Peter Praet: European financial integration in times of crisis

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the Annual General Meeting and Conference 2012 of the International Capital Market Association (ICMA), Milan, 25 May 2012.

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I would like to thank Ignazio Angeloni and Stéòffphanie Stolz for their contribution to the preparation of this speech.

It is my pleasure to be here today at the annual ICMA General Meeting. In the last 40 years, ever since European capital markets acquired a global importance, the International Capital Markets Association has played an important role in promoting contact, information exchanges and initiatives among issuers, managers, dealers and investors active in international financial markets. A central goal of ICMA is to foster the openness and competitiveness of financial markets, globally and in Europe. This is an objective that the ECB wholeheartedly shares. In times of crisis, more than ever, we need effective action, so that we can achieve this goal.

The topic of my talk today is financial integration in Europe: its meaning, its importance, recent developments, and – not least – why the ECB cares about it, and what the ECB does to preserve it. Well-developed capital markets are important – as we all know – because they channel funds from savers to investors, promote the efficient use of resources and create more opportunities for individuals and firms, ultimately leading to higher growth. But this is not yet sufficient in a multi-country setting. A united Europe, especially one that has decided to have a single currency, needs united financial markets as well. Financial integration – that is the cohesion of financial markets and their ability to operate as a single entity – enhances these benefits and gives them a cross-country dimension. Not surprisingly, a single market for capital and financial services has been a central goal of the European Union for decades. Many policy initiatives have paved the way to greater financial integration, the most ground-breaking of which being, without a doubt, the introduction of the euro. This progress towards financial integration was interrupted and reversed by the global financial crisis and, more recently and dramatically, by the European sovereign debt crisis.

I will first talk about why integrated financial markets are important, for Europe in general and for the conduct of the single monetary policy of the ECB in particular. I will then explain the role the ECB plays in this area. Next I will focus on developments during the first ten years after the introduction of the euro – which saw continuous and significant progress in the integration of European financial markets – and then on developments in more recent years, which have been marked by a dramatic reversal of this progress. I will conclude by indicating actions the ECB has taken to protect financial markets, including their integration, from the impact of the crisis, and what further actions, largely outside the control of the central bank, are needed to ensure integrated and functioning European financial markets going forward.

The single European financial market and the euro

Creating a single capital market has been a central European goal for several decades. In the 1980s, the Single Market Programme – which included financial services – set objectives and started the ball rolling, mainly with Community directives which were subsequently implemented by national authorities. The impact of these regulatory changes was deepened, at the end of the decade, by the removal of all capital controls across borders. Studies conducted over the years, which are summarised in a special chapter of the recent ECB report on Financial Integration in Europe, have attempted to measure the impact that the removal of capital controls and the related harmonisation measures had on the European financial sector. Interest rates, for both borrowers and lenders, converged across countries and became more stable; new investment and diversification opportunities became available for households as well as firms. Estimates of the positive effects on growth and employment differ, but the prevailing opinion is that they were significant and widely spread across Europe.

The launch of the euro at the end of the 1990s and, shortly afterwards, the Financial Services Action Plan were major milestones in the integration process, aimed at tackling the remaining obstacles to integration stemming from currency and regulatory segmentation.

The euro contributed to financial integration through a variety of channels. A single currency lowers transaction costs for consumers and firms, freeing up resources that can be used for business investment, both domestically and across borders. In addition, a single currency removes all exchange risk among the participating countries and also lowers exchange rate volatility vis-à-vis third currencies. Less "noise" in currency markets means more certainty in conducting international transactions, and this encourages foreign direct and portfolio investment flows. All this leads to a more efficient international allocation of capital and therefore higher growth. Moreover, an independent central bank, firmly focused on maintaining price stability, creates a favourable environment for developing new financial instruments that are useful for the real economy – a case in point being the emergence of a euro area corporate bond market in recent years.

A highly integrated financial system is also necessary for the efficient functioning of the single monetary policy, because integrated financial markets ensure a smooth and balanced transmission of monetary policy throughout the euro area. For this reason in particular, the Eurosystem decided that the promotion of financial integration would form part of its "mission". The Eurosystem formally defined financial integration as "a situation whereby there are no frictions that discriminate between economic agents in their access to – and their investment of – capital, particularly on the basis of their location". In the early years of the euro, largely under the direction of Tommaso Padoa-Schioppa, then member of its Executive Board, the ECB set up a new internal work stream dedicated to analysing and monitoring the progress in financial integration, and managing a set of indicators that are regularly updated and made available online. These indicators serve as an information base for the ECB's Financial Integration Report, which has been published annually since 2007. The report describes recent developments in the integration indicators, features essays analysing specific aspects of financial integration, and concludes with a detailed description of activities through which the Eurosystem contributes to the enhancement of financial integration.

The crisis has shown that, in addition to the clear benefits, financial integration also carries financial stability risks in the absence of a strong institutional framework.

Financial integration may create conditions for higher volatility, by facilitating an abrupt reversal of capital flows, contagion, and the cross-border transmission of financial shocks. This is particularly true when the institutional framework is incomplete in other respects, as is the case in Europe today. In order for capital markets to reap the benefits of integration, they require integration on other fronts as well: they require fiscal integration, first and foremost, but also integration in the areas of financial regulation and supervision. The deficiencies of the European institutional framework in these key areas have, it is now clear, played a key role in destabilising European financial markets. I will return to this shortly, but first, a brief overview of developments.

The first ten years: swift progress towards euro area financial integration

Financial markets progressed steadily towards integration in the years following the introduction of the euro. Let me show you some indicators that demonstrate the degree and pace of convergence in different market sectors.

The ***money market*** was the financial market segment that was the most integrated prior to the crisis. Slide 2 illustrates how quickly, and almost completely, money market rates converged following the introduction of the euro. Note, in particular, that the convergence of unsecured interbank interest rates on all maturities was strong until 2007.

Convergence was also strong and rapid in the ***sovereign debt markets***. Slide 3 shows that after the launch of the euro, markets virtually priced the debt of different Member States as identical. During the period 2003–2007, the spreads were very small and did not reflect the differences in fiscal positions between countries, even when ratings changed. This period was therefore characterised by a significant underpricing of risk, with investors searching for yield in an environment of abundant global liquidity.

Slide 4 paints a similar picture for the ***retail banking*** sector. We can clearly see the gradual convergence across countries in the rates charged for new loans to households for residential mortgages (on the left) and to corporations (on the right).

Unlike convergence in price-based indicators, quantity-based indicators point to a slower pace of financial integration: Slide 5 shows that outstanding cross-border loans to the non-financial sector in other euro area countries increased by only 3 percentage points over the last decade. Hence, overall, the process of financial integration in retail banking – though steady and significant – was slower than in the sovereign bond markets and has never reached completion.

Despite differences in the degree and pace across market segments, before the crisis financial integration was widely assumed to be a *structural* phenomenon, and as such progressive and not easily reversible. However, the crisis has shown that gains in financial integration are vulnerable to market conditions: the dispersion in various market segments clearly indicates that the process of financial integration has been brought to a halt or even reversed.

The reversal of financial integration since the crisis

Allow me to examine separately the developments in different market segments, starting with the money markets.

This segment was the most integrated one before the financial crisis, and the one most affected by the crisis. The functioning of these markets has become increasingly impaired, especially across national borders. For example, the standard deviation of EURIBOR rates across frontiers within the euro area has moved systematically above the corresponding standard deviation within domestic borders. It's a sign that market participants are demanding an extra premium to lend to counterparties located in other countries, and that this premium rises when market conditions are tense. There's a similar phenomenon in the secured money market, which is usually more resilient given its collateralised nature. A significant increase in price differentiation in repo markets has occurred as market participants have increasingly taken correlation risks into account: the pricing of risk has become much more dependent on the geographic origin of both the counterparty and the collateral, in particular when these are from the same country. An additional sign of risk aversion has been the tendency of market participants to shift from the unsecured to the secured market.

Another segment that has been particularly affected by the crisis is the ***bond market***. Both sovereign and corporate bond markets have been dominated by sharp differentiation, especially across borders. Bond holders are acutely aware of credit risks and price them in, taking into account the risk characteristics of the individual instruments and, increasingly, the country risk. However, in the most critical phases of the sovereign debt crisis, the risks relating to some euro area sovereigns may have been overestimated, leading to an overshooting of the respective yields. But a comparison over time is also interesting:

countries with increasing bond yields are facing spreads that are reminiscent of those recorded before the launch of the euro.

The financial crisis has had a more limited impact on cross-border integration in ***equity markets***, compared with its effect on bond markets. In particular, cross-border holdings are not discriminating significantly according to the country of origin. Also, national stock price indices seem to be reacting without any overwhelming country-specific influence.

Finally, the indicators of the euro area ***banking market*** integration have generally signalled a deterioration, albeit slower than in other markets. However, in both the retail and wholesale euro area banking markets, there is evidence of a slow erosion of the earlier – equally slow – progress toward financial integration.

The effects of weaker financial integration and, in extreme cases, the re-emergence of separate national markets have considerably impaired the transmission of monetary policy. In fact, monetary policy has ceased to convey balanced and homogeneous signals to the euro area economy as a whole.

The impairment of transmission through banks is of particular concern, as they play a key role in financing the euro area economy. The left-hand chart on slide 10 indicates a strong differentiation in banks' costs of deposit funding across the euro area. Banks are likely to pass them on to their customers in the supply and price of credit. The right-hand chart shows the ongoing segmentation of various money market rates and the interest rates charged by monetary financial institutions on short-term loans. Consequently, the pass-through of changes in key interest rates to money market rates, and along the money market yield curve to longer maturity rates and then to retail interest rates, has become more differentiated. In addition, the market for sovereign debt, which is essential for the functioning of the interest rate channel, has become severely disrupted in a number of euro area countries. This implies that monetary policy impulses have been transmitted differently in the various euro area countries.

Eurosystem market operations and financial integration

The Eurosystem has become increasingly active in its market interventions since the outbreak of the financial crisis. This is not unusual: history shows that financial crises tend to broaden the operational boundaries and range of responsibility of central banks, as these take on a larger share of financial intermediation in the economy. In doing so, central banks perform, in a centralised way, a function that decentralised private markets are incapable of or unwilling to provide, and consequently they take on greater risks in their balance sheets.

The unconventional monetary policy measures taken by the Eurosystem were motivated by the pressing need to avoid disruption to the monetary policy transmission mechanism. In response to the fragmentation of interbank markets, the ECB has adopted several measures to temporarily complement impaired intermediation in the interbank market by increasing intermediation via the central bank. These non-standard measures range from the fixed-rate full allotment tender procedure to foreign currency operations and, more recently, to a temporary broadening of the collateral pool. Most notably, the ECB introduced 12-month refinancing tenders and subsequently conducted two 36-month operations at a time when the sovereign debt crisis was hampering euro area banks' access to market-based funding. The exceptionally long maturity of these operations provided banks with a longer horizon for their liquidity planning, mitigating the funding pressure they were experiencing around the turn of the year. In addition, it gave them the necessary breathing space to deleverage in an orderly manner over the medium term. The evidence we have confirms that this measure was critical in avoiding disorderly asset sales and a downscaling of longer-term lending.

With hindsight, the Eurosystem's operational framework has proven to be effective and flexible during the crisis, adjusting well to difficult conditions. However, there is a limit to what market operations alone can achieve. They can neither address the underlying causes of the deterioration nor completely offset its effects. The stability and functionality of financial markets, and notably their cross-border integration, will depend on Europe's success in giving itself a sounder, more complete and resilient economic governance framework. This effort is ongoing; some steps have been taken, others are under way, but more will need to come.

Conclusions: restoring financial integration on a stable basis

Let me conclude. Financial integration has made good progress in the EU, and particularly in the euro area, and has brought with it substantial benefits. However, recently, it has been severely affected by the crisis. The effect is unfortunately proving to be pervasive and persistent. The ECB's measures targeted at financial markets have helped to mitigate the problem, but the problem is far from solved. Hence, further action is needed.

To restore and preserve financial integration, the euro area financial stability framework needs an urgent overhaul. Despite important recent improvements, it is still marked by the cross-border openness of private financial markets and highly mobile capital flows on the one hand, and by the supervisory, regulatory and crisis management arrangements which, on the other hand, remain essentially national. This dichotomy is detrimental in two ways; it prevents, in normal conditions, a reaping of the full benefits of the removal of barriers to cross-border movements of capital and financial services; and it impedes, in crisis times, even-handed action to maintain financial stability that is consistent across the euro area. The resulting fragilities become more apparent under stress. It is now clear that these weaknesses in the EU's crisis management framework, exposed during the crisis, are largely responsible for the partial re-nationalisation of several important financial market segments.

Significant reforms are already under way in the EU. The economic governance framework is being overhauled on the fiscal and macroeconomic sides. The establishment of the European Financial Stability Facility and the European Stability Mechanism and the adoption of the "six-pack" are important milestones. Also, financial supervision has undergone significant, though still partial, reform: three European Supervisory Authorities were established, and the European Systemic Risk Board now adds a macroprudential perspective. Regarding financial regulation, the current reforms address the need for stronger resilience, better infrastructure, and greater harmonisation of rules. The Commission has also announced proposals in the area of crisis management and resolution.

While these are important steps, more is needed for the euro area to break the link between fiscal imbalances, financial fragmentation and financial instability. Europe needs to move towards a "financial union", with a single euro area authority responsible for the supervision and resolution of large and complex cross-border banks. This authority should also be responsible for a euro area deposit insurance scheme. With bank resolution and deposit insurance funded primarily by private sector contributions, taxpayers would be shielded from picking up the bill for future banking crises. Essentially, I envision an authority similar to the Federal Deposit Insurance Corporation in the United States.

Decisive and far-sighted reforms like these, unrealistic until a short while ago, are now gaining support. Reacting to the pressure of events may seem unattractive, but it may also be the only way forward. As on other occasions in European history, this crisis offers a chance to progress; we must be ready to act on it. Let us not waste this opportunity to advance European integration.

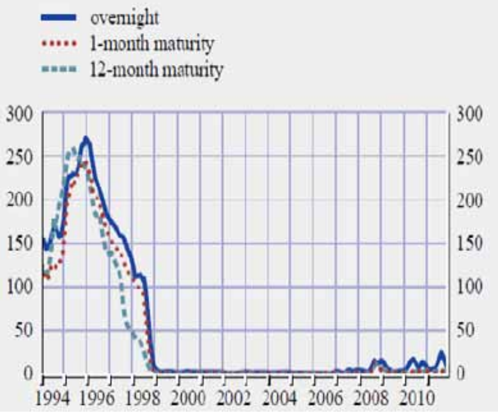
Slide 2

Integration indicators – money markets

- **Rapid convergence of money market rates.**
- **Most highly integrated market segment.**

Cross-country standard deviation of average unsecured interbank lending rates across euro area countries

(61-day moving average; basis points)



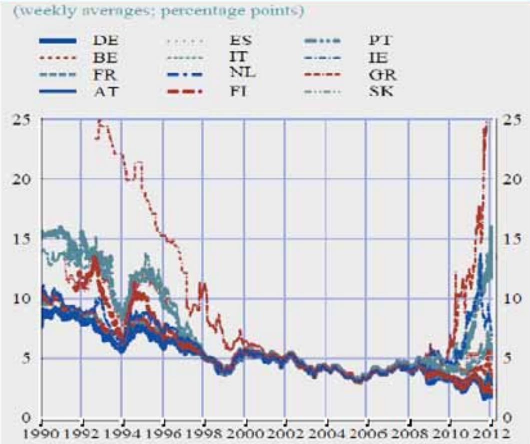
Sources: EBF and ECB calculations.

Slide 3

Integration indicators – sovereign bond markets

- **Rapid convergence of sovereign bond yields in the euro area.**

Euro area ten-year sovereign bond yields



Sources: Thomson Reuters and ECB.
Notes: The chart presents the yields of euro area sovereigns for the country composition as in 2011. The yields for Cyprus, Estonia, Luxembourg, Malta and Slovenia are excluded owing to infrequent or a lack of observations. Last value for Greece: 31% (not shown).

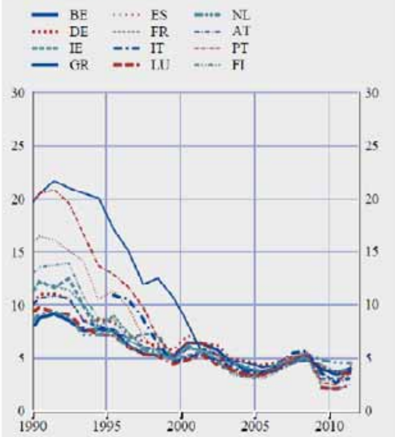
Slide 4

Integration indicators – banking markets

- **Rapid convergence of interest rates for private sector loans.**

Interest rates on new loans to households for house purchases in euro area countries

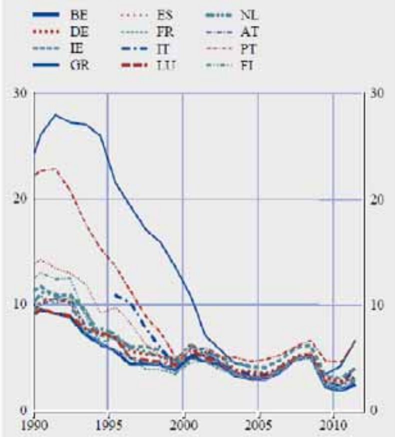
(percentages per annum)



Sources: ECB and national sources.

Interest rates on new loans to euro area non-financial corporations

(percentages per annum)

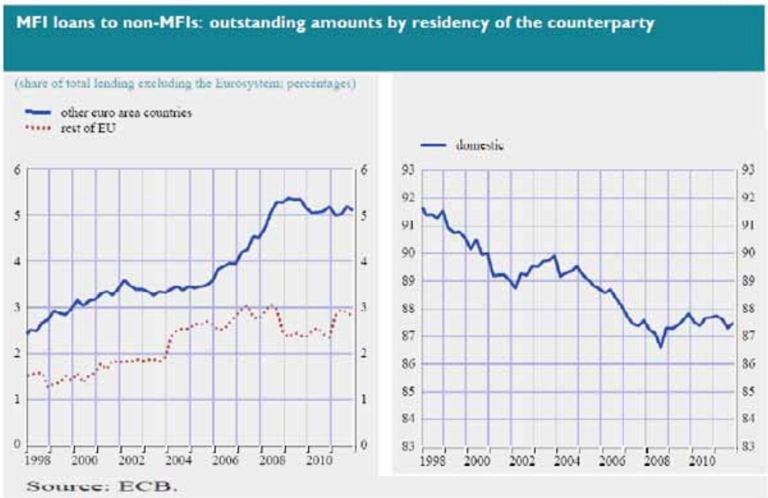


Sources: ECB and national sources.

Slide 5

Integration indicators – banking markets

- **Slow convergence of cross-border lending.**



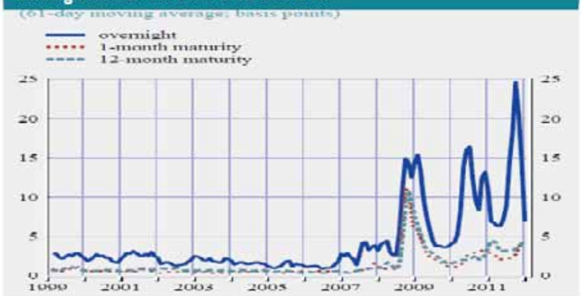
Slide 6

Money market integration – financial crisis reversed earlier convergence

- **Convergence in lending rates across euro area countries reversed sharply in the financial crisis (see left-hand chart).**

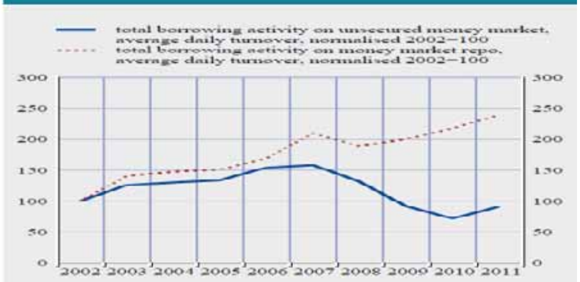
- **Market participants shifted from the unsecured to the secured (repo) market (see right-hand chart).**

Cross-country standard deviation of average unsecured interbank lending rates across euro area countries



Sources: EBF and ECB calculations.

Borrowing activity in the euro area secured and unsecured markets



Source: Euro Money Market Survey.

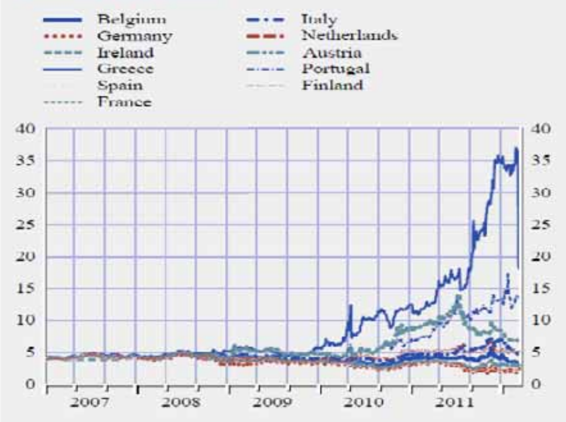
Slide 7

Bond market integration – financial crisis giving rise to concerns of a systemic nature

- **Euro area sovereign bond yields have diverged strongly, returning to pre-euro levels (see left-hand chart).**
- **Corporate bond markets have also experienced significant tensions, both in the financial and non-financial sectors (see right-hand chart).**
- **Country-level effects have become more important in driving yields.**

Euro area ten-year sovereign bond yields

(percentages per annum)



Sources: Bloomberg, ECB.

Dispersion in five-year CDS premia across euro area countries

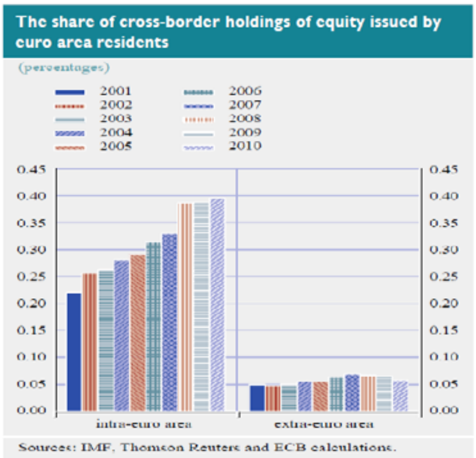
(daily data; basis points)

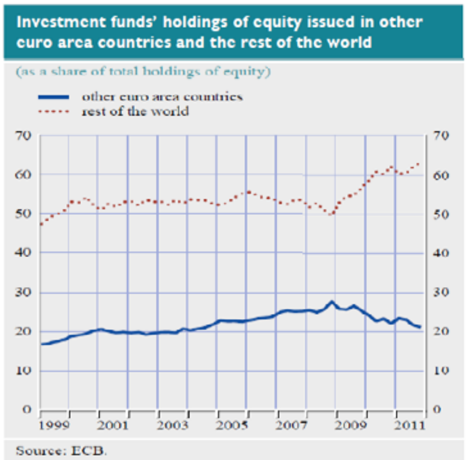
Sources: Thomson Reuters and ECB calculations.
Notes: The data do not include Greece and Ireland. Greece is excluded owing to very high sovereign CDS premia, and Ireland is excluded owing to the very high CDS premia of its telecommunications company. All sectors are presented for this smaller sample to ensure comparability.

Slide 8

Equity market integration – apparently more limited impact of financial crisis

- No significant discrimination with regard to the country of origin.
- The share of cross-border holdings of equity issued by euro area residents has increased steadily over the last decade (see left-hand chart).
- Equity holdings held by investment funds have declined only slightly since the beginning of the financial crisis and are still higher than before the introduction of the euro (see right-hand chart).





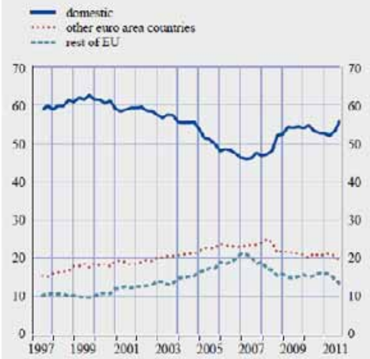
Slide 9

Banking market integration – slow erosion of earlier progress

- **Relative to other markets, slower erosion of the earlier progress towards financial integration.**
- **Share of domestic lending activity has increased again, but without attaining the earlier level (see left-hand chart).**
- **Price dispersion regarding short-term loans has steadily increased throughout the crisis (see right-hand chart).**

MFI loans to MFIs: outstanding amounts by residency of the counterparty

(share of total lending excluding the Eurosystem; percentages)



Source: ECB.

Cross-country standard deviation of MFI interest rates on new loans to non-financial corporations

(unweighted; basis points)

Source: ECB.

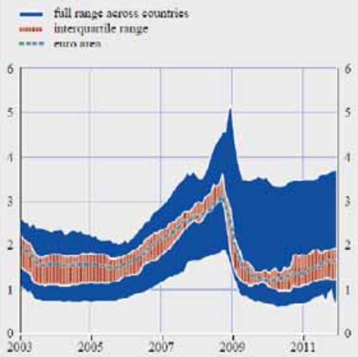
Slide 10

Effects of weaker financial integration on the transmission of monetary policy

- **Strong differentiation in banks' cost of deposit funding across the euro area, which may be passed on to customers in the supply and price of credit (see left-hand chart).**
- **Ongoing segmentation of various money market rates and the interest rates charged by MFIs on short-term loans (see right-hand chart).**

Interest rates on MFI deposits for households in the euro area

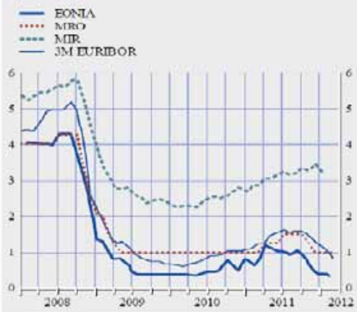
(percentages)



Sources: ECB and ECB calculations.
Notes: The deposit rates are aggregated using outstanding amounts. Latest observation is January 2012.

Relationship between the MRO, EONIA and three-month EURIBOR rates and interest rates on MFI loans to NFCs (MIR)

(percentages)



Source: ECB.
Notes: MRO (dotted reddish brown line) is the main refinancing operation rate set by the Governing Council of the ECB. MIR (dashed petrol blue line) is the MFI interest rate charged to NFCs on new loans with an initial rate fixation period of up to one year. EONIA (thick blue line) is the average euro area overnight unsecured money market rate. 3M EURIBOR (thin blue line) is the average interest rate at which euro area banks offer to lend each other unsecured funds at three months.

Slide 11

Annex