Lucas Papademos: Integration and development of financial markets – a key to faster sustainable growth in Europe

Speech by Mr Lucas Papademos, Vice President of the European Central Bank, at the annual meeting of the Institut International d'Etudes Bancaires, Athens, 20 October 2006.

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I. Introduction

This impressive gathering of the Presidents and Chairpersons of Europe's top banks brings to mind a statement made by a famous economist: "People of the same trade seldom meet together even for merriment and diversion, but on those occasions when they meet the conversation ends in a conspiracy against the public or some contrivance to raise prices". It was Adam Smith who expressed this view in the 18th century. If he could have seen this gathering of top bankers from across Europe, would he have expressed such an opinion, which would also be a cause of alarm for a central banker because of the potential "contrivance to raise prices"? I very much doubt it. I am in no position to judge the degree of "merriment and diversion" you have experienced during this annual meeting of the Institut International d'Etudes Bancaires – the 111th meeting since the Institute's establishment. I am sure, however, that today's sessions must have provided very useful opportunities to exchange views on current banking matters and major economic policy issues. It is a privilege for me to be here with you tonight and I would like to thank you for inviting me to be the speaker at this gala dinner. At the same time, I am aware that it is a challenging task to stand between an audience and the first course of the meal. However, this is not necessarily an unfamiliar position for a central banker to find himself in. After all, it is said that it is the very job of the central banker to take the punchbowl away just when the party starts to get going.

The nature of your meeting and the current favourable prospects for a sustained recovery in Europe suggested to me four issues on which I would like to share some thoughts with you:

> First, how can financial markets – and the banking system in particular – promote faster and sustained economic growth in Europe?
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> Second, and more specifically, how can increased integration, competition and development in Europe's financial markets foster innovation and productivity growth, which are crucial for enhancing Europe's growth performance?
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> Third, how far have we advanced in reaping the benefits of a more integrated and developed financial system? And, what can we do to speed up this process?
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> And, finally, can the current supervisory arrangements in Europe function effectively and efficiently in a rapidly changing financial environment and help to promote integration and efficiency while safeguarding financial stability?

Let me give you the general message of my remarks first: we have good news to report in answering these questions and we, the European Central Bank in particular, are committed to making further progress in the areas of our responsibility.

II. The contribution of financial markets to growth – what do we know?

While the outlook for growth in the euro area in the coming quarters appears to be very positive indeed, we cannot deny that the growth performance of the continental European economies over the past decade has been rather disappointing – especially if we compare this to the impressive growth rates recorded in the United States over that period. A plethora of analyses of the causes of Europe's less-than-satisfactory performance has been presented, and I am sure that in your discussions on the various features of European social models – the theme of this year's annual session – you certainly touched upon many of the explanations put forward in this regard: inadequate labour utilisation; insufficient competition in product and services markets; excessive bureaucracy and administrative burdens; tax and benefit systems that create the wrong incentives; insufficient investment in education, research and development, etc. I think we can all agree on the diagnosis – the supply side of our economies is less than optimal. Thankfully, we also have a shared understanding of what the remedies should be. The necessary measures and policies are laid down in the so-called Kok report and the revised and refocused Lisbon strategy of the EU: structural reforms in labour, product and services markets to improve flexibility; removal of obstacles to cross-border competition and the completion of a genuine Single Market in the EU; policies to improve education and training and to boost (both public and private sector) research and development; measures to improve the business climate. Last, and by no means least, we should tackle the obstacles to competition and innovation in our "trade" and the area of our responsibility – the financial sector – and we should promote financial integration and development. It is this last point – financial integration and development as a key to faster sustainable growth – that I will explore next.

As you know, the fundamental function of financial markets and intermediaries is to channel funds from economic agents who have a surplus of savings to those who have a deficit. If financial markets are functioning efficiently and are supervised effectively, they contribute to an optimal allocation of resources, reduce the cost of capital, and allow for risk-sharing and risk-diversification. But are markets sufficiently efficient and effectively regulated in Europe? Do they perform their tasks as optimally as they should? These questions can be addressed from various perspectives: allow me to concentrate on two angles, that of financial integration and that of financial development.

Intuitively, it seems obvious that segmented markets – with higher transaction costs and reduced possibilities for risk-sharing and optimal resource allocation – are not efficient and hence are hindering growth. Financial integration could thus be conducive to growth. What I mean by financial integration is the establishment of a fully integrated market, in which all potential market participants with the same relevant characteristics face a single set of rules, have equal market access and are treated equally when they are active in the market.

Moreover, the process of financial development can also further improve the performance of already well-integrated markets and thus enhance growth. What I call financial development is the process of introducing financial innovations and organisational improvements in the financial system that reduce asymmetric information, increase the completeness of markets and the contracting possibilities of agents, reduce transaction costs and increase competition. Both financial integration and development are therefore crucial in contributing to the efficiency and stability of the financial system.

This is the theory. But what do we make of this? What are the practical consequences and policy implications of the theoretical perspective? Leonid Brezhnev – a man not usually remembered for scholarly discourse – is said to have stated that "there is nothing more practical than a good theory". Well, this is definitely not good enough for me. We should try to assess the facts and take the necessary action to improve the situation if this is warranted. Can we measure the degree of integration and the state of development of financial markets in Europe? Can we estimate quantitatively the effects of further integration and enhanced financial development on economic growth? The answers to these questions are important in order to know where we stand, to assess the expected benefits of further progress and to implement the appropriate policies to achieve our objectives.

At the European Central Bank we are making a systematic effort to measure and assess the extent of financial integration and the degree of development of Europe's financial markets and to estimate the impact of the associated processes on the economy. To this end, we have developed a set of indicators of financial integration and we are also monitoring and evaluating the process of financial development in Europe on the basis of another wide-ranging set of indicators measuring the degree and process of development of financial markets. Let me briefly report on some of the results and findings of this work.

Overall, the good news is that we now have some solid evidence to prove the theoretical propositions I previously mentioned and their quantitative implications. For example, there is strong empirical support, based on the analysis of data for many countries and many sectors, that the size and depth of capital markets has a significant positive impact on economic growth – the larger, more liquid and also more integrated, the better. Financial development is good for productivity growth and capital accumulation, and financial liberalisation generates sizeable growth benefits.

Why is this the case? There are several reasons. But a central explanation is that well-developed and efficient financial markets are better at channelling capital from sectors in decline to those with growth opportunities, in a process of Schumpeterian "creative destruction" that ultimately drives economic growth. It is particularly beneficial for firms with good investment prospects, which depend more on external finance, especially for small and medium-sized enterprises and start-up companies. The practical implication of this empirical analysis is that it demonstrates – quantitatively – that productivity improvements and economic growth will be fostered by a more integrated and efficient European financial system, in which private capital is more easily channelled into financing innovations and in which risk-taking and venture capital markets are better developed.

An equally strong message can be conveyed about the beneficial effects of financial integration on growth from the American experience. It has been estimated that the removal of restrictions on branching and cross-state ownership for US banks contributed to an increase in real per capita growth by between 0.6% and 1.2%, mainly as a result of enhanced productivity. Moreover, the "quality of banking" improved. For instance, the share of non-performing loans and write-offs declined by 0.3% to 0.6% after the removal of these restrictions. Deregulation, which allowed for financial integration across states, also fostered bank consolidation, thus allowing banks to realise economies of scale and specialisation benefits. The result was not only lower borrowing rates for firms and households, but also positive spillover effects in other markets, enhancing competition and fostering entrepreneurship. Finally, and quite interestingly for us central bankers, banking deregulation and the increased financial integration it entailed played a significant role in reducing output volatility in the United States and in improving risk-sharing.[1]

Of course, these findings cannot be applied exactly to Europe. Moreover, deregulation and the removal of legal barriers is a necessary, but not a sufficient, condition for more integration, as there remain other obstacles, not least those of a prudential or tax nature. Nevertheless, the general and practical message of the evidence available is clear: if we further pursue financial integration in Europe, we can realistically expect significant tangible benefits in terms of higher productivity and economic growth.

III. Improving the functioning of the European financial system

The good news, the second piece of good news, is that this message is better and more widely understood. The creation of a true single financial market in Europe is a clear priority. And the euro, of course, plays its part. If the original justification for the single currency was neatly encapsulated in the title of the European Commission's Report "One Market, One Money"[2] that set out the potential benefits and costs of an economic and monetary union, we should now aim, more specifically, to fully complete the process and achieve the twin objectives.

Are we there yet? Again, let me mention a few hard facts. The ECB's research and its monitoring of financial integration portrays a somewhat mixed integration picture. Recently, a few weeks ago to be precise, we published our second report on financial integration indicators[3] and a study on interest rates across the euro area countries[4]. One of the findings, perhaps unsurprisingly, is that there is a close link between the degree of market integration and the available underlying market infrastructure. The euro money market is essentially fully integrated, thanks to the integration of large-value payment systems. By contrast, retail banking continues to be fragmented for various reasons, but an important one is that there are too many retail payment infrastructures. This is one reason why the ECB is strongly supporting the establishment of the Single Euro Payments Area (SEPA) as quickly as possible. The completion of SEPA will not only have direct benefits for the consumer, but will also further promote integration in retail banking. More generally, the further and faster integration of clearing and settlement systems in Europe is an essential motive behind the ECB's initiative to offer in the future securities settlement services in central bank money in euro – the so-called TARGET2-Securities system. Yesterday, the ECB's Governing Council decided to further investigate the feasibility of this project, and to take a final decision in February next year. Afterwards, we intend to launch a broad public consultation of all interested parties.

Another sign of incomplete integration is that bank interest rates still vary considerably across countries. I should stress, though, that such differences are also partly the consequence of various other factors, such as product characteristics and business practices. Some press commentators concluded from the ECB's report that these high cross-country differences reflected insufficient

1 See Morgan, P., Rime, and E. Strahan (2004). "Bank Integration and State Business Cycles", Quarterly Journal of Economics, 119(4), pp. 1555-85.

2 Commission of the European Communities (1990) "One Market, One Money" European Economy 44.

3 European Central Bank, "Indicators of financial integration in the euro area", September 2006.

4 European Central Bank, "Differences in MFI interest rates across euro area countries", September 2006.

competition. This is only part of the explanation. Market fragmentation also affects the financial system's efficiency. Again, a comparison between Europe and the United States is quite revealing. Whereas the cost-to-income ratio of banks in the euro area is 64% on average, it is only 58% on the other side of the Atlantic. This superior US performance can be explained, at least partly, by a more integrated market and a more harmonised regulatory environment.

Many of you experience first hand the obstacles that continue to hamper financial integration and cross-border banking in Europe. Some of these obstacles are related to legal and fiscal differences, while others may relate to the regulatory and supervisory framework. The latter are of particular interest to us considering that a task of the ECB, which is enshrined in the Treaty, is to contribute to the smooth conduct of policies by national authorities in the field of supervision and financial stability. Financial regulation and prudential supervision have a significant role to play in the financial system: to address market failures and safeguard financial stability. However, it is also true that in an evolving and integrating financial system, banking regulation and supervision need to evolve in order to keep up with developments.

This, of course, begs the question whether the European regulatory and supervisory framework has kept pace with the development and integration of European financial markets. There are two aspects to this question: first, whether the current framework may be an obstacle to further financial integration. Bankers often see the decentralised institutional set-up in Europe as a major hurdle to efficient cross-border operations. Much has already been done to alleviate the concerns, though perhaps not to the extent some of you would have wished. The second issue is whether the current institutional framework is able to effectively maintain financial stability in a context of increased financial integration. Allow me to touch upon both issues.

Since March last year, the Lamfalussy framework for financial regulation and supervision has been formally extended to the banking sector. I see this extended Lamfalussy framework as a major step to achieve the objective of consistent supervisory action across the EU and, in this way, to further promote financial integration. In its young existence, the Committee of European Banking Supervisors (CEBS) has already delivered an impressive amount of work in this area. Rightfully, the Committee has focused extensively on defining common approaches in the supervisory tools and practices (mainly relating to the implementation of the Basel II Framework) as well as on the cooperation between home and host supervisors. Both aspects are clearly of great interest to banks with cross-border presence. Looking ahead, what I see as the main challenge is the consistent implementation of the agreed standards and guidelines by the national supervisors. In this respect, I consider the recent decision of CEBS to establish operational networks (or colleges of supervisors) for specific cross-border groups and to create a coordination mechanism among them to be two important steps in the right direction.

But there is more. Work is underway which aims at the development of a common supervisory culture; the adoption of a non-binding mediation mechanism among supervisors; the possible use of the cross-border delegation of supervisory tasks and responsibilities; and a further streamlining of banks' reporting requirements.

The ECB very much supports both the work of the CEBS and the concrete measures I have just mentioned in order to achieve the necessary convergence in supervisory practices. The aim is to exploit the opportunities offered by the existing institutional framework to the maximum possible extent.

Is this enough? I am aware that for some of you the present arrangements and initiatives do not go far enough, and a number of much more far-reaching proposals have been put forward, such as extending the coordinating role of the consolidating supervisor, the establishment of a lead supervisor or the move towards a federal system for supervision. But, in my view, it is essential that the existing framework should be given sufficient time to show that it can indeed deliver on its promises. By the end of next year, we will have the findings of the review that is currently underway of the processes and procedures. It would seem reasonable to me to await this before embarking on another major assessment.

Ladies and gentlemen, before I close, let me make a couple of brief remarks on the nexus between financial integration and financial stability. You are undoubtedly aware that only a few weeks ago, we witnessed the largest ever loss incurred by a hedge fund, 6.4 billion US dollars, suffered by the US-based fund Amaranth Advisors. Fortunately, there was little market disruption. I mention this, because this episode should serve as a solitary reminder that the channels through which financial innovation, development and integration can potentially affect the financial system's resilience are manifold, diverse, and complex. One could expect financial integration to affect financial stability in two directions: on the one hand, there is an increased risk of contagion and a larger exposure to common shocks; on the other hand, there are more opportunities for funding as well as for risk-sharing and risk-transfer. The net effect is difficult to gauge. In my view, it is likely to be positive for the stability of the financial system. What is certain, however, is that, in the case of banking strains, the likelihood that they will remain confined within domestic borders is less in comparison with the past.

Therefore, it is necessary for the supervisory framework as well as for the arrangements for financial stability in the EU to be able to cope effectively with the management of a possible crisis of cross-border banking groups. These issues are a central main topic of discussion at the moment in the policy-making circles in the EU and, indeed, globally. In Europe, a lot of progress has been made in clarifying the roles of, and the procedures to be followed by, the competent authorities (central banks, banking supervisors and ministries of finance) in crisis situations. In addition, the degree of preparedness of the authorities to manage a situation of stress can be enhanced through crisis simulation exercises. However, there are other areas, such as deposit insurance schemes and the winding-up of financial institutions, where there is room for regulatory intervention at the EU level. Reflections on possible legislative proposals in this regard are underway.

The general conclusion from all these observations is that any future modification to the supervisory framework should follow a holistic approach, carefully considering all the implications of any such change for all the components of the financial safety net. The stakes are indeed high, as an efficient and effective supervisory framework for a more integrated, competitive and developed financial system is crucial for Europe's growth.

IV. Concluding remarks

Ladies and gentlemen, a "holistic" approach to this gala dinner should also mean combining the food for thought, which I hope to have provided, with our attention to the more tangible nutritional elements, that is, our dinner. Let me conclude by returning to Adam Smith and some pertinent views of his, as assessed by Alan Greenspan: "Modern economic analysis has confirmed much of what Adam Smith inferred from a far less impressive set of data. Today's economists generally point to three important characteristics influencing growth: (1) the extent […] of a country's integration with the rest of the world, (2) the quality of a country's institutional infrastructure, and (3) the success of its policy-makers in implementing measures necessary for stability". As I have highlighted tonight, each of these three elements – integration, institutional infrastructure and stability (both for macroeconomic and financial) – remain of crucial importance to Europe's economic growth and prosperity.

Thank you very much for your attention.