Klaus Liebscher: The integration of financial markets in the euro area

Speech by Dr Klaus Liebscher, Governor of the Oesterreichische Nationalbank, at the CEMS Graduate Conference 2000 "The Post Merger Syndrome - Effects on Relevant Markets, Industry Sectors and Competitors", held in Vienna, on 13 October 2000 (slightly abridged).

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Ladies and Gentlemen,

Financial markets are essential. They perform a very important role in the implementation of monetary policy decisions into the economy. Well-functioning and efficient financial markets are crucial to the achievement of a smooth and homogeneous transmission of monetary policy impulses. The continued integration and deepening of financial markets is therefore also a significant issue for policymakers, and particularly for central bankers.

Over the past few years financial markets have become more and more global, as technological progress and stepped-up competition have supported the accelerating move towards greater integration of financial markets. The creation of EMU an the single currency were undoubtedly another important milestone spurring many European countries to promote this drive for integration.

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Where do we stand in the integration process 21 months after the successful introduction of the euro?

The euro has brought fundamental changes to the economic and financial environment of the euro area. Acting as a catalyst, the single currency made a major contribution to competition and efficiency in financial markets across the euro area.

The removal of exchange rate risk has both lowered transaction costs and enhanced price transparency. Moreover, there is no doubt that the introduction of the euro has facilitated the establishment of more cross-border links between financial institutions and has fostered the internationalization of business on the financial markets further. In addition, we can see a well-functioning money and capital market supported by a sophisticated cross-border payment system.

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Let me now focus on the degree of development of the euro area's key financial markets:

The implementation of monetary policy in the euro area has proved highly efficient. The Eurosystem has successfully introduced a market-oriented, modern and flexible operational framework. The ***money market*** has clearly benefited from this in its refinancing operations. Short-term interest rates have totally converged and the money market within the euro area has become fully integrated. As a result, we have an efficient and liquid euro money market, and banks benefit from the conformity of market conditions.

The euro money market has widely used daily reference indices for interest rates, notably EONIA for overnight transactions and EURIBOR for transactions with longer maturities. These euro area indices were swiftly accepted on the market and form a common basis for pricing. Market participants are now able to manage their day-to-day funds in an efficient manner, incurring relatively low costs.

The rapid integration of the euro area's money market was also supported by the developments in the payment systems infrastructure, above all the establishment of the TARGET system operated by the ESCB, which links the national real-time gross settlement systems with the ECB's Payment Mechanism. The smooth functioning of the settlement of cross-border payments allows banks to trade safely throughout the euro area. Therefore the money market has gained a clear cross-border orientation, and some large banks have started to act as "money center" banks, based on a euro area-wide scope of activity.

The broadening of the market and the increasing share of cross-border transactions have had a positive impact on the provision of liquidity: the wider euro area money market can now absorb liquidity shortages more easily than before, as banks can borrow more readily from foreign institutions.

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The creation of the euro has also accelerated the development and integration of Europe's ***capital markets***. Following the introduction of the euro, which was accompanied by the redenomination of government bonds into euro in order to quickly reach a "critical mass" of euro-denominated paper, the integration of the European capital markets moved up a gear in 1999. Last year euro-denominated bond issues played a far larger role than the predecessor currencies of the euro had done in their day.

Moreover, recent data on bond issues denominated in euro clearly indicate that the euro was rapidly gaining in importance as an ***international transaction currency***. Euro-denominated assets accounted for more than 30% of the volume of new issues during 1999, which is comparable to the market share of bonds denominated in US dollars, which declined from 58% to 48% between 1998 and 1999. If we take into account bond *and* note issues, this trend is even more distinct, underlining the euro's competitiveness vis-à-vis the US dollar: of all publicly announced international bond and note issues in 1999 33% were denominated in euro and 37% in US dollars.

Thus, the euro, together with the US dollar, has become the most widely used currency. This basically reflects the outcome of a market-driven process, as the ECB has adopted a neutral stance on the internationalization of the euro. But by maintaining price stability, the ECB almost automatically fosters the attractiveness of the euro as an international currency. The commitment of the ECB to primarily pursue price stability remains a key factor behind market confidence in the euro as a stable currency.

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Two factors are likely to determine the international role of the euro. *First*, the size factor: a broad, deep and liquid euro area capital market with lower transaction costs facilitates the development of the euro as a vehicle currency for trade and commodity pricing and may eventually lead to greater use of the euro in the future.

Second, the risk factor: if international investors and issuers consider the euro to be a stable currency, they will hold euro assets to minimize risk in their internationally diversified portfolios.

There has been a considerable increase in private issuance activity in the euro area. The European corporate bond market posted significant gains in 1999, although it should be taken into account that temporary or exceptional factors may have been partly responsible for this. However, this trend has continued in 2000. The rising number of companies with relatively low ratings shows that it has become easier for firms to tap the capital market. Indeed, the integration and deepening of the capital markets are particularly beneficial to smaller companies in need of venture capital.

The newly created euro-denominated bond market is better able to absorb very large issues than the individual bond markets of the euro's predecessor currencies. Indeed, the average size of new bond issues increased considerably in 1999, reflecting the investors' growing preference for deep and liquid instruments. In line with the trend towards higher average issuing volumes, Austria also recorded re-openings of government bonds aimed at boosting liquidity.

EMU has contributed positively to this development, and the single currency has been facilitating the standardization of debt instruments and has been driving a continued reduction in transaction costs. Progress in the harmonization of market standards, practices and conventions across the euro area is reflected in the increased market liquidity, the broader maturity spectrum and the development and spread of new financial products.

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Let me now turn to the ***stock market*** where we have observed an increase in new listings: in the course of 1999 close to 900 companies were newly listed on stock exchanges in the euro area, which represented an increase of some 40% compared with 1998. The growth rates in the "new market" segments seem to reflect the enhanced attractiveness of going public in the euro area. Furthermore, the development of a range of euro area-wide stock market indices is an obvious indicator of the progress already made in the integration of euro area stock markets.

The euro area capital market is larger and more open than any of the domestic markets and provides investors with more varied opportunities for investment, but it is not yet fully integrated. There are still some barriers: for example different traditions and local market practices, national regulations and tax regimes. One major obstacle to the efficient functioning of financial markets is also the prevailing segmentation of financial markets in Europe.

So, while the introduction of the single currency was a major step towards integration, the high degree of segmentation in Europe's securities markets remains one of the primary reasons for structural weaknesses. Allow me to illustrate this by providing an example: there are currently more than 20 different securities settlement systems in the euro area operating on different trading and clearing platforms. In other words, the euro area lacks a sufficiently integrated system for the clearing and settlement of securities and for managing collateral at the cross-border level. But market pressure is growing and the securities settlement systems are faced with increasing demands for consolidation.

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The euro, in tandem with technological progress and continuing globalization, has put more pressure on European exchanges to strive for structural improvements. We should also be aware that the ***process of consolidation*** of stock exchanges is taking place within the context of the integration of capital markets in the euro area. This allows exchanges to benefit from increased economies of scope and scale they may obtain by using new information and telecommunication technologies. Since the introduction of the euro several initiatives have been launched by stock exchanges with a view to forming alliances or merging activities. The recent flurry of excitement about the future of the London Stock Exchange gives an indication of just how important the push to consolidate Europe's stock exchanges has become.

The increase in M&A activity is a sign of the competition between business and financial locations due to changing market conditions and the increasing competitive pressures to which the different financial intermediaries are exposed.

Further efforts must be undertaken to remove the remaining segmentation and harmonize market architectures, accounting rules and tax treatment. Several initiatives are already under way and progress is being made on the harmonization of market practices; here, eg the "Financial Market Action Plan" of the European Commission comes to mind, and national governments and European market organizations have been working towards these goals. An important recent initiative was the decision of the ECOFIN-Council to establish a Committee of Wise Men in order to identify the obstacles which stand in the way of a single market in securities and consider how they might best be removed.

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Let me finally briefly address the Austrian financial market as well, which forms an integral part of the euro area.

Notable improvements in the structures and procedures of Austria's financial markets have been undertaken in the last couple of years in order to improve Austria's competitive position. The Wiener Börse (VSE), acting as a regional exchange with a strong domestic base, has taken a series of measures to brace itself for the stiffer competition faced by European securities exchanges in terms of costs, the range of services offered and changing industry practices.

The November 1999 linking of Vienna's cash market to the German Xetra electronic trading platform, which was developed by the Deutsche Börse, benefited the enterprises listed on the Vienna exchange by assuring them Europe-wide exposure, greater liquidity as well as attractiveness thanks to the increased number of market participants. In addition, trading hours were extended and preparations were made for the establishment of a new exchange for Central and Eastern European securities, a joint project of the Deutsche Börse and the Wiener Börse (VSE). This New Europe Exchange

(NEWEX), which will be a specialized exchange for Central and Eastern Europe located in Vienna, will take up its activities on 3 November and will build on Austria's expertise in and ties with Eastern Europe. NEWEX is set to become the central trading and financial platform for companies from the region and for international market participants. A key feature offered by NEWEX is the high-tech trading platform Xetra that bundles liquidity and enables remote access to trading for market participants.

As part of the budgetary consolidation currently under way, the Austrian government plans several privatization measures. These activities will likely give a further boost to the Vienna stock exchange. Moreover, the government recently presented a package of measures to increase the attractiveness of Austria's capital market, eg by abolishing the stock exchange turnover tax or by fine-tuning regulations with regard to international best practices standards. All in all, I have great trust in the Vienna Stock Exchange and its necessity even for a smaller regional financial market.

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Let me conclude by saying that 21 months is a very brief period in the life of a new currency. But in my view, EMU and the euro are already today a success.

The euro holds a strong position in the financial world. The introduction of the euro and the development of a sound institutional framework based on monetary stability and fiscal sustainability have contributed to international and economic stability.

The single monetary policy, based upon efficient instruments and payment and security settlement systems, has been conducted in a credible manner and has successfully maintained price stability for about 300 million people.

The overall economic outlook for the euro area is quite favourable with good chances for a sustainable and non-inflationary growth and more employment. Compared with other parts of the world, inflation rates are relatively low, budgets increasingly consolidated and structural reforms under way. Financial markets within the euro area are in full process of dynamic restructuring - we can already observe a highly liquid and fully integrated money market and deeper and more efficient capital markets.

Therefore I am fully convinced that after its successful launch, the euro has all the potential for a strong, competitive and well-accepted currency in international financial markets.