Miguel Fernández Ordóñez: Financial integration and stability in Europe

Opening remarks by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at the Conference on "Financial Integration and Stability in Europe", organised by the Bank of Spain, the European Central Bank and the Center for Financial Studies, Madrid, 30 November 2006.

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Good morning ladies and gentleman. First of all, allow me to welcome you. We are really delighted to host this conference at the Banco de España in Madrid.

Some of you are perhaps too young to remember, but it was here in Madrid, in 1989, that the European Council decided to embark on the first stage of Economic and Monetary Union, as envisaged in the Delors Report which was the catalyst for the EMU process. I would like to start my intervention today with a quote from the Delors Report; a quote that refers to financial integration. Simplifying, it said the following:

> *The objective of a single financial area, in which all monetary and financial instruments circulate freely, and banking, securities and insurance services are offered uniformly throughout the area, would be fully implemented through the approval and enforcement of the necessary Community directives*.

You can appreciate the appealing simplicity of its definition of an integrated financial market: one where all monetary and financial instruments circulate freely, and where banking, securities and insurance services are offered uniformly.

Nevertheless, the word “uniform” might sound a little strange to us today, when we prefer to use softer terms such as “convergence”. But of course Mr Delors was not thinking about uniformity of the services themselves, but rather about the need to ensure that they could be offered and accessed on an equal basis across the EU.

But what it is remarkable is that Mr Delors was referring to the steps that should be taken in Stage One of EMU. He expected the integrated financial market to be in place at the beginning of the EMU process, before going to the subsequent stages. Almost seventeen years have passed since Stage One was launched. And we entered Stage Three almost eight years ago. EMU has proved to be a successful reality, but the single financial area as defined in the Delors Report has not yet been fully achieved.

Of course, there has been impressive progress in some areas, for instance, the European money markets. And there has been good progress in others, like corporate bond markets and Government bond markets.

In some fields, however, we are a long way from Mr Delors’ vision of integration.

Looking at stock exchanges, for instance, we have certainly witnessed a decrease in the home country bias in investor portfolios. But the overall level of home country bias remains high, indicating that a significant degree of fragmentation remains.

And progress has been very limited in the retail financial services sector, where the cross-border provision of services is still almost symbolic.

Also, while we have continued to see domestic consolidation of financial intermediaries, merger and acquisition activity across borders has not been as high as we might have expected, as the European Commission has pointed out. There are exceptions, of course - a notable one being on our doorstep, with Banco Santander’s acquisition of Abbey in the UK.

But what is the interest of central banks in all this? Should we worry about the lack of progress? Should we actively promote greater financial integration? My earlier quote from the Delors report would seem to indicate that the answer should be yes. Indeed, from the perspective of EMU it is very clear that greater integration is desirable.

Why is this? Because in general terms, the higher the degree of financial integration in EMU, the more homogeneously monetary policy decisions will be transmitted across the Member Countries.

The integration of money markets is an important achievement in this respect. It is at this level of the financial system that central bank liquidity is distributed and that monetary policy decisions are transmitted to short-term interest rates.

By the same token, the lack of integration in retail markets is an important concern. This is because the European financial structure is mainly bank-based. Therefore, retail banking plays a central role in the transmission of the single monetary policy impulses in EMU to the interest rates which actually influence the expenditure decisions of households and firms.

But apart from our interest in the effective transmission of monetary policy, there is a broader reason why central banks wish to see greater integration.

At the end of the day, the ultimate objective of a central bank, as of any public policy maker, is to enhance citizen welfare. A number of pieces of empirical evidence reveal that financial integration has a positive effect on economic growth and, therefore, on welfare. The European Commission, London Economics and several researchers have provided us with interesting studies which estimate that a total removal of national barriers in European financial markets would imply a long-term increase in GDP growth of up to one percentage point.

There is also evidence for the US, based on analysis of the effects of the removal of restrictions on cross-state bank branching and ownership, which points in the same direction.

These two aspects – monetary policy transmission and promoting citizen welfare - explain the efforts that central banks have made to contribute to the integration process, although the leading roles and initiatives rightly correspond to the European Commission and to market forces.

Maybe the most telling example of the central bank contribution is the establishment of TARGET, promoted by the Eurosystem and introduced at the beginning of Stage Three with the aim of integrating the system of large value payments across the euro area. It is widely recognised that its success has played a crucial role in the integration of interbank markets in Europe.

However, the mandates of most central banks, including indeed both the Eurosystem and the Banco de España, also cover other objectives. There is, in particular, an area which deserves special attention in this context. I am referring, of course, to the function of promoting financial stability.

It is precisely in this area where the impact of financial integration is less clear. Does financial integration promote financial stability? Or does financial integration put financial stability in danger?

As a matter of fact, while the effects of higher integration on per-capita income and on the efficiency of monetary policy transmission have received a lot of attention by researchers, the impact of financial integration on financial stability is under-researched. That is why we are holding this conference.

Despite the lack of research, it seems clear that there are some areas where financial integration favours financial stability.

Firstly, a more integrated financial system enlarges the opportunities available to investors, lenders and borrowers to diversify the different risks associated with their financial decisions. Through such diversification, they should become less exposed to idiosyncratic shocks, asset prices and financial flows should behave in a smoother way and as a result, the risk of financial distress should be reduced.

Secondly, in a more integrated system, financial intermediaries would find it easier to grow and at the same time would find the incentive to do so in the enlargement of their potential markets. Larger institutions would therefore be in a better position to reap the benefits of greater economies of scale, and would also increase their financial muscle to withstand potential shocks.

Unfortunately, however, there are no free lunches in the economy and it seems that financial integration can also have negative effects on financial stability.

Therefore, fully integrated financial markets pave the way for shocks to propagate more quickly among market participants, thereby affecting a wider range and number of them. Contagion becomes more likely.

In the same way, the larger an institution, the higher is the probability that it becomes systemically relevant, which would clearly have implications for financial stability in the event that it runs into problems.

And, the more institutions operate across borders, the more the risks associated with their business extends across these borders.

Despite these challenges for financial stability of an increasingly integrated financial system, let me stress that, so far, the experience both for Spain and the Global Economy seems reassuring, but these aspects clearly need further investigation. And the immediate and obvious question that arises is the following: can we mitigate the potentially negative effects of integration on financial stability in order to take full benefit of the advantages that I mentioned earlier in my intervention?

It is the supervisory authorities who are responsible for dealing with the risks I have identified. But this is not an easy task. Despite the existence of common EU legislation in many key areas, supervision is still organised on a national basis. This raises two key challenges.

First, it means that it is not easy for supervisors to capture all the relevant risks – within and across borders - faced by the financial institutions for which they are responsible.

Secondly, institutions operating on a cross-border basis face duplications and inconsistencies in the supervision applied to them by the different national authorities with which they are required to deal. This increases their costs of doing business, and can therefore act as a barrier to integration.

In summary, supervisors face a double challenge in the face of increased EU integration: how to ensure that their actions are effective, and thereby contribute to preserving financial stability; and how to ensure that their actions are efficient. Their response has been to enhance cooperation. Indeed, cooperation between supervisors has increased exponentially over the years.

More recently, the Lamfalussy approach has been implemented, and has set this cooperation in a new structure that aims to promote a more efficient and effective approach to both supervision and regulation in the EU financial services sector. The supervisory committees that form part of the Lamfalussy structure have a major role to play in this respect.

And I think everyone would agree that the efforts being made by these committees are extremely impressive. But we need to give these efforts time to bear fruit – the Lamfalussy approach is still rather new, especially in the banking and insurance sectors. In addition, there are a number of initiatives currently underway to exploit more fully the possibilities of cooperation and convergence provided by this approach, and I think the results will be positive.

Now it may be that over the longer term, the current structure is judged to be insufficient to meet the needs of a more integrated market, and that a more fundamental re-think of the organisation of EU supervisory responsibilities is necessary. I personally think that this debate will intensify in the next decade. But we would certainly need to proceed with great caution in this debate. I am a firm supporter of the idea that changes should only be made if clear problems are identified.

But whatever happens, I think the solutions we have to look for should be cooperative in nature, embracing the needs of all EU member states. This would, in my view, be preferable to an approach which would tend to concentrate responsibilities in the hands of a few Member States while the implications of their actions would extend far beyond their borders. Taking a more inclusive approach is the way that we have found solutions in the past to European challenges, and I think it is the best way forward. EU-wide financial stability is of interest to all of us.

Against the background that I have portrayed in my previous comments, it is clear that central banks have a genuine interest in improving their understanding of how the objectives of financial integration and financial stability, or even macroeconomic stability, interact with each other.

I already mentioned that this is an area which is under-researched. Two years ago, the Network on Capital Markets and Financial Integration in Europe identified this gap and decided to include the relationship between financial integration and financial stability in a list of the network's priority areas, posing a series of stimulating questions aimed at providing some guidance for researchers' efforts.

I think it is useful to recall the five questions posed by the Network:

- First, how can financial regulations be designed so as to be conducive to integration while still ensuring financial stability?
- Secondly, what are the main links between financial integration and contagion?
- Thirdly, what are the mechanisms that can trigger contagion and financial fragility?

- Fourth, how does competition in the financial services industry affect the ability of the financial system to withstand shocks?
- And finally, how and to what extent do financial crises affect economic activity?

As you will have realised, there is an almost perfect correlation between these questions and the main topics of the different papers that make up the excellent and well-balanced programme that the organisers have put together for this Conference.

This is important because it shows that there is another less-explored way in which central banks can effectively contribute to fostering financial integration: identifying the policy issues where the input from research is welcome and providing researchers with a forum where they can debate their ideas among themselves and with policy makers who, if convinced, will be in charge of carrying them forward.

I am sure that the presentations and discussions during the course of this conference will provide central bankers with fresh and high-quality material which will be useful to us in finding the most efficient way to foster financial integration without jeopardising our objective of promoting financial stability.

I sincerely hope too that this conference will encourage researchers to go on working on these and other related areas in the coming years, thereby rapidly filling the current gap between the policy relevance of the questions posed and the availability of profound analytical and empirical research to substantiate the possible answers.

I would like to end my intervention by thanking the organisers for gathering together such an impressive group of researchers and policy makers, thanking the audience for their attention and wishing you all a fruitful exchange of ideas and a pleasant stay in Madrid.

Thank you very much.