Lucas Papademos: Monetary stability and financial integration in Europe

Speech by Mr Lucas Papademos, Vice President of the European Central Bank, at the First Annual Meeting of Greek and Turkish Bank Chief Executives, organised by the Institute of International Finance, Alpha Bank and Işbank, Athens, 9 May 2005.

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Introduction

Thomas Jefferson, the third President of the United States of America, once said: "Banking establishments are more dangerous than standing armies". If he was right, then I have certainly ventured straight into the lion's den by accepting to speak at the first annual meeting of Greek and Turkish Bank Chief Executives. But Jefferson's remark is clearly not relevant to this gathering. And it is, indeed, a great pleasure for me to address the first such meeting, organised by the Institute of International Finance, Alpha Bank and Işbank. The increasing cooperation and good, neighbourly relations in this region can be further enhanced through this bankers' forum, which offers opportunities to exchange views, establish contacts and foster closer ties in the economic and financial fields. Moreover, such a forum can also contribute to a deeper understanding of the process of European integration, which both Greece and Turkey support. A better understanding of the requirements and implications of this evolving process is useful so that all participants can undertake appropriate action in order to maximise the benefits expected from integration and minimise potential adjustment costs.

Being a central banker among commercial bankers, I have chosen my topic accordingly. I will address two issues that are of fundamental importance to the banking sector and closely related to the responsibilities and functions of a central bank: monetary stability and financial integration. More specifically, I will first review past achievements of and future challenges for the single European monetary policy in securing price stability in the euro area. Then, I will assess the current state of financial integration and the outlook for the completion of the single market in financial and banking services. In examining the latter issue, I will highlight the role of the ECB in fostering financial integration and the importance and implications of an integrated financial sector for the conduct of the single monetary policy and for the establishment of conditions conducive to economic growth in Europe.

Securing monetary stability in Europe

Price stability is an essential condition for sustainable growth and entails many benefits for all sectors of the economy. Monetary policy can effectively deliver price stability over the medium and longer term, provided that it is supported by consistent economic policies. This is why the maintenance of price stability in the euro area has been enshrined in the Treaty as the ECB's primary objective. With an average euro area inflation rate of close to 2% since 1999, the ECB's record so far has been in line with our quantitative definition of price stability. It is true that inflation has been somewhat higher than 2% for some fairly long periods of time as a result of several adverse shocks – such as repeated rises in oil prices or indirect tax increases, to name but two. Nevertheless, the ECB has succeeded in delivering a high degree of price stability over the medium term. In fact, by focusing on maintaining price stability over the medium term rather than seeking to counteract unfavourable price shocks with an overly aggressive monetary policy designed to restore price stability within a short period of time, the ECB has avoided excessive volatility in economic activity and employment.

The ECB's commitment to its primary objective of price stability and its ability to achieve this goal over the medium term are widely recognised by financial markets. A central bank's credibility in pursuing policy objectives is vital to the preservation of monetary stability. The credibility of the ECB's monetary policy has been established, and it is reflected in long-term inflation expectations, which have remained low and stable. And this, in turn, has been a major factor in attaining the historically low level of euro area bond yields that is giving considerable support to economic activity.

What is the outlook for price stability and what are the challenges ahead? Overall, there is no significant evidence of underlying domestic inflationary pressures building up in the euro area. HICP inflation, excluding its more volatile components of energy and unprocessed food, was 1.6% in March, unchanged from February. Economic analysis suggests that domestically generated inflationary pressures are likely to remain limited. In an environment of moderate economic growth and continuing slack in labour markets, wages should continue to increase at a modest pace and the pricing power of firms should be constrained.

Nevertheless, there are several upside risks to price stability, despite the presence of downside risks to economic growth. At the present juncture, the persistently high oil prices and their potential second-round effects on wage and price-setting pose a threat to price stability. At the end of April, oil prices were around 30% higher than at the beginning of 2005 and around 50% higher than a year ago. They have exerted upward pressure on inflation and are the main reason why, over the coming months, HICP inflation is likely to remain around the level of 2.1% recorded in March and April. Responsible behaviour on the part of social partners is essential if such second-round effects are to be avoided. Further unanticipated increases in indirect taxes and administered prices could also have adverse effects on price developments. Moreover, continued strong monetary and credit growth stimulated by low interest rates in the euro area, together with the high level of excess liquidity, signal risks to price stability over the medium to longer term, as economic activity gains momentum and approaches its potential aggregate output level. We must therefore continue to be vigilant with regard to the materialisation of these upside risks to price stability.

There are two other important and more general issues that I would like to address with regard to the preservation of monetary stability. They concern the role of national fiscal policies and of the structure and functioning of markets in determining the effectiveness of monetary policy in maintaining price stability in the euro area and in individual Member States.

I do not have to explain to this audience that prudent fiscal policies foster growth and employment directly, through various channels; for example, by allowing a reduction of distorting taxes and of the inefficiencies and burdens resulting from excessive levels of government expenditure and deficits. Sound fiscal policies are also key to the effective functioning and credibility of the macroeconomic framework of Economic and Monetary Union. In particular, they can support monetary policy in maintaining price stability with low interest rates. Over relatively short periods, fiscal policies that are incompatible with a stability-oriented monetary policy may not give rise to tensions in credit markets, depending also on the influence of other determinants of economic activity and inflation. Over the longer term, however, persistently high budget deficits and rising debt-to-GDP ratios will come into conflict with the ECB's monetary policy, which is committed to the objective of price stability.

Unfortunately, fiscal developments in the euro area continue to be, on average, far from satisfactory and, in several Member States, disappointing. While some countries have succeeded in achieving and maintaining sound budgetary positions, a significant number of others have not, including the larger ones. The prospect of a determined return to balanced budgetary positions is rather bleak. In the meantime, euro area governments' indebtedness as a percentage of GDP of has again increased. It is therefore essential that the recently revised Stability and Growth Pact be implemented in a firm, rigorous and credible manner in order to ensure a rapid return to sound budgetary positions. This will not only facilitate the conduct of monetary policy over time, but is primarily in the interest of the countries themselves.

The positive confidence effects of fiscal consolidation measures can be enhanced if such measures are part of a comprehensive structural reform agenda. I cannot spell out here in detail which reform measures would be appropriate. However, the main thrust of the necessary reforms is fairly obvious and generally agreed upon. Besides, it has been clearly outlined in the recently revised Lisbon agenda, which the ECB very much supports. What I would like to stress here is that the necessary reforms for increasing the euro area's potential output growth and reducing the high rate of unemployment will also contribute to enhancing the effectiveness of monetary policy in maintaining price stability in the euro area and to minimising output volatility in response to adverse price shocks. Reforms that foster productivity growth, improve the flexibility and adaptability of labour markets, and increase competition in the markets for goods and, in particular, services, will produce multiple benefits in terms of faster growth and lower output volatility in an environment of price stability. Moreover, such reforms, together with prudent fiscal policies implemented at the national level, will help bring the higher inflation rates recorded in some euro area countries down to the average for the single currency area. The ECB's monetary policy can and will secure price stability for the euro area as a whole. It is the responsibility of governments to ensure that the same high degree of monetary stability is attained at the national level, so that the competitiveness of the respective economies will not be eroded and faster growth can be sustained together with price stability.

Structural reforms are not only needed on the "real" side of the economy. Reform and integration in financial markets are also crucial for economic welfare in Europe. Closer to home for me, they also have direct implications for the transmission of monetary policy impulses. The degree of financial integration is important in determining how effectively this transmission will work in practice. For example, it cannot be ruled out that single monetary policy decisions may sometimes be channelled to countries in a non-uniform manner on account of the fact that the financial system of the euro area – that is, financial institutions, markets and the infrastructure – are not yet fully integrated in all aspects. This brings me to the second part of my address: European financial integration.

The state of financial integration in Europe

First of all, what do we mean by financial integration? We at the ECB see it as an objective that is achieved when potential market participants with the same relevant characteristics face a single set of rules, have equal access to markets and are treated equally. If the opportunities thus created have been exploited by market forces to a substantial degree, financial integration will have been attained. Success in advancing towards that goal has varied across market segments. While the euro has undoubtedly played a very important role as a catalyst for financial integration in general, it is a fact that integration is more advanced in the market segments that are closer to the single monetary policy, notably the money market. There we have achieved almost complete integration, thanks, inter alia, to the establishment of the necessary pan-European payment infrastructure (the TARGET system). A fully integrated interbank money market was, and is, a sine qua non for the implementation of the single monetary policy, since it ensures an even distribution of central bank liquidity and a homogeneous level of short-term interest rates across the euro area.

Integration in bond markets has also progressed significantly. Government bond yields have converged considerably and they are now mainly driven by euro area-wide shocks and news, and only a small fraction of yields can be explained by national risk factors. The convergence of government bond yields has largely been due to the elimination of (intra-euro area) exchange rate risks and the convergence of inflation expectations across countries as a result of the introduction of the euro. The corporate bond market has witnessed exceptional growth since 1999 and is also fairly integrated, in the sense that the country of issuance is only of marginal importance in explaining yield differentials. From a central banking perspective, the development of an integrated corporate bond market is of relevance, as a shift from intermediated financing to market financing implies a diminished role for the bank-lending channel of monetary policy.

Looking at equity markets in Europe, I think an appropriate characterisation would be that their integration is a slow and laborious process of overcoming fragmentation. That said, there are encouraging signs of an increasing degree of integration, such as the substantial decrease in the so-called "home bias" in the equity holdings of investment and pension funds, and a more homogeneous reaction of equity prices across the euro area to monetary policy signals.

In all of this, the banking sector has of course played – and will continue to play – a crucial role. As was discussed at various sessions during the morning, the European banking sector has undergone considerable consolidation in recent times, and the banking markets in the different EU countries have become fairly similar in terms of their market structures, not least because the euro has created more transparency across national borders.

Thus far, however, the consolidation process has mainly involved mergers and acquisitions (M&As) of relatively small credit institutions within national boundaries, and mostly in countries where the degree of bank concentration was lowest. By contrast, there have been very few cross-border mergers. Indeed, the presence in EU countries of large pan-European banking groups through branches and subsidiaries is relatively limited. The average share of foreign branches and subsidiaries accounts for only about 15% of the euro area banking market. From a euro area-wide perspective, the lack of progress in creating pan-European banks is a reflection of significant impediments to cross-border M&As, which are hindering the realisation of economies of scale and blocking the beneficial effects of increased efficiency within the EU economy.

The pace of integration in the banking sector has been uneven. Integration is well advanced in wholesale and capital-related activities, while it is lagging behind in the retail markets. This partly reflects differences in the nature of competition in these segments of financial services. Proximity to clients, bank-customer relationships and access to information play a key role in retail banking, while they are less crucial for investment banking and for corporate banking aimed at large companies.

Overall, the rather modest progress in the integration of the banking sector translates into persistent cross-country differences in bank lending rates, which are relatively large, as can be seen, for instance, in the case of bank overdrafts to non-financial corporations and consumer loans to households. These differences stem from differing national regulatory arrangements, practices and product characteristics; and they result in different levels of collateralisation, average maturities and periods of fixation. Especially in the retail sector, the low degree of integration causes different pass-through of changes in monetary policy rates to retail bank interest rates – which is a key aspect in demonstrating to the European citizens, in a tangible manner, the benefits of the euro and integrated financial markets.

Fostering financial integration: the role of the ECB

Given the importance of financial integration, not only for the welfare of European citizens and the competitiveness and dynamism of the financial sector in Europe, but also for the effective transmission of our monetary policy, what can the ECB do to foster financial integration?

The ECB, as the central bank of the euro area, can first make a direct contribution in its fields of competence, e.g. through the provision of the pertinent infrastructure. To be more concrete we are, as I am sure you are aware, replacing the euro area's current decentralised payment system with a single technical platform, TARGET2, which is due to go live in 2007. TARGET2 will further improve financial integration. It will increase cost-effectiveness and allow for the provision of a harmonised level of services across Europe, supported by the implementation of a single price structure for domestic and cross-border payments. TARGET2 will also offer new functionalities in terms of banks' euro liquidity management and consolidated information – which should make it one of the most sophisticated payment systems in the world.

Beyond such a direct contribution, the ECB sees itself predominantly as a catalyst for change, seeking to enrich the debate in the relevant EU-wide fora and through dialogue with market participants. In this endeavour we wish to support and complement the activities of the private sector and public authorities, notably the European Commission.

One such field of activity relates to retail payment systems, particularly the initiative to create a Single European Payments Area (SEPA) as from 1 January 2008. The SEPA is important, not least because it represents a very tangible benefit in the everyday lives of Europeans. European citizens and enterprises will 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 they do today in the national systems. In addition, national infrastructures should migrate to a pan-European payments infrastructure by the end of 2010, which means that investments in the next generation of national systems should be made from a pan-European perspective in order to ensure compliance with the SEPA. Of course, all of this concerns the investment decisions in individual banking establishments, but I am confident that banks which can offer payment services of the quality envisaged by the SEPA will have competitive advantages.

As outlined already, for the ECB, as a supranational institution, the cross-border dimension of the banking sector in the EU, and the related regulatory and supervisory issues, are of particular interest. At the ECB, we see the ongoing consolidation of the European banking sector as a predominantly market-driven process. What public policy at the EU level can and should do is to remove potential prudential and supervisory obstacles to cross-border M&As. For example, in 2004 the European Commission launched work on possible obstacles to cross-border consolidation in the financial sector, aiming to clarify, inter alia, the supervisory approval process for the acquisition of a qualifying shareholding in a credit institution. The ECB, through its participation in the Committee of European Banking Supervisors, is contributing to the shaping of the relevant rules. Similarly, the implementation of the Financial Services Action Plan (FSAP) should help to reduce company law obstacles to cross-border M&As. I believe that the introduction of the European Company Statute, the forthcoming Directive on cross-border mergers, and the new EU Takeover Directive should all have an influence on spreading cross-border bank M&As across EU Member States in the years to come.

Finally, as you might be aware, the European Commission recently issued, for public consultation, a Green Paper with its strategy for the so-called "post-FSAP period". Indeed, this period consitutes a "window of opportunity" to further enhance European financial integration. The ECB will contribute to defining the priorities to be pursued in order to complete the Single Market for financial services. From our perspective, the focus should now be on the consistent implementation and enforcement of existing EU legislation at the national level. New legislative initiatives should be kept to a necessary minimum. Furthermore, the policies relating to the regulatory and supervisory framework should be complemented by and be closely coordinated with other relevant policies for financial services. I am thinking, in particular, of competition policy, which is crucial for the development of a pan-European market. And lastly, incentives should be provided for the private sector to play its role in exploiting the opportunities offered by public action.

Concluding remarks

Obviously, I have managed to close the circle. My remarks have brought me from the realm of public policy to the more concrete activities of the banking sector and back to public policy issues. I shall now heed the advice that a speaker should always take care to stop talking before his audience has stopped listening. Let me therefore conclude with two brief remarks:

The ECB is committed to, and will continue to support, the process of structural reform in financial markets, as well as in labour and product markets. One of the most important contributions that the ECB can make in this respect is to provide, as in the past, a strong and reliable anchor for safeguarding monetary stability. That said, the relationship between a stability-oriented monetary policy and structural reforms is not unidirectional. As the reform process gains momentum, it will facilitate the conduct and enhance the effectiveness of monetary policy in maintaining monetary stability at a higher rate of economic growth.

Thank you very much for your attention.