Jean-Claude Trichet: Major issues related to the process of European financial integration – the regional and global perspective

Keynote luncheon remarks by Mr Jean-Claude Trichet, President of the European Central Bank, at the conference "Transatlantic Roundtable on Finance and Monetary Affaris", at the invitation of the European Institute, Washington, DC, 13 April 2007.

* * *

Introduction

Ladies and gentlemen,

I would like to thank the European Institute for inviting me to share with you some thoughts on the financial integration process, both within the euro area and between the euro area and the rest of the world.

I will structure my remarks into two parts. In the first part, I will elaborate on the regional dimension of European financial integration. After stressing the importance of financial integration for economic growth in Europe, I will highlight some of the main achievements of European financial integration thus far, as well as the challenges still facing us.

Seen from an international perspective, the European process of regional financial integration should not be misunderstood as creating an isolated fortress, but on the contrary as a tool for European financial markets to become better integrated with global markets. In the second part of my speech, I will therefore provide some evidence illustrating that the financial links of the euro area with the rest of the world are already particularly strong in comparative terms. I will also show that the advent of the euro has given further impetus to such financial linkages, which now also increasingly include capital flows to and from key emerging market economies.

The regional perspective

Implications of European financial integration for economic growth

Financial integration is of key importance for the European Central Bank (ECB), given its relevance for the conduct of the single monetary policy: a well-integrated financial system enhances the smooth and effective transmission of monetary policy impulses throughout the euro area. Today, I would like to highlight a further implication of financial integration, namely that it raises the economy's potential for stronger non-inflationary economic growth.

Generally speaking, financial systems serve to channel funds from those economic agents that have a surplus of savings to those with a shortage; and to trade, hedge, diversify and pool risks. These functions are facilitated by financial integration. As a result, there is a better sharing and diversification of risk and a greater potential for stronger non-inflationary economic growth.

Regarding risk sharing, it is interesting to note that in the US, according to a particularly interesting research, capital markets would smoothe out 39 % of the asymmetric shocks to gross state product (the equivalent of our GDP), the credit channel would smoothe out 23 % of such shocks and the federal government, through the fiscal channel, 13 %. 25 % of the shocks would not be smoothed out.[1] Hence in the United States financial markets and financial institutions would contribute 62 % to the absorption of state idiosyncratic shocks. The effect is very substantially higher than the effect of the federal budget. We see from the US example that the financial channel can be much more important than the fiscal channel and that is a particularly important additional reason to speed up financial integration in Europe.

Financial integration is also very important for stimulating economic growth in Europe via its impact on the development of the European financial system. Financial development refers to the process of

1 See P. Asdrubali; B. Sorensen; O. Yosha, "Channels of Interstate Risk Sharing: United States 1963-1990", The Quarterly Journal of Economics, Vol. 111, No. 4, November 1996, pp. 1081-1110.

financial innovation, and to the institutional and organisational improvements in a financial system that reduce asymmetric information, increase the completeness of markets, add possibilities for agents to engage in financial transaction through (explicit or implicit) contracts, reduce transaction costs and increase competition. Progress in financial development can obviously also occur in perfectly integrated markets.

Therefore, by speeding up the reallocation of capital from declining to evolving and promising industries – the Schumpeterian process of “creative destruction” – both financial integration and financial development positively influence the efficiency of a financial system, ultimately leading to a higher potential for economic growth.

The introduction of the euro has already brought about important benefits resulting from increased financial integration. And the process of European financial integration and development is still ongoing: a research study by London Economics estimates the benefits of the full integration of European bonds and equity markets to be around 1% of GDP growth over a ten-year period, or approximately €100 billion.[2]

This brings me to the next point I would like to make, namely the identification of major achievements and challenges of European financial integration.

Achievements and challenges of European financial integration

Let me first draw your attention to a new report entitled “Financial integration in Europe”, which the ECB published for the first time just three weeks ago.[3] The main purpose of this report, which will become an annual publication, is to contribute towards the advancement of European financial integration and to raise public awareness of the role of the ECB and the Eurosystem in supporting this process. My remarks will also draw on some of the findings of this report.

In order to better assess the state of European financial integration, the ECB has developed 42 quantitative indicators which are described in our report.[4] In a nutshell, the evidence confirms that the degree of integration varies according to the market segment, and that integration is generally more advanced in those market segments that are closer to the single monetary policy.

With respect to the euro area money market, the unsecured money market reached a stage of “near-perfect” integration almost immediately after the introduction of the euro, with the cross-country standard deviation of the average overnight lending rates among euro area countries as low as one to two basis points. This success has been sustained by the high degree of integration of the large-value payment systems. The launch of the single technical platform, TARGET2, in November this year will promote further financial integration, in particular through a harmonised service level, a single price structure, and a harmonised set of cash settlement services.

It is, however, also a fact that the euro area short-term debt securities market has witnessed only a limited degree of cross-border activity. This may partly be due to the fact that short-term debt securities issued in the euro area have very similar risk characteristics and therefore offer little scope for international diversification. Our indicator, which gives the share of short-term debt securities issued by euro area residents and held by other euro area residents, shows a rising trend – from 7% in 2001 to over 12% in 2005 – but the absolute numbers are small when compared to the corresponding indicators for the bond and equity market. In this respect, I would like to emphasise the Short-Term European Paper (STEP) initiative. The STEP initiative promotes the development of a European short-term paper market through market players’ voluntary compliance with a set of standards encompassed in the STEP Market Convention. By the end of March this year, 35 STEP-compliant programmes, amounting to €201 billion, had been launched under the STEP label.[5]

---

[2] London Economics (2002), “Quantification of the macroeconomic impact of integration of EU financial markets”, Report to the European Commission.

[3] See the ECB’s website at http://www.ecb.int/pub/pdf/other/financialintegrationineurope200703en.pdf.

[4] See the ECB’s website at http://www.ecb.int/stats/finint/html/index.en.html.

[5] The ECB regularly produces statistics on yields and volumes in the STEP market and publishes them on its website. See http://www.ecb.int/stats/money/step/html/index.en.html#data. The data are published weekly on the first business day of each week, referring to each day of the previous week.

With respect to bond markets, euro area cross-border holdings of long-term debt securities have increased strongly – from about 10% at the end of the 1990s to nearly 60% in 2005 – suggesting that investors are increasingly diversifying their portfolios across the euro area and, therefore, that the euro area government bond market has reached a very advanced stage of integration.

Finally, the quantity-based measure of euro area equity market integration also indicates a rising degree of integration in the equity markets. Between 1997 and 2005, euro area residents doubled their holdings of equity issued in another euro area country to reach nearly 30%. This implies that, following the introduction of the euro, euro area investors have significantly reallocated their equity portfolio from domestic holdings to holdings elsewhere within the euro area.

As a remaining challenge to the integration of euro area securities markets, I note that the euro area securities clearing and settlement infrastructure is not yet sufficiently integrated, although several initiatives are underway. Last November, for example, at the European Commission's request, the relevant European industry associations and their members signed a "European Code of Conduct for Clearing and Settlement", which aims to foster competition and efficiency of clearing and settlement in the EU. The ECB welcomes this initiative and acknowledges the commitment by the industry.

In this respect, let me also mention that the Eurosystem considers developing a single platform for the settlement of securities in central bank money – the so-called TARGET2-Securities. The scope of this project is restricted to the settlement layer of the post-trading activity regarding securities settled in central bank money. The next step will be the definition of user requirements which will benefit from a public consultation.

Last but not least, I would like to mention the retail banking markets, which are less integrated than the other euro area financial market segments. However, we also see progress in some fields.

For example, the current fragmentation of the European retail payment infrastructures is being addressed by the so-called SEPA project that has been initiated by the European banking industry with a view to creating a single euro payments area. The Eurosystem supports this project in a catalyst role, by providing guidance to banks and the payments industry in setting objectives and defining high-level requirements. The self-regulatory approach chosen for SEPA is working well and we expect the European banking industry to launch the first SEPA instruments on 1 January 2008.

Furthermore, a number of indicators point to increasing cross-border banking activities in the euro area, such as the growing cross-border share in the financial holdings of banks and cross-border mergers and acquisitions. I would like to emphasise the fact that cross-border banking is first and foremost a market-driven process. Still, the public sector can play a significant role in providing an adequate policy framework. According to our assessment, which we also explain in the new ECB report, the EU supervisory arrangements have been substantially enhanced by two significant measures: the extension of the Lamfalussy approach to the banking sector and the adoption of the Capital Requirements Directive (CRD), which sets up the new regulatory framework in the EU for banks' capital adequacy as agreed by the Basel Committee on Banking Supervision. Both measures contribute to increasing cooperation and coordination between supervisors on a cross-border basis. The CRD provides for better home-host supervisory cooperation, among other things, by enhancing the role of the authority responsible for the consolidated supervision.

I would also like to mention that regulatory convergence is important not only within the EU but also in a global context. The ECB supports the EU-US Financial Markets Regulatory Dialogue and believes it can serve as a forum where solutions to important regulatory issues on both sides of the Atlantic can be sought, such as accounting standards, the revised proposal for de-registration of foreign firms from US markets, and the recent announcement regarding the cooperation between the United States and the EU in audit oversight. Furthermore, the ECB supports the European Commission's objective to deepen the financial dialogue with other countries, such as China and Japan.

The global perspective

I would now like to turn to the financial links between the euro area and the rest of the world.

Let me first recall a fact that is already well-known: namely that, in trade terms, the euro area is very open, actually more open than the other G3 economies, the United States and Japan. Extra-euro area exports of goods and services account for around 20% of euro area GDP, roughly the same share as extra-euro area imports. This is substantially higher than in the United States, where exports represent about 10% of GDP and imports 16%, as well as in Japan, where exports and imports of goods and services amount to 15% and 13.4% of GDP, respectively.

Probably less well-known is, however, that the euro area is also more open than the United States and Japan regarding the financial linkages. Such linkages can be measured with different indicators. As I would like to highlight long-term trends, I will focus here mainly on stock data, given that flow data tend to be very volatile and usually reflect cyclical patterns in the short run.

Five main observations can be derived from cross-country comparisons of international investment positions.[6]

First, comparative data highlight the financial openness of the euro area, thus contradicting any notion that this region is inward-looking when it comes to financial integration. The external assets and liabilities of the euro area account for a large share of GDP, around 124% and 137%, respectively. By comparison, in the United States, the corresponding numbers are substantially lower: 90% for assets and 110% for liabilities. In Japan, foreign financial assets are likewise significantly lower than in the euro area (94% of GDP in 2005), and the difference is even stronger for liabilities, which represent only 60% of GDP, i.e. less than half of the corresponding figure for the euro area.

Second, it is interesting to observe that the advent of the euro seems to have significantly contributed to the process of opening up euro area financial markets. The euro area has indeed become progressively more open since 1999. On the assets side, stocks of euro area assets held abroad have increased from less than 87% in 1999 to, as mentioned, over 124% in 2005. On the liabilities side, the increase was also very substantial, from around 92% to 137%. The rise has actually been much less pronounced for the United States during the same period: US assets grew from 80% of GDP in 1999 to 90% today, and US liabilities increased from 91% to 110% of GDP. In other words, the euro area and the United States held roughly comparable assets and liabilities in 1999, but the euro area witnessed a more substantial increase since the start of Economic and Monetary Union.

Third, the euro area appears to be a very important player in world financial markets. Comparing assets and liabilities in absolute value terms, the sizeable gross financial liabilities of the United States (USD 13.62 trillion in 2005) have received a lot of attention in recent years because this country also runs very large net foreign liabilities: USD 2.5 trillion, against USD 1.2 trillion for the euro area. The euro area, however, has about the same amount of gross financial liabilities as the United States (USD 13.65 trillion). The difference between the two economies in net terms – hence their different contribution to global imbalances – can be related to the fact that the euro area holds significantly more assets abroad (USD 12.4 trillion) than the United States (USD 11.0 trillion). The difference between the net positions on both sides of the Atlantic is related to the persistent current account deficits run by the United States in recent years whereas the euro area has been running a current account position close to balance.

Fourth, the euro area is an attractive place for foreign direct investment (FDI). A breakdown of extra-euro area liabilities indeed reveals that inward foreign direct investment (FDI) amounts to more than 27% of euro area GDP, against 22.5% for the United States. The euro area seems to have received, proportionally to GDP, a similar amount of FDI as China, 27.3% for both economies, according to the IMF statistics. In net terms the euro area is close to balance as the stock of direct investment abroad is only slightly higher than that of FDI within the euro area (30.4% against 27.3%, respectively).

Fifth, let me conclude with a few remarks on the bilateral FDI linkages of the euro area. In this regard, one should keep in mind that the geographical breakdown of FDI flows and stocks is clearly subject to some caveats, as a substantial share of FDI is channelled through offshore centres, which makes it sometimes difficult to establish their true geographical origin and destination.

Based on available data, it is worth noting that the stock of euro area FDI abroad is mostly held with mature economies: nearly 21% in the United States, 24% in the United Kingdom, 9% in Switzerland, and between 2.5% and 3% in Sweden, Canada and Japan. Likewise, on the liabilities side, the United Kingdom and the United States account for an even larger share than on the assets side (nearly 40% and 23.5%, respectively).

6 All data in this section refer to 2005 unless otherwise indicated, as 2006 data are not yet available for all countries. The data source is the IMF International Financial Statistics, which provides comparable data across countries. These data may somewhat differ from other data sources.

At the same time, I should also stress that the amount of euro area FDI in emerging market economies rose quickly. Between 1999 and 2005, outward FDI from the euro area to the so-called BRIC group – which includes Brazil, Russia, India and China – increased markedly. Over this period, the stock of outward FDI in the BRIC group rose from €63 billion to €133 billion (or by 111%). In comparison, the stock of euro area FDI in the United States increased by 55%, from € 360 billion to €558 billion, during the same period. While the overwhelming share of outward FDI to the BRIC group was directed to Brazil, euro area companies have raised considerably their FDI stocks in Russia, China and India in recent years.

Even more interestingly, the euro area has also become attractive as a destination for FDI from the BRIC countries: between 1999 and 2005, FDI stocks from the BRIC group in the euro area tripled, from €4 billion to €12 billion, while still remaining low in comparative terms (for instance, the figures for US FDI stocks in the euro area rose from €322 billion to €560 billion over the same period). The Brazilian and Russian firms account for the bulk of the BRIC countries' FDI surge in the euro area, but Chinese and Indian FDI has picked up in most recent years, as frequently reported in the media.

On the whole, this evidence suggests that the euro area is financially integrated not only with mature economies but increasingly also with the most sizeable emerging economies.

Concluding remarks

Ladies and gentlemen,

This brings me to the end of my remarks in which I have highlighted some major issues related to the process of European financial integration, a process that should not be seen in isolation but rather as an important contribution to global financial integration. I very much appreciate the transatlantic dialogue on the lessons we can learn from each other. This round table today contributes a great deal to increasing our awareness of these issues.

Thank you very much for your attention.