Jean-Claude Trichet: The eurosystem and the integration of european financial markets

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the 50th Anniversary of ACI – The Financial Markets Association, Paris, 28 October 2005.

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1. Introduction

Ladies and Gentlemen,

I accepted with pleasure the invitation to speak to you today on the occasion of the 50th anniversary of ACI – The Financial Markets Association.

First of all, I would like to congratulate your association – fifty years is an impressive length of time. The anniversary prompts us to look back in time. When I think back to the 1950s, the year 1952 immediately comes to mind. It was the year when the European Union started out as the European Coal and Steel Community. As we know, the idea at that time was to better preserve peace by bringing together under a common European roof, with rules that were binding for all participating countries, those resources that had been decisive for the conduct of wars – coal and steel.

Encouraged by their success, the European countries decided to also integrate other sectors of their economies in order to form a common market. In the course of time, other countries joined the European Union – as it has been called since the Maastricht Treaty of 1992 – encompassing today 25 countries.

Key milestones have been successfully reached during these years. As President of the ECB, let me in particular highlight the fact that the euro indeed acted as a strong catalyst for the further integration of European financial markets. On the side of the ACI, allow me to mention that you founded in 1999, at the time of the launch of the euro, the Euribor ACI, which has since then led several initiatives – and I will later address some of them – that foster financial integration in Europe and in particular in the euro area.

This is actually the topic I would like to address today: European financial integration.

I have organised my remarks along the following main lines. I will first explain the Eurosystem's interest in European financial integration. Then I will mention different kinds of activity conducted by the Eurosystem that contribute to enhancing European financial integration. I will today focus on a particular financial market, namely the money market, and on a particular kind of Eurosystem activity, namely our possible role to act as a catalyst for private-sector activities to foster the integration of European financial markets. Such initiatives involve close collaboration with market participants, among them the ACI and the Euribor ACI.

2. The Eurosystem's interest in European financial integration

The Eurosystem's interest in European financial integration is founded on three basic reasons.

First, the financial system is used for the conduct of monetary policy in the euro area, which is the basic task assigned to the Eurosystem under the Treaty establishing the European Community ("the Treaty").[1] A well-integrated financial system enhances the smooth and effective transmission of monetary policy impulses throughout the euro area.

Second, financial integration has implications for the Eurosystem's task of safeguarding financial stability in the euro area and the EU, as laid down in the Treaty.[2] The pursuit of financial integration

[1] In accordance with Articles 4 (2), 105 (1) and 105 (2) of the Treaty, the primary objective of the definition and conduct of the single monetary policy, which is a basic task of the Eurosystem, shall be to maintain price stability.

[2] Article 105 (5) of the Treaty sets out the statutory tasks of the Eurosystem to "contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system."

can have very beneficial effects on financial stability as more integrated financial markets could provide the necessary conditions for the smoother absorption of financial shocks. It may also help financial institutions to better manage and diversify their risks and realise economies of scale, which may, in turn, lead to greater efficiency. At the same time, it is necessary to closely monitor the profound changes in the nature of financial stability challenges due to the structural transformation of the financial system, including intensified cross-border links.

Third, financial integration can generally help to promote the development of financial markets, institutions and infrastructures, thereby helping to support economic activity and to raise the potential for economic growth. According to the Treaty, the Eurosystem shall "without prejudice to the objective of price stability, […] support the general economic policies in the Community".[3] The Eurosystem is fully committed to supporting the general economic policies of the Community, with a view to contributing to the achievement of its objectives. This includes financial integration, which is a priority Community objective. I recall in this respect the findings of a recent study that quantified the macro-economic impact of the integration of European bond and equity markets.[4] The study found that such financial integration would result in additional EU GDP growth of around 1% - i.e. around EUR 100 billion – over a ten-year period.

On a more general note, I would like to recall another principle laid down in the Treaty that states that the Eurosystem "shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources".[5] This also determines the Eurosystem's view that financial integration is first and foremost a market-driven process. In addition to this, the Eurosystem sees it as a basic task of public authorities to create a framework conducive to fostering financial integration. If the opportunities thus created have been exploited by market forces, true financial integration will have been achieved and its benefits can be reaped.

3. The Eurosystem's contribution to fostering European financial integration

As we see it, the basic task of public authorities with regard to the process of financial integration is to create a framework whereby, 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.

The Eurosystem generally distinguishes between four types of activity through which it contributes to fostering financial integration.

First, we provide central banking services that are conducive to European financial integration. An example of this is the TARGET system that we run, which today handles around 90% of large-value euro payment traffic. TARGET is one of the two largest wholesale payment systems in the world, the other being Fedwire in the United States. TARGET2 – the launch of the single shared platform is planned for November 2007[6] – will foster financial integration even more. TARGET2 will enable the provision of a harmonised level of services across Europe, supported by a single technical platform and a single price structure for domestic and cross-border payments, and it will have new functionalities for banks to better integrate their euro liquidity management.

Second, we give advice on shaping the legislative and regulatory framework for the financial system. As an example, I would like to mention the Eurosystem's contribution to the European Commission's consultation on the priorities for financial services policy over the next five years.[7] In this contribution, the Eurosystem expresses its support to the key policy orientations of the Green Paper which focuses

3 See Article 105 (1) of the Treaty.

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

5 See Article 105 (1) of the Treaty.

6 See under http://www.ecb.int/pub/pdf/other/target2progressreport200510en.pdf (Second progress report on TARGET2, ECB press release dated 21 October 2005).

7 See http://www.ecb.int/pub/pdf/other/ecgreenpaperfinancialservicespolicy2005en.pdf

on the consolidation and consistent implementation of the legislative framework for financial services to be achieved by exploiting the potential of the existing institutional set-up and by a profound assessment – both ex ante and ex post – of new legislative initiatives. The Eurosystem also supports the strands of action suggested by the Commission in the area of financial regulation and supervision, in particular the importance attached to the objective of rationalising the existing regulatory framework and the pursuit of supervisory convergence.

Third, we try to enhance knowledge and raise awareness of the state of and need for European financial integration, and we measure the progress made towards its achievement.

And fourth, we can act as a catalyst for private-sector activities by facilitating collective action and assisting with possible coordination problems.

I would like to concentrate more particularly on these last two kinds of activity, namely measuring the state of financial integration and acting as a catalyst for private-sector activities.

4. The integration of European financial markets and selected examples of fostering it

The basic starting point for any possible action is to first assess the state of affairs in order to gather the evidence upon which the decision to undertake a certain activity can be based. For a financial instrument or financial service, a price normally exists, so one can use quantitative indicators, based on the law of one price, to measure the degree of integration. In this respect, let me draw your attention to the ECB's report on "Indicators of financial integration in the euro area" that was published at the end of last month.[8]

This report provides an assessment of the degree of financial integration in the main segments of the euro area financial market, covering the money market, the government and corporate bond markets, the equity market and banking markets. I should also like to point out that while this first report, which covers financial and banking markets, already focuses on important dimensions of the financial system, the coverage of the indicators will be further developed; in particular, it is envisaged to add indicators of the underlying factors of integration related to financial institutions and market infrastructures.

The ECB report provides, on the basis of 20 quantitative indicators, an overall assessment of the degree of financial integration in the main financial market segments. It is shown that the degree of integration differs from market segment to market segment, with integration being more advanced in those market segments that are closer to the single monetary policy. Today, I will indeed concentrate on the most integrated market, namely the money market, and I would like to refer you to the report for our assessment of the other financial markets.

As regards the money market, the various indicators presented in the ECB report measure financial integration based on the dispersion of lending rates – namely overnight rates, unsecured lending rates and repo rates – offered by banks in euro area countries, with the data referring to actual transactions or rates offered by EONIA, EURIBOR and EUREPO panel banks.

Also the different segments of the money market show different degrees of integration.

The unsecured interbank market has, since shortly after the introduction of the euro, been integrated to a nearly perfect extent. In fact, our indicators display a euro area cross-country standard deviation for the overnight maturity of around 3 basis points shortly after the start of 1999 and only around one basis point by today. As a comparison to these impressive figures, just recall that 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 still stood at more than 130 basis points.

As a first example of the Eurosystem's contributions to fostering financial integration by acting as a catalyst for private-sector activities, I would like to mention the ECB's calculation and publication of the EONIA rate. The technical definition and the procedures for the calculation of the EONIA rate were defined by market participants through a series of market conventions. The EONIA rate is a concrete

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8 See http://www.ecb.int/pub/pdf/other/indicatorsfinancialintegration200509en.pdf

example how market participants play an important role in fostering financial integration through the adoption of market conventions, facilitated by the ECB acting as a catalyst.

A consistent picture of a highly integrated unsecured money market is also painted by the indicators for the maturities longer than overnight. Both the cross-country standard deviation of EURIBOR lending rates among euro area countries for the one-month and for the 12-month maturity stood even below one basis point shortly after the introduction of the euro and remained stable thereafter. This compares with the respective values in January 1998, i.e. one year before the start of monetary union, of more than 100 basis points for the one-month rates and of around 50 basis points for the 12-month rates.

The growing repo market is still somewhat less integrated than the unsecured segment, but integration is progressing. The creation of the EUREPO index – the benchmark for secured money market transactions in the euro area – in 2002 was an important market initiative to further promote the integration of the repo market. Our indicators for the integration of the repo market reveal that the euro area cross-country standard deviation of the one-month EUREPO rates was around, and normally below, one basis point and today stands at around 0.5 basis point. The indicator for the 12-month EUREPO rates shows larger movements, in part reflecting the lower liquidity of this market. Still, with a standard deviation always below 2.5 basis points, and today standing at around 1.5 basis points, the indicators suggest that there is a relatively high degree of integration also in the euro area repo market.

The major role of the euro in enhancing financial market integration is also visible in the interest rate derivatives markets. The total of euro interest rate OTC derivatives contracts reaches a daily turnover of around EUR 380 billion, thereby being larger than the US dollar segment, with a daily turnover of around EUR 290 billion.[9] A particularly important part of this is the euro interest rate swap market, with a daily turnover of almost EUR 250 billion. It is the largest interest rate swap market in the world, i.e. also larger than the equivalent US dollar segment that has a daily turnover of around EUR 160 billion.[10] Let me in this respect also highlight the success of the euro overnight index swap market, where contracts are exchanged in which one party pays a fixed rate of interest for the duration of the contract, while the other party pays an average of the overnight EONIA rate realised over the period. The launch, conducted jointly by Euribor FBE (European Banking Federation) and Euribor ACI, of the EONIA Swap Index in June this year is evidence of both the importance and the further potential of this market segment.

I now turn to the least integrated money market segment, namely the one for short-term securities. Compared with the equivalent US commercial paper market, which has an outstanding amount of around EUR 1.3 trillion, the aggregate size of the commercial paper and certificates of deposit markets in Europe is around EUR 0.8 trillion.[11] In addition, while the US market is integrated, the short-term securities markets in Europe continue to be segmented, with de facto several markets based in several market places. Issuers and investors in the European short-term paper markets are therefore confronted with reduced depth and liquidity, and they have less diversification opportunities than in the US.

The Short-Term European Paper (STEP) initiative, which was set up and is being led by ACI – The Financial Markets Association, aims to overcome such fragmentation and to promote the development of a pan-European short-term paper market. STEP specifically aims to promote the convergence of the standards and practices prevailing in the European short-term securities markets through market players' voluntary compliance with the standards set out in the STEP Market Convention, which covers aspects like information disclosure, documentation, settlement, and the provision of data for the production of STEP statistics.

Since May this year, the European Banking Federation has been very fruitfully supporting the ACI in the completion of the preparatory work. Moreover, the European Banking Federation will directly contribute to the functioning of the STEP market, once in operation.

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9 See BIS Triennial Central Bank Survey - Foreign exchange and derivatives market activity in 2004 (March 2005).

10 See BIS Triennial Central Bank Survey - Foreign exchange and derivatives market activity in 2004 (March 2005).

11 Including instruments issued on European markets, but denominated in currencies other than the euro.

The promoters are at present finalising the STEP convention and expect to see the first STEP-labelled programme in early 2006.

As with the example of the ECB calculating and publishing the EONIA rate, which I mentioned earlier, the ECB has supported the STEP initiative since its inception by acting as a catalyst for private-sector activities. Back in 2001, the first discussions on STEP took place at the meetings of the ECB Money Market Contact Group. In 2002, the ECB hosted on its website the ACI's public consultation on the first STEP report. And, finally, ECB staff have contributed to the work of the Euribor ACI STEP Task Force since its creation.

The Eurosystem will also provide operational support to the functioning of the STEP market. In July 2004, the Governing Council of the ECB discussed the recommendations addressed to the European System of Central Banks in the final report of the Euribor ACI STEP Task Force. The Governing Council welcomed the STEP initiative and took a favourable attitude towards its aim to ease the convergence of standards and to foster the integration of the fragmented European short-term paper markets through a market-led initiative.

Specifically, the Governing Council decided to support, in principle, the activities pertaining to the introduction of a STEP label, which will acknowledge the adoption of the STEP standards, for the first two years after its launch. The STEP Secretariat, which will be created and managed by the European Banking Federation, will perform the STEP labelling with the support of the Eurosystem and, in particular, of several of its national central banks. Such a technical contribution to the labelling process would, however, not lead to a national central bank taking any action, such as the prohibition or suspension of issuance, in the event of non-compliance by an issuer with the convention's requirements. In such a case, the only consequence would be that the STEP Secretariat would withdraw the STEP label from the issuance programme in question.

Moreover, the Governing Council of the ECB decided, subject to a final check regarding the efficiency of the collection process, to accept the request put forward in the Euribor ACI STEP Task Force report, to produce and publish STEP statistics on yields and volumes on an ongoing basis, which would foster integration and reduce issuers' costs through greater market transparency.

I have the pleasure to inform you today that the work of the ECB and the national central banks in this respect is well advanced. Just a few days ago, the Governing Council has approved the so-called efficiency check, i.e. the assessment of the costs and benefits related to the production of STEP statistics, and decided that the Eurosystem will indeed produce such statistics.

Now, after a long preparatory phase, the urgent priority is to complete the STEP Market Convention, which is the cornerstone of the whole project and the last step to be overcome to achieve its successful completion. I am confident that the promoters of the initiative, foremost the ACI, will find the necessary drive to overcome the last technical difficulties in the preparation of this document and will successfully launch STEP early next year. This will bring about the necessary integration and development in this market, surpassing the remaining current segmentation between the part of this market.

The success of the STEP initiative will also be proof that market-led initiatives are essential for the benefits of integrated financial markets in Europe to be reaped. Furthermore, it should show that self-regulation – to which the Eurosystem, like yourselves, attaches significant importance – complements and can even, in some respects, be a substitute for public regulation. Markets obviously do not function only on the basis of public regulation: they also need rules devised by the market players themselves, who know best which standards and business practices would lead to efficient outcomes. In view of the potential to realise economies of scale and scope inherent in an integrated European financial market, the private sector should accordingly contribute to establish such rules at the European level.

Market forces alone may not always be able to drive financial integration forward or towards an optimal outcome. In areas such as standard setting or the establishment of common infrastructures, the cooperation between private agents of the financial sector is as necessary as competition. Also, there is still a need for market participants to further develop the coordination of joint interests. Market associations, such as the ACI, have an important role to play in this respect.

The function of a catalyst can help coordination. A central bank can perform this role thanks to its acknowledged competence and objectivity, its direct participation in financial markets and its numerous contacts with market participants which ensue from its basic tasks. In fact, I consider the catalyst function of the ECB and the Eurosystem in fostering European financial integration to be a major responsibility at the current juncture.

5. Concluding remarks

Ladies and Gentlemen,

I would like to conclude my remarks by stressing that progress in European financial integration requires an effective interplay between market forces and action by public authorities.

The ECB and the Eurosystem prefer a market-first approach in this process, with a significant role given to self-regulation. Examples like the STEP initiative show that the private sector can contribute substantially to the integration of the European financial system and that the Eurosystem supports such market-led initiatives.

While expressing my congratulations to ACI – The Financial Markets Association on its 50th anniversary, I would also like to encourage you all to take up the challenges that lie ahead of us. STEP-like initiatives should become a more widely used approach to fostering financial integration in Europe. A lot has been achieved, but just as much remains to be done.

Thank you very much for your attention.