Gertrude Tumpel-Gugerell: Financial integration and stability – efficiency gains vs pitfalls

Keynote address by Ms Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank, at the conference "Heterogeneous Nations and Globalized Financial Markets: New Challenges for Central Banks", organised by the National Bank of Poland, Warsaw, 11 June 2010.

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Ladies and Gentlemen[1],

It is a pleasure for me to speak at this conference today here in Warsaw. Heterogeneous nations and globalized financial markets – the title of this conference – are an old phenomenon. In fact, in the late medieval ages of the 14th to the 16th century, the Kingdom of Poland, the Holy Roman Empire and the Hanseatic area have formed a well financially integrated area contributing to more specialization in trade and hence to economic growth at that time. In fact, despite the existence of many currencies, money was easy to transport and so financial integration was rather more advanced than the integration of markets for goods. The Kingdom of Poland was playing a particular role for the financial integration at that time as a key provider of silver from its silver mines for the coin production, also for the neighbouring regions.[2]

In today's modern economies, we think of financial integration having mainly two positive impacts. First, to improve the allocative efficiency of capital, and second, to help the diversification of risks.

The mission statement of the Eurosystem very well reflects this by stating that, beyond the overriding objective of maintaining price stability, "*we aim to safeguard financial stability and promote European financial integration.*"

In the light of the recent events, the benefits of financial integration are sometimes put into question and it may look like that the two objectives – safeguarding financial stability and promoting financial integration – potentially conflict with each other. It is exactly because we live in an increasingly interconnected world that the crisis has been so severe and widespread.

So why should we – after the recent crisis – still promote financial integration? And still believe in the reconcilability of financial integration and financial stability?

I will argue that financial integration is not only a fact, it is absolutely necessary for the functioning of the euro area economy. It is an irreversible process which should be promoted. While it may be true that financial integration poses some risks to financial stability – such as contagion fostered by greater interconnectedness – the benefits stemming from financial integration far outweigh its costs. I will try to convince you that – instead of containing financial integration – our efforts need to be directed at a better understanding of the different forms of financial development, particularly related to two aspects, namely complexity and size. Opaque products, when difficult to understand, may lead to mispricing of risks and distorted allocation of resources. With respect to size, an overly large financial system could have negative effects on the functioning of the economy, either because it drains too many

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[1] I would like to thank Simone Manganelli for his valuable input.

[2] Volckart, Oliver and Nikolaus Wolf (2006). Estimating Financial Integration in the Middle Ages: What can we learn from a TAR-model?, Journal of Economic History 66, 1, 122–139, Late medieval financial market integration: the Hanseatic Area, the Holy Roman Empire and the Kingdom of Poland, c. 1300–1550, research project proposal by O. Volckart, London School of Economics.

resources from other sectors, or because it increases the risks of bubbles. I will conclude with a few considerations on how the establishment of the European Systemic Risk Board can contribute to enhance the stability of our financial system.

1. Financial integration: an irreversible process

In my view, three elements constitute an integrated financial market: (i) a single set of rules, (ii) equal access to financial instruments or services, and (iii) equal treatment in operating in the market. If these conditions are satisfied, any price difference between assets with identical risk-return characteristics will be immediately arbitraged away.

This definition stems from the intuition that lack of integration reflects the existence of barriers to cross-border activities. One can think of three main categories of obstacles to financial integration: cultural, legal and technical. Recent academic research has shown that there are non-negligible psychological and cultural barriers to financial integration. While further cultural integration may take time, the integration policies of the European Union (EU) had the explicit aim of removing legal barriers and building the necessary technical infrastructure. Indeed, the recent economic history of the EU has been marked by distinctive efforts aimed at the removal of barriers to cross-border activities. The EU Banking Directives (1977, 1988), the Financial Services Action Plan (1999), the White Paper (2005) are all examples of EU initiatives aimed at creating a true level playing field in the financial sector.

Financial integration is essential for the functioning of the euro area as it is for other economies and regions. The financial system represents the primary channel through which monetary policy affects the economy. A stable, efficient and integrated financial market is the basis for smooth transmission of monetary policy in which monetary policy decisions are transmitted equally across member countries.

The Eurosystem has taken since the launch of the euro a proactive stance to promote financial integration in the single currency area. For instance, the establishment of an integrated European payments infrastructure – through the creation of the Eurosystem large-value payment system TARGET and its successor TARGET 2 – has been instrumental for the integration of the money market. The integration of the money market has been of particular help in the recent crisis for the ECB to react promptly and successfully. It has proven to be beneficial in effectively providing liquidity to the market, and thereby ensuring a proper and smooth transmission of monetary policy.

Therefore, to improve financial stability by a lower degree of financial integration would certainly be the wrong measure. We should not undo those reforms which have paved the way to financial integration and revert back to a retrenchment within the national borders. This is certainly not the right strategy for the euro area, and it would be undesirable at global level.

Admittedly, financial integration generates greater interconnectedness, which in turn may increase the risk that failure in one part of the system may trigger chain reactions in the formation of expectations which could have a destabilizing effect. But financial isolation – the opposite of financial integration – is not the rational answer to such a risk. We nowadays live in a global world, where not only financial, but also economic and cultural links have become increasingly tighter. News spread instantaneously and shape global market sentiments; products are designed, assembled and sold in different countries; political events in a small region can send shockwaves around the world. It would be naïve to think that a country could isolate itself financially. And even if it were possible, the costs in terms of lost efficiency and productivity would far outweigh any possible benefit.

2. Financial development – opportunities and risks

If financial integration is both an irreversible process and a process we do not wish to reverse, finance *per se* is not always good in any form and size. This is where we can and should have a reasonable and fruitful discussion. Financial development refers to the process of financial innovation and organisational improvements that reduces asymmetric information, increases the completeness of the markets, and reduces transaction costs.

When these conditions are satisfied, finance can promote economic growth and serve best the society at large. Indeed, a well developed financial system serves the primary functions of screening and monitoring investment projects, allowing the diversification of risks, facilitating the process of price discovery, and providing the service of liquidity transformation by matching short-term savers with long-term borrowers. Overall, finance helps lifting financial constraints for firms, allowing the realisation of projects with positive net present value, which would have otherwise not been implemented.

There are however some forms of financial innovation which may generate perverse incentives, reduce transparency, and overall weaken the stability of the financial system.

Let me take securitisation as an example. When correctly implemented, securitisation allows risk to be transferred from the originators of the loans to financial investors willing to hold that risk. This in turn generates a more efficient allocation of risks. The recent financial crisis has, however, highlighted severe weaknesses of such a scheme, related to misaligned incentives, lack of transparency and poor risk management. This form of intermediation has introduced several layers of management between the investor and the investment. Managers had the incentive to place in the market as many instruments as possible, as their compensations were mainly coming from collection of fees. Investors, on the other hand, were attracted by the relatively higher return in times of low investment rate levels and by the sense of security provided – among other things – by the assessment of rating agencies. The ultimate outcome was that instead of dispersing risks associated with bank lending, securitisation had the opposite effect of concentrating them in the banking system, with harmful consequences for financial stability.

The size of the financial sector is another aspect which deserves close scrutiny. When the financial system grows too large it may eventually lead to a misallocation of resources. Of course, it has to be acknowledged that developed credit markets are important for business start-ups. However, while finance is a crucial element for the Schumpeterian process of creative destruction, the recent financial crisis has also highlighted the role that large financial markets play in downside risk.

A growing number of academics and opinion makers are questioning the theory that the effect of financial markets on growth is always positive and increasing. The relationship may well be non-linear: when of reasonable size, financial markets do help allocating resources efficiently and promote economic growth. However, as they grow larger, it may well be that financial markets may exert a decreasing marginal contribution to growth. In extreme cases, as the size of financial systems exceeds some threshold, their effect on growth could even turn negative. In fact, when the financial system grows out of proportion with respect to economic fundamentals, this may go hand in hand with the creation of exceedingly complex financial products, herding behaviour, materialization of tail risks and it may attract more resources relative to its value added.

The theoretical channels through which excessive finance may be detrimental for growth are still unclear. One possibility is that distorted incentives – deriving from the increasingly higher payoff coupled with limited downside risks – may lead managers to take hidden tail risks. That is, managers may have increasingly higher incentives to invest in assets offering generous compensation most of the time, but generating severe losses with small probability. These incentives may be further exacerbated by herding behaviour, as the performance of managers is often evaluated in comparison with that of peers. Herding behaviour, in turn, generates bubbles and makes the loss associated to the unlikely bad outcome even more severe than it would have been otherwise. During financial bubbles, the search for yield intensifies, risk-taking increases, and leverage in the system reaches unsustainable levels. The exponentially rising volume of financial assets and transactions, especially by highly leveraged and interconnected institutions, leads to financial fragility. Shocks to the system can lead to fire sales and asset price decreases, resulting in liquidity squeezes and solvency risks.

Another channel through which an exceedingly large financial sector may have a negative impact on the real economy is the brain drain of human capital from other sectors, owing to the high compensation schemes in the financial profession. The overexpansion of the financial sector has induced banks to increase their demand for highly skilled employees, driving up the average wage of the industry. The depletion of human capital from other – potentially more productive – sectors may have a long term effect on economic growth.

Although theoretical and empirical research on this channel has just started, I believe it is important for policy makers to have a better understanding of how financial excesses may produce significant macroeconomic distortions. And I have not mentioned the impact on fiscal balances yet.

3. Improving the resilience of the financial system

Market economies are based on the simple principle that economic agents reap the benefits and bear the risks from their actions. It is this trade-off which leads to optimal decision-making, given the available opportunities and the tolerance of risks. If, however, the costs of bad decisions are not entirely borne by the economic agent, significant distortions are introduced, leading to misallocation of resources. Therefore, as a fundamental principle, one has to ensure that incentives of all agents are correctly aligned with the cost and benefits of their financial decisions.

Still, even when from an individual perspective agents seem to follow a sound behaviour, macro-financial factors, particularly related to the interconnectedness of financial markets and institutions, the interaction between finance and the macro-economy can contribute to the build-up and propagation of aggregate macro-systemic risks. These effects have been at the heart of the recent financial crisis and it has specifically highlighted the need for a macro-prudential approach to regulation and supervision, focusing on the financial system as a whole, complementing the existing micro-prudential framework. Macro-prudential policies aim to contain the build up of imbalances and ensure that the financial system is better able to withstand shocks. They will focus on regulatory and supervisory actions aimed at curbing the macro risks of financial market activity. In this regard, it Is, of course, of utmost importance to have a close co-operation and exchange of information between the institutions in charge of macro- and micro-prudential supervision.

In the EU, the Ecofin Council has agreed to establish a new independent body responsible for macro-prudential supervision, the European Systemic Risk Board (ESRB). The main task of the ESRB – in which the European System of Central Banks, the Supervisory Agencies of the 27 Member Countries as well as the newly created European authorities will play a key role – is to identify and assess risks to the stability of the EU financial system and issue risk warnings if systemic risks appear to be significant. If deemed appropriate, the ESRB can make explicit policy recommendation. However, the responsibility for the implementation of macro-prudential policies lies with national authorities.

4. Conclusions

We live in very challenging times. Although the increased interconnectedness of global financial markets have facilitated the build up of imbalances and transmission of shocks, financially integrated markets have served Europe well and remain a necessary pre-condition for the proper functioning of the euro area. The ECB will therefore continue its efforts to promote closer integration of our financial system.

At the same time we should be aware of the opportunities, but also the challenges and risks that new developments in financial markets pose to financial stability and to the functioning of the real economy. With its involvement in the ESRB, the ECB will continue to play an active role in safeguarding the financial stability of the euro area.