EUROPEAN CENTRAL BANK

European Integration and the Financial System

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Challenges in the financial system – ageing and low growth

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Political integration is at a cross-roads

Rejection of the project for a European Constitution sent a strong signal.

The Union brought peace. Citizens want prosperity.

Prosperity is a goal of the Union.

Messina declaration (1955): the creation of a common market “seems indispensable if Europe is to improve steadily the living standard of the population.”

Common market in place with EMU.

Where is growth?

From economic to financial integration

Financial integration has been an important element of EMU from its inception.

Delors Report (1989), on the first stage to EMU:

"In the monetary field, the focus would be on removing all obstacles to financial integration (…) 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".

However financial integration lost its prominence in the run up to EMU, for two reasons:

1) The implementation of financial integration was limited to the elimination of capital mobility.

2) The broad focus on the achievement of a single market, mixed with the belief that financial integration would almost automatically follow suit once the euro was introduced.

Where do we stand now?

Outline

1. What is the current state of financial integration?

2. What is the contribution of the financial system to growth in Europe?

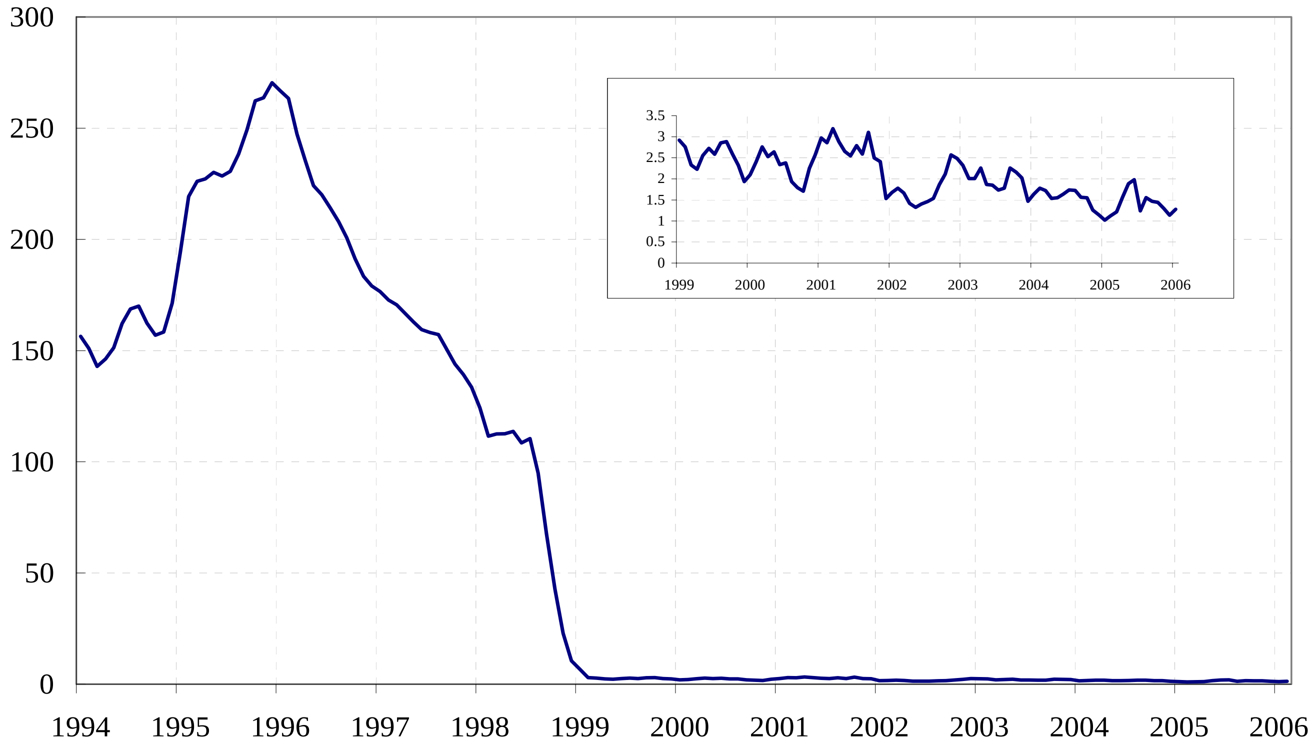
3. What can Europe do to strengthen the financial system?

4. Conclusions

1. Financial integration in the euro area

- FI is very strong in the money market (EMU).

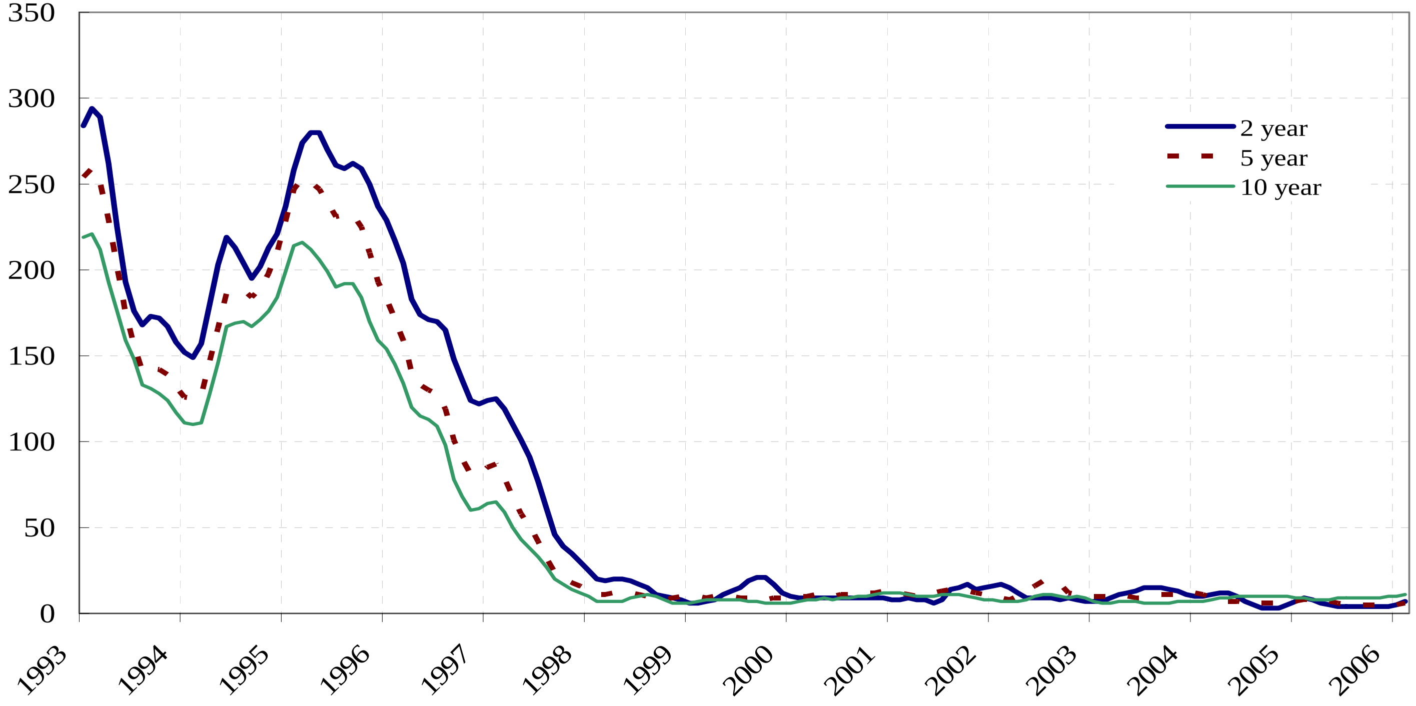
Cross-country standard deviation of the average overnight lending rates among euro area countries



Sources: EBF, ECB calculation

- FI progressed significantly in the <u>government bond</u> markets.

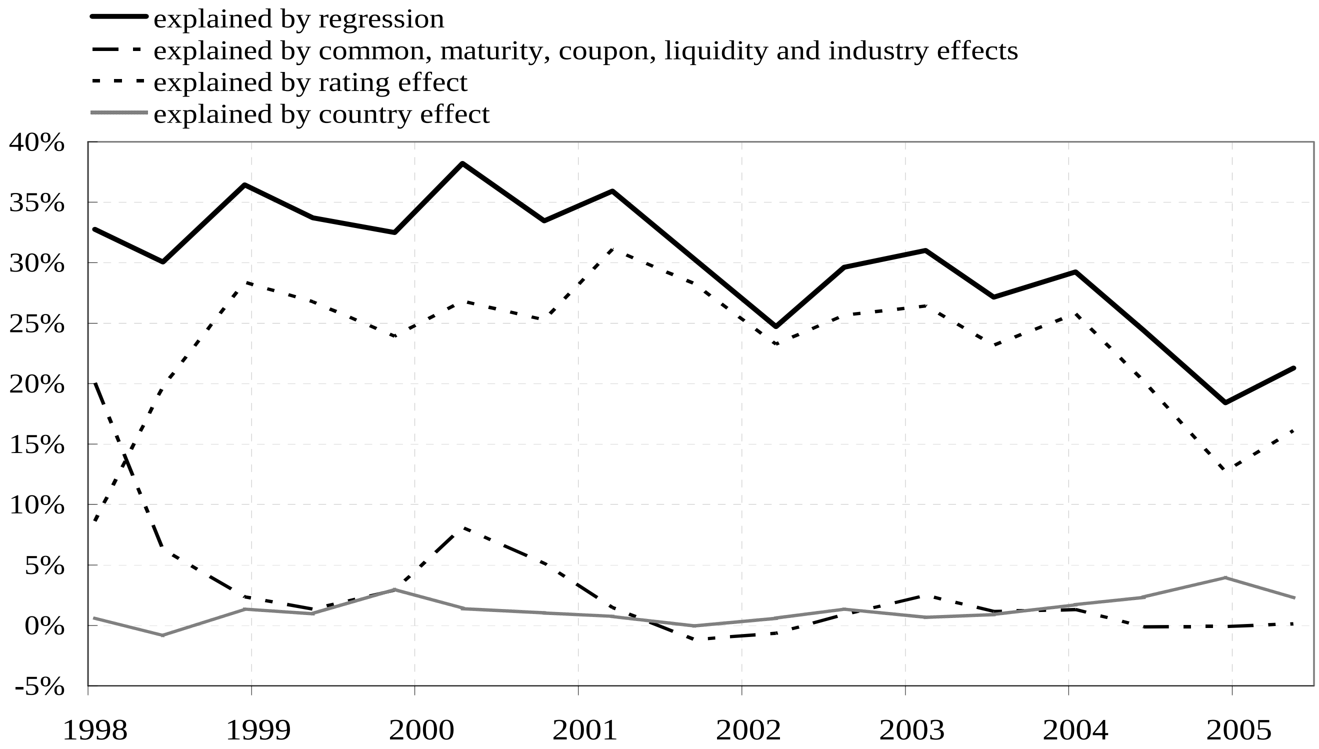
Standard deviation in gov. bond yield spreads for 2-5-and 10 year maturities



Source: ECB

- FI improved for the <u>corporate bond market</u>.

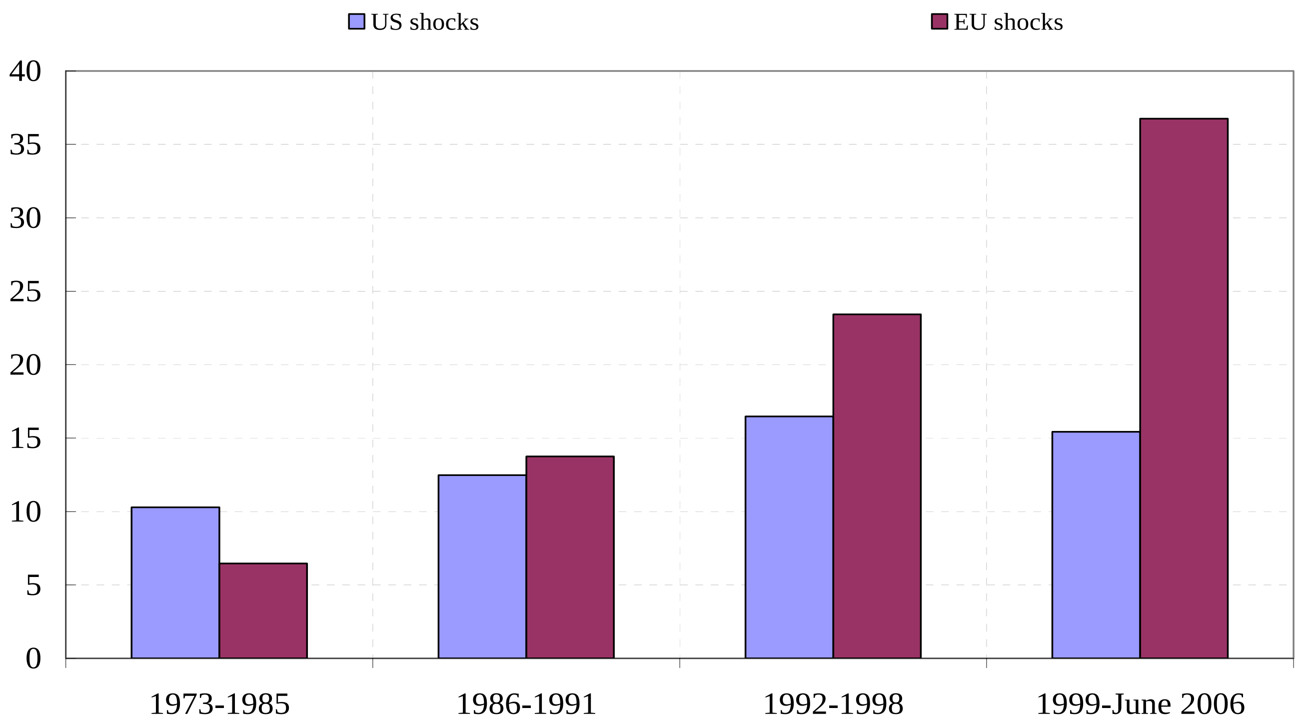
Proportion of cross-sectional variance explained by various factors



Sources: Bloomberg and ECB calculations

• FI is slow but progressing in the equity market.

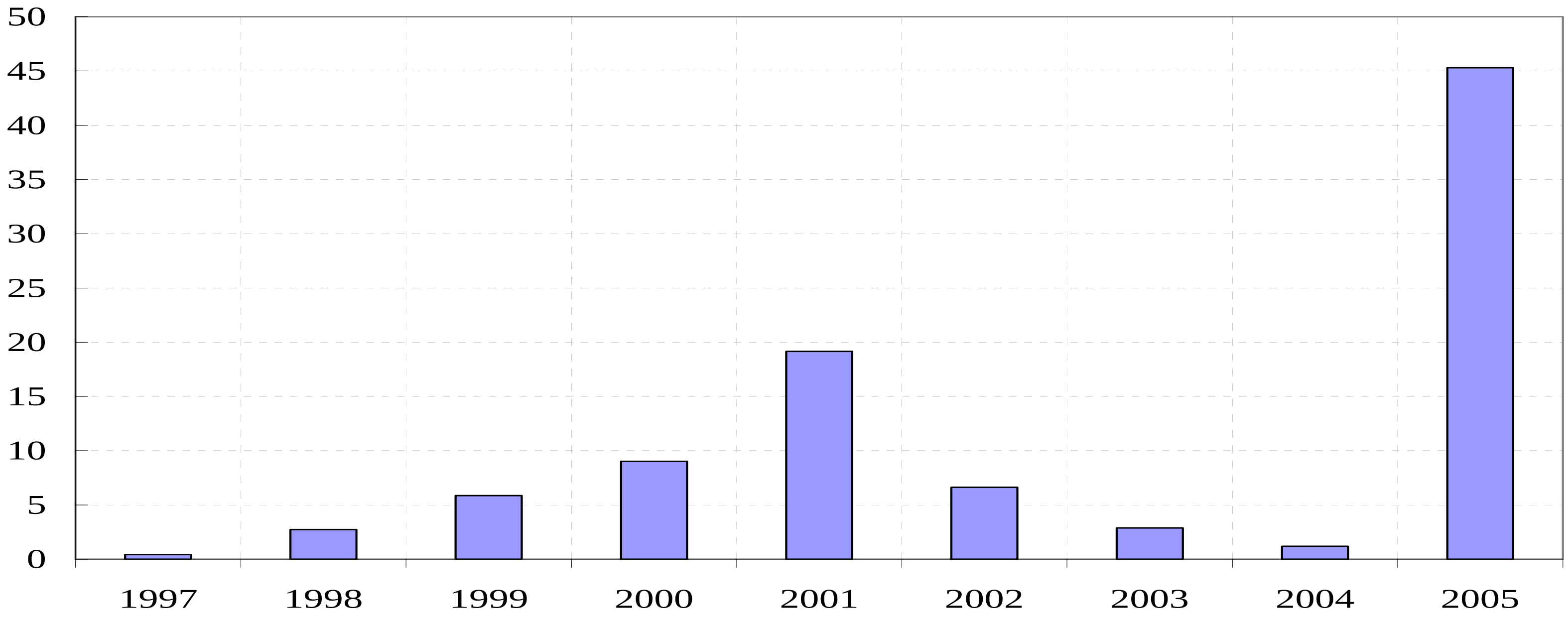
Proportion of variance in local equity returns explained by Euro area and US shocks



Sources: Thomson Financial DataStream and ECB calculations

- Only 3.5% of lending activities are cross-border.
- Wave of M&A mostly a domestic development.

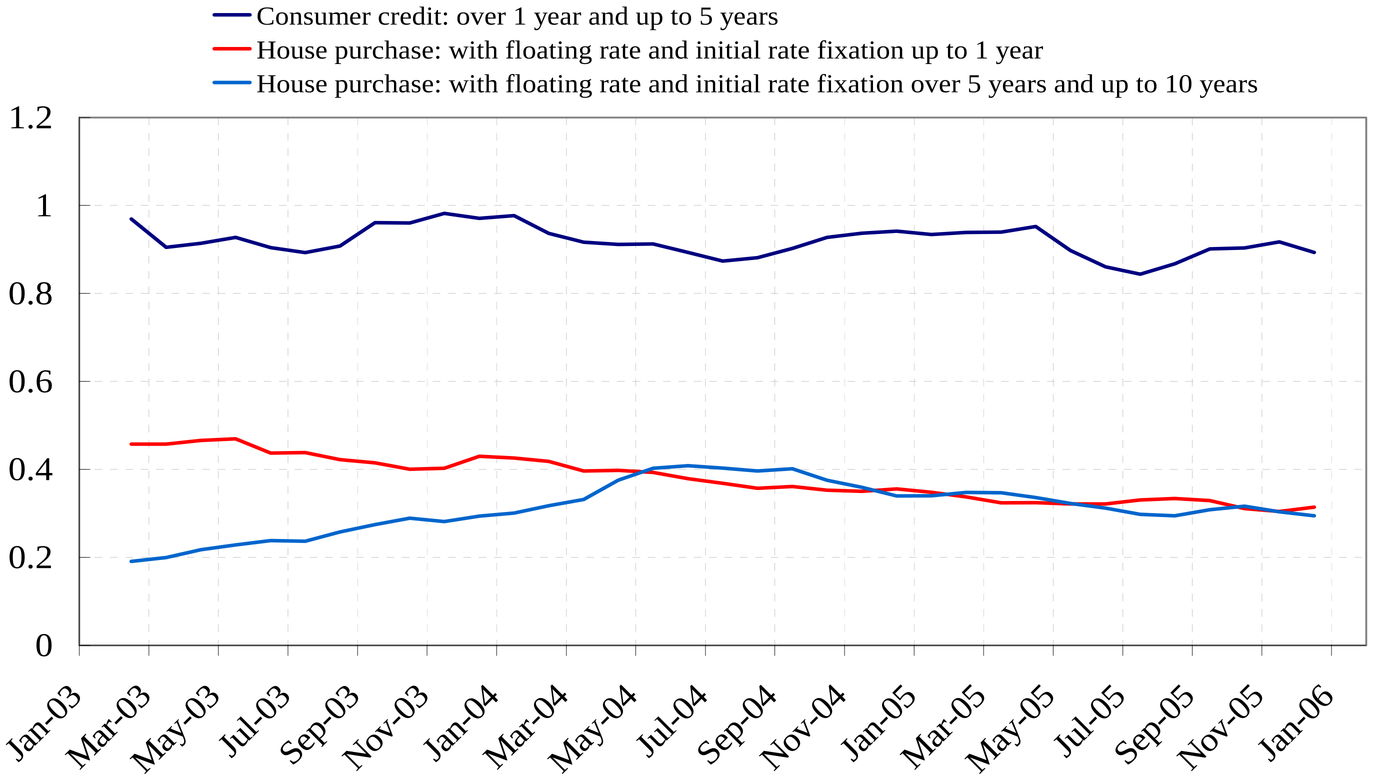
Euro area cross-border banks M&As deal values of assets purchased (in percentage of the total euro area banking system's M&As)



Sources: Thomson financial SDC, ECB and ECB calculations

- FI is unsatisfactory in <u>retail banking</u>.

Cross-country standard deviation of rates on consumer credit and on lending for house purchase



Source: ECB

2. What can the financial system contribute to growth in Europe?

Conceptual work is helpful.

<u>Financial system:</u>

The set of institutions through which households, corporations and governments obtain funding for their activities and invest their saving.

<u>Financial efficiency:</u>

The condition in which resources available in a financial system are allocated to the most valuable investment opportunities at the lowest possible costs.

Financial development:

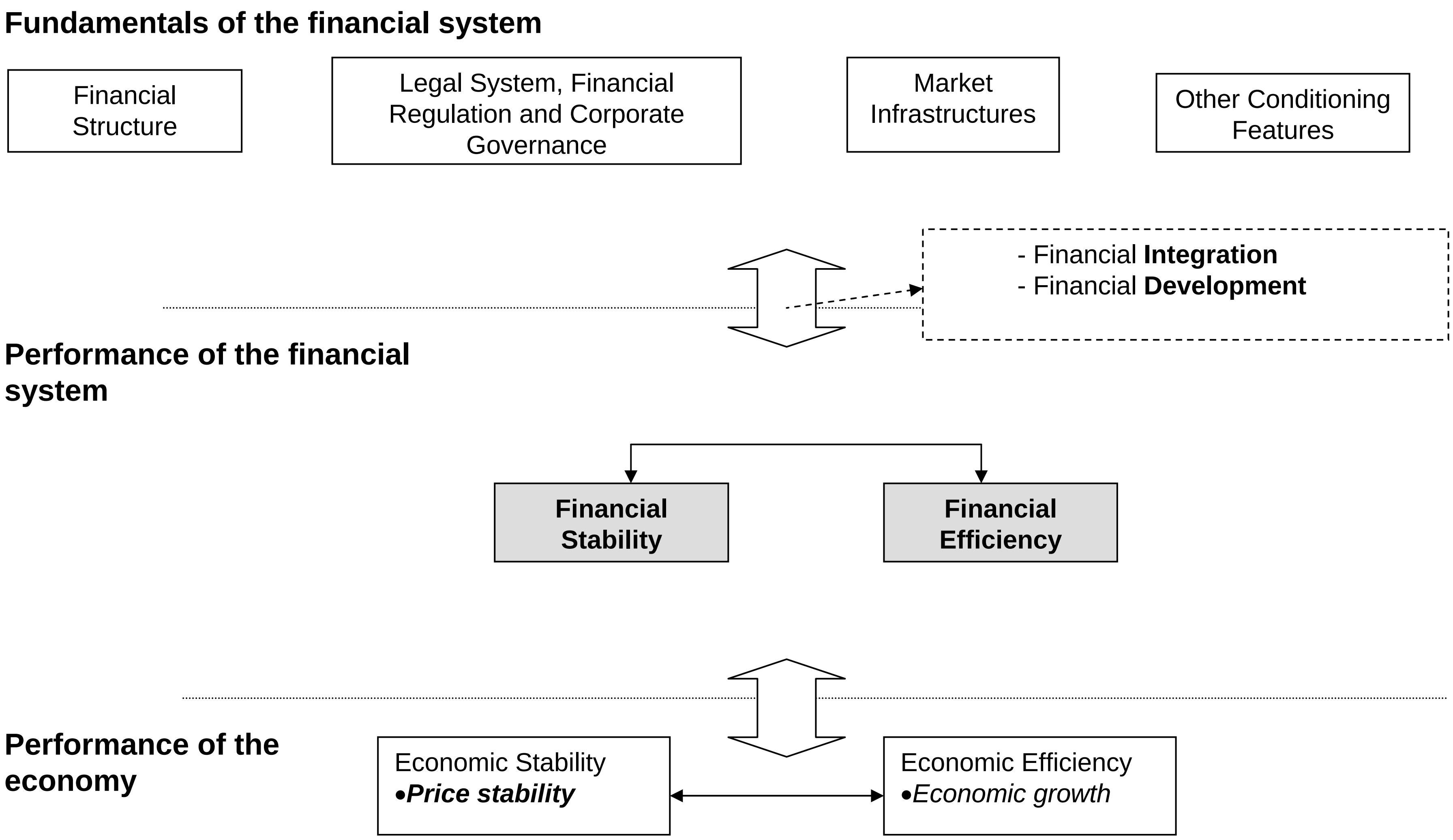
The process of financial innovations and organisational improvements in the financial system that reduces asymmetric information, increases the completeness of markets and contracting possibilities, reduces transaction costs and increases competition.

Financial integration:

The market for an asset is integrated if all agents with same relevant characteristics

1) face the same set of rules
2) have equal access
3) are treated equally

The link between financial efficiency, financial integration, financial development and economic efficiency



Quantitative findings:

- Raising the level of financial development increases firm value-added growth by approx. 0.5% to 0.9% in old EU member countries (Guiso et. al. 2005).

- Benefits of integrating the European bonds and equity markets is 1% of GDP growth over 10 years, or 100 billions euro (London Economics 2003).

- Relevant for new EMU member States: growth accelerates by 0.8% in countries who adopted measures enhancing integration in global markets (Aghion et. al. 2005, Favara 2003).

Quantitative findings specific to banking:

- Effect of bank deregulation in the US between 1970 and 1994. Annual average state gross product increased after the reforms by approx. 1 percentage point (Strahan 2003).

- Preliminary ECB research shows that capital market size (a proxy for financial efficiency) is affected negatively by public ownership of banks and banks concentration.

  => High a share of public banks and highly concentrated banking sector seem to prevent the financial system from speedily reallocating capital.

- ⇛ An efficient financial system is necessary for Europe to deliver the highest economic growth.

- ⇛ Most of our effort should concentrate on integrating our retail banking markets.

3. What can Europe do to strengthen the financial system?

- Promotion of financial integration through the harmonization of the regulatory framework and of standards so that actors face a level playing field.

- Market-driven approach to financial integration. However, a prerequisite is that closed national markets are opened up.

- Integration of retail banking (post FSAP priority) will be successful only if incumbent firms are open to play the market game.

Two examples of FI in retail banking

1) **SEPA (Single Euro Payment Area)**

SEPA is to remove all national barriers for payments within the euro area allowing for potential economies of scale as well as a customer experience similar to the situation in national markets today.

Need: technical standards, business practices, etc. become SEPA ones.

Problem: entails costs and opens up competition. Revenue may fall => Some banks slow down SEPA

Benefits for banks: processing cost will go down !

2) **Mortgage market**

Mortgage market has an outstanding volume of more than EUR 4 trillion in residential mortgage debt in the EU: 40% of EU GDP!

Need: Fully integrated euro mortgage market. Given its size and the direct benefits to citizen, it is urgent that progresses are made.

Problem: Fragmented secondary market for mortgage loans due to: legal, tax and regulatory framework, heterogeneity of standards and practices adopted by market participants.

=> secondary market liquidity is low.

Facilitating the transfer of mortgage loans across borders

$\Rightarrow$ Foster the development of a pan-European funding market

$\Rightarrow$ Ease the penetration of lenders in foreign markets

$\Rightarrow$ Increase competition

$\Rightarrow$ Primary market dealers able to offer better deals on the primary market.

$\Rightarrow$ Rates to borrowers lower and converging.

Conclusions

Growth and prosperity is one the main goals of the Union.

Financial integration can bring growth to Europe.

Our efforts should be concentrated on the retail banking market. Examples are SEPA and the mortgage market.

Still large economic gains from integration that will be a tangible proof for European citizens that Europe can bring large benefits to them.