis has provided a stressful but valuable test for financial innovation and cross-border integration, indicating what needs to be changed so as to reap the benefits of integration and development for efficiency and growth, while safeguarding financial stability, by addressing potential systemic risks that might stem from these processes. The recent experience, the ongoing policy debate and economic research converge on the need for greater transparency, reduced financial product complexity, improved corporate governance and more effective risk management. Moreover, the crisis revealed the need for a strengthened regulatory framework, enhanced macro-prudential oversight, intensified micro-prudential supervision and better cross-border crisis management and resolution regimes. The list is long, but it is vital that progress continues to be made on all relevant fronts. A lot has been achieved so far, but much more remains to be done.

In particular, the global regulatory reform underway and the new EU supervisory framework will greatly contribute to both financial stability and increased financial integration. The European System of Financial Supervisors will support financial integration by promoting a single set of micro-prudential rules and the equal treatment of market participants. In parallel, the European Systemic Risk Board will foster financial integration by safeguarding financial stability that allows market participants to better exploit cross-border opportunities.

III. The impact of the crisis on the sovereign bond markets in the euro area

Let me now turn to the second issue, namely the impact of the crisis on the sovereign bond markets in the euro area. This has been significant but heterogeneous, as demonstrated by diverging yield spreads. Moreover, it has varied over time reflecting the effects of different factors.

The major phases in the movements in intra-euro area government bond yield differentials since the outbreak of the crisis are broadly familiar. (SLIDE 1) Therefore, I will abstain from a chronological description of developments and will focus on three key factors that shaped euro area sovereign bond spreads at different stages: First, the risk transfer from the

financial system to the government sector; second, the importance of market liquidity premia; and third, the emergence of more country-specific sovereign credit risks.

III.1 Risk transfer from the financial system to the government sector

In March 2008, euro area government bond spreads showed the first discernible increases since the beginning of the crisis in summer 2007. Thereafter, spreads abated somewhat but did not return to pre-crisis levels. Intra-euro area sovereign bond spreads picked up appreciably after the bankruptcy of Lehman, reflecting "flight to quality", but they widened substantially in October 2008, when EU governments announced large fiscal stimulus packages and comprehensive measures to support financial institutions. These measures led to higher government bond yields as market participants perceived that they induced a risk transfer from the banking system to the public sector. These perceptions were also reflected in credit default swap (CDS) premia during this period.

There were marked increases in CDS for government securities, while those on contracts for banks decreased. (SLIDE 2) Moreover, as the fiscal burden associated with the financial system support measures was perceived to differ across countries, sovereign credit risk premia increased to different degrees, leading to a widening of intra euro area government bond yield spreads.

The bank rescue support packages also had a *dynamic* effect on sovereign credit spreads. As analysed in a recent ECB study[1], the financial system support measures apparently brought about a stronger reaction of sovereign credit spreads to shocks, and correspondingly, a more muted reaction of bank credit spreads to the same disturbances. Hence, after October 2008, the general intensification of financial market pressures had stronger effects on sovereign credit spreads, while the "crisis sensitivity" of banks' credit risk premia decreased.

III.2 The relevance of market liquidity premia

Besides credit risk premia, market liquidity premia have constituted an additional important determinant of the pricing of sovereign debt securities. Investors have been willing to accept a lower yield for those debt securities, which are readily convertible into cash. While the co-movement between CDS premia and sovereign bond yield spreads suggests that a large part of the fluctuations in the latter during the crisis was due to changes in the relative pricing of credit risk, other factors also influenced the pricing of government securities. (SLIDE 3) There is evidence that market liquidity conditions played a vital role in the widening of sovereign bond spreads during the crisis.

This becomes apparent by taking a closer look at the French and German sovereign bond yield spreads. (SLIDE 4) In March 2009 the difference between the ten-year bond yields reached more than 50 basis points. Did this sizeable gap reflect different perceptions of the credit risk of these two AAA-rated sovereign issuers or did it reflect the effects of differences in market liquidity conditions?

An answer is provided in the ECB Financial Integration Report by examining the difference in agency bond yield spreads in these two countries. Debt securities issued by the French CADES and the German KfW would be expected to have the same risk characteristics as French and German government debt, respectively, since the debt securities issued by these two agencies are fully guaranteed by the respective governments. It turns out that, in contrast to the government bond yield spreads, agency yield spreads remained remarkably stable. This suggests that there were no significant changes in the perceived relative credit

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[1] See J. Ejsing and W. Lemke (2009), "The Janus-Headed Salvation: Sovereign and Bank Credit Risk Premia during 2008–00", ECB Working Paper No 1127.

quality of the sovereign issuers, but market liquidity factors influenced favourably the German government bond yields.

III.3 The role of individual sovereign issuers' credit risk

Let me turn to the third factor that has shaped developments in the euro area government bond markets, namely country-specific sovereign credit risk. After reaching new peaks at the beginning of 2009, sovereign bond yield spreads have followed a downward trend, but with a few exceptions. (SLIDE 5) For some euro area Member States, notably Greece, they have widened again since mid-November 2009.

The large and persistent increase in the spreads in the case of Greece has been driven by concerns regarding its long-term fiscal sustainability as well as worries about the country's ability to refinance its maturing government debt this year. Following the announcement of additional fiscal consolidation measures by the Greek authorities in March and the statement by the Heads of State and Government of the Euro Area later in that month, Greek bond spreads narrowed somewhat. But re-ignited market concerns on the macroeconomic outlook and the government's refinancing requirements drove spreads substantially higher over the past few days. Contagion effects to other countries via the government bond markets have been limited so far. The statement on the support to Greece by Euro Area Member States issued yesterday had a significant favourable impact on the Greek sovereign spreads today. Overall, government bond yield spreads in some countries remain at relatively elevated levels compared to their pre-crisis levels.

III.4 The relation between corporate and sovereign credit risk premia

Before concluding, I want to briefly focus on the relationship between sovereign and corporate credit risk premia. Should we expect adverse spill-overs from developments in sovereign credit spreads to the relative costs of corporate financing across euro area countries? In particular, in the European monetary union is it still the case that sovereign credit risk premia provide a lower bound for credit risk premia of corporations residing in the respective country?

As there are no intra-euro area exchange rate risks and the cross-country money market volatility is very small, these sources of cross-country differentials in risk premia are not relevant. But there may be other channels of adverse spill-overs from the sovereign to the corporate bond markets: A country with significantly higher sovereign financing costs would need to reduce its fiscal deficit, and would be expected to take fiscal consolidation measures, including increases in corporate taxes. This would potentially dent into firms' profits, worsen their credit risk assessment and drive up their credit risk premia.

So what is the empirical evidence so far? During several phases of the crisis, bond yield spreads for euro area non-financial corporations showed distinct co-movement with the respective sovereign bond yield spreads. This may be explained by common factors which affected both a country's fiscal position and its firms' profitability, or by changes in risk perceptions that affected both types of credit spreads.

However, we have also observed episodes of decoupling between developments in sovereign and corporate credit risk premia. Lately, it turned out that sovereign credit risk premia (in terms of CDS spreads) did not always provide a floor for all corporations operating in the respective country. A case in point is that CDS premia of several euro area telecommunication companies ranged above the respective sovereign CDS spreads in 2008 and early 2009, but this relation has been reversed during various periods thereafter. (SLIDE 6)

The crisis has also shown that there are several channels through which deteriorating public finances and worsening sovereign credit risks can spread to the financial sector and affect the credit risk of financial institutions. Spreads on CDS contracts for larger banks and the

sovereign CDS for government securities of the countries where these banks are domiciled have moved together over the past six months. (SLIDE 7) Two snap-shots are shown on this chart, one on 30 September 2009 and the other on 26 March 2010. Between these two dates, as sovereign CDS spreads rose, so did bank CDS spreads, and in some cases substantially so. This important pass-through of sovereign credit risk to bank funding costs is in the opposite direction from the feedback observed in the fall of 2008, when bank credit risks resulted in an increase of sovereign funding costs, when governments committed to support their banking sectors. In assessing this evidence, we should keep in mind that the limited market liquidity characterising some CDS markets suggests particular caution in interpreting cross-country developments in CDS premia on government bonds.

These relationships clearly deserve further analysis and they underscore the important interactions between the government and corporate sectors across the euro area countries despite the high degree of financial integration in the euro area.

IV. Concluding remarks

In conclusion, I would like to stress three points. First, developments in sovereign yield spreads and CDS premia on government bonds should be interpreted with great caution with regard to their implications for market integration. The degree of integration of sovereign bond markets is difficult to measure and assess. Most importantly, in a monetary union, sizeable bond yield spreads may not indicate lack of market integration but market participants' judgement on relative sovereign credit risks. It is a salient feature of an integrated bond market that investors can easily change their positions among different sovereign securities whenever the credit risk outlook changes. Hence, a widening of sovereign bond yield spreads, reflecting changes in perceived credit risks, does not necessarily signal a reduced degree of market integration. However, at the same time it cannot be excluded that some fragmentation may indeed have taken place during the crisis, reflecting different market liquidity conditions, as I previously explained.

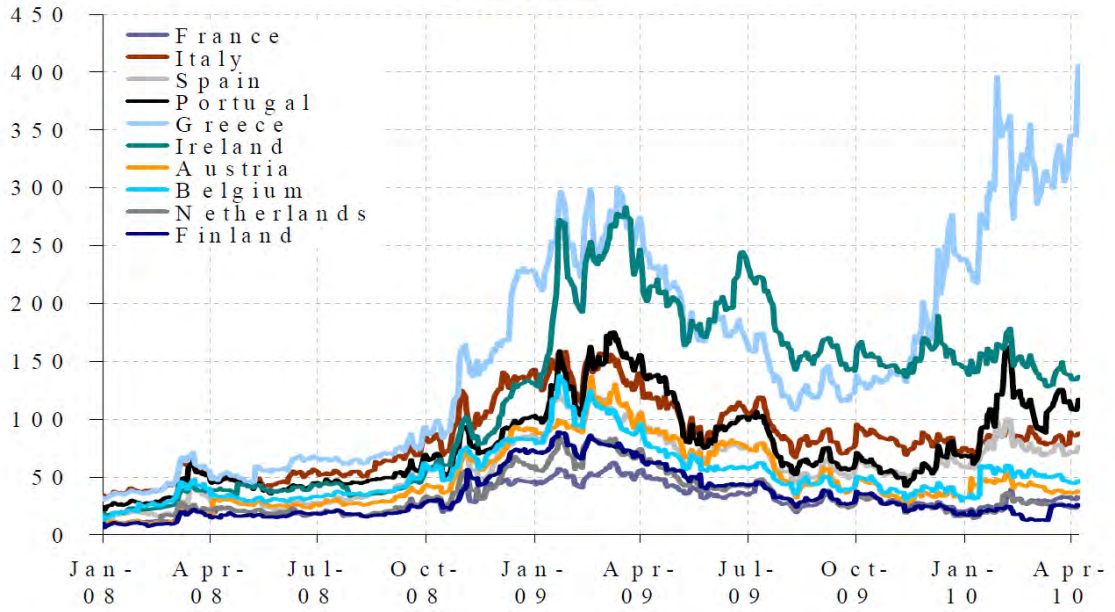
Second, looking ahead, the cross-country dispersion of price-based indicators of financial integration in various markets is likely to reflect a different appreciation of risks across the EU compared with that prevailing before the crisis.

Finally, it is important to recognise that despite the adverse temporary effects of the crisis on the integration of financial markets, the high degree of financial integration achieved in the euro area before the eruption of the crisis helped contain its impact on the financial system and the broader economy.

SLIDE 1

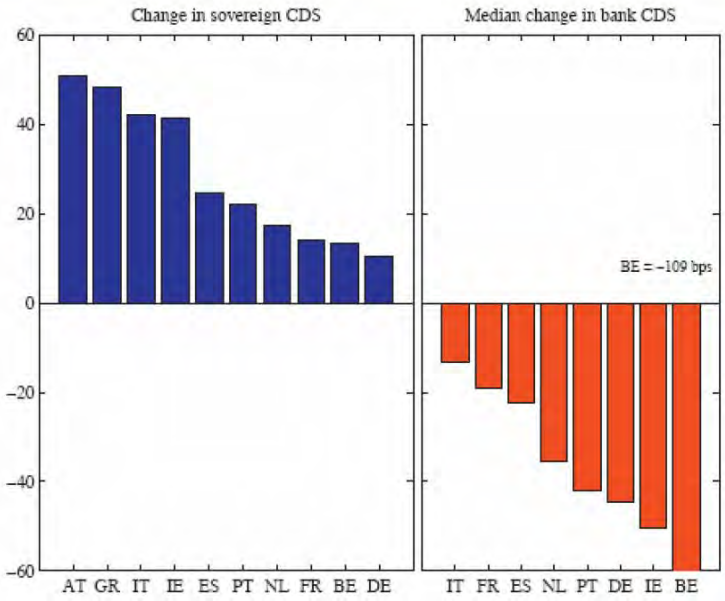
Selected euro area sovereign ten-year bond yield spreads vs Germany Jan. 2007 – Apr. 2010

(basis points)



SLIDE 2

Change of average CDS premia between early and mid October 2008 *(basis points)*



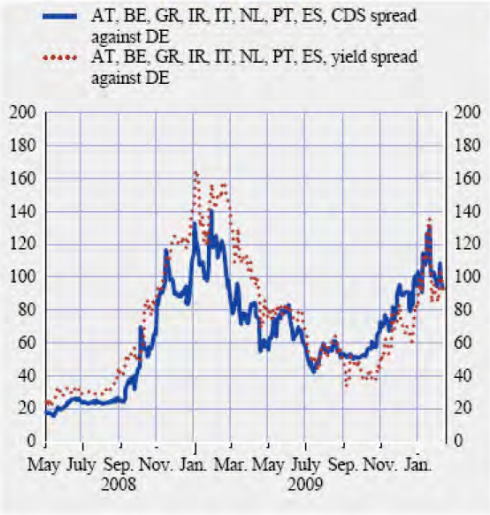
Source: Ejsing and Lemke (2009)

Note: Due to insufficient data, there is no reporting of bank CDS for Austria and Greece in the left panel

SLIDE 3

Average five-year CDS premia and sovereign bond yield spreads

(basis points)



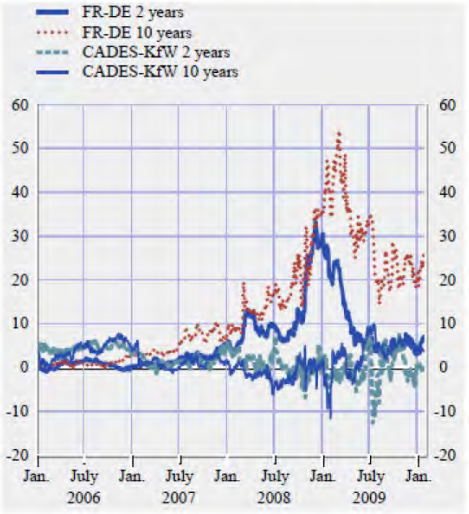
- **While the co-movement between CDS premia and sovereign bond yield spreads suggests that a large part of the fluctuations in the latter during the crisis was due to changes in the relative pricing of credit risk, other factors also influenced the pricing of government debt**
- **There is evidence that market liquidity conditions played a vital role in the widening of sovereign bond spreads during the crisis**

Source: ECB Financial Integration Report 2009

Note: The five-year CDS (yield) spread is computed as a difference between the five-year CDS (bond yield) of the respective countries against the CDS (bond yield) of Germany.

SLIDE 4

French-German sovereign and agency yield spreads *(basis points)*



- **Take a closer look at French-German sovereign bond spread developments:**
  - **In March 2009 the difference between their ten-year bond yields reached more than 50 basis points**
  - **Did the spread reflect different perceived credit risks? Or did it reflect liquidity differentials?**
- **Debt securities issued by the French CADES and the German KfW would be expected to have the same risk characteristics as French and German government debt, respectively, since the debt securities issued by these two agencies are guaranteed by the respective governments**
- **Agency spreads remained remarkably stable: This suggests that there were no significant changes in the perceived relative credit quality, but liquidity factors favoured the German bond market**

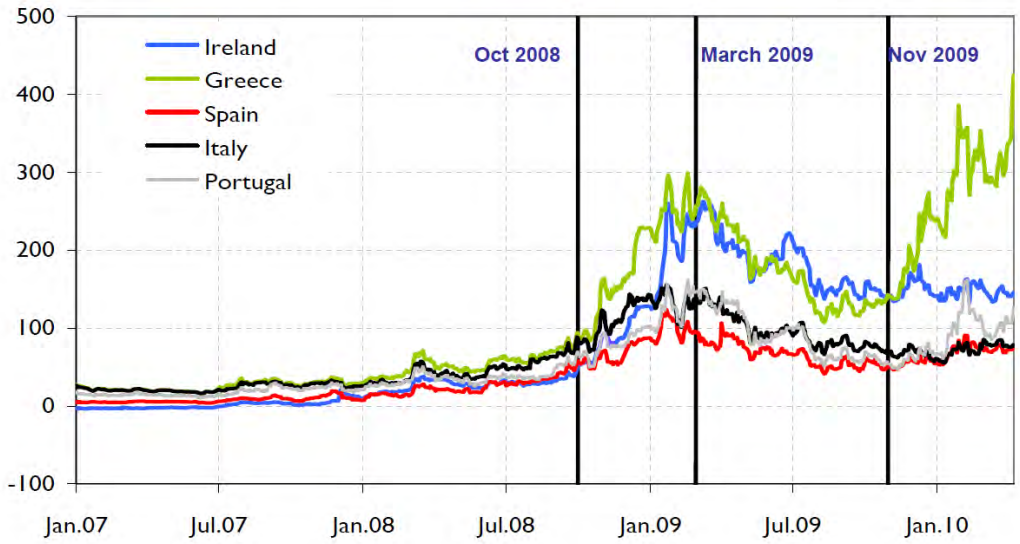
Source: ECB Financial Integration Report 2009

Note: French Cades and German KfW bonds enjoy full state guarantee of the respective government.

SLIDE 5

Selected euro area sovereign ten-year bond yield spreads vs Germany Jan. 2007 – Apr. 2010

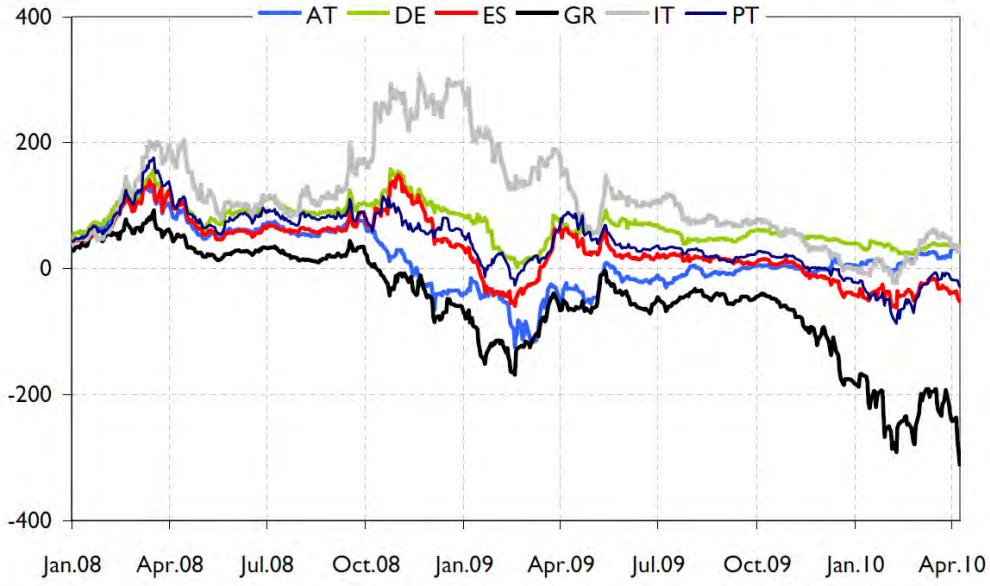
(basis points)



Latest observation: 8 April 2010
Sources: Datastream and ECB calculations.

SLIDE 6

Difference between telecom companies' and sovereign 5-y CDS premium *(basis points)*



Source: Datastream, Latest observation: 8 April 2010
Note: Difference between 5-y sen. CDS premia of major telecom company and sovereign issuer of the respective country

SLIDE 7

Sovereign and bank 5Y CDS spreads

(basis points; first snapshot: 30 Sep. 2009; second snapshot (*): 30 Mar. 2010)