Jean-Claude Trichet: The euro and the dollar – pillars in global finance

Closing remarks by Mr Jean-Claude Trichet, President of the European Central Bank, at the conference organised by the European Commission and the Federal Reserve Bank of New York "The euro and the dollar: pillars in global finance", New York, 17 April 2007.

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Introduction

Ladies and gentlemen,

Let me start by thanking the organisers of this conference – the European Commission and the Federal Reserve Bank of New York – for inviting me to speak at this extremely interesting conference. You have addressed the main topics: macroeconomic developments and growth, achievements and challenges of financial integration within the European Union (EU), regulatory convergence in the United States and the EU, and the role of US and EU financial markets in the global economy. In my closing remarks, I would like to address the state of European financial integration and I will touch upon these conference themes. I will first address the relationship between financial integration and economic growth; and then I would like to highlight the main achievements and challenges of European financial integration by referring to the role of financial markets and their framework conditions, above all financial infrastructures, market standards and codes, and financial regulation.

I would also like to draw your attention to a new report entitled "Financial integration in Europe", which the European Central Bank (ECB) published for the first time just three weeks ago.[1] 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 the financial integration process in Europe. My remarks today will also draw on some of the findings of this report.

The implications of European financial integration for economic growth

Financial integration is of key importance for the ECB, given the 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 economic 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.[2] 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 financial innovation, and to the institutional and organisational improvements in a financial system that

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

[2] 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.

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 processes of financial integration and financial development positively influence the efficiency of a financial system, ultimately leading to a higher potential for economic growth. For example, a research study by London Economics estimates the benefits of the integration of European bonds and equity markets to be around 1% of GDP growth over a ten-year period, or approximately €100 billion.[3]

Whereas an indicator for the degree of integration of a European financial market could build on the law of one price, a possible indicator for the degree of development of the financial system could be the size of a market. Let me take as an example the size of an economy's capital markets. An overall indicator would measure total financing in the economy by aggregating bank credit to the private sector, stock market capitalisation and the outstanding amount of domestic debt securities issued by the private sector. If this indicator is calculated as a share of an economy's GDP, we see that the US is a region with one of the largest capital markets relative to its own economy: a broad estimation for the period 2000-05 gives a figure of around 450% for the US and around 220% for the euro area.[4]

But let me also give you an example of an integrated and developed financial market segment where the euro segment stands up to the transatlantic comparison, such as the over-the-counter interest rate derivatives market: the euro segment's notional amounts outstanding reached around €82 trillion in June 2006, compared with the equivalent US dollar segment of around €70 trillion.[5]

To sum up, the introduction of the euro has brought about huge benefits resulting from increased financial integration. And as the process of European financial integration is gradually taking place, it is also important to be aware of the related process of financial development. In the first edition of the new ECB report, we focus on the concept of financial integration. However, as the efficiency of a financial system also depends on other factors, such as the degree of financial development, we envisage widening the report's scope over time.

Achievements and challenges of European financial integration

Let me now highlight some major achievements and remaining challenges of European financial integration. Both can best be identified on the basis of an assessment of the state of European financial integration. We do this with the help of a set of quantitative indicators that the ECB has developed and which are described in our report.[6]

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. Let me focus on a few selected aspects related to financial markets and their framework conditions, such as financial infrastructures, market standards and codes, and financial regulation.

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. One of our indicators, the cross-country standard deviation of the average overnight lending rates among euro area countries, was as low as three basis points in early 1999 and has since decreased to between one and two basis point. This success has been sustained in particular by the high degree of integration of the large-value payment systems and our TARGET system. The launch of our new single technical platform,

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

[4] See "The role of financial markets and innovation for productivity and growth in Europe", ECB Occasional Paper No 55, forthcoming.

[5] See the BIS Quarterly Review, March 2007, Table 21B.

[6] The data underlying the, at present, 42 indicators are published and updated twice per year on the ECB's website. See at http://www.ecb.int/stats/finint/html/index.en.html.

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 by euro area residents have very similar risk characteristics and therefore offer little scope for international diversification. Our respective 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.

With respect to the absolute size of the short-term debt securities market, I would like to emphasise the Short-Term European Paper (STEP) initiative. The STEP initiative promotes the development of a pan-European short-term paper market through market players' voluntary compliance with a core set of standards encompassed in the STEP Market Convention, which was signed in June 2006. By the end of March this year, 35 STEP-compliant programmes, amounting to €201 billion, had been launched under the STEP label. The ECB regularly produces statistics on yields and volumes in the STEP market and publishes them on its website.[7]

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. As a way of testing the idea that, in integrated markets, bond yields would react to common factors, rather than local ones, one can also make a regression of changes in bond yields of individual governments against changes in yields of a benchmark bond. In the ECB's new report, we show that the estimated coefficients of this regression varied substantially up to 1998, but converged afterwards towards 1, which is the level of perfect integration, suggesting 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 underpinning both bond and equity markets is not yet sufficiently integrated. Several initiatives to achieve an efficient and integrated market infrastructure 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". In essence, this Code aims to foster competition and efficiency of clearing and settlement in the EU, by ensuring the transparency of prices and services, interoperability between exchanges, central counterparties and central securities depositories, and unbundling in the provision of services. The Code represents the first self-regulatory approach in the area of EU clearing and settlement. The ECB welcomes this initiative and acknowledges the commitment by the industry to implement the Code. A Monitoring Committee by the European Commission, the ECB and CESR will assess whether the – voluntary – compliance with the Code will be effectively achieved.

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 and does not involve custody services and other activities, which remain separate economic activities performed by the central securities depositories. The present step is the definition of user requirements, and these will benefit from a public consultation.

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

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[7] See at 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.

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. I am very glad to report that the self-regulatory approach chosen for SEPA is working well and that we expect the European banking industry to launch the first SEPA instruments according to schedule on 1 January 2008.

Also, 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 the 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 our new 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 transposes in the EU the new regulatory framework 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. For now, I would summarise the situation by saying that the ECB is supportive of the Lamfalussy framework and that this framework should be fully exploited to show its full potential. A review of the Lamfalussy approach is scheduled to take place by the end of this year and this will enable us to evaluate the overall functioning of the current institutional arrangements.

In this context, I would also like to mention that regulatory convergence is important not only within the EU but also in a global context. In this respect, 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. Examples where progress is being made include the equivalence and convergence of accounting standards, the revised proposal for de-registration of foreign firms from US markets, and the recent announcement regarding the cooperation between the US and 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, as highlighted in the White Paper on Financial Services Policy 2005-2010.

Ladies and gentlemen,

This brings me to the end of my remarks. I see this conference today as another crucial step in increasing our mutual awareness and understanding of such issues. I very much look forward to continuing this fruitful transatlantic dialogue that is so beneficial to us all.

Thank you very much for your attention.