Axel A Weber: European financial integration and (its implications for) monetary policy

Speech by Professor Axel A Weber, President of the Deutsche Bundesbank, at the Annual General Meeting 2006 of the Foreign Bankers' Association in the Netherlands, Amsterdam, 23 May 2006.

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Introduction

Mr Sawaya, ladies and gentlemen

First of all, I would like to thank you for inviting me to your Annual General Meeting. Looking at the list of previous speakers, I certainly feel honoured to contribute to what has now become established as a major forum of debate on European issues. I should like to use this opportunity to discuss some aspects of ongoing financial integration in Europe and its implications for monetary policy. Finally, I will touch upon some issues of cross-border banking integration and banking supervision in Europe.

Talking about financial integration at a foreign bankers ' association harbours the risk of "carrying coals to Newcastle" – managing financial integration is, after all, your daily business. But, for that reason alone, it might be the right place to take stock of what we have achieved in Europe and to give you my assessment, from a monetary policy perspective, of the successes and future challenges in this rapidly evolving field.

Financial integration: definition, importance, and benefits

Meaning, benefits, and developments of financial integration

Financial integration – adopting a commonly used definition – is an objective that is achieved when:

(i) all potential participants in a market for a given set of financial instruments or services are subject to a single set of rules,

(ii) have equal access to this set of instruments and services,

(iii) and are treated equally when they operate in the market.

Financial integration in this sense can be seen as the absence of location-based discrimination in accessing the capital markets.

Financial integration has, in general, two main benefits: Firstly, increasing the potential for higher economic growth: owing to a more efficient allocation of capital, financial integration boosts the efficiency of the financial system. An efficient financial system has a positive impact on (non-inflationary) economic growth, as the empirical evidence shows. Secondly, regionally diversified investment alternatives lead to a better diversification of risks.

In this sense, the integration of financial markets can be considered as making a positive contribution to financial stability since it helps to improve the capacity of economies to absorb shocks. It is thus clear that fostering financial integration is of major relevance for general economic and specific monetary policy reasons.

These benefits of integrated financial markets are the main reason for the global phenomenon of rapidly growing cross-border linkages of financial assets and liabilities. On a global scale, financial integration has accelerated over the past ten to 15 years: In industrial countries, the average of foreign assets and liabilities to GDP has tripled since the mid-1990s. A similar process can be observed in emerging markets, although the cross-border linkages start at lower levels.

Main drivers of financial integration?

In general, three drivers of financial integration can be identified: market forces, collective action, and public action. These reflect the complementary role of private and public sector action in this process.

Market forces are the natural origin of financial integration, mainly through economies of scale and scope as well as technological progress. Collective and public action comes into play when market forces alone are incapable of removing inefficiencies – on account of “network externalities”, for example . The existence of network externalities has two implications: Firstly, national financial infrastructures have developed individually over a period of decades. Changing these structures is often associated with switching costs – at least in the short run. Secondly, however, in the long run the positive externalities of integrated financial markets outweigh the costs of switching from one institutional arrangement to another, so collective or public action may be necessary to achieve more efficient outcomes.

Moreover, frequently collective action is crisis-driven – which reflects a somewhat pathological learning on the part of market participants. Examples of this are collective action clauses in international bond contracts or the growing importance of standards and codes of conduct in the aftermath of the Asian financial crisis (for instance, core principles of banking supervision). In this way, public authorities can play a role as a catalyst or a facilitator of collective action as well as being an originator of legislative or regulatory frameworks.

While not denying the importance of market driven developments in the process of financial integration, we should not forget that what lies behind the latest wave of integration is the deliberate political decision to liberalise the cross-border movement of capital. This is true not only of emerging markets but also of countries in Europe. Economists usually explain the conceptual background to these difficult policy choices as solutions to the macroeconomic “trilemma” of striking the right balance between freedom of capital movements, monetary policy autonomy, and the exchange rate regime.

European monetary union is a cornerstone solution to this trilemma. Elimination of national monetary policy, irrevocable fixing of the participating exchange rates, and the introduction of a new currency in order to reap the benefits of integrated financial markets in Europe. Thus, EMU is both the European response to globalisation and at the same time the most important stimulus to European financial market integration in history.

What is the current state of financial integration in Europe?

The current degree of financial integration in Europe varies between market segments. A simple, but useful quantitative measure of financial integration is to check the validity of the law of one price. It states that in a fully integrated market risk-adjusted prices should be equal irrespective of the place of transaction.

Money markets

Nearly full integration in this sense has been achieved in the money market. This comes as no surprise as it is a prerequisite for the functioning of the single monetary policy. The integration of the euro area money market has been supported by developments in the payment systems infrastructure, most notably the establishment of the Trans-European Automated Real-time Gross settlement Express Transfer (TARGET) system. TARGET allows the smooth functioning of the settlement of large-value cross-border payments. This also shows that one important field of financial integration, other than markets, is infrastructure. Although it is of major relevance in the current European context, I will not go into this issue in greater depth here.

The unsecured segment of the money market was already almost perfectly integrated when monetary union was launched. The cross-country standard deviation of the average overnight lending rates among euro area countries fell from more than 100 base points at the beginning of 1998 to 3 base points at the beginning of 1999. This measure is now moving around 1 base point.

Almost perfect integration has also been established on the repo market. The EUREPO index has shown cross-country standard deviations below 1.5 base points and below 2.5 base points for the one-month and the 12-month maturities, respectively, since its launch in March 2002. Another example of a perfectly integrated market is the overnight interest rate swap market, given a perfectly standardised product definition.

The less integrated money market segments are, accordingly, those where standardisation is underdeveloped and fragmentation persists. In particular, the short-term securities market is still segmented in several market places, but the Short-Term European Paper (STEP) initiative, led by the

ACI (Financial Markets Association) and supported by the Eurosystem, is expected to reduce the current fragmentation.

Bond markets

Government bonds

The bond markets are nearly as integrated as the money markets. This is largely due to the elimination of exchange rate risks and the convergence of inflation expectations across the euro area. The standard deviations of government bond yield spreads have declined from figures above 200 base points in the mid-1990s to close to zero. It should be borne in mind, however, that, owing to differences in credit risk, government bonds will never be perfectly homogenous products. But there is, of course, no contradiction between financial integration and country-risk-adjusted pricing.

Corporate bonds

This is equally relevant to the pricing of corporate bonds as it depends on a large number of influencing factors – the country of issuance being just one possible factor amongst others. Encouragingly, econometric studies of the corporate bond market show that the yield spreads have no systematic country component. The corporate bond market is thus also fairly integrated.

Moreover, the European corporate bond market has witnessed exceptional growth since 1999 which has not been restricted to traditional financial instruments, but also includes alternative and innovative financing such as mezzanine capital and credit derivatives.

Equity markets

In contrast to money and bond markets, and in spite of the fact that "home bias" in the equity holdings of institutional investors has been reduced markedly, the equity markets of the euro area are still much more fragmented. For example, the proportion of foreign stock and bond holdings of German investment funds increased from 15% in the mid-1990s to more than 50% after 1999. Notwithstanding increasingly homogenous reactions of stock prices to euro-area-wide factors and news, particularly from monetary policy, country effects still have an important explanatory role for the variance of equity returns.

Banking

As regards the integration of the European banking markets, there has been some progress, but further integration is still desirable. The degree of integration varies across the various segments of banking business. Cross-border activities have increased significantly in inter-bank and wholesale business. The share of securities issued by non-monetary financial institutions of another euro area country which are held by euro area monetary financial institutions has more than doubled since 1997.

Euro area cross-border loans between monetary financial institutions have increased from 15% of all loans among EU MFIs in 1997 to currently 23%.

What is disappointing from my point of view is the small degree of integration achieved so far in the retail banking segment. The share of euro area cross-border MFI loans granted to non-MFI's has risen from 2% of total loans in 1997 to 3.5% at present, which is still a very low level. The cross-country standard deviation of MFI interest rates on consumer credits has been fluctuating between 80 and 100 base points in recent years, and the corresponding figure for house purchase credits has varied between 40 and 60 base points.

Accordingly, one of the five priorities contained in the European Commission White Paper on EU financial services policy for the next five years is the creation of more competition between service providers, especially those active in retail markets.

Financial system developments: "bank-based" versus "capital-market-based" systems

Financial markets integration implies the transformation of national financial systems. Textbooks typically distinguish between two types of financial systems: bank-based systems and capital-market-

based systems. Classical stereotypes of this dichotomy are the European bank-based system and the US financial system, which is dominated by capital markets.

Actually, the reality in Europe is more like a continuum of characteristics. Comparing the countries of the European Union, one can see that domestic bank credits in relation to GDP vary markedly across EU countries. And Germany, often regarded as the archetypal bank-based financial system, has a credit-to-GDP ratio that does not significantly exceed the EU(-25) average. The Netherlands has the largest proportion of domestic credits to GDP (almost 180%).

Despite some variability from country to country, the euro area ' s stock market capitalisation of nearly 70% is still well below that of the US and the UK (2004). The UK's stock market capitalisation was more than 127% of its national GDP in 2004. The corresponding figure for the US stock markets was nearly 140% of GDP in 2004. But the importance of capital markets in the euro area is growing continuously. For comparison: euro area stock market capitalisation in relation to GDP was 19% on average in 1990-94. It grew to 50% in 2000-2004 (US: 1990-94: 69%, 2000-2004: 132%).

Accordingly, there is a significant trend in Europe towards financial systems that are more capital-market-based, but the disintermediation effects of this gradual shift towards a greater capital market orientation have not been as strong in Europe as they have been in the US. While it is true that the share of bank deposits in households ' financial assets is on a declining trend in the euro area, the ratio of bank deposits to GDP is still growing in contrast to the developments in the US over the past 15 years. In addition, the ratio of credit to GDP in the euro area has – from a higher base level than in the US – increased even more markedly than on the other side of the Atlantic. So, while shifts towards a more market-based financial system are clearly under way, continental Europe and the euro area, in particular, have – and will retain – a bank-dominated financial system for the foreseeable future.

In this mostly market-driven process of gradual system transformation, the characteristics of bank-based systems will lose some of their importance in the euro area in the years ahead. Most notably, relationship lending will be affected. Relationship lending has two possible major positive effects: reducing debtor moral hazard and smoothing interest rates. In contrast to direct capital market financing or arm's-length banking, customers that have a close and long-term relationship with their bank (*Hausbank*), have greater incentives to preserve mutual trust. Borrowers know that defaulting on a credit provided by a relationship lender would finish the relationship. Thus, relationship lending might prevent borrowers' moral hazard in terms of inefficiently risky projects. *Hausbanks* usually have more detailed and timelier information on a firm than a comparable arm's-length bank or the capital market. Such a close and long-term relationship as well as better knowledge of the firms assist interest rate smoothing.

Implications for monetary policy

And this is where monetary policy enters the scene. If capital-market-based financing becomes more important in relative terms, it will have an impact on the pass-through of monetary policy changes. In general, it can be said that, other things being equal, the higher the degree of financial integration is, the faster will be the transmission process of monetary policy.

A further implication of the trend towards capital-market-based financing is the growing importance of asset prices. The Eurosystem does not target asset prices. The primary objective is to maintain price stability in the euro area (HICP inflation below but close to 2% in the medium term). However, the Eurosystem monitors asset price dynamics closely, because strong appreciation and subsequent rapid reversals in asset prices are associated with potentially high costs for the economy and thus for price stability.

Moreover, the increasing importance of the capital market does not just have an impact on the transmission mechanism and the role of asset prices. Extracting signals regarding risks to price stability stemming from monetary developments becomes a more challenging task. One example of this is the enhanced short-run monetary dynamics between 2001 and 2003 due to exceptional economic, financial and geopolitical uncertainties that led to portfolio shifts from capital markets to money markets bloating the monetary aggregates and their growth rates.

Finally, more integrated financial markets and asset prices affect financial stability, too. A growing importance of capital market instruments allows banks to spread risks more evenly, thus making a positive contribution to financial stability. On the other hand, rapidly developing risk spreading tools like Collateralised Debt Obligations (CDOs) or credit derivatives necessitate a more ambitious

monitoring from financial stability authorities in order to evaluate the effective distribution of risks among financial institutions and markets.

European banking markets and banking supervision

As I mentioned earlier, the European financial systems remain bank-dominated. At the same time, European banking market activities are still not integrated to a great extent, most notably in the retail segment. Notwithstanding this, the ongoing pressures of competition and integration in the common market and EMU will certainly shape the future banking landscape in the euro area.

And it is not only EMU that is responsible for these developments. Other regulatory steps are also exerting pressures. Well-known examples are the forthcoming revision of international capital adequacy rules – Basel II – and, in terms of the EU, the Capital Requirements Directive (CRD). CRD offers banks incentives to be more proactive in improving risk management techniques and customer selection, and it is expected to have a profound impact on the strategies of European banks and global competition.

In this context, a broad trend towards more international and European structures and a greater capital market orientation will have implications not only for the institutions involved but also for the public authorities. The possible consequences for monetary policy of a more market-based financial system have been already mentioned. The emergence of cross-border banking structures, on the other hand, also creates major challenges for supervisory bodies.

Despite the somewhat disappointing state of banking integration in general, the common market and EMU have already initiated perceptible cross-border M&A activities. While it is true that overall M&As in the European banking sector have been declining since the cyclical peak at the end of the 1990s, the relative importance of cross-border deals within the EU has increased steadily over the past 15 years (EU cross-border M&A in relation to domestic M&A: 1990-1994: 23.5%; 1995-1999: 31.6%; 2000-2004: 42.4%).

Although we have witnessed an increasing proportion of cross-border M&A activities in the EU banking sector since the introduction of the euro, there is still a lack of pan-European banks. Consolidation in the banking sector is mostly domestic. The presence of pan-European banking groups' branches or subsidiaries in the EU countries is quite limited – even if there is a lot of representation of it in this conference room today. The average share of foreign branches and subsidiaries accounts for approximately 25% of the EU banking market. Higher figures can be found in some smaller countries, such as the Benelux, and very high figures in many new member states with the market share of foreign-owned banks exceeding 95% in the Czech Republic, Slovakia, Estonia and Lithuania.

The lack of retail market integration in banking, of course, reflects to some extent the fact that retail banking is a local business where proximity to clients and knowledge of cultural attitudes is of special importance. But it might also mirror possible impediments to cross-border M&As. It is sometimes argued that the supervisory environment poses such an impediment. And some experiences over the past couple of months have certainly not dampened such fears.

In general, public policy should not interfere with market-driven cross-border merger processes but remove potential supervisory obstacles. And, somewhat encouragingly, according to a recent (CEBS) survey of European banks. the current supervisory framework is not really substantially hindering European cross-border banking consolidation.

It is clear, however, that the current state of play poses a number of real challenges for banking supervisors. Firstly, as long as we do not see pan-European banks on a larger scale, there is no justification for a pan-European supervisory body or what is known as a "lead supervisor". Secondly, emerging cross-border structures mean that the legitimate interests of home and host country supervisory authorities have to be balanced without burdening the involved banks too heavily with bureaucratic costs.

In striking that balance, convergence and cooperation in supervisory practices are inevitable. And further harmonisation of supervisory rules in Europe may be required to ease the cross-border activities of credit institutions. And there is indeed a lot of work going on in the relevant institutions, such as CEBS or BSC. Some examples may justify this claim:

(i) The implementation of the CRD, which I have mentioned, will strengthen the ties between home and host country supervisors and foster the coordinating role of home-country supervisors.

(ii) The European Commission has launched an initiative to eliminate existing barriers to cross-border mergers with consequences for the supervisory approval process as well as home and host-country interactions.

(iii) Finally, reflecting the need for timely cooperation between several players in times of stress, a Memorandum of Understanding involving banking supervisors, central banks, and finance ministries in the EU was signed in 2005.

The details of some of these plans are not uncontroversial and will need further clarification, but the overarching goal is unequivocally positive: to improve the functioning of European cross-border banking markets. Some of you may still argue that the current institutional setting is too complex and burdensome. But, given the current European banking landscape, it is, in my view, an appropriate institutional configuration. Nevertheless, it clearly has to be constantly adapted to changes in the markets:

The guiding principle should be that the structure of banking supervision follows the market structures. It should neither lead them nor lag behind them.

Concluding remarks

Let me conclude by summarising the main points. Financial integration is a mostly beneficial process which is driven by market forces as well as collective action and public action. The current state of financial integration varies across the various market segments, with integration being most advanced in those areas where the relevant market is closest to the common monetary policy. Thus, a large measure of integration has been achieved on the money market and the bond markets. A lower degree of integration has been achieved on the equity markets and the banking markets. European cross-border banking is still underdeveloped; there is still a lack of pan-European banks.

The banking business itself is under the pressure of a general trend towards a more market-based financial system, but the financial systems of the euro area countries will certainly stay bank-oriented for the foreseeable future. Loans will remain the dominant financial instrument for small and medium-sized enterprises, but capital market products will gain a more important supplementary role in corporate finance. Even those enterprises with no access to capital markets will be affected indirectly owing to the emergence of credit risk securitisation and credit derivatives. Banks will become knowledge providers in the increasingly complex securities and financial markets. In such a symbiosis with the capital market, even relationship banking might gain new attractiveness.

As regards the monetary policy implications of this process, it may be expected that the bank lending channel will have a diminishing role in the transmission process in favour of the interest channel, that asset prices will have a growing impact, and that there will be a more challenging interpretation of monetary developments.

Finally, banking supervision must not impede European cross-border banking consolidation. The current cooperation-based supervisory system in Europe is more appropriate at the current juncture than more advanced concepts such as a “lead supervisor” or even a “central supervisor”.